




WHITE PAPER

BUILDING A LEGACY *AND* GENERATIONAL WEALTH through 1031 Exchanges and DSTs

Someone's sitting in the shade today because someone planted a tree a long time ago.
- Warren Buffett



There are many benefits for creating and building one's wealth, but beyond the immediate rewards, is the opportunity to create an inheritance for future generations. In an era of economic uncertainty, families and individuals are increasingly seeking strategies that not only preserve capital but also build enduring legacies.

Real estate has long been a cornerstone of wealth creation. Its tangible nature, potential for appreciation, and ability to generate passive income make it uniquely suited as an option for long-term financial planning. And this is about more than just simple ownership. Strategic real estate investment offers sophisticated avenues for tax deferral, portfolio diversification, and estate planning, which are critical to building, sustaining, and most importantly, passing on wealth to future generations.

At the foundation of this discussion is Section 1031 of the U.S. Internal Revenue Code which allows real estate investors and business property owners to defer paying capital gains taxes when they sell a property and reinvest the proceeds into a similar ("like-kind") property. The 1031 exchange originated in the 1920s under IRS Code Section 202(c) and evolved over time through court decisions and legislative acts through IRS Code Section 1031. The act was initially intended for simultaneous exchanges, but in 1979, the landmark decision in Starker v. United States by the Ninth Circuit Court of Appeals ruled exchanges did not need to be simultaneous. In fact, this ruling in is why 1031 exchanges are sometimes referred to as "Starker" exchanges.

As a result of the Starker decision, Congress codified new restrictions and introduced two critical time limits: the 45-day rule for identifying a replacement property, and the 180-day rule for completing the exchange. Additionally, the IRS issued comprehensive regulations for deferred exchanges which define "safe harbors" for using a qualified intermediary (QI) to hold funds during an exchange and ensure the taxpayer does not have constructive receipt of the sale proceeds. It is imperative that investors consult with their tax advisor, qualified intermediary, and financial advisor for each specific circumstance.

1031 exchanges allow investors to defer their capital gains taxes and redeploy their sales proceeds indefinitely until (1) they take the proceeds and pay the capital gains taxes due based on the difference between their cost-basis and sale price, or (2) pass away, at which time their beneficiaries will receive a stepped-up cost basis to fair market value, resulting in little to no capital gains tax, so long as the property is sold soon after it has been inherited.

While investors have used 1031 exchanges for tax planning purposes for decades, vehicles for investment ownership have evolved to provide more options. In the early 2000s, the popularity of tenant-in-common (TIC) structures- where multiple investors hold undivided fractional interests in a property- opened the door for smaller investors to access institutional multifamily and commercial real estate. In response, the IRS issued guidelines addressing concerns about the TIC structure resembling partnerships. Revenue Procedure 2002-22 outlined 15 conditions that TIC structures must meet to qualify for 1031 exchanges. This includes the limitation of no more than 35 co-owners, and that major decisions (including leases and capital improvements) require unanimous co-owner approval.

But the limit of 35 investors meant that a higher minimum investment was required depending on the size of the asset, and unanimous consent for decisions was cumbersome and logistically challenging, and gave rise to the Delaware Statutory Trust (DST) structure which is what most securitized real estate sponsors use today.

A DST is a legal entity created under Delaware Law that allows multiple investors (up to 499) to hold fractional ownership in real estate assets. Instead of owning the property directly, investors own a beneficial interest in the trust which holds title to the property. Delaware has long been a preferred jurisdiction for trust and corporate law due to its flexible, business-friendly legal environment and trusts have been used for estate planning and asset protection for decades. The formal legal foundation for DSTs was laid in 2002 with the enaction of the Delaware Statutory Trust Act which defined DSTs as separate legal entities capable of conducting business and holding real estate. Additionally, it clarified the rights and responsibilities of trustees and beneficial owners, making DSTs suitable for real estate investment.

In 2004, the IRS issued Revenue Ruling 2004-86, which officially recognized DSTs as qualified replacement property for 1031 exchanges. This ruling allowed investors to defer capital gains by completing a 1031 exchange into fractional interests in a DST. Unlike a TIC investment, the number of investors is not limited to 35, allowing for lower minimum investments, and investors hold beneficial interests- not direct title. Furthermore, DSTs must be passively managed and investors cannot make operational decisions. To ensure the DST remains a passive entity, the trust must not renegotiate leases, refinance debt, or reinvest proceeds.





There are many reasons an investor may choose to invest in a securitized DST offering as part of a 1031 exchange to defer taxes. Through fractional ownership, DSTs allow investors to pool funds and acquire institutional-grade real estate they would otherwise not have access to. The lower minimums, typically $50,000 - $100,000, also allow investors to diversify into multiple properties across asset classes such as multifamily housing, office buildings, retail centers or industrial warehouses. Investors often choose to not only diversify among asset classes, but to allocate their investment among multiple DST sponsors. The turn-key closing process for a DST allows investors to potentially close within three to five business days of completion of paperwork, and offerings often come with pre-arranged, non-recourse financing to replace debt from their relinquished property.

DSTs are professionally managed, and the sponsor will oversee the day-to-day operations and long-term strategy. Investors may receive monthly or quarterly distributions depending on the offering, with the funds often deposited directly into their bank account via ACH transfer. Regular updates on property performance and market conditions, including quarterly and annual reports, are provided to investors by the sponsor.

DSTs are typically held for between five and 10 years, after which the sponsor sells the property and the investor has a few options: complete a 1031 exchange into another DST offering, conduct a 1031 exchange into a directly owned property, exchange into operating partnership units (OP units) of a REIT (called a 721 Exchange (IRC Section 721)) if that option is offered by the sponsor, or take the sale proceeds from the sale of the property and pay capital gains taxes.

As with any investment, due diligence is crucial, and because DST ownership interests are not easily sold before the property is sold by the sponsor, DST investors must also consider liquidity risk.

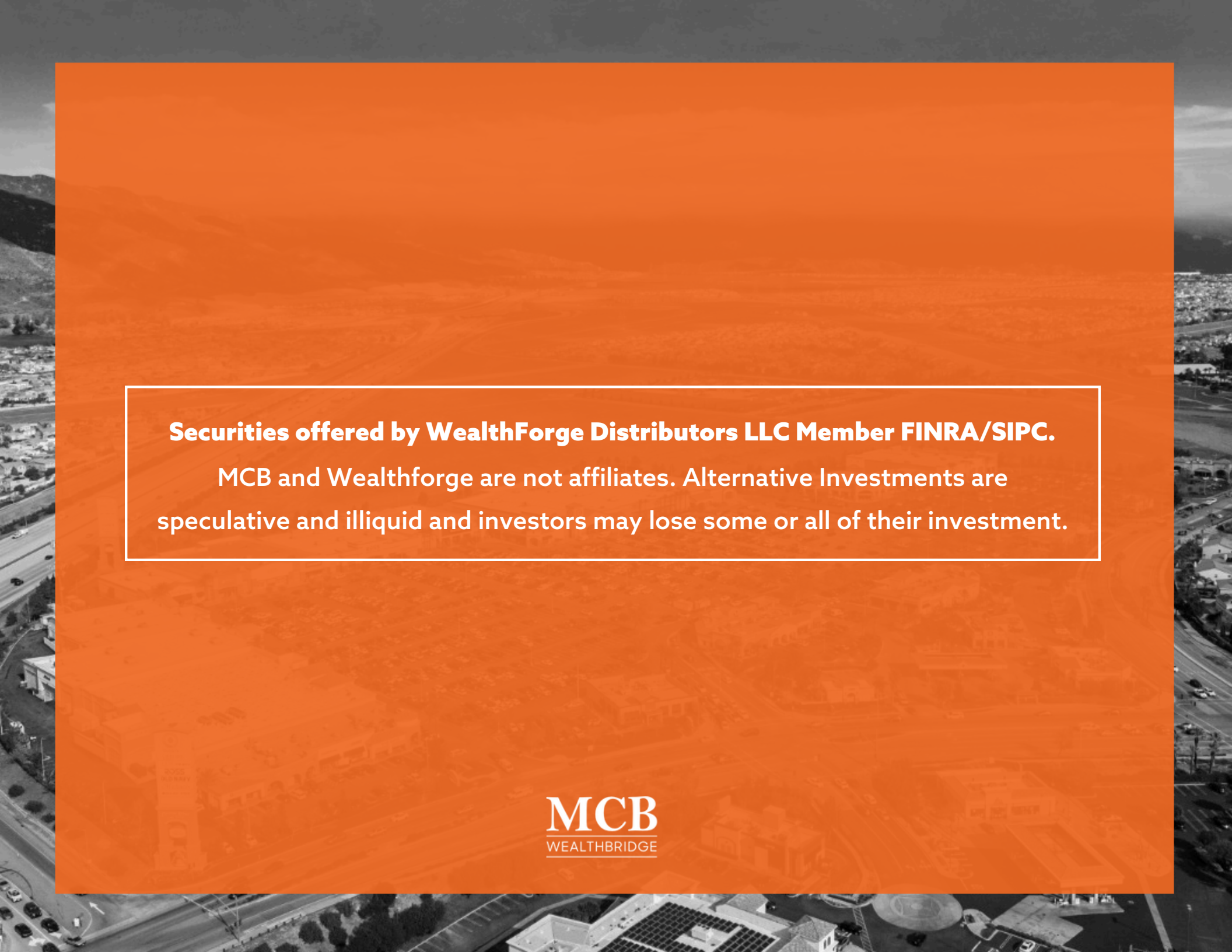
When considering 1031 exchange investments and options upon their sale, it is important for the investor to include their financial advisor, tax professional, and estate attorney in the planning process as part of a broader wealth transfer strategy.



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