DELAWARE STATUTORY TRUSTS

KNOW MORE THAN YOUR ATTORNEY

IN 15 MINUTES

by Scott Royal Smith

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INTRODUCTION

The rich don't own assets. They control them.

The Delaware Statutory Trust (DST) is one of the legal tools the wealthy use for this purpose.

A DST is a structure for passive real estate ownership. "Passive" means that you (the investor) are removed from the day-in, day-out headaches of property management such as dealing with tenants, collecting rents, maintaining the property, etc. When you use a structure to protect your real estate investments, each asset will be held in its own legal space. You retain control of your investment properties and the entire structure as its beneficiary.

You technically aren't the "owner" of the properties; the DST assumes that rule.

Introducing the DST

The DST is a highly innovative legal structure that combines asset protection, estate planning, tax benefits and personal control. The trust is formed pursuant to the laws of the state of Delaware. Delaware residency is not necessary, however; all business decisions of the trust may be delegated to out of state co-trustees and managers.

DSTs also allow investors to pool together their 1031 exchange proceeds into the trust, making it an attractive investment option. DSTs are commonly organized and sold (appropriated) as securities that must be acquired via a securities agent, or broker. DST brokers ordinarily work with sponsors to help investors make an informed choice about whether or not DST property proprietorship interest is good for you.

Don't get confused. Properly set up by an experienced attorney, a DST is easy to form and maintain. Additionally, there are no annual fees or filing requirements—simply a one-time fee upon the filing of the certificate of trust.

We'll review all of these aspects of the DST (and more) in the sections below.

History

In 1988 Delaware adopted the Delaware Business Trust Act, which became the Delaware Statutory Trust Act (the "DST Act") in 2002. This legislation overruled the principles of common law trusts. The new rules authorized a high degree of **freedom of contract** between the trustor and the trustee in determining their respective liabilities and the manner in which a trust could be administered.

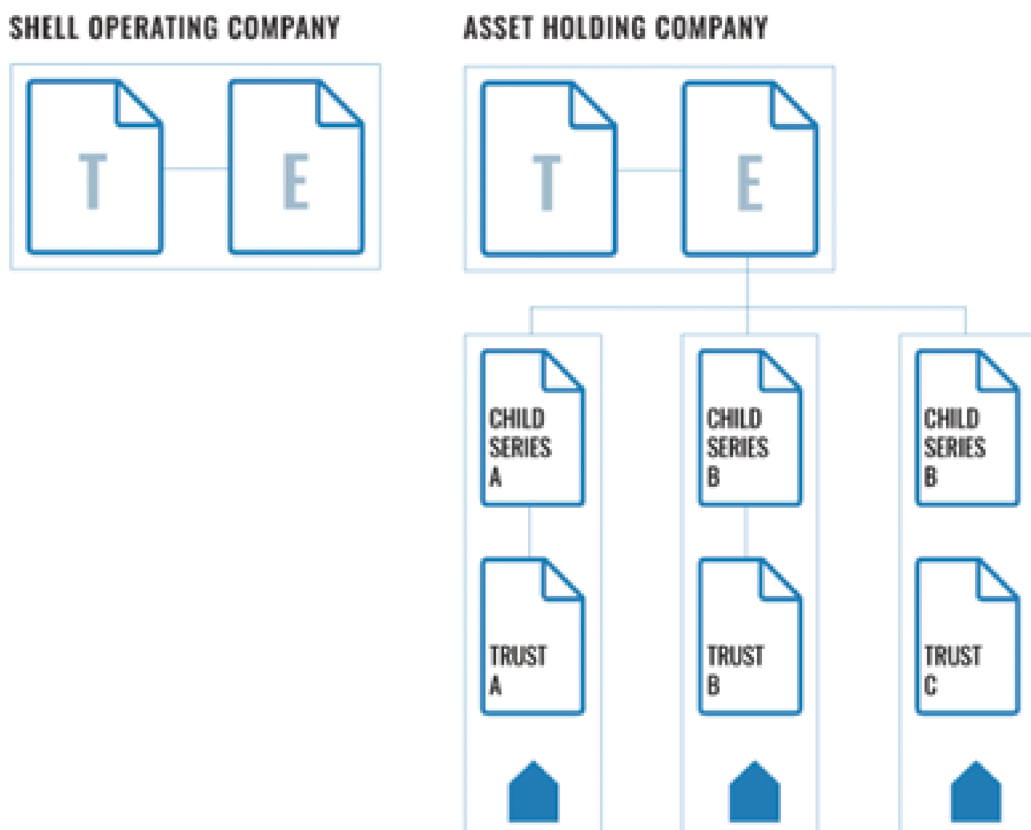
While other states have each enacted their own versions of the act, Delaware's has evolved over the years and remains the most advantageous for investors all over the country.

Structure

If you're familiar with the Series LLC, you may already be familiar with this mechanism behind the Delaware Statutory Trust and its benefits. The structure can be seen like a "parent" and "child."

In fact, the DST pioneered the "parent-child" LLC structure. The DST is the parent and each series beneath it is the child. Each series is treated as if it were its own entity, which provides you the same type of asset protection as individual LLCs holding each entity.

To put it another way: **The DST lets you efficiently compartmentalize each asset**. Take a look at the image below to better understand how the DST's structure works.



As you can see, each "child," or series, is a separate entity with a single corresponding asset. The DST itself plays the role of the mother and father, rolled into one. The DST can have as many "children" (series) as you want.

Despite the fact that the DST is its own legal entity with a single filing and tax return, each child/series receives the same protections as a traditional LLC. This includes, of course, liability protections.

This setup is ideal because it separates your assets from one another, meaning if one property ever is subject to a lawsuit, your others are shielded from legal action.

The DST is infinitely scalable at no additional costs, no matter how many assets you acquire. Incorporating new real estate investments into the structure is quick and easy. Creating a new series is simple and can be done in a matter of minutes.

Who Is It For?

First thing to know: **A DST can be used anywhere in the U.S. (not just in the state of Delaware)**. It is also an excellent product for Californian investors—or anyone doing business in California.

When we talk about who can benefit the most from DSTs, there are a few categories of people to keep in mind.

- Investors with multiple properties or rapidly scaling businesses.
- Investors seeking a high degree of security in their asset protection plan.
- High-earning or high net worth individuals

California Investors

If you're an investor in California, you know the state has famously brutal tax laws. An unprepared investor can stand to lose downright sinful amounts of profits to the state's Franchise Tax Board (FTB).

The reason the Delaware Statutory Trust is ideal for California residents is it avoids the $800 a year franchise tax that California charges LLCs. Since the structure is a Trust and not an LLC, it does not trigger the franchise tax.

If you own multiple LLCs to hold multiple properties, the yearly franchise tax adds up to an awful lot of money. Using the DST structure, you can own multiple properties in individual child series without the need for multiple LLCs. Therefore, not only does the DST save money, it allows you to efficiently compartmentalize and separate each asset into individual child series.

CA's Franchise Tax law can be vague. Several situations may trigger the $800 a year franchise tax.

You should opt for a DST over a parent Series LLC in the following two situations:

1. **You are a California resident looking to form a foreign LLC and own foreign property**. Example: You live in CA, but would like an LLC in another state and you want

to own property outside of CA. In this situation, even though the LLC would be "foreign," (out of state, in this case) you are a CA resident and due to the broadness of the law, the franchise tax could be triggered.

2. **You are a California resident looking to form a foreign LLC and own property in California**. What this means is you live in CA, would like an LLC in another state, but will own property in CA. In this situation, although a Land Trust (under the parent Series LLC) will technically own the property, it would be good practice for you to opt for a DST because the property is located in CA and the franchise tax may be triggered.

Non-California Investors

As mentioned, you don't have to live in California to use the Delaware Statutory Trust. But California's tax law isn't particularly kind to businesses, particularly those owned by out-of-state investors.

The dreaded Franchise Tax Board is the agency that defines what it means to be "doing business in California." Here is both the state law and the FTB's criteria, with plain English explanations alongside:

- You are " incorporated or organized in California." Was your business formed in the state? If yes, you're checking this box.
- You are "qualified or registered to do business in California." You'd know.

That's just the basic definition of "doing business." Even if you said no to both of the above, if you're a member of an LLC or partnership that's doing business in California, you still have to play by FTB rules. This is particularly true if:

- The LLC is in California and runs operations there.
- Sales in California meet or exceed 25% of all sales or $50,000—whichever is less. The same goes for real property owned by the LLC. If it's over one-fourth of all of the company's property or $50,000 in value, you're doing business in California.
- The amount paid in California by the LLC for compensation exceeds $50,000 or 25 percent of the total compensation the entity pays.

For these reasons, an out-of-state LLC can be "doing business" in California and subject to the $800 franchise tax. The DST presents an elegant way to not have to even think about this stuff.

Who Doesn't Need It?

What if you are outside of California, with no interests in that state?

There's an alternative that works for a broad range of investors. The anonymity, asset protection, and operational benefits offered by the Delaware Statutory Trust can be duplicated with other tools.

Delaware was the very first state to enact **Series LLC** legislation back in 1996. Since Delaware pioneered the Series LLC, other states have looked to Delaware's legislation when creating their own Series LLC options. The entity has stood the test of time, and today the Delaware Series LLC remains one of the strongest asset protection tools available to investors nationwide.

To be precise, the Series LLC combined with anonymous land trusts is a system that offers top-notch protection to investors in all other U.S. states. If you have multiple properties, investigate the Series LLC first. The Series LLC is a business model unique among sole proprietorships, partnerships, corporations, non-profits or any other LLCs. It uses that same parent-child structure that makes compartmentalization a snap with the DST. Anonymous land trusts can easily disguise company and property ownership—they go hand in hand with the Series LLC.

These tools together will offer the same powers, and perhaps additional benefits, to real estate investors or business owners in other states.

We point out the DST advantages primarily for California investors because it allows them to save money on taxes. If you're an investor with, say, 1-3 properties and you're looking for budget-conscious options, the Series LLC may be the solution you seek.

Even our clients in California ask us to help them establish Series LLCs until we convince them how much better the DST is for them. But a Delaware Series LLC confers the many benefits non-California investors need.

Note: A Delaware Series LLC is simply a Series LLC set up in Delaware. Delaware entities are always some of the strongest available, but they will operate like a typical Series LLC except with lower costs and more legislative support if anything goes wrong. See the "Delaware Series LLC" section for more information.

SECTION I: WHY YOU NEED IT

Let’s delve a little deeper into the major advantages to the Delaware Statutory Trust. These include:

- Guard against lawsuits
- Limit trustee power
- Get tax benefits
- Get bankruptcy protection
- Get contractual flexibility
- Simplify estate planning

Guard Against Lawsuits

Successful investors make attractive targets for litigious types, and frankly, the only meaningful defense from this threat is an **anonymous business structure**.

DSTs are a highly effective tool for lawsuit prevention because they give you anonymity.. An effective structure will stop lawsuits before they even start. A well-implemented DST will kill the suit before it’s even filed by sapping any financial motivation for somebody to sue you.

Think about it: Why does anyone ever file a lawsuit? You might think of things like indignant rage, pure spite, etc., but the only motivation that matters for attorneys is **money** (or assets that can be converted into money).

For a lawsuit to be profitable, an attorney must be able to both secure a judgment against you, then collect on that judgment. To collect, you need to have money or valuable assets lying around.

Let’s say an angry tenant tries to sue you for a problem related to your rental condo in series 1. Even if he/she is successful, only the condo is on the line. Your other assets in series 2, 3 and the holding company are safe—and so is anything you own personally.

A smart lawyer will do their homework to make sure you’re worth suing before getting started. In the internet age, it’s pretty easy to figure out who owns a piece of property. County clerk records are public, and they list the owners of a given property.

Using a DST to own your assets will show any attorney that you are not worth his/her time. The opposing attorney often gives up on clients who are employing asset protection strategies because investigating them is time-consuming.

Would you spend time researching a project at YOUR job that you weren’t sure you’re getting paid for? Hell no! Attorneys are even more hawkish than the average professional in this regard. We aren't going to waste money investigating you, let alone taking you to court, if it's going to cost us more than we could win. There are many, many more tasks that we can bill for and receive guaranteed payment.

Without representation, even the most vindictive plaintiff doesn't stand a snowball's chance in hell of winning the judgment.

Limit Trustee Power

With the DST you never lose control of your assets. The DST allows you to restrict the ability of the trustee to act. In fact, the DST can be constructed so that the trustee cannot act at all and instead all of their powers are conferred upon you as a "managing trustee". As such, you maintain complete control with the safety of knowing that somebody else cannot unexpectedly sell your property.

For more information, see the "How To Avoid Problems" section below.

Get Tax Benefits

A Delaware Statutory Trust comes with tax flexibility.

A properly structured DST is a haven for California investors (and out-of-state investors doing business in California) since it also avoids franchise taxes, which at the time of this writing are $800 per year per LLC.

Let's recap: Owners of companies such as LLCs or S-Corps are **operating entities**. They will pay $800 for each one. So if you have four properties in the Golden State, sticking them in four LLCs will protect your assets, but it'll cost you $3200 in franchise taxes alone annually to maintain this clunky, unnecessarily pricey operation.

The DST is viewed by the state, including California's Franchise Tax Board (FTB), as an estate planning tool rather than a traditional corporate entity. But the savings powers of the DST are at their greatest while you're still very much alive.

You may elect that it be taxed as an LLC, trust or as a pass-through entity (where the profits and losses of the business pass through to the trust's individual investors) depending upon the manner in which the DST is formed. The trust may qualify as a RIC (registered investment company), a FASIT (financial asset securitization investment trust), a REMIC (real estate mortgage investment conduit) or a REIT (real estate investment trust).

At the end of the day, for the California investor this means the DST isn't subject to the same $800 annual expense as out-of-state LLCs and other corporate structures.

Get Bankruptcy Protection

A "bankruptcy remote" company is a company within a corporate group whose bankruptcy has as little economic impact as possible on other entities within the group. As a bankruptcy remote entity, the DST protects individual beneficiaries from liens against the property, giving greater security against judgement. Individual investors are protected against creditors holding the DST's debts. The DST also prohibits an individual investor from placing liens on the property of a DST, giving protections to mortgage lenders and other beneficiaries

DSTs also are typically financed with non-recourse debt, which limits a lender's remedies to the DST's underlying property. The investor is not underwritten for the debt on the property owned by the DST. Therefore, the debt does not show on your credit report.

Get Contractual Flexibility

DSTs can designate many beneficiaries. The DST beneficiary is anyone receiving funds from the trust structure. Not only can you have more than one beneficiary, you can have dozens, even hundreds of them.

Theoretically, since you're a beneficiary, you can hide among them for extra anonymity around your asset protection measures. So can any partners, children, or people in life you wish to do business with or support using your DST's earnings.

The parties to the trust are able to dictate matters such as management and economic rights of owners, duties of managers, indemnification, mergers and other management and operational issues.

Beneficial owners of a DST enjoy the same liability protections as stockholders of Delaware corporations. We're talking **limited liability** here. Trustees and other managers are not personally liable to third parties for acts, omissions or obligations of the DST. The investor is shielded from personal liabilities beyond the amount of their investment, similar to an LLC or corporation.

Simplify Estate Planning

Estate planning is simplified with the DST. The DST can act just like a living trust. Since all of the assets are underneath one umbrella of control, it becomes exceptionally simple for your heirs to manage. The DST can simply distribute assets to the beneficiaries upon your death or divide ownership interest to your liking. The DST can take advantage of all available tax avoidance strategies, as discussed above.

Additional Benefits

There are even more good reasons to use the DST:

- Ability to “scale up” without additional charges
- Simplification of tax filings
- Access to loan and financing options
- Ability to maintain traditional book- and record-keeping practices
- The DST’s trustee makes all major decisions, minimizing disagreements between investors
- The DST acts as “single borrower,” owning the property and making the process of obtaining a mortgage much simpler
- DSTs are typically “pre-packaged” investments, meaning the asset is already owned and the mortgage put in place before the DST sponsor syndicates out the equity to investors. This makes it easy for investors to use 1031 Exchange funds to purchase one or more fractional DST investments.

SECTION II: HOW IT WORKS

How To Set Up

Cost

The cost of your DST will depend on who forms it, what if any special details your asset protection plan must account for, and whether services like property transfers are included or sold separately.

As a general rule, the DST has an upfront cost similar to or higher than a Series LLC, but remember: the benefits of the DST structure include some the Series LLC doesn't. For instance, we often recommend that Series LLC owners also make use of Anonymous Land Trusts. But for DST owners, land trusts would be a redundancy.

Which costs and possible uses will affect you most? Speak with an expert familiar with your circumstances to know for sure.

Documents

Filed Certificate of Trust: This document files your DST with the Delaware Secretary of State. You may need this document when you open a bank account.

EIN Letter: This document has your DST's EIN. You will need this number to open a bank account and to file your taxes.

Trust Agreement: This document forms the Trust and sets out the rules for how your trust operates. You will need to show portions of this document to the bank when you open a bank account.

Trust Staffing Agreement: This document establishes the trustee in compliance with Delaware law.

Banking

Your DST needs a bank account. Set up a checking account. You will need: Trust Agreement (redacted) and your EIN. You should only provide them with the portions of the trust that show the name of the trust, the grantor(s), the trustee(s), the signatures, and the trustee's powers. You can go ahead and omit any pages that don't have this information when you show your document to the bank.

Any bank with a National Charter should be able to set up your account, however, if your local bank is not familiar with DSTs, they may refuse to set up the account. If that happens, we recommend Solera National Bank. Your bank account with Solera will be a "Regular Business Account."

How To Manage Beneficiaries

Both you and your beneficiaries can easily benefit from the Delaware Statutory Trust. You stay in control, pick who gets what, and modify your plans at any time.

Adding a new beneficiary is easy when you've got a DST. Removing one is a separate process, but no harder.

DSTs offer both a high degree of control over and tremendous flexibility for handling beneficiaries. Thank the concept of **beneficial interest**. You can think of it as a way of issuing "shares" from your DST to reflect a person's interest in a property, or even the whole trust, is.

The concept is known as "beneficial interest in the trust." The beneficial interest in a land trust is considered personal property as opposed to real property, like the land itself. Beneficial interest allows individuals or entities to receive benefits associated with assets held by another party

You can even have them issued for minors. Parents often do to offset college or living expenses of the child beyond age 18, and you can sell/give fractions of a property to others under the same reasoning. The accuracy and control you'll have over how your beneficial interests are distributed is unique to the DST. It's a form of co-owning that doesn't put you at risk and is strictly, clearly defined. Whether Johnny gets 1/16th of a single DST property or the entire trust, you're the decider.

How To Keep Records

Record-keeping for the DST structure is simple, and you're most likely using a structure that works if you err on the side of traditional bookkeeping methods.

Proper record-keeping and vigilance on your part is essential for preventing the DST from being compromised. **In legalese, this is called "piercing the corporate veil."** When a court pierces the structure, it can fall apart. You don't want that, because it would allow the court to treat all of the series as one, stripping you of the benefits of compartmentalization.

The DST must abide by several legal requirements. These include a valid trust agreement, initial and current filing with Delaware, a Delaware Registered Agent, and keeping in line with laws and IRS regulations governing the structure.

Our firm takes care of the trust agreement and ensures your DST is complying with these requirements. But you have a part, too. Your job is to maintain accurate and responsible records.

You need to maintain books for each individual series. Remember, th**e power here is in the fact that you are treating them as separate companies**. This means separate bank accounts, as well as keeping everything separate in your bookkeeping software. Generally, this just means identifying any money flowing in or out as belonging to that particular series in your accounting software.

How To Resolve Disputes

What about dispute resolution? The Delaware Court of Chancery is generally regarded as the preeminent business court in the United States. It has jurisdiction over trust and fiduciary matters as long as the trust agreement contains certain required language, which your lawyer can help you with.

How to Avoid Problems

As we've seen, DSTs are excellent investment vehicles, but you must complete due diligence and choose the right kind of DST for better and secure returns.

The IRS has specified **seven deadly sins that limit the DST trustee's power**. These seven deadly sins are in place to allow DSTs to qualify as suitable investments for the purpose of a tax-deferred 1031 exchange. DSTs have benefits for investors, but can create challenges for trustees.

Remember: if a DST is in danger of losing a property because the "seven deadly sins" prohibit the trustee from taking necessary actions, the state of Delaware permits the DST to convert to an LLC, assuming a provision was listed in the origination documents.

#1 No Future Equity Contribution Is Permitted

When you acquire beneficial interests in a DST, you get a percentage of ownership. If a trustee decides to accept additional contributions to the DST after the offering is closed, the original investors' ownership percentages will be diluted, decreasing their claim to the DST's assets.

That's why the DST trustee is restricted from borrowing new funds or renegotiating the terms of the existing loans. Trustees are not allowed to assume greater obligations because it can hurt the beneficiaries' interests.

#2 The DST Trustee May Not Borrow New Funds Or Renegotiate Existing Loans

Trustees are not permitted to assume greater obligations because it can lead to a significant impact on the beneficiaries' interests. Remember, DST beneficiaries do not have the right to vote on operating decisions, and loans are liabilities.

When you invest in a DST, the sponsor will disclose the loan amounts due. Do your due diligence and understand how the liabilities impact the returns before finalizing the investment.

#3 Trustees Can't Reinvest Proceeds From The Sale Of DST Investments

All proceeds earned by the DST must be distributed to the beneficiaries—not reinvested. Beneficiaries have the right to determine how to use the capital earned from their DST investment. When the assets of a DST are sold, the DST sponsor may create a new DST offering, giving beneficiaries the option to reinvest with the sponsor, but the investor can cash out or reinvest elsewhere.

#4 Capital Expenditures Are Limited

Trustees may spend money to maintain the real estate property and its value, but they can't risk the beneficiaries' investment to enhance the property when there is no guarantee that the cost of the upgrade will be recovered at the time of sale.

To put it another way: Trustees may reasonably maintain the real estate property and its value, but capital expenditures are limited to standard repair and maintenance, minor non-structural capital improvements and any expenses required by law.

#5 Cash Must Be Invested In Short-Term Debt Obligations

Liquid cash retained in the DST between distribution dates must be invested in short-term debt obligations. An investment in a short-term debt obligation can easily be converted back into cash that can be distributed to beneficiaries. As such, it is considered a cash equivalent. This allows the trustee to increase the value of the DST on behalf of the investors without risking the DST's value.

#6 Cash Should Be Allocated To The Beneficiaries On A Current Basis

DSTs can keep cash reserves on hand. This is to help with unexpected expenses, property management, and repairs. However, earnings and proceeds must be distributed to the beneficiaries within the expected timeframe.

This protects the beneficiaries' rights to receive their income in a timely manner and prevents trustee fraud.

#7 The DST Trustee May Not Renegotiate Leases

DSTs operate well with long-term leases to creditworthy tenants on a "triple-net" basis (meaning tenants are responsible for paying property taxes, building insurance, and some maintenance expenses, on top of rent and utilities).

A master-lease structure to hold multifamily, student and senior housing, hospitality, and self-storage facilities are also great for DSTs. These leases provide a more secure investment than year-by-year multi-tenant contracts.

Because the IRS prohibits a trustee from renegotiating existing leases or starting new leases, beneficiaries can be assured that trustees will not make risky leasing decisions. Exceptions are allowed in the case of a tenant bankruptcy or insolvency.

SECTION III: THE BIGGER PICTURE

1031 Exchanges

The Delaware Statutory Trust is a bona fide legal workhorse. For the right investors and circumstances, it's an excellent tool that preserves passive investment income, prevents lawsuits, and has special tax benefits. It can pull double duty for asset protection and estate planning, but that's hardly all.

The DST can bring even greater rewards to DST 1031 exchange real estate investors. All investors (regardless of where they live) can exploit the DST for its 1031 Exchange compatibility, flexible asset protection and estate planning benefits. The DST 1031 Exchange also gives you a high degree of control over the structure's protected assets.

Capital gains taxes also are deferred with the DST performing 1031 deals. As long as your **like-kind property** stays safely within the structure, you don't owe a dime.

In 2004, the IRS (via Revenue Ruling 2004-86) specified how to structure a DST to qualify as replacement property for 1031 Exchanges. Investors have spent millions since then on 1031 exchange property acquisitions.

While some investors see DSTs and 1031 Exchanges as a "one or the other" proposition, others find value in pairing the structures, particularly where long-term investing or capital gains deferment are primary goals.

What Is A DST 1031?

Section 1031 is a provision in the Internal Revenue Code (IRC) that allows property owners to defer federal taxes on certain real estate exchanges (known as 1031 exchanges, like-kind exchanges, or Starker exchanges).

The provision is used by investors to sell one property and reinvest the proceeds in one or more other properties. It is not available to buyers or sellers of personal homes for their own use.

DSTs are a separate legal entity qualifying under Section 1031 as a **tax-deferred exchange**. DSTs are considered a preferred investment vehicle for passive 1031 Exchange investors.

Most DST investments are assets that your average real estate investors could not otherwise afford. However, by pooling their assets, DST investors may benefit from a professionally managed, institutional-quality property.

The real estate sponsor acquires a property under the DST umbrella and opens up the trust for investors to purchase a beneficial interest. These investors can deposit their 1031 Exchange proceeds into the DST or purchase an interest in the DST directly.

What Are 1031 Exchange Properties?

As mentioned, DST offerings might include high-value commercial real estate that the private investor isn't typically able to afford. The property could be a 500-unit apartment building, a 200,000 square-foot office property, or a shopping center. Other types of DST 1031 exchange properties include self-storage buildings or medical facilities. These properties typically have long-term lease contracts with the tenants.

Most DSTs are set up by real estate syndicators or private investment corporations. Even though the beneficiary of a DST Trust has no management responsibilities, some due diligence on the tenants and the particular property is required. The trustee and the management company selected are also important.

Financing A DST Property

The financing used on DST 1031 properties is typically non-recourse to the investor, meaning the lender's only remedy in the case of a default is the subject property itself. The lender is not able to pursue the investor's other assets beyond the subject property. So, in the case of a major tenant bankruptcy, marketwide recession or depression, you (the investor) could lose your entire principal investment amount, but your other assets would be protected from the lender.

Internal Revenue Code Section 1031 defines an investor's exchange requirements of taking on "equal or greater debt." However, in order to mitigate the risk of using financing when purchasing properties, some DST 1031 properties are offered all-cash, without financing. You can find 1031 exchange DST portfolios with minimum investment requirements in your price range.

Can You 1031 Out Of A DST?

Yes, you can 1031 exchange out of a DST. Two scenarios for this to occur would include:

Scenario One: When the DST property itself goes "full cycle" (meaning the property is sold on behalf of investors), you can exchange out. Once the DST sponsor has sold the asset (per the DST business plan), you and any other individual investor will enjoy the same options you had when you first exchanged into the DST.

This means you can exchange into any other type of like property, which you would then own and manage. At this point you could exchange into more DSTs or simply pay taxes.

Scenario Two: When an individual investor wants to sell out of their DST position before the DST property itself goes full cycle, things are a bit more tricky. DSTs are considered illiquid investments; There is no public market where an investor can sell their ownership interests in a DST. That's why you should only purchase a DST via a 1031 exchange if you can hold the investment for 5-10 years or more. There may be secondary markets available if you want to sell early, but all the same rules apply as though you were selling a traditional investment property.

Like Kind Properties

As we've seen, a DST is an entity used to hold title to investment real estate. A Limited Liability Company (LLC) can also hold title to real estate; however, a DST 1031 Property will qualify as "like kind" exchange replacement property for a 1031 exchange.

"Like-kind property" generally means both the original and replacement properties must be of "the same nature or character, even if they differ in grade or quality." In terms of real estate investing, you can exchange almost any type of property, as long as it's not personal property.

Taxation of DST Properties

The term "1031 Exchange" is defined under section 1031 of the IRS Code. To put it simply, this strategy allows an investor to defer paying capital gains taxes on an investment property when it is sold, as long as another "like-kind property" is purchased with the profit gained by the sale of the first property.

In 2004, the IRS specified how to structure a DST to qualify as replacement property for 1031 Exchanges. This allowed the DST to own 100 percent of the fee simple interest in the underlying real estate, with up to 100 investors to participate as beneficial owners of the property.

If you sell a property to invest in a DST, you can defer the capital gains tax through a 1031 exchange. You have 45 days to identify replacement property or else you are going to be slapped with the capital gains tax and/or the Depreciation Recapture Tax, along with state taxes and sometimes a NIIT (Medicare surtax).

If you're an accredited investor, you can defer taxes by investing your money into another property within a specific timeframe. This property replacement is called a 1031 exchange.

Note: The Security and Exchange Commission (SEC) defines an accredited investor as an individual with a net worth of at least $1 million (excluding the equity in your home) or net income the last two years of $200,000 ($300,000 if joint income with spouse) and with a reasonable expectation of equal or greater earnings in the current calendar year.

Thanks to IRC section 1031, investors can postpone paying taxes by reinvesting proceeds in similar property as part of a qualifying like-kind exchange.

When you purchase an interest in a DST 1031 exchange property, you will get a year-end operating statement that shows their pro-rata portion of the property's rental income and expenses. Your CPA will enter the numbers into Schedule E of your tax return, along with any other rental and commercial investments you own.

Depreciation Deductions

Your basis in property is a specific value assigned to property at various points in time. It's used in determining your periodic depreciation deduction for the property, and in computing gain or loss when the property is disposed of.

With a 1031 exchange, if you fully depreciated the property you sold, the basis from the property you recently sold will carry forward into the new DST property you purchase. If you still have basis in the property you sold, or if you purchased a greater value in the DST properties than you had in the property you sold, you can take advantage of depreciation deductions to shelter the income from the DST properties.

State Tax Treatment

When owning DST properties out of state, you will need to file state income tax returns in that state unless the property is in a state with no income tax filing requirements (such as Texas or Florida).

Future 1031 Exchanges

When a DST investment property eventually sells, you are free to purchase any other type of like kind real estate. "Like-kind property" generally means both the original and replacement properties must be of "the same nature or character, even if they differ in grade or quality." In terms of real estate investing, you can exchange almost any type of property, as long as it's not personal property. Many investors end up 1031 exchanging back into more DST properties when it is time to reinvest.

Purchasing Equal Or Greater Value

Many investors that are at or near retirement have already paid off their properties in full. Taking on more debt is not wise, especially considering the 1031 exchange rules. One of the 1031 exchange rules requires investors to purchase property of equal or greater value. That's why investors who have paid off their properties in full should invest in DST properties that are all-cash/debt-free if they are able to do so—not using leverage/loans reduces the risk of loss.

DST 1031 Limitations

Pairing the DST with a 1031 isn't without limits, which we'll spell out in greater detail now.

You Need To Hold The Property

The average 1031 property is held for upwards of five years as a capital gains tax deferment strategy. For this reason these real estate assets aren't easily liquidated in a financial emergency. Shorter-term investors may want to consider alternative strategies.

You Have Limited Control

Investors who are accustomed to the total control of say, a self-directed retirement account or even more traditionally controlled/owned property, may be uncomfortable with the DST with 1031 model. Here's why: When Uncle Sam okayed DSTs for participation in 1031 Exchange transactions, they placed direct regulatory limits on beneficial owners of the DSTs. That means you. Internal Revenue Code says you aren't allowed to have "direct operational control" or even simple decision-making authority over the properties involved. The object of the law is to keep you from getting your own hands too close to the investment. Many investors feel suffocated by this restriction, but you should know there are ways to maintain control (with the help of your attorney).

New Property Doesn't Mean New Money

All those funds that similar new property will raise come with a huge catch: you can't pour any capital back into the DST itself. Even new investors into the property or DST are barred from benefiting financially while the 1031 is in effect. Again, this is a problem your competent legal and tax pros should be able to help you address.

Anonymous Trusts

Investors who follow the recommendations about using DSTs effectively can survive a lawsuit against one asset.

Of course, the best thing of all is when we can implement the right structures to stay out of court altogether.

Investors seeking additional defenses may employ the power of the **Anonymous Land Trust**.

Anonymity strengthens the protections of the DST, making it difficult to even connect you to your property. The anonymous trust structure enables you to hide company ownership by listing your company as a member in your LLC's Articles of Incorporation.

If you want a totally comprehensive asset protection plan, consider pairing the DST with an anonymous trust. When you use this powerful combination, the DST helps you achieve total legal separation of your assets, while the anonymous trust helps protect your anonymity.

Anonymous trusts will ultimately hold the assets. They also disguise the ownership of the asset in the first place.

Remember: it's pretty easy to figure out who owns a piece of property. County Clerk records clearly show the name of the owner of the property. But if you use the DST/Anonymous Trust strategy, the trust's name will be listed instead.

You can name that trust whatever you want. So when anyone, including a potential opposing attorney, goes to research the property, they'll see it is owned by "The XYZ Can't Find Me Trust" rather than a person. Your name is kept out of the whole affair. And to file a lawsuit, the litigant needs a name.

Trusts, including the example "XYZ Can't Find Me Trust" are made up of several parts. This is the DST Structure:

Parent = Delaware Statutory Trust

- Grantor (the client)
- Trustee (the client)
- Beneficiary (the client, or the client's Living Trust)

Child = Individual Child Series of a Delaware Statutory Trust

- Grantor (the same Grantor as the Parent = the client)
- Managing Trustee (the client)
- Beneficiary (the same Beneficiary as the Parent)

Land Trust = Living Trust that holds title to the real estate

- Grantor (the Child)
- Trustee (a nominee trustee to start, then the client)
- Beneficiary (the Child)

Ordinarily, the trustee and the beneficiary cannot be the same person. The use of the structure outlined above keeps you, the individual with a name, from being both.

The legal structures you control stand in for you. So your interests are represented regardless. Even if the trust itself is scrutinized in court, the worst-case scenario is that the trust is "merged." When this happens, your assets just return to the original DST.

Estate Planning

If you love the idea of your business outliving you, you can make it happen with the DST. While other tools and trusts can help estate planning for real estate investors, the DST comes with everything you need for a business that can outlive you. And not only that, you get to stage-direct exactly how the whole affair goes down.

Your attorney can explain the full estate planning potentials for your particular situation. But most investors love the DST's ability to become a legacy business that doesn't rely on any one person. Your real estate empire could exist in its own right, simply passing through the hands of different "managers" as generations click by.

If you proceed with buying new entities or assets, these should always be included in your estate plan. Real estate investors can use tools to account for everything, but with good asset protection, you'll want to plan ahead for business succession or liquidation.

DST vs. Delaware Series LLC

As mentioned, a Delaware Series LLC is simply a Series LLC set up in Delaware. Delaware entities are always some of the strongest available, but they will operate like a typical Series LLC except with lower costs, and more legislative support.

All Series LLCs offer a unique way to limit liability, protect the equity of your assets, separation of assets, flexibility with tax treatment, and a mechanism for concealing your assets from prying eyes. There are, however, certain benefits that are specific to the Delaware Series LLC. Some of these benefits include:

Low-cost single filing fee. Filing a Series LLC in Delaware costs only $300 (as of this writing). This fee does not change based on the number of series within the entity.

Lower tax costs. The Delaware Series LLC must pay a franchise tax annually. However, at only $300, this is a relatively inexpensive in-state tax. While states like Texas may have no in-state tax at all, states like California would require $800 per series. The Delaware Series LLC will pay the same $300 regardless of the number of series, just like its filing fee.

Judicial benefits. Delaware uses a Chancery Court. The Chancery Court's judges are experts in business law. The Court has a reputation for providing fair rulings in keeping with the state's pro-business reputation.

Clear legislation. State law in Delaware specifies the Delaware LLC's asset protection benefits—including the insulation of assets and liabilities within and between series. Similarly, Delaware law has clarified that series may sue or be sued, enter into contracts, and hold title to real estate assets without exposing the entire structure.

FAQS

Why Don't DSTs Have To Pay California's Franchise Tax?

California's tax law can become a profit-syphon for real estate investors. While investors in most states can take advantage of LLCs and Series LLCs as primary asset protection tools, Californians are better suited for the DST largely because of the state's franchise tax. LLCs, Corporations, and other types of companies must pay $800 per entity in annual franchise taxes.

DSTs are more correctly classified as estate planning tools, and therefore need not meet the same requirements as traditional companies. But the savvy investor can still use this tool in a manner similar to the Series LLC for highly effective asset protection, all while dodging the tax obligations of the Series LLC. Perfectly legally, of course!

Can Investors Outside California Get A DST?

The DST may be a great choice for you if you are doing business in California—even if you don't live there.

But if you're outside of the state with no interests there, there's an alternative that works for a broad range of investors. The anonymity, asset protection, and operational benefits offered by the DST can be duplicated with other tools. To be precise, the Series LLC combined with Anonymous Land Trusts is a system that offers top-notch protection to investors in all other U.S. states. If you have multiple properties, investigate the Series LLC first. It uses that same parent-child structure that makes compartmentalization a snap with the DST. Anonymous Land Trusts can easily disguise company and property ownership; they go hand in hand with the Series LLC. These tools together will offer the same powers, and perhaps additional benefits, to real estate investors or business owners in other states.

Remember: the only person who should be calling the shots on asset protection structures is the legal expert of your choosing.

How Many Assets Can The DST Protect?

This is where things get fun. The answer is simple: **however many assets you have**.

And each of those assets is compartmentalized for optimal protection. That means if a would-be-litigant tries to come for your trust-owned property, they'll have an extra difficult time. Because the DST is such an excellent anonymity tool when set up appropriately by an experienced asset protection attorney, even connecting you to the property in question becomes a chore.

In practice, many asset protection tools are effective because they throw up roadblocks to stall out the lawsuit process. In our experience, a properly established DST stops lawsuits before they're even filed.

How do I get paid?

You can take an Owner's Draw or a Salary from the traditional LLC's bank account before you transfer the additional profit up to your DST account. This will be tagged in your traditional LLC's bookkeeping software as a "personal disbursement."

What rate of return can I expect?

The typical range you can expect to see on Delaware Statutory Trust investments will usually be a fixed percentage based on the expectations on projections of the DST portfolio of properties. The rate of return is anywhere from 5-9 percent on your cash-on-cash monthly distributions.

One factor to consider is DST appreciation rate of return, which is impacted by supply and demand and is often the most overlooked yield on your investment. A 1031 DST is typically held for 10 years or more, during which time you should see an appreciation—unless there's been an economic downturn—in the double digits.

What about rental income for my properties?

If you have a traditional LLC acting as your forward facing entity, all rent checks or rental income received should be payable to your traditional LLC and deposited in that account. Your Tenants can pay you directly this way, or your Third Party Property Manager can pay you the rental income after they receive it.

If you do not have a traditional LLC acting as your forward facing entity, the tenants should pay your third-party property manager, and then your property manager will write the check to your DST. Remember, any time you give out the name of your DST you are compromising your anonymity.

If you don't have a traditional LLC or a property manager, you need to get one in place to protect your anonymity. If your tenants are paying your DST directly, your DST name is not anonymous. If your tenants are paying you personally, you are at risk of commingling your personal funds with your LLC funds, which can compromise you in the event of a lawsuit.

How does the money come from the LLC to the DST?

If you have a traditional LLC as your property manager, you can collect all rents and pay all expenses out of that account. Just be sure to tag each line item with the property address in your bookkeeping software (we like Quickbooks, but any similar bookkeeping software will work). Your profits will then get transferred from your LLC's bank account to your DST's bank account so that your LLC remains an empty shell.

If I place my homestead in the DST, will I lose my homestead exemption?

You will not lose any tax exemptions.

Are all assets in a DST vulnerable/liable if found?

That is correct typically, but the nature of the DST is that assets are separated out into individual cells. By using the child series for the DST, each asset is housed into its own cell and liability is capped at what is in the individual cell (one property per cell).

When I transfer title to a trust or DST, does it trigger a reassessment for property taxes?

No, it will be a transfer to a trust that is exempt from transfer taxes and since you are still the ultimate beneficiary of the property there is no 'real' change of ownership that would trigger a reassessment.

Can I use the DST to purchase real estate in all 50 states?

Yes, due to the full faith and credit clause (the clause in Article IV of the U.S. Constitution that requires states to give full faith and credit to the public acts, records and judicial proceedings of the other states), the DST can be utilized nationwide.