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The sharp downturn in the overall real estate market has significantly reduced the number of 1031 exchanges. Most income property owners are waiting for real estate prices to further improve before selling. However, some owners have had their property for decades and have sizeable capital gains even at the current level of real estate valuation. As they grow older and retire, they would like to sell their income property to move to warmer climates or to be closer to grandchildren. Perhaps they have simply become tired of being a hands-on property owner. However, sale of their property would entail payment of sizeable capital gains taxes, which makes the tax deferral advantage of a 1031 exchange attractive.

The challenges of successfully completing a 1031 exchange are finding suitable replacement property, doing the due diligence on the property, securing bank financing to replace the amount of debt on the original property, identifying the property within 45 days, and successfully closing on the purchase within 180 days. A sole ownership property would most likely still require the owner to be a hands-on property owner. Contracting out property management for a small individual property may be quite expensive and in many cases impractical.

There is a class of commercial real estate properties that are structured as securities in a Delaware Statutory Trust (DST), blessed by the IRS in 2004. (Revenue Ruling 2004-86) They have been structured to meet the IRS requirements qualifying them as 1031 exchange replacement properties. Investors purchase interests in the Trust, which holds title to property and guarantees the mortgage loan. Investment in the real estate is shared amongst many investors. DST properties are institutional grade commercial properties, e.g. apartment communities, office buildings, retail buildings, or shopping centers, generally valued at $5M-$50M. An individual exchanging a house, condominium, small office/retail building would not have funds to purchase such high quality, commercial properties without sharing the investment with other investors. The key difference between a traditional TIC offering and a DST offering is that in a DST offering the investors are not direct owners of the real estate; they hold beneficial interests in a particular form of trust, known as a Delaware Statutory Trust. This eliminates the need for the investor to be on the deed and sign the loan documents. Accordingly, lenders do not care about the number of investors in a DST (assuming compliance with securities laws), and the limitation to 35 investors set forth in Revenue Procedure 2002-22 also does not apply

The property sponsors, who are Trustees of the DSTs, are national real estate developers who purchase the property and structure it as a securities DST. There is a written offering document that provides very detailed information on tenants/leases, area demographics, financial projections, investment risks, and information about the property sponsor. Supporting documentation includes third party appraisal, property condition, and environmental reports. Mortgage bank financing and property management are pre-arranged by the property sponsor. These are issues that a 1031 exchanger would expend considerable effort to resolve. Reserves are set up to fund future capital expenditures, tenant improvement and leasing commissions for new tenants, and contingency funds for unexpected events. Any reserves remaining upon property sale are returned to the investors. Oftentimes, individual real estate owners do not adequately reserve for such future expenses and contingencies. Investors receive net monthly distributions after paying operating expenses, mortgage payments, and reserve contributions. The annualized income is generally 6%-7% of their cash investment amount.

There are some drawbacks of DSTs that do not make them suitable for all 1031 exchangers. The pre-packaging, trust structure, and property management described above makes a DST a truly passive investment with very limited input from investors. A DST is not for someone who would miss the hands-on property management. It is also important to chose a property sponsor that has a proven past performance track record, which is usually discussed in the offering document. These investments are designed for a holding period of 2-10 years. Investors receive their share of the proceeds when the property is sold. A DST is not for someone who wishes to park his/her money for a couple of years while waiting for some other investment. Individual investors that have managed their own properties may be used to better than the 6%-7% DST annual income. However, the property manager needs to be paid and there needs to be adequate contingency reserves from cash flow.

When investing in a DST, there are some positives over the original TIC structure

- Greater exit strategies for the investor. When transfer of ownership occurs, the banks are not involved.
- The ability to have more diversification options available during the 45-day identification period. The limitation to 35 investors set forth in Revenue Procedure 2002-22 also does not apply. This allows offerings to 100 or more investors, with the minimum investment amounts in a more reasonable range of $100,000 to $250,000.
- No need to set up individual single member limited liability companies. The DST itself shields investors from any liability.

1031 Investment Solutions specialize in providing DST 1031 exchange replacement properties and feel that certain 1031 exchangers should consider them. Please visit us at www.1031investmentsolutions.com
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