Forensic Accounting Today

Newsletter of Ron J. Anfuso, CPA/ABV, An Accountancy Corp.

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Serving all of California

Ron's Corner

In the last issue of ***Forensic Accounting Today***, we covered the issues that arise when divorcing spouses need to divide investment properties, including a possible alternative to recognizing a taxable gain through the exchange of properties under IRC §1031 for an interest in *Delaware Statutory Trust* (DST) investments. We also discussed Rev. Rul. 2004-86, which addressed whether a taxpayer can exchange real property for a DST interest in a §1031 exchange and how a Delaware Statutory Trust is treated by the IRS. Here we address the practical application of DSTs for divorcing spouses.

I trust you will find this information helpful. If you have any questions concerning DSTs, I welcome you to contact me, or visit the website mentioned at the conclusion of the article.

Ron

* For an explanation of these titles, please visit our website or request a copy of Issue 3 of ***Forensic Accounting Today.***

Mitigating Taxation of Investment Properties upon Dissolution

Presented by Ron J. Anfuso, CPA, ABV, CFF, CDFA, FABFA
(Part 2)

An Example Case

Fact Pattern Upon Dissolution:

- Divorced spouses co-own rental property valued at $4 million (net of sale costs)
- Loan balance: $2 million
- Current net income: $5,000 per month ($60,000 per year, or 3% yield on equity)
- Purchase date: 15 years ago
- Original purchase price: $2 million
- Cumulative depreciation: $500,000
- Adjusted cost basis: $1.5 million
- Taxable gain if sold: $2.5 million
- Total federal/state tax liability @ 40%: $1,000,000
- Net proceeds for each party after tax: $500,000

In this example, the forced sale of the investment property created a tax liability of $500,000 for each of the two parties, representing half of the cash they received at the close of escrow. This is a typical result in California.

Instead of selling and simply paying taxes, the parties may agree to conduct a §1031 exchange, with the intent to acquire separate interests in one or more *Delaware Statutory Trusts* (DSTs). These are offered as private placements through syndicates of independent broker-dealers. The divorced parties may invest in the same replacement properties or choose different ones. Investment decisions are made near the time of sale, as most DST programs are available for less than two months. The familiar §1031 exchange deadline applies 45 days after close to identify all replacement properties, and 180 days to complete the acquisitions. Between the sale and purchase (often only a few days with DSTs), all proceeds are held by a *Qualified Intermediary*.

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Most DST offerings include built-in financing, typically at loan-to-value ("LTV") ratios of 45% to 57%. In the fact pattern above, the divorced parties have an LTV of 50%. To defer all taxes, they must replace their entire $4 million property, including $2 million of equity and $2 million of debt. A traditional exchange would require the parties to qualify for new investment loans, whereas DST non-recourse loans require no qualification or application.

Among current DSTs, the average first-year yield on equity is approximately 5%. Accordingly, the divorced parties each would receive $50,000 per year or $4,167 net per month, with much of this income offset by depreciation lowering taxes.

Upon liquidation of each DST property (typically in six to eight years), the respective parties have the option to:

- Receive their pro rata sales proceeds and pay taxes; or
- Exchange back into traditional, directly-owned real estate; or
- Exchange into another DST.

After the exchange, either party may readily transfer their DST shares into their respective grantor trusts. Like other real estate, the adjusted cost basis of DST shares is stepped up to the fair market value at the time of death. Heirs typically do not conduct §1031 exchanges with inherited DSTs, as any incremental capital gains are likely to be relatively low in the short time between the decedent's death and the disposition of the DST property.

If divorced spouses own investment property via a shared LLC, they can exchange initially into a portfolio of DSTs in the name of the company. Later, they may dissolve the LLC and easily re-register their respective DST interests as separate individuals.

Conclusion

For many divorcing couples, real estate equity represents their largest source of shared wealth. When investment properties are forcibly sold without conducting a §1031 exchange, the financial consequences for both parties can be severe. On the other hand, continued co-ownership is usually untenable.

DST exchanges offer family law practitioners a simple and practical alternative to recommend selling or holding appreciated property. Divorced spouses can maintain or increase their income, avoid capital-gains taxes and separate their interests, without needing to qualify for financing, while investing in a potentially diverse portfolio of institutional properties across multiple asset classes, geographies and tenants.

For more information regarding §1031-qualified DST investments, visit *1031capitalsolutions.com* or contact my office.