
1031 EXCHANGES AND DELAWARE STATUTORY TRUSTS

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REAL ESTATE, GENERALLY

Real estate has long been one of the most popular forms of investment. Specifically, real estate investment is a common means of diversifying an investment portfolio outside of the stock market, it provides an asset which can appreciate instead of losing value to inflation year over year, and it offers many tax benefits.^[1] There are also various options in the methods of investment and the types of real estate in which to invest. Methods range from more traditional direct ownership to the more complex such as investment through a Delaware Statutory Trust.

Our attorneys at Wiggin and Dana have extensive experience in all legal aspects of the acquisition, financing, and leasing of all manner of real estate. There are important considerations, costs, and benefits to each major type of real estate investment—residential, commercial, industrial, and land. Commercial office spaces, for example, are not nearly as attractive as they once were in the pre-COVID era. Residential and commercial real estate ownership can also require more “hands on” day to day management, whereas industrial and land investment offer more passive management options through longer term leases and ground leases,^[2] thus making them an appealing option for newer investors and smaller scale operations such as family offices.

A drawback of all real estate investment generally is that it is an illiquid asset often requiring a significant initial cash outlay. Family offices, however, are uniquely positioned to take advantage of this, particularly in a distressed real estate market. A family office, unlike many other individual and commercial investors, may be able to make appealing cash offers, while other competing purchasers struggle with high interest loans, loan contingencies, etc.

1031 EXCHANGES

Experienced family offices also may choose more complex forms of investment, such as 1031 exchanges, or “like-kind” exchanges (a “1031 Exchange”). A 1031 Exchange is a real estate transaction in which a taxpayer sells real estate held *for investment or for use in a trade or business* and uses the funds to acquire replacement property. A 1031 Exchange is governed by Internal Revenue Code Section 1031 as well as various IRS Regulations and Rulings (collectively, the “Regulations”).^[3] Through a 1031 Exchange, the taxpayer may delay capital gains tax on a real estate investment property upon that property being sold, as long as the taxpayer uses the proceeds from the sale for the purchase of another “like-kind” property.^[4] While the tax benefits

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- 1 [Eight Reasons You Should Consider Real Estate Investing](#) | forbes.com
- 2 [How to Approach an Investment in Industrial Property](#) | JLL
- 3 [Exchanges Under Code Section 1031](#) | American Bar Association
- 4 [1031 Exchange: Rules And Basics To Know](#) | Forbes Advisor

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are significant, there are specific legal regulations and very strict timelines involved in a successful 1031 Exchange. At the most basic level, a 1031 Exchange requires that a taxpayer enter into an exchange agreement with a 'qualified intermediary' and the buyer. This must be entered into before closing of the sale of the property that the taxpayer is seeking to sell (the "Relinquished Property"). The qualified intermediary then holds the taxpayer's net realized proceeds until purchase of the new property (the "Replacement Property") and the taxpayer is prohibited from pledging, borrowing or otherwise receiving the benefits of the funds.

The taxpayer's contract rights are assigned to the qualified intermediary, a requirement of the Regulations which allows the Relinquished Property to be conveyed directly to the Buyer. The taxpayer will enter into a contract with the qualified intermediary to hold the funds between transactions in addition to the exchange agreement. When the Relinquished Property is sold, the funds are transferred to the qualified intermediary which holds the funds and transfers to the escrow for purchase of the Replacement Property.

The taxpayer must identify the Replacement Property within 45 days following the sale of the Relinquished Property. Additionally, the taxpayer must close on the acquisition of the Replacement Property within 180 days following the closing on the sale of the Relinquished Property or before the taxpayer's next tax return is due, whichever is earlier.

The exchange funds can be used *only* to buy Replacement Property, pay closing costs or pay off a mortgage or deed of trust covering the Relinquished Property.^[5] Wiggin and Dana is well positioned to assist your family office navigate the intricacies of this more advanced real estate investment strategy.

DELAWARE STATUTORY TRUSTS (DSTs)

Another related vehicle for real estate investment is through a DST. A DST is a legal entity formed under Delaware law in which multiple investors can hold an undivided fractional interest in the trust holdings.^[6] In summary, a DST is a trust which owns a large, institutional quality property. There are many benefits to investing in real estate through a DST. Because most DSTs hold multiple assets in one trust, they provide a simple means for real estate investors to further diversify their portfolios rather than tying up significant amounts of wealth into one asset. The diversification relates to geographic areas, asset classes and various types of commercial grade tenants. Compared to other forms of real estate investment, such as direct ownership of multi-family building for which the owner must manage tenants and building maintenance, DSTs are a much more passive investment option. This makes DSTs a particularly attractive investment strategy for individual and family office investors who may be looking for an opening into the real estate market that does not require the same level of location specific market knowledge and management.

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⁵ We note that the payment of existing mortgages or deeds of trust encumbering the Relinquished Property may be deemed as realized gain unless properly offset.

⁶ [Top 10 Reasons Real Estate Investors Are Jumping into DSTs](#) | Kiplinger

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This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.

Further, DSTs qualify as “like-kind” property for 1031 exchange purposes.⁷ This is particularly useful for those looking to wind down their day to day involvement in their real estate investments, as one can effectively “trade in” traditional real estate for passive investment in a DST, delaying the capital gains tax in the process. Because there are time constraints on closing on a replacement property after the sale of the original property within the 1031 exchange, DSTs also supply a safe back up option in the event the investor has not yet identified a suitable replacement property.

While DSTs can serve as an important investment vehicle, we note that there are disadvantages with respect to DSTs as well. For example, some investors who have historically managed properties and desire greater input on day to day management activities may see the lack of control or decision making as a drawback. In the DST context, these types of decisions are usually done by the trustee of the DST. DST investments may include high fees as compared to direct ownership. Typically, these fees include selling commissions and management costs

such as acquisition and disposition of property. Further, DSTs are illiquid assets that are typically held for prolonged periods of time, often between 5 to 10 years. As with any investment, it is important to consider one’s long term goals, risk tolerance, and experience when investing in real estate. Neither an investment in the form of a traditional 1031 Exchange or a DST is a guarantee for cashflow or appreciation.

Whether your family office is looking to gain a foot hold in the real estate market or expand, our attorneys at Wiggin and Dana are here to assist. We offer substantial experience with all legal aspects of real estate investment, including forming ownership entities, assisting with acquisitions, conducting due diligence searches, financing, and navigating more advanced investment strategies such as the 1031 exchange and investment through Delaware Statutory Trusts. For additional guidance on this and other real estate matters, please reach out to our real estate team to develop a legal strategy for your family office’s near and long term goals for its real estate investments.

⁷ [Top 10 Reasons Real Estate Investors Are Jumping into DSTs](#) | Kiplinger