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An Easier Path to Real Estate Investing: 1031 Delaware Statutory Trusts

By C. GRANT CONNESS | Global Wealth Management

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Being a landlord isn't for everyone, but getting out of the biz could trigger capital gains taxes. There's another way to stay in real estate, without the tenant hassles and without the bite of capital gains.

I've written before about helping clients who feel trapped in real estate investments because of the high capital gains tax they would owe if they sold their properties.

In my column about Deferred Sales Trusts, I outlined how to use Section 453 of the Internal Revenue Code to defer the tax and roll the money into investments other than just real estate.

Another strategy that I've been getting a lot of questions about lately uses a 1031 Exchange to put the proceeds of a sale into a Delaware Statutory Trust (DST). It's a way to stay in real estate – and avoid capital gains taxes – but as a more passive owner.

Many real estate investors know at least a little bit about the 1031 Exchange. The concept has been around since the 1920s; it became Section 1031 of the Internal Revenue Code in 1954, and it's been updated through the years.

Basically, it allows an owner or investor to sell a property and defer the capital gains tax on the sale.

There are some guidelines that you have to follow. You must set up your 1031 prior to closing on the sale, and your sales proceeds go to a third party, called an accommodator or a qualified intermediary, to hold. From closing, you have 45 days to identify the property you're going to exchange into. And then you have six months to close on the property you identified. If you do all that, you've accomplished a successful 1031 Exchange. But until 2004, you were still replacing one property with another – so, like it or not, you were still a working landlord.

More recently, Revenue Ruling 2004-86 determined that a Delaware Statutory Trust qualified as real estate and, as such, could serve as a replacement property solution for 1031 Exchange transactions. If you were tired of managing a property yourself, you could, instead, acquire a fractional or percentage interest in a DST, and become a part owner in a much larger real estate investment – a 300-unit apartment building, a grocery center, medical office building, etc.

So now instead of Mr. and Mrs. Smith as your tenants, calling you to come fix the garbage disposal, Walgreens or CVS is your tenant with a corporate lease. It's a more hands-off way of owning income-producing real estate that's especially well-suited to retirees. A dozen or so fairly large companies put together deals for investors to exchange into that are professionally managed and pretty much turnkey.

There is a downside (of course), and that's liquidity. You still own real estate – it's not like stock, where you can hit a button and sell. The holding period might be five to 10 years.

You also should be sure you're dealing with a reputable company, called a sponsor, when you structure the deal. I prefer ones that have been in business over 10 years -- which proves that they sustained the market downturn and can demonstrate a proven track record of acquiring, managing and disposing of assets on behalf of investors -- and ones that manage a sizable portfolio of real estate throughout the U.S. The good news is there's a handful of them that have been doing this for many years. If you have a trusted financial adviser, he can help you determine who to work with.

Investment strategies can run hot and cold – and DSTs cooled off for a while, thanks to the most recent recession and real estate bust. But they offer a viable solution to a common investor problem. Talk to your tax attorney and your financial adviser to see if this strategy makes sense for you.

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