UNDERSTANDING SECTION 1031 EXCHANGES & DELAWARE STATUTORY TRUSTS

WHAT IS SECTION 1031?

Section 1031 of the Internal Revenue Code provides that no gain or loss shall be recognized on the exchange of real estate, provided that several technical requirements are satisfied.

- Commonly referred to as a "like-kind exchange."
- Seller of a relinquished property must reinvest sale proceeds into a like-kind property.
- Allows for the complete deferral of all federal and state taxes on relinquished property.
- Can exchange any type of real estate for any other type of real estate (personal property does not qualify).

WHY CHOOSE A SECTION 1031 EXCHANGE?

Taxpayers may structure a series of exchanges to compound the benefits of tax deferral, thereby potentially building wealth over time.

- Defer federal and state taxes (does not forgive taxes; tax will be paid if later sold in a taxable transaction).
- Build family wealth over time with multiple exchanges.
- Exchange non-income producing property (for example, land) for income-producing property (for example, multifamily).
- Exchange actively managed property (rental house) for passive property (DST).
- Acquire higher quality replacement property than a taxpayer can afford on their own.
- Diversify to reduce risk by acquiring several replacement properties.
- Potential tax forgiveness for heirs with a step-up in basis upon death.

The taxpayer may exchange real property for any other real property located in the United States or its possessions for productive use in a trade or business or for investment.

- "Like-kind" refers to the nature or character of the property and not its grade or quality.
- Generally, all real property is "like-kind" to all other real property.
- Real estate and personal property are not like-kind.
- Real property can be improved or unimproved (land), which means taxpayers may exchange unimproved real estate for improved real estate and vice versa.
- The exchanger's intent must be to hold the replacement property for investment or use in a trade or business.

DELAWARE STATUTORY TRUSTS

A Delaware statutory trust (DST) is a private real estate investment vehicle that allows investors to participate in a Section 1031 exchange and receive passive income as well as potential for appreciation from real estate ownership. This equation provides the potential for superior risk-adjusted returns.

Benefits of a DST Structure

Asset protection

Limits rights of creditors (creditors of a DST investor cannot attach trust assets).

Confidentiality

Provides privacy for the beneficial owners.

Liability Protection

DST investors of the trust have the same liability protections that Delaware law provides to stockholders of a Delaware corporation (generally, no personal liability).

Contractual flexibility

Provides maximum contractual flexibility.

Ease of Formation and Maintenance

Simple process and reasonable filing fees:

- A certificate of trust is filed with the Office of the Secretary of State of Delaware.
- A Trust agreement is prepared but is not filed with the State of Delaware.
- There are no annual fees in Delaware, not subject to Delaware's franchise tax.

Flexible tax treatment:

A DST can be taxed as a corporation, partnership, trust, or disregarded entity for 1031 programs (see Rev. Rul. 2004-86).

DSTs provide a number of potential benefits to investors:

- Tax deferral
- Portfolio diversification
- Passive income
- Passive management - no management responsibilities
- Access to higher quality real estate
- Potential tax forgiveness to heirs (step up in basis on death)
- Ability to shelter distributions using depreciation deductions plus bonus depreciation and cost segregation

DST 101

For many exchangers, DSTs are a better option than a traditional "whole property" exchange, where the investor sources and acquires 100% of a property (a "whole property") and actively manages that property.

Taxes are deferred until a replacement property is sold in a taxable transaction. When the time comes to sell the replacement property, many real estate investors will structure another exchange, continuing the deferral, instead of selling on a taxable basis.

To qualify for exchange treatment, the taxpayer's existing property (the "relinquished property") and the new property (the "replacement property") must be of like-kind. The term like-kind is very broadly interpreted. Generally, any real property qualifies as like-kind to another real property regardless of type (personal property is excluded). For example, a rental house may be exchanged for an apartment community or undeveloped land for a medical building.

Timing is one of the most challenging aspects of a Section 1031 exchange. The taxpayer has only 45 days from the sale of their relinquished property to identify potential replacement properties, and up to 180 days to close the acquisition of one or more replacement properties. In addition to the time constraints, other factors can make exchanges very difficult to accomplish, including:

- complexity of the tax rules
- limited supply of replacement properties
- debt requirements
- potential difficulties identifying and closing replacement properties within the 45- to 180-day window

DSTs solve most of these challenges.

DSTs are structured to satisfy the like-kind requirement and provide the same tax benefits as direct ownership of real estate. Combined with impressive returns generated by skillful and experienced sponsors, the simplified investment process makes DSTs a superior option for many exchangers.

DST sponsors, such as Capital Square, have an inventory of qualifying DST replacement properties, solving the 1031 timing issues.

These properties have already been acquired by the DST; if the DST is leveraged, the loan is in place with no personal liability to the investors; and all due diligence has been completed, with investors given electronic access to documents and reports (title, survey, appraisal, environmental report, property condition report, roof report, etc.).

The many benefits of DSTs are available to any accredited investor, not just exchangers. DSTs can make an excellent cash investment for anyone looking for a tax-advantaged source of passive income with the potential for capital appreciation.

Diversification does not guarantee profits or protect against losses.