Utilizing DSTs in a 1031 Exchange

Section 1031 of the Internal Revenue Code provides an effective strategy for deferring capital gains tax that may arise from the sale of a business or investment real estate property. By exchanging the real property for like-kind real estate, real property owners may defer taxes and use the proceeds to purchase replacement properties.

Utilizing Delaware statutory trusts (DSTs) in conjunction with 1031 exchanges is an attractive option for investors that can provide many benefits.

A DST is a passive investment vehicle that allows multiple investors to own fractional interests in a single property or portfolio of properties. Beneficial interests in DSTs, which hold real estate, may qualify as a replacement property as part of an investor's 1031 exchange transaction. Prior to DSTs, Tenant-in-Common (TIC) deals were popular in 1031 exchange transactions. The transition from TIC deals to the more beneficial DST structure began occurring after the real estate recession in 2008.

DIFFERENCES BETWEEN TICS & DSTS

The main differences between TIC programs and DSTs are management and control advantages. The DST structure places all the decision-making into the hands of an experienced sponsor-affiliated trustee, taking it out of the hands of investors. In TIC deals, in contrast, the IRS requires that certain fundamental decisions — such as a sale or refinancing of the property or entering into leases or management agreements — be made unanimously by investors. Simply put, in times of crisis, DSTs are more agile decision-makers. DSTs also provide structural simplicity, as investors only need to execute one agreement – the trust agreement for the DST. The DST owns 100 percent of the fee interest in its real estate so, unlike a TIC program, a lender only needs to make one loan to one borrower.

INVESTOR BENEFITS

In addition to being passive real estate owners, investors who participate in DST offerings may also benefit from lower costs. In a DST program, investors do not incur annual costs of maintenance and qualification of a special purpose limited liability company (LLC) to hold their real estate interest. Moreover, DST investors are not required to execute lender guarantees or indemnities, given their purely passive relationship to the real estate.

Furthermore, investors also benefit by the enhanced scalability and diversification that DST programs can achieve. Since the IRS limits the number of investors in any single TIC program to 35, they are generally limited to mid-size or smaller properties (less than $25 million total value) and require large minimum investment amounts. DSTs, however, are not subject to an investor limit under tax law and generally can have up to 2,000 investors if offered in a private placement context. Therefore, DSTs can own properties with an aggregate value much larger than any TIC deal, while simultaneously accommodating much smaller minimum investment amounts, which ultimately allows investors to diversify their investments across multiple DST programs.

LEADERSHIP

Keith Lampi
President, Director and Chief Operating Officer

Key Benefits of DST 1031 Exchanges

No property management responsibilities: The property is professionally managed by a third party in the DST, therefore the DST acts as the single owner and agile decision maker on behalf of investors.

Access to institutional-quality properties: Most real estate investors can't afford to own multi-million-dollar properties. DSTs allow investors to acquire partial ownership in properties that otherwise would be out-of-reach.

Limited personal liability: Loans are non-recourse to the investors and the DST is the sole borrower.

Lower minimum investments: DSTs can accommodate much lower minimum investment amounts, whereas TIC minimums are often $100,000.

Diversification: Investors can divide their investment among multiple DSTs, which may provide for a more diversified real estate portfolio across geography and property types.

Estate planning: All 1031 exchange investments receive a step-up in cost basis so your heirs will not inherit capital gain liabilities.

Insurance policy: If for some reason the investor can't acquire the original property they identified, a secondary DST option allows them to meet the exchange deadlines and defer the capital gains tax.

Swap until you drop: The DST structure allows the investor to continue to exchange properties over and over again until the investor's death.

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THINGS TO NOTE