Leveraging DSTs in Section 1031 Exchanges

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Section 1031 of the Internal Revenue Code provides real property owners with a major tax-deferral and reinvestment opportunity that can be utilized by investors to build long-term growth in their real estate portfolio. Section 1031 establishes a procedure where real property owners may simultaneously realize appreciation from a business-use or investment asset, defer capital gains taxes upon the sale of the asset, and use the equity from the asset to invest in a replacement like-kind business use or investment asset.

The principal advantage of a Section 1031 tax-deferred exchange is the ability to use the entire equity of a property owned by a taxpayer to acquire replacement property. It eliminates the immediate tax implications of selling real property, thereby allowing property owners to employ their equity into more advantageous real estate positions. If a property owner wishes to continue to invest in real estate, an exchange can be a beneficial alternative to a sale and purchase. A Section 1031 exchange can provide the following benefits to real estate investors: consolidation and diversification of investments, greater cash flow, relocation of investment, “stepped-up basis” for heirs, and appreciation leveraging.

Section 1031 exchanges have two critical timing rules that must be followed for a successful exchange. These are known as the 45-day identification period and the 180-day exchange period. Failure to adhere to these standards will result in an unsuccessful exchange. There are no exceptions or extensions to these two standards.

Property Identification Rules: The individual completing the exchange may identify as many as three replacement properties, regardless of their total value. This is known as the “3-Property Rule”. In the alternative, the individual completing the exchange may identify any number of properties provided their aggregate fair market value on the 45th day does not exceed 200% of the aggregate fair market value of all of the relinquished property on the date of its transfer (the “200% Rule”). If the individual complies with these rules, they do not need to acquire all of the property identified.

Deferring all Capital Gains Taxes: As a general rule, exchanging taxpayers should keep three important considerations in mind. First, replacement property fair market value must be equal or greater than the fair market value of the relinquished property. Second, all of the exchange proceeds from the sale of the relinquished property must be used to acquire the replacement party. Third, the replacement property debt must be equal to or greater than the relinquished property debt so as to avoid taxable gain due to debt relief. Not following these rules may result in taxable gain. These three considerations are mentioned to help exchanging taxpayers structure a Section 1031 exchange. If these considerations are not followed, the exchange can still be completed. However, it is extremely important for taxpayers to seek guidance regarding the effects of debt relief or receiving cash for personal use.

As a single purpose entity, Delaware Statutory Trust (DST) investment vehicles qualify for Section 1031 real estate exchanges. Section 1031 establishes a procedure where real property owners may simultaneously realize appreciation from a business-use or investment asset, defer capital gains taxes upon the sale of the asset, and use the equity from the asset to invest in a replacement like-kind business use or investment asset. As part of Section 1031 exchanges, individual investors receive shares in the DST Trust. The property is owned and professionally managed by the DST Trust and is leased triple net to a single Master Tenant. When the DST property is sold, any capital distributions to investors remain eligible for subsequent Section 1031 exchanges.

The DST investment vehicle is ideal for Section 1031 exchanges due to the following characteristics:

45 Day ID Period — DSTs eliminate much of the hassle of the identification process by offering investors numerous properties that can be identified immediately. Section 1031 exchanges have two critical timing rules that must be followed for a successful exchange.

Excess Boot — When a replacement property is lesser in value than the previously sold property, the remaining money must be taxed. This leftover money is known as excess boot. With a DST you can invest down to the penny, ensuring that 100% of your exchange funds are invested.

Backup Insurance — With a DST, the property is already purchased, thus removing any closing risk. This makes a DST a great potential backup in your identification process. Some investors choose to identify a DST as “backup insurance” in the event their other identified properties do not close.

Professional Management — The DST structure allows investors to collect returns without the management demands of typical real estate ownership. DSTs are managed by professional real estate asset managers who provide expert knowledge on the type of real estate and handle all obligations associated with owning property.

DST Farmland has formally launched as a sponsor of Delaware Statutory Trust (DST) investment vehicles, focused on a first-of-its-kind offering in the farmland asset class. The application of the DST vehicle to farmland investing is exciting, as it allows investors to take direct ownership in an asset class historically requiring capital at a scale that is out of reach for many investors. DST Farmland has contracted exclusively with Peoples Company, a national full-service land transaction firm, to provide professional farm management on all offerings. With its launch, DST Farmland is offering its first land tract, Delta Organic Ag Properties, located in Chicot County, Arkansas. Delta Organic Ag Properties boasts 1,102 USDA certified organic acres with corn, rice, soybeans, and rice planned for production. Visit **DSTFarmland.com** to download a free e-book for more information on the DST investment vehicle and farmland investing.