Investments:

The Delaware Statutory Trust for 1031 Exchanges

By: Christopher Miller

Several years ago; Tenant in Common, or TIC, investments were quite popular. These offerings were used to create potential downleg properties for 1031 exchangers. (In a 1031 Exchange, you sell your upleg property and replace it with a downleg one.) Today, TIC investments are rarely seen. Instead, the industry favors a structure known as the Delaware Statutory Trust, or DST. Note that I have seen other investment options that use the DST acronym: a deferred sales trust, for example. Any other investment using the DST abbreviation is not necessarily the same. That is one reason that I use this vehicle's full name often in conversation. In this article, DST will refer only to the Delaware Statutory Trust.

The TIC structure was easy enough to understand: each investor owns a percentage of the underlying asset and is on title as a tenant in common. The Delaware Statutory Trust works in a similar way. First, the DST will purchase the property and assume a loan. Next the sponsor, or asset manager, will sell shares of the DST to investors. If a DST has a total value of $20 million; with $10 million of equity and a $10 million loan, an investor who contributes $300,000 of equity will own 3% of the DST – and therefore 3% of the property. In this example, he'll receive "credit" in his 1031 exchange for 3% of the loan as well.

DST History

On August 14, 2004, the IRS issued Revenue Ruling 2004-86, which accepted the use of the Delaware Statutory Trust for 1031 exchanges. Shortly afterwards, TIC sponsors began to also package some deals as DSTs. Today, due to various advantages that I will explain shortly, nearly all partial interest syndicated properties intended for 1031 exchanges are offered under the Delaware Statutory Trust, rather than the TIC, structure.

Drawbacks of the TIC Structure – Which the DST Addresses

The majority of TIC real estate transactions worked for investors. Some properties, stressed by the recent severe economic downturn, ran into challenges. When the managers began to deal with these issues, some of the disadvantages of the TIC structure became apparent.

1. **With TICs, major decisions need to be approved by all the investors.**

   Sometimes, in real estate, decisions need to be made quickly. Under the TIC structure; any sale, refinance, and sometimes new lease had to be approved by all investors. In cases like these; management found itself dealing with as many as 35 investors, with varying degrees of real estate expertise, who did not know each other. Getting them to agree was difficult: Sometimes an investor had died, and his estate didn't know how to vote. Maybe an investor was touring Europe and was unavailable for a month. (Only 10 years ago, it wouldn't be common to have a working cell phone with you in Europe.) In some cases, one investor was just crazy and couldn't be convinced to do what was right.

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2. **The TIC structure proved costly and required annual filings.**

   If 35 investors were buying TIC interests in a property, the escrow company saw that as 35 separate closings. That meant these investors each needed to pay closing costs of around $5,000. Additionally, to limit liability, each TIC was held in an LLC incorporated in the state their property was in. Next, that LLC was "wrapped" in a Delaware LLC to make friendlier Delaware corporate law apply to the entity. For an investor living in California, this could mean over $1,000 of extra fees each year. Also – this was another filing that needed to be remembered. If an investor forgot; there were penalties to pay. Worst of all; when a property was sold, these entities required a cumbersome process to close – and more cancellation fees. With substantial annual fees, and account closing fees, it was almost as bad as investing in the stock market!

3. **Each TIC investor needed to be approved for the loan.**

   If you've applied for a loan recently, you're way ahead of me on the inconvenience this entails. Each investor needed to send 3 years of tax returns to the lenders and I've seen them asked follow up questions about their reckless driving conviction from the 1960's, their bankruptcy from 20 years ago, etc.

Benefits of the Delaware Statutory Trust

The first benefit of the Delaware Statutory Trust is that is eliminates the three TIC disadvantages listed above. With the DST, the asset manager is given the power to manage the property as they see fit. This is good – these companies manage institutional-grate real estate for a living, and it's what the investors hired them to do in the first place. There is only one escrow closing with a DST – when the property is purchased by the sponsor. No additional closing fees are charged to investors. Lastly; investors are not personally named on the loan. Therefore; no tax returns are necessary. In fact, the paperwork process is greatly simplified when compared to the "old TIC days."

The Trust also offers investors the benefit of a lower minimum investment. Investments using the TIC structure were limited to 35 investors. If a larger property required a $35 million equity raise, this made the minimum investment $1,000,000. This limitation is removed for the DST, so most sponsors will accept a $100,000 investment – and less than that in some cases. This allows investors greater diversity, and the chance to build a real estate portfolio with their upleg purchases. Rather than putting all their $750,000 into one investment, they can now choose 2 or 3 properties.

Requirements of the Delaware Statutory Trust

The Delaware Statutory Trust has some requirements that govern how it is administered:

1. The DST may not accept additional contributions or assets. "No capital calls" is a good thing, right? Yes – but care needs to be taken to ensure that capital will be available for future expenses. For instance, let's say that a property's roof will cost $1 million to replace, and that it will last for 10 years. The manager plans to sell the property on behalf of investors in 10 years, so they don't think a roof replacement will be necessary. But what if it is? To be safe, the sponsor may reserve $1 million of the offering proceeds. So – if they were raising $15 million to buy the property, they will now raise $16 million. That $1 million will go to a reserve account that is owned by the investors. If the property is sold, and that money is never spent, they will get it back. If the roof does need replacing 8 years from now; the money is there for a "rainy day."
2. The DST may not re-negotiate the loan terms or refinance the loan. This means that if the loan is due in 10 years, the sponsor needs to sell the property in 10 years. This could be a benefit for investors seeking assurance that a property will not be held for a very long term. If a loan needs to be refinanced, there are ways to re-structure the investment to allow it. Such a restructuring, however, could limit your ability to do another 1031 exchange if/when that property sells again. I remind investors that this is not as big a deal as it seems – if your property is in trouble; possibly doing a 1031 exchange in the future should be the least of your worries.

Much as cellular phones have improved over the last 10 years, the technology in the partial interest real estate industry has, too. Investors have been using these programs for years as a way to delegate management responsibility to a professional company while deferring taxes. Since the structure of these offerings has improved, this option may be more attractive to you: perhaps it's worth a look.

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