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Jan 20 2015

# DSTs - The Entity of Choice Post-Recession

Last week, Louis Rogers, Founder and CEO of Capital Square Realty Advisors, LLC, introduced us to Section 1031 Tax-Deferred Exchanges. This article discusses the Delaware Statutory Trust or DST as the entity of choice post-recession.

*To read part one, click here.*

Following the 2007-2011 recession, TIC lending essentially ended; over time, lenders started making loans to DSTs structured to accomplish tax-deferral under Section 1031. DSTs are widely used today for virtually all fractionalized 1031 programs. TICs are no longer a viable structure for 1031 programs.

## History of DST

DSTs were formerly known as Delaware Business Trusts and have been in use for many decades. A DST is a flexible, unincorporated entity formed under Delaware law and can be used for many purposes, including real estate ownership.

## Revenue Ruling 2004-86

Like the Rev. Proc issued in 2002 for TICs, Revenue Ruling 2004-86, or the Ruling, provided needed guidance on DST qualification. To qualify, a DST must satisfy a number of requirements and avoid any of the so-called “seven deadly sins”. A detailed discussion of the Ruling is beyond the scope of this article. Bottom line – only passive real estate qualifies for Section 1031 treatment in a DST. This means that DST programs may be used to hold net leased real estate or active real estate subject to a master lease that makes the investment passive to the investors.

## Tax Opinions

National sponsors of DST offerings provide a legal opinion from tax counsel stating that the DST interests should “qualify” for Section 1031 treatment. This is a positive feature of syndicated DST offerings.

## Key Attributes of DST Programs

When compared to TICs, DST offerings have a number of positive attributes for investors, including a simpler and less costly closing process because DST investors are not on title, lower minimum investments, and greater ability to transfer interests.

DST interests solve a number of problems experienced by real estate investors, especially small real estate investors who frequently struggle with the requirements of Section 1031. The biggest challenges for most investors include sourcing replacement property, conducting customary due diligence, identifying replacement property within 45 days, and placing required debt on the replacement property. DSTs solve many of these problems. This will be described in greater detail in a future column.

### Strictly Passive Ownership Structure

The Ruling requires DSTs to be passive owners of the replacement property. This excludes many categories of active real estate unless the sponsor uses a master lease structure to make the investment passive to the investors.

## Conclusions

### Creativity/Evolution

The leading 1031 sponsors are very creative in structuring fractionalized real estate offerings to qualify for Section 1031; first TIC offerings and, now, DST offerings. Future structures will evolve and change over time to conform to applicable tax requirements and possibly changing demographics of exchangers (for example, many aging baby boomers seek passive ownership and preservation of principal).

### IRS Support

The IRS has consistently supported Section 1031 with guidance, including the Rev. Proc., the Ruling and a large number of private letter rulings, technical advice memoranda and the like. Back in 1991, regulations were issued on deferred or delayed exchanges that included the use of a qualified intermediary or accommodator to hold exchange proceeds. This “safe harbor” eliminated concerns about taxpayers being taxable due to actual or constructive receipt of sales proceeds. Over time, the cost of using a qualified intermediary or accommodator has declined to the point where even small transactions can be cost-effectively structured as an exchange.

As the body of favorable tax guidance grows, a greater number of taxpayers are comforted that a properly structured DST investment qualifies for 1031 treatment and will not subject the taxpayer to an audit. The modern DST is particularly efficient in keeping transaction costs to a minimum, works well for smaller investors, and provides additional comfort of a “should” qualify tax opinion. To twist a famous quote, “today, even the little people DO NOT have to pay taxes” when they exchange investment property.

### Change is the Only Constant

From whole properties to TICs, and now from TICs to DSTs, legal structures come and go, but sponsors are ever mindful of the importance of qualifying for tax deferral under Section 1031. Large and small real estate investors across the land who may struggle with the technical requirements of Section 1031 are the beneficiaries of these evolving exchange programs.

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