



## **IRC section 1031 in jeopardy! Even if repealed, there is still a solution for tax deferral**

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Most real estate professionals and nearly all real estate investors know something about the tax deferral and other benefits of the "like-kind" exchange. Section 1031(a) of the Internal Revenue Code (IRC) details the recognition rules for realized gains (or losses) that arise as a result of an exchange of like-kind property held for productive use in trade or business or for investment. It states that none of the realized gain or loss will be recognized at the time of the exchange. It also states that the property to be exchanged must be identified within 45 days, and received within 180 days. However, the future of the like-kind exchange and section 1031 now appears a bit murky.

The like-kind exchange provision of the IRC, since 1954 known as "section 1031," traces its roots back to 1921, only three years after the enactment of the first income tax code. Now in 2014 after nearly 100 years, section 1031 and the entire like-kind exchange principle is under the very real threat of reformation or repeal.

On February 26, 2014, House Ways and Means Committee Chairman Dave Camp released a discussion draft of his Comprehensive Tax Reform Proposal. If enacted, this proposal would repeal IRC section 1031 in its entirety. Moreover, in his 2015 budget, President Obama seeks to limit capital gains deferral to \$1 million per year per taxpayer. If enacted, this provision would apply to all like-kind exchanges completed after December 31, 2014.

Regardless of the future of section 1031 and the like-kind exchange rules contained therein, over the past decade there has emerged an alternative. Using IRC section 453, the installment sale provision, also nearly 100 years old, those seeking tax deferral on the sale of any highly appreciated property can do so through the use of a Deferred Sales Trust (DST.)

The DST is a proprietary tax strategy that leverages the power of IRC section 453. In its simplest form, the seller of real estate (even a primary residence) or other highly appreciated property (e.g., the sale of a business, highly appreciated art, etc.) contacts our firm, which is licensed to do DST business. We work with the seller to understand the seller's goals and circumstances. If the disposition is appropriate for DST treatment, we work with the trustee and trustee's counsel to effectuate a sale to an end buyer. The property is sold to the trust. The trust sells to the end buyer. The trust has the sale proceeds and the seller has a note.

The terms of the note vary with the risk tolerances of the seller. The proceeds of the sale can be invested in stocks, bonds, mutual funds, insurance products or a portfolio containing these or other not-overly-speculative instruments. The income derived from these investments is paid out to the seller by the trust and is typically taxed as ordinary income. The principal can be paid to the seller/note-holder in equal installments or in a balloon payment at the conclusion of the trust. When principal is paid to seller, the applicable capital gains obligations related thereto become due. If there is just a desire to create income and no present need for return of principal, the principal and

the corresponding capital gains tax burdens can be passed on to the seller's heirs.

This strategy achieves complete capital gains tax deferral. While there is no step up in basis in a DST as there is in a like-kind exchange, there are numerous other benefits that can be derived from selling into a DST - diversification into more liquid instruments (e.g., marketable securities), the ability to time repayment of principal for tax minimization purposes, the promise of regular income with the ability to liquidate on short notice by calling the note and the ability to monitor the performance of the investments made by the trust in real time - just to name a few.

It is important to fully understand the nuances as to the differences between a like-kind exchange under section 1031 and a DST under section 453. But for those who are unable or unwilling to enter into a 1031 exchange, even while section 1031 is still with us, the DST may be just the answer to a problem facing those with onerous capital gains tax obligations.

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