IDENTIFYING DELAWARE STATUTORY TRUSTS (DST) IN A 1031 EXCHANGE

As the US investor population ages we've seen an upward trend in investment funds being shifted into real estate holdings that are passively held. It is also becoming increasingly difficult for investors to find viable replacement properties within the narrow deadlines of IRC section 1031. A Delaware Statutory Trust (DST) therefore represents a viable solution for many investors.

A DST is an investment trust in which investors purchase fraction ownership interests in the underlying property. For example, a DST may consist of a portfolio of apartment buildings, drugstores, or triple-net properties. A DST may also consist of a single asset, such as a large warehouse operation or self-storage facility.

The good news for 1031 investors is that DSTs (if structured properly) are considered to be direct investments in real estate and are eligible for 1031 tax deferral treatment. However, if DST property is not correctly identified during a 1031 exchange, a failed exchange may result.

To complete a successful 1031 exchange, exchangers must identify replacement property(ies) within 45 calendar days after their relinquished property transfer. Exchangers can do this by following <u>one</u> of the following three identification rules:

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  - **Three Property Rule (most common)** – The exchanger can identify one, two or three properties without regard to the value of the property(ies) identified;
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  - **200% Rule** – The exchanger can identify as many properties as they would like, so long as the aggregate value does not exceed 200% of the value of the relinquished property they are selling. *For example*: If the exchanger sells a property for $1M, they can identify properties with an aggregate value of $2M or less;
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  - **95% Rule (least common) –** The exchanger can identify as many properties as they like for as much value, as long as they acquire 95% of the value of the identified property. *For example*: the exchanger identifies 10 properties, each valued at $100K. If the exchanger only closes on 9 of them, the entire exchange fails.

Properly identifying DSTs in a 1031 exchange can be quite challenging. It is therefore imperative that an investor consult with their tax advisor to ascertain the precise manner in which identification should be made. Some tax advisors are comfortable with simply naming the DST and specifying the percent interest being purchased. Other advisors prefer to see each underlying property in the DST identified,

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along with the respective percentage for each property. Finally, other advisors want their clients to identify the fractional interest of the DST which can be purchased with "$X" of equity. Once again, it is extremely important that exchangers obtain guidance from their tax advisor with respect to identifying replacement property in this regard.

Each property held by the DST should be counted for the identification rules. This is critical in determining which of the above identification rules is utilized. Accordingly, if ABC DST only holds one CVS store in Nogales, Arizona, the exchanger can consider this as one property. However, if a DST holds four apartment complexes in four different cities, each property should be counted and they will need to use either the 200% or 95% rule.

To summarize, most Qualified Intermediaries will require the following information when identifying a DST:

- **Name of the DST**
- **Addresses of all underlying properties in DST**
    - If DST has multiple properties, you can attach a separate page that contains the list of addresses and submit with the ID Form.
- **Beneficial/Fractional % Interest in the DST**
- **Total $ Investment in DST**
    - This would be the amount of Exchange/Personal Funds **+** [if any] assumed debt in the DST.

Understanding how to identify DST property and keeping in mind total properties and values will ensure an exchanger does not run into issues near the end of the identification period. Be sure to consult with your tax and legal advisors to determine if you can take advantage of these valuable tax-deferral methods.

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