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## **Using a Delaware Statutory Trust as replacement property for a 1031 exchange - by Brendan Greene and Mark McCue**

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Internal Revenue Code (IRC) Section 1031 allows a property owner, who holds property for “the productive use in a trade or business or for investment”, to defer paying any capital gains taxes if the property owner sells such property, identifies “like kind” property within forty-five days of the sale, and acquires other “like kind” property within 180 days of the sale.

Many investors no longer want the day-to-day hassles of managing investment property but still want the ability to sell such investment property, defer their capital gains taxes, and purchase other investment property that is managed by someone else. A Delaware Statutory Trust (DST) offers investors the ability to do so, and the IRS has agreed that a purchase of a DST is considered like kind property for 1031 purposes.

A DST is a legal entity created under Delaware laws which allows an investor to own a pro-rata undivided fractional interest in the trust with the right to receive distributions from the trust from the rental income and/or the sale of the property. The trustee of the DST holds title to the properties and manages the properties. The investors are the beneficiaries of the trust.

The co-ownership nature of the DST allows investors to expand their options of possible replacement properties to invest in larger properties including multi-family apartments, commercial and industrial real estate. Some other benefits of DSTs are that they allow for various size investments, the properties are professionally managed, and investors may receive rental income.

One of the downsides of DSTs is that they are not liquid. Given the current difficulty of the marketplace in finding replacement properties, a DST is a possible solution for investors who want passive management, but still want to defer their capital gains taxes when they sell.

There are some large national real estate companies (often Real Estate Investment Trusts (REIT)) offering potential investors the ability to buy into their DST. Typically, the REIT will have an option to purchase the DST interest from the investor for fair market value after a 2-3 year holding period. Assuming the REIT exercises that option, the investor receives a partnership interest tax free under IRC Section 721.

IRC Section 721 allows a taxpayer to convert an interest in real property (being the interest in the DST) for an interest in a partnership without incurring any taxes. If and when the REIT exercises its option to purchase an investor's interest from the DST, and the investor receives partnership interest, a/k/a "units", and not cash, then the transaction is deferred under IRC Section 721. Some of the potential benefits to the investor of such conversion is the (i) access to institutional quality, professionally managed, diversified portfolios, (ii) income distributions, (iii) appreciation of the portfolio, and (iv) partial and full liquidity. After some period of time, generally around one year, the investor may sell some or all of their partnership interest and pay the capital gains tax at that time.

This article is a very brief overview of how DSTs are used as replacement property in 1031 exchanges. These transactions must be very carefully planned and structured and investors should always seek out experienced legal, financial and tax advice before entering into a 1031 exchange transaction involving the purchase of a DST.

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