Deferring capital gains from the sale of appreciated investment properties - by Michael Packman

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When investing in real estate, the key is to buy a property well and then sell it for a profit at some point in the future. Many investors know they may be able to utilize Internal Revenue Code Section 1031 and exchange their property for a replacement property and defer their capital gains. This has been one of the cornerstones of real estate investing for over one hundred years. In addition to the appreciation earned, many investors use deductions to offset some of the income earned, further reducing their cost basis. If the rules are followed each time an investor sells and subsequently buys a property, the taxes can potentially be deferred until they pass away. At the time of their death, the property owner’s heirs inherit the property at the stepped up basis, potentially wiping out all the accumulated gains, regardless of how many exchanges the investor may have done in the past (and depending on the total market value of the estate).

While most real estate investors know how to take advantage of a 1031 exchange in the traditional sense, there is an option to invest in an alternative structure and still defer the gains - this is called a Delaware Statutory Trust or (DST). A DST gives investors another avenue to take advantage of the tax code while staying within the parameters of the 1031 requirements. The rise in real estate prices we experienced until recently increased the demand for DST offerings. According to Mountain Dell Consulting, LLC, as of this article, an estimated $8 billion in transactions have been completed in 2022. If a property owner is tired of dealing with the hassles of property management, yet has a low-cost basis, the DST structure still allows for a way to take advantage of section 1031 and pass on the day-to-day management tasks to professional real estate management firms. If there is any leverage used in one of these programs, the debt is all non-recourse to the investor. This may be of particular interest if the current property owned has a personal guarantee, as the investor can exchange the property for a DST and not be liable for the new debt of the DST. A DST can also be used for a partial exchange. For instance, if an investor is selling a $10 million property and replacing it with one valued at $8 million, the remaining $2 million may be invested in a DST and still defer the capital gains. We also see DST’s used quite often as a back-up plan in case one or more of the properties an investor identified to complete their exchange falls through.

The underlying real estate in a DST may be any asset class including multifamily, office, retail, self-storage, or industrial properties. In recent years, given the state of the economy and the demographics, the most utilized asset class has been multifamily apartment buildings, followed by NNN, credit-tenant properties, self-storage and industrial. The real estate in a DST is typically of institutional quality with professional management by a qualified sponsor. As they are completely passive investments, when evaluating a DST, it is important for the investor to do due diligence on both the real estate and the sponsor of the offering. In many cases, investors enlist a financial advisor or securities broker to assist with locating a DST that may be a fit and help perform the due diligence necessary prior to investing. While a DST is an option for many 1031 exchange investors, it is not for everyone and therefore the investor should consult professionals familiar with the DST structure prior to investing.

Whether you are an investor, residential or commercial broker, CPA, or attorney, being educated on the DST structure can be beneficial. If you are an investor and are tired of managing your property, want to remove liability from the debt on your property, or need a property to fall back on because the planned exchange might not close in time, the DST structure may be your answer to avoiding that big tax bill.

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