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1031 exchange replacement property alternatives for investors - by Pamela Michaels

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Investors in the Northeast are confronted with a number of obstacles when attempting to close on replacement property in an IRC Section 1031 exchange. Foremost amongst them may be the shortage of attractive inventory and the high price of available replacement properties. In addition, many investors in the Northeast may wish to buy real estate located elsewhere but do not want the headaches arising from managing such properties far from their location. So what's an investor to do?

One possible solution for certain investors, particularly "accredited investors" (high net-worth individuals and certain entities, as defined in Regulation D of the Securities Act of 1933) is to acquire an interest in a Delaware Statutory Trust (DST) as replacement property to complete a 1031 exchange. A DST is a type of trust formed under Delaware law. Provided that the DST's governing documents conform to the requirements of Revenue Ruling 2004-86, a DST investor's ownership interest in the DST is treated as a fractional interest in the property owned by the DST. Consequently, if the DST owns like-kind replacement property, an investor can acquire a fractional interest in the DST to complete the tax deferred exchange.

An ownership interest in a DST, sometimes called a "beneficial interest" or "DST unit" is an indirect way of owning investment real estate.This can be appealing to investors who are interested in acquiring a managed real estate investment. The trustee of the DST initially purchases the property and holds title to the property. A sponsor structures the investment and arranges for the issuance of beneficial interests in the DST. Although interests in the DST are treated as securities under federal securities laws, they are treated as ownership of real estate under Section 1031. The sponsor generally arranges the bank financing for the purchase of the property, and coordinates the property management. In order to comply with applicable securities laws, the sponsor will generally provide a written document called a Private Placement Memorandum (PPM) to the investor. The PPM provides information about the property, area demographics, tenants and leases, financial projections, risks of the investment along with additional information about the sponsor, and other disclosures.

When to consider a DST?

When the investor is interested in passive ownership of high grade commercial property, but the investor lacks the financial wherewithal to purchase the property entirely on their own.

When the investor wants a pre-packaged replacement property where the financing is in place and the sponsor has already performed due diligence.

As a reliable backup property on the list of identified properties in the event the primary identified property does not work out, or they have not used all of the proceeds from the relinquished property and they wish to reinvest those funds to achieve full tax deferral.

When an investor wants geographic diversification.

For more information about DSTs, visit The Alternative and Direct Investment and Securities Association (ADISA) at www.adisa.org.

Pamela Michaels, Esq., is senior VP with Asset Preservation, Inc., New York, N.Y.