DELAWARE STATUTORY TRUSTS

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Real estate owners, at some point, decide the time is right to sell their property. In many cases, the owners do not want to pay taxes on the sale but wish to use all of the proceeds to invest in another piece of real estate that will provide cash flow. Internal Revenue Code Section 1031 allows the like-kind exchange of real estate for real estate. A like-kind exchange of real estate allows the owners to defer the capital gain that would be recognized on the sale of their relinquished property until the ultimate sale of the replacement property.

Several rules must be followed in order to comply with Section 1031. The replacement property must be actual real estate, or a fractional share of real estate, not a partnership interest in real estate (which is specifically excluded). Section 1031 also includes timing rules; the replacement property must be identified within 45 days of the sale of the relinquished property and the closing on the replacement property must be within 180 days. These time restraints can make it difficult for the seller to find a replacement property that is superior to the property that was sold.

Another issue for property owners is that they may be tired of managing their property and would like to make all of the proceeds work for them without having to be involved in the day-to-day operations.

One possible solution is to invest the proceeds from the 1031 transaction into a Delaware Statutory Trust (DST). Created under Delaware law, a DST is an unincorporated association that is recognized as an entity separate from its owners. One benefit of a DST is that a beneficial owner of the trust is considered to own a fractional share of the trust's assets (real estate), and this qualifies for section 1031 treatment.

IRS Revenue Ruling 2004-86 outlines the rules that the DST must follow in order to qualify for 1031 treatment: once the DST is funded, the trustee cannot accept further contributions; once a property is contributed to a DST subject to a mortgage, the trustee cannot refinance or modify the mortgage, unless under certain conditions; once the property is leased, the trustee cannot cancel or modify the lease; the trustee must distribute all cash on a regular basis except for necessary reserves; the trustee can only invest cash into short-term investments that must mature prior to the next distribution date.

In addition, the trustee's activities are limited to collection and distribution of income; the trustee may not exchange the property for other property; the trustee can only spend money on regular repairs and maintenance on the property and to make minor non-structural modifications and all beneficial ownership interests must be of a single class.

The DST is a special vehicle created to allow the investment proceeds from 1031 exchange transactions to defer capital gains tax and generate cash flow for several years; it could not be considered as a regular investment.

In addition to allowing the investment of proceeds from 1031 exchanges, the DST has other advantages. The trust is a passive investment that allows for someone else to manage the property and for the investor to sit back and enjoy the cash flow. Diversification is another benefit. The DST can be invested in a wide variety of real estate such as multi-family, commercial or mixed-use developments, etc. The DST investment allows the investor access institutional-level management which, in most cases, is not available to the average investor. The number of investors has no limit but typically caps at 499, which allows for smaller investors to participate.

There are, of course, some downsides to DSTs. The investment is for the most part illiquid. The investor is invested in the deal until the property is sold, which in most cases is between five and 10 years. Another negative is that investors in DSTs have a lack of control. The DST sponsor has final say in all of the decisions, as the investors are truly passive.

DSTs provide real opportunities for real estate owners looking to park their proceeds in a passive investment that allows them to remove themselves from daily management operations. DSTs are not investments without downsides or risks, so the investor must study the pros and cons carefully before deciding on making such an investment.