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Delaware Statutory Trusts Have Become the Structure of Choice for Fractionalized Section 1031 Exchange Programs in an Expanding Real Estate Marketplace

By Louis Rogers, CEO, Capital Square Realty Advisors, LLC

Section 1031 exchange programs, which raised over $3.5 billion of equity at the peak in 2006, and then nearly disappeared during the recession, are back in a big way. The Delaware Statutory Trust (DST) has taken the place of Tenants in Common (TIC) as the structure of choice for fractionalized Section 1031 exchange programs.

Equity raised for DST programs has increased dramatically coming out of the recession as investors have sought to defer federal and state income taxes through qualifying Section 1031 exchanges. The primary goal is the same as before the recession– tax deferral—but the vehicle has changed to a DST from a TIC structure.

Why the Increase in Exchange Activity?

As the U.S. economy has slowly recovered from a painful double dip recession, the demand for investment real estate has increased dramatically. With substantially more buyers in the market, there are more sellers who desire tax deferral in Section 1031exchanges.

Prior to the recession, the Commercial Mortgage-Backed Security (CMBS) market provided financing for billions of dollars of commercial real estate, including most TIC programs. During the recession, the CMBS markets froze and stopped real estate lending. Banks, life insurance companies, agencies, and other sources of real estate financing dried up as well. However, over the past two years, lending markets have unfrozen; real estate financing is available again on favorable terms from CMBS lenders, banks, insurance companies and agencies. While interest rates have increased recently, interest rates remain historically low. Also, as the economy has recovered, the fundamental economics of real estate investing have improved, driving demand for new real estate investments. In these ways, the economics of real estate have begun to normalize, increasing the appetite of buyers to acquire investment real estate. On the other side of each buyer is a seller who may desire tax deferral from an exchange.

In addition, a meaningful number of old TIC and DST programs are selling their real estate as the programs go "full cycle." Because investors in TIC and DST programs tend to have low tax basis, they frequently structure their exit as another Section 1031 exchange to continue the tax deferral. Moreover, billions of dollars of old TIC and DST programs will be sold in 2014-2017, when their loans mature. This is likely to produce substantial additional exchange activity over time.

Aging Baby Boomers Face Exchange Challenges

Aging baby boomers own billions of dollars of highly appreciated investment real estate. Many have owned their property for decades and have a very low tax basis. Many would like to sell but do not want to pay the federal and state income taxes that would be due on such a sale.

With retirement on the horizon, aging baby boomers with low tax basis (and some with mortgage balances) structure exchanges in increasing numbers; many desire a more passive form of real estate ownership. Many taxpayers in this group would like access to a higher quality "investment grade" replacement property with the potential for highly stable returns but do not have sufficient funds from their relinquished property to acquire a larger whole property; few have access to investment grade properties.

Many investors actively manage their investment real estate. The classic case is a couple who have owned rental property for decades, actively managing the property on their own as they built wealth through appreciation. Many such investors have financed and refinanced their property a number of times over the decades. Some have "exchanged up" over the years, for example, by selling a single family home and exchanging it for a duplex or quad, structuring Section 1031 exchanges along the way to defer income taxes from sale to sale.

It is common for real estate investors, especially aging baby boomers, to have low tax basis in their investment property. Many purchased property years, even decades, ago at very low prices compared to the current value. Most have reduced their cost basis with many years of depreciation deductions (some on an accelerated basis). Finally, the situation is compounded by substantial appreciation in value. The result—low initial cost basis reduced by depreciation deductions over a long period and compounded by substantial appreciation—high rates of income taxation on sale. Many taxpayers view the current rate of federal and state income taxation as punitive—punishment for decades of hard work and savings. They have found Section 1031 exchanges to be a solution to the high rate of taxation on the sale of investment property.

Section 1031 Exchange Solution to Punitive Income Taxes

A properly structured Section 1031 exchange solves the first problem—income taxes—by providing tax deferral for the aging baby boomers and other taxpayers who want to sell their low basis investment property but do not want to pay punitive federal and state income taxes. However, to qualify for tax deferral under Section 1031, taxpayers must make a new real estate investment. This could take the form of another "whole" replacement property or a fractionalized property, such as a DST.

Section 1031 Exchange Ramifications

Many taxpayers do not have the time, skill or desire to find replacement property, not to mention conducting due diligence, and negotiating replacement property financing. The challenge is compounded by the strict rules under Section 1031 to "identify"

replacement property within 45 days of transferring their relinquished property and to close all replacement property within up to 180 days. Taxpayers frequently struggle if left on their own to comply with Section 1031 rules.

Further, to qualify for tax deferral, taxpayers generally must offset debt secured by the relinquished property with debt secured by the replacement property; any reduction in debt is taxable. While replacement property debt is required for most exchangers, many smaller real estate investors still struggle obtaining replacement property financing.

Also, many older TIC and DST programs that are going full cycle have relatively high loan-to-value. This means the replacement property generally must have an equal level of debt to avoid taxation (taxpayers may contribute cash from another source to offset debt). While individual taxpayers may struggle obtaining financing, DST program sponsors have access to numerous sources of real estate financing.

A small group of sponsors are presently structuring DST programs for taxpayers who seek qualifying replacement property for an exchange. An exchange program must have adequate debt to produce the desired tax-deferral. Today, virtually all lenders favor DSTs and will not finance a TIC-owned property. The presence of available financing for DST programs has led to their widespread use for exchange programs; the absence of TIC financing has essentially killed the TIC structure for fractionalized ownership programs.

DST programs satisfy the demand from aging baby boomers and others for high quality investment grade replacement property. These properties are presented to investors as a turn-key solution to the Section 1031 requirements.

DST Has Become the Structure of Choice for Section 1031 Exchange Programs

Prior to 2008, TIC syndications were the most popular structure for fractionalized 1031 ownership, but flaws in the TIC structure were exposed during the recession. Lessons were learned by sponsors; the DST structure is believed to be superior for 1031 investors in several important respects.

DSTs, which allow for many more investors than TICs, typically have low minimum investment amounts. This means that DSTs can be used to reduce risk through greater investment diversification.

DST sponsors have greater control to make important decisions, and investors are far more passive than in a TIC offering. The typical DST investor is tired of managing their own property, such as a duplex or farm, and do not want to actively manage their real estate; they favor DSTs with passive ownership of real estate.

Demand continues to grow for DSTs from aging baby boomers and other investors who want stable income and potential for appreciation from their investment real estate, while avoiding the headaches of active management. DSTs have become a turn-key solution to the demand for quality Section 1031 replacement property.

Master Limited Partnerships;

Real Assets—Real Returns

By Clay Womack, Adageo

For the last seven years, including through the Great Recession, Master Limited Partnerships (MLPs), have been on a capital formation tear. This investment vehicle has become the entity of choice for natural resource-related capital formation, from an industry market cap of about $35 billion in 2006, to a market cap in excess of $500 billion today. Traditionally, the largest MLPs have primarily been involved in the "midstream" sector of the energy industry—pipelines, terminal storage facilities, etc. However, there has been an explosion in Private Letter Rulings from the IRS which has broadened the definition of "Qualifying income" to enable a wider array of businesses to use the structure.

What is a MLP? A Master Limited Partnership is a pass-through investment vehicle that has a friendly tax treatment of qualifying income distributions. The bulk of the distributions are treated as return of capital and therefore not taxed. Taxable income is often quite low because deductions such as depreciation and depletion are also passed through to individual partners. MLPs can be publicly traded on one of the national exchanges, or they can be privately held. They can also be structured as Limited Liability Companies (LLCs).

There are over 120 Publicly Traded Partnerships according to the National Association of Publicly Traded Partnerships, a trade association for the industry. Over half of these partnerships are natural resource oriented and include the "midstream" component (pipelines, terminals, storage facilities, etc.), the "upstream" component which is comprised of oil and gas exploration companies, and the "downstream" component which includes refineries and distribution facilities such as convenience stores. In addition, there are now MLPs which own Frac sand mines and distribution, saltwater handling and disposal facilities, and fertilizer manufacturing and distribution operations.

The MLP Parity Act Historically, renewable energy companies have been precluded from utilizing the MLP structure for investment capital formation. The MLP Parity Act, a bill recently introduced by Sen. Chris Coons, D-Del., has large bipartisan support. The bill would allow renewable energy projects to structure themselves as MLPs in order to attract capital and provide liquidity—significantly enhancing the growth prospects for the industry.

The MLP Parity Act simply expands the definition of "qualified" sources to include clean energy resources and infrastructure projects. Included are those energy technologies that qualify under Sections 45 and 48 of the federal tax code, including wind, closed and open loop biomass, geothermal, solar, municipal solid waste, hydropower, marine and hydrokinetic, fuel cells, and combined heat and power.

The legislation also allows for a range of transportation fuels to qualify, including cellulosic, ethanol, biodiesel, and algae-based fuels, as well as energy-efficient buildings, electricity storage, carbon capture and storage, renewable chemicals, and waste-heat-to-power technologies.

This legislation, if passed, will greatly expand the investment opportunities available to high net worth investors as the entrepreneurs in this industry will be seeking the lowest cost of capital possible to finance these ventures.