Legal1031 Exchange Services, LLC
a Kensington Vanguard Company

1031 EXCHANGE INSIGHTS:
WHAT IS A DELAWARE STATUTORY TRUST (DST)? PROS & CONS

A Delaware Statutory Trust (DST) is a legal entity formed under the laws of Delaware providing the ability to acquire fractional ownership interests in investment real estate. It is an investment trust that functions similar to a partnership or other pass-through entity. A DST is legally recognized as separate from its owners, but for tax purposes it does not report income at the trust level. This structure allows for co-investment and can qualify as real property that is “like-kind” to traditional real estate interests for purposes of an IRC Section 1031 exchange, thereby providing an opportunity for investors to exchange and to defer capital gains upon its purchase or sale. Simply put, DSTs are professionally managed, passive investments that are marketed as replacement property options for investors in a 1031 exchange. The DST programs include offerings in diverse property types including multi-family apartment complexes, multi-tenant retail and office space, drugstores, industrial buildings, self-storage facilities, medical/health offices, and other comparable types of commercial real property.

This article seeks to highlight various pros and cons of DST programs, in general and not specific to a particular offering, to facilitate a productive conversation between you and your tax advisor in deciding whether a DST is the right choice as your 1031 replacement property.

ADVANTAGES AND DISADVANTAGES TO DSTs

Benefits / Advantages

Ability to Identify and Close

- DST offerings are subject to market availability, however, available offerings provide 1031 exchangers with the ability to quickly identify and close with a high level of certainty that facilitates the completion of an exchange within the 1031 timelines. Furthermore, given the availability and ease of investment, the DST offerings can provide exchangers with fall back options on their identification statements to mitigate the risk of a failed exchange.

No Active Management / Passive Income Stream

- As a passive-income investment vehicle, DSTs are professionally managed, permitting investors to benefit from a monthly income stream without the hassles and stresses of property or business management.

Diversification of Investment

- Since DSTs allow for co-investment, they provide investors with the opportunity to diversify their larger investments into multiple smaller properties. DSTs generally have low entry points where the minimum investment may be as low as $50,000 or $100,000, whereas a comparable triple-net leased property may at minimum cost $1.5 million. This diversification allows co-investors the ability to not only branch out investments, but also their risk. They are also a good replacement property option for smaller investors who do not want to add additional money or debt to an exchange.

[1] To read more about the co-ownership of real estate (fractional TIC interests), check out our web article here.

Long-Term Investment / No Contract Renegotiation

- DSTs can provide investors access to high quality triple-net lease properties that have lease terms ranging from 3-20 years. For many investors, this long-term investment provides them with steady, passive income, without the burdens of repetitive contract renegotiation.

Assumable Non-Recourse Debt

- DSTs generally include non-recourse debt thereby shielding investors from personal liability. Non-recourse debt is generally defined as a loan whereby the only remedy on default is the real property itself, and not any of the investor's other assets. In a situation of non-recourse debt, the borrower has no personal liability on the loan.
- The DST may be able to secure institutional-type debt terms that may include better terms and rates than an individual investor. Furthermore, such debt will be in place at the time of the offering and will not require the investor to individually go through a traditional loan application process.

<u>For e.g.:</u> John sells relinquished property and nets $1,000,000 in proceeds after expenses. Of that $1,000,000, he has $500,000 in equity and $500,000 of debt that must be replaced in a 1031 exchange. He plans on purchasing a fractional beneficial interest in a DST, which will absorb his $500k in equity (taking closing costs into consideration) and will allow him to assume $500k in non-recourse debt at a favorable rate. The DST's LTV of 50% is tuned to the value of his interest and he replaces $500k in debt along with his equity. Note that in many scenarios, the investor may have to take on extra debt or add extra cash to balance their exchange.

For additional information on debt replacement strategies using a DST with debt at a high LTV, read our article Zero Coupon Strategies.

Risks / Disadvantages

Accredited Investor Requirement

- In order to be eligible to invest in a DST, the investor must be "accredited."
- According to the Securities and Exchange Commission, an "accredited investor" is an individual investor who either (1) earns an income of over $200,000.00 yearly; (2) jointly earns an income of over $300,000.00 yearly; or (3) is an investor who has a net worth of over $1,000,000.00, not inclusive of the fair market value of their primary residence.

The "Seven Deadly Sins"

- In Revenue Ruling 2004-86, the IRS classifies how a DST holding only real property can be a fixed investment.
- It should be noted that although they appear unduly burdensome and restrictive, the Seven Deadly Sins were enacted for the protection of investors.
- Essentially, if a DST does not commit any of the Seven Deadly Sins, then its investors may be eligible for full tax-deferral:

[2]The full requirements for individuals and various entities are explained in 17 CFR § 230.501(a).

(1) No new capital: Once a DST offering is closed, there can be no additional contribution of capital by either current or new investors. The main justification for this is once the DST offering is closed, if the DST accepts new equity contributions, the ownership percentages could become diluted.
(2) Debt restrictions: DST Trustees cannot renegotiate existing debt terms or initiate new loans from any party.
(3) No reinvestment of sale proceeds: DST Trustees cannot reinvest proceeds from the sale of the real property. Instead, all DST earnings must be distributed to the beneficiaries.
(4) Required distributions: All funds received by the DST – except those in necessary reserve – must be regularly distributed to investors.

- "Necessary" reserves include those for property management, emergency maintenance or repairs, and other unexpected business or management expenses.

(5) Limited capital expenditures: DST Trustees have very limited authority with regard to capital improvements, except for those costs associated with the following:

- Normal repair and maintenance;
- Minor, non-structural capital improvements; and
- Those rquired by law.

(6) Restrictions investing reserves: Any cash reserves retained by the Trustee between distributions may only be invested in short-term debt obligations. This is largely because DST sponsors are not allowed to take on new debt or raise extra cash once the offering is closed, therefore any reserves are generally substantial, and their use must be monitored.
(7) Lease restrictions: Once a DST offering has closed, the DST's Trustee may not renegotiate or enter new leases.

Highly Illiquid Investment

- Although no real estate is generally considered liquid, DSTs present further liquidity challenges due to the fact investors generally own a partial, non-controlling interest. Furthermore, many offerings are considered the sale of a security requiring the involvement of a registered representative as well as a qualified buyer. Lastly, there is a limited secondary market for the sale of such security interests.
- Depending on the unique business plan of each DST, oftentimes holding periods can range from 5-10 years, making such an investment only suitable for investors who can afford to tie up sums of money for years at a time.

Lack of Control

- Although DSTs are a passive investment vehicle that frees investors from property management, such freedom comes at a cost with a complete lack of control over the day-to-day dealings and the business plan.
- All decisions regarding the DST's daily dealings, operations, and functions, are decisions for management – investors have no voice in these matters. The DST is professionally managed, thereby centralizing decision-making to management only.

[3]Sometimes, total upfront costs of a DST investment can range anywhere from 10% to 18% of your total invested equity.

Fees

- There are oftentimes substantial fees associated with a DST investment vehicle.1
- These fees are assessed three times: upfront, again throughout the holding period, and once again upon disposition/exit.
- These fees can include selling broker commissions, broker-dealer allowances, offering and organizing expenses, asset acquisition fees (“finder’s fees”), disposition costs, etc.

As stated above, a DST is a complex investment vehicle that comes with its own set of benefits and risks. An investor should always consult with their tax or legal advisor when considering a DST investment or 1031 exchange and thoroughly review the DST’s Private Placement Memorandum which lays out the risks specific to each DST.

P: 877.701.1031 | F: 877.703.1031 | info@legal1031.com | www.legal1031.com