

1031 Exchange

Alternative Investments: DST's

Internal Revenue Code Section 1031 allows deferment of capital gains taxes on real property used in trade or business or held for investment

Co-ownership of real estate has been around for a very long time. Most people are familiar with the "tenant in common" or "joint tenant" form of co-ownership. However, co-ownership of real estate via a Delaware Statutory Trust (DST) is not as well known, but has been recently gaining popularity for many investors.

A DST is a unique legal entity which can own real estate. For tax purposes, each member of the trust is treated as owning a beneficial interest in the trust and is considered to own an undivided fractional interest in the property.

In 2004 the IRS released Revenue Ruling 2004-86 which established the requirements for investing in DST's as part of a 1031 Exchange. In order for a DST to qualify for 1031 Exchange, the trustee may not have the power to do any of the following:

- Accept contributions from either current or new investors after the offering is closed;
- Renegotiate the terms of the existing loans, or borrow any new funds from a third party;
- Sell real estate and use the proceeds to acquire new real estate;
- Make other than minor repairs that are considered (a) normal repair and maintenance (b) minor non structural improvements and (c) those required by law;

- Invest cash held between the distribution dates other than in short-term government debt;
- Retain cash, other than necessary reserves (all cash must be distributed on a current basis);
- Enter into new leases or renegotiate the current lease. With guidelines established, many large "sponsors" or real estate syndicators have started offering slices of institutional grade properties to individual investors.

Access to property that might otherwise be unavailable to individuals is just one of the advantages of the DST structure. Investors can also benefit from financing that is typically non-recourse and cheaper, as the lender views the Trust as only one borrower. With large properties come economies of scale and professional management relieves the owners of the burdens of daily management. Predictable and stable cash flows can also come with owning a much larger property with a diverse tenant base or a national credit tenant.

DST ownership, however, is not without its disadvantages. Co-ownership can be a problem. Someone used to 'calling the shots' regarding his/her real estate may not be comfortable with relinquishing control. Liquidity can also be an issue. Currently there is not a well-established secondary market for fractional real estate ownership, so those who need immediate liquidity may encounter difficulties.

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How It Works:

DST's are typically sold through a broker/dealer network. Although technically real estate, the government requires that the brokers who publicly market and sell DST's be registered with the Securities Exchange Commission (SEC). DST's won't typically be listed on your local MLS and chances are the local realtor won't be selling them. So investors will want to deal directly with a brokerage firm or financial planner that specializes in DST's.

The typical structure includes 15 to 50 DST investors in a property (however there is no limit set by the IRS) and often there is a minimum equity requirement to participate. Once acquired, a DST investment can be sold, gifted, bequeathed by will or inherited and is subject to property taxes, gift taxes, estate and inheritance taxes in the same manner as a sole ownership property. For more information on DST property and the brokers and sponsors that sell them, feel free to contact Asset Exchange Company.