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## Delaware Statutory Trusts: An Innovative 1031 Exchange Solution

By Robert Smith

For years, real estate investors have successfully used section 1031 of the IRS Code to exchange their property for bigger and better “like kind” property and defer payment of capital gains tax on their sale. Traditionally, investors have used the “three property rule” for identification and exchange purposes.

However, now there is another solution which provides investment property owners with even greater flexibility from a property identification standpoint and much more potential diversification. This comes in the form of the Delaware Statutory Trust or DST.

A Delaware Statutory Trust is simply a separate legal entity created under the laws of Delaware to hold title to one or more income producing commercial properties. This can be any type of commercial property; apartments, retail space, office buildings, industrial parks, etc. And much like a REIT (Real Estate Investment Trust), an individual DST may hold title to multiple properties at one time.

Each investor owns a “beneficial interest” in the trust which, in turn, owns the underlying real estate. This interest entitles said investor to his or her pro-rata share of any income and appreciation in these assets.

Furthermore, this income stream is truly passive. All properties are managed by the DST sponsor. The investor is no longer responsible for the “Terrible Ts,” tenants, trash and toilets. By exchanging into one or more DSTs, they are now in the “mailbox money business.” Cash distributions from property operations inside the trust are made monthly to investors if and when funds are available based on the performance of the properties.

This income stream is also very tax advantaged. Just like rental income from your plex or apartment property, it is sheltered by depreciation and interest expense.

In summary, the DST offers many benefits to income property owners and exchangers. These include, but are not limited to:

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## Delaware Statutory Trusts *Continued from other side*

- **Low minimum investment:** DSTs typically have a minimum investment of \$100,000 for 1031 exchangers and \$25,000 for cash investors.
- **Remote management:** The DST structure takes management responsibility for the property(s) out of the hands of investors and places it into the hands of a sponsor-affiliated trustee.
- **Cash distribution potential:** Any rental income generated from the DST properties is distributed on a monthly basis directly to your bank account if/when funds are available. No more chasing down dead beat tenants in the dark of night. As rental income, this cash flow is also very tax advantaged. Just like your current rental income stream, much of it is tax sheltered via depreciation and interest expense.
- **Diversification:** Instead of having all your money tied up in one property exposing you to the risk incumbent in overconcentration, DSTs allow you to diversify both geographically and functionally. Like a REIT (Real Estate Investment Trust), DSTs can own multiple properties in different geographic areas with different functions. Ownership of apartment buildings can be mixed with retail centers, office buildings, industrial warehousing, etc. In this way, a downturn in one sector of the economy can be offset by an uptick in another.
- **Low cost of ownership:** Unlike a tenant-in-common (TIC) program, DST investors are not required to maintain any type

of special purpose LLC (limited liability company) to hold their real estate.

- **Non-recourse loans:** DST investors are not required to execute any loan guarantees or indemnities, given their purely passive relationship to the DST and its real estate. Therefore, if there is debt on the property(s), investor risk is limited to invested equity. Lenders have no recourse to investors' other assets.
- **Liability protection:** The DST "wrapper" shields the exchanger/investor from any liabilities with respect to the property. Ambulance chasing lawyers and their "slip and fall" clients will have to tap someone else.

These benefits say nothing of the leisure time exchanging into Delaware Statutory Trust properties may provide you. Property management is a full time job. This unending round of responsibility precludes enjoyment of many other activities. It's hard to travel and see the world, visit your grandkids, or just plain relax, when you are tied to your telephone, tenants and properties.

In our past, present and future zero interest rate environment, investing in a multi-property DST portfolio may also be a good strategy for cash investors without a property to exchange. Unlike other passive, fixed-income investments, real estate still has the potential to provide a livable yield. As rental income, this cash flow is also very tax advantaged. Finally, it positions the investor to avoid capital gains tax upon a profitable sale of their

real estate through a 1031 exchange.

Exchanging into a DST portfolio which holds multiple income producing properties may make great sense for real estate owners who no longer want to shoulder the burden of active management. *You're not going to live forever, so you might as well start enjoying it now. Let someone else change the light bulbs and collect the rent.*



**Robert S. Smith**  
President/CEO  
Peregrine Private Capital



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Private Capital Corporation

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22210 NE Sunnycrest Road  
Newberg, Oregon 97132  
P 503.241.4949 | TF 866.762.4520  
F 503.469.4578  
RS@PeregrinePrivateCapital.com  
www.PeregrinePrivateCapital.com

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There is no guarantee that any strategy will be successful or achieve investment objectives. Potential for property value loss - All real estate investments have the potential to lose value during the life of the investments. Change of tax status - The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities. Potential for foreclosure - All financed real estate investments have potential for foreclosure. Illiquidity - Because 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments. Reduction or Elimination of Monthly Cash Flow Distributions - Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions. Impact of fees/expenses - Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits