

Delaware Statutory Trust (DST) Purchases **Fractional Ownership Interests In Real Estate**

The Delaware Statutory Trust, or DST, is a separate legal entity created as a trust under Delaware statutory law. The law permits a very flexible approach to the design and operation of these entities. The IRS issued a revenue ruling on July 20, 2004 regarding the use of DST's for purchase of fractional interests in real property in conjunction with a §1031 exchange.

Background

Arnie Harrison, attorney for Inland Exchange, developed a concept several years ago whereby a DST would be the holder of the title for the property to be purchased by fractional investors. The investors would actually be purchasing beneficial interests in the trust, which owned the real property. This was thought to be the "better mousetrap" of how to structure fractional interest purchases in real property and was picking up steam as a strong alternative to the tenant-in-common (TIC) format.

Inland was using the format for their fractional interest ownership deals. Triple Net did one or two and Evergreen was planning on doing one. The key rationale for why the DST would work for a §1031 exchange is that the trust would not behave like a trust and therefore would be disregarded for tax purposes. The owners of the trust would be considered to own the assets of the trust rather than the trust itself.

In the summer of 2002 Deborah Harrington and Jeanne Sullivan of the IRS and the Treasury Department started making public statements that the DST format would not work for a §1031 exchange. The crux of the matter was whether the interest purchased is real property or a business interest. If the trust is disregarded, then the beneficial investor ("BI") owns real property and the exchange should work. If the BI's own the trust itself (for tax purposes), then the trust is a business entity, in which case it would not be like-kind and the exchange would not work.

After the public statements were made at various conferences, a meeting was held at the Treasury Building in November of 2002 with key participants in the TIC industry and both Deborah Harrington and Jeanne Sullivan. What came out of this meeting was that IRS and Treasury would review the matter and the attorneys in attendance would provide more legal analysis and a white paper to assist the IRS and Treasury in their review.

Since there was sufficient uncertainty as to how the IRS would view the DST, if used, most Broker/Dealers and sponsors decided to take a wait-and-see approach. For nearly two years, an informal group, spearheaded primarily by Patricia DelRosso, Arnie Harrison, and Louis Rodgers, worked with the IRS and Treasury.

As you might imagine, the Revenue Ruling issued on July 20, 2004 was eagerly anticipated. [Click here](#) if you wish to review the full text of Rev. Rul 2004-86.

Conclusions

- The IRS said the Delaware Statutory Trust can work for a §1031 exchange, if structured correctly.

- There are specific requirements woven throughout the hypothetical example provided by the IRS in the ruling. These requirements cover a multitude of areas (such as master lease, non-recourse loans, powers of the trustee, etc.) but the restrictions can be summarized as follows:
 1. Once the offering is closed, there can be no future contributions to the DST by either current or new beneficiaries;
 2. The trustee cannot renegotiate the terms of the existing loans nor can it borrow any new funds from any party;
 3. The Trustee can not reinvest the proceeds from the sale of its real estate;
 4. The trustee is limited to making capital expenditures with respect to the property to those for (a) normal repair and maintenance, (b) minor non-structural capital improvements and (c) those required by law;
 5. Any cash held between distribution dates can only be invested in short term debt obligations;
 6. All cash, other than necessary reserves, must be distributed on a current basis; and
 7. The trustee cannot enter into a new leases or renegotiate the current lease.

Following the issuance of the ruling, an adhoc group of lawyers and industry participants debated the issues in an effort to determine if a DST, structured in conformance with the ruling, could be used effectively by sponsors. The general consensus was that the DST can work under a very narrow set of circumstances, but will not become a full on replacement for the TIC structure.

While no one participating in the adhoc group's conference calls ventured to guess what percentage of future deals would be done as Delaware Statutory Trusts, it was thought likely to be a very small percentage, at least at first. As was the case with TICs subsequent to issuance of the Rev Proc, it took more than a year for Sponsors to begin fine tuning and incorporating the DST structure into their offerings.

Structure

In response to the restrictions noted above, DST Agreements most often provide for a master lease structure with lender required reserves put in place to deal with the financial issues typically associated with real estate ownership. While it was initially thought that the DST structure would only be appropriate with single tenant, net leased properties, its use has expanded to include offerings that involve a portfolio of multi-tenant properties.

It should also be noted that should the trustee determine the DST is in danger of losing the property (e.g. due to its inability to act because of the prohibitions in the trust agreement), it can temporarily convert the DST into a limited liability company (e.g. Springing LLC) under pre-existing agreed-upon terms contained in the DST Agreement.

Delaware law permits such a conversion, by what is basically an election. The LLC will contain the same Special Purpose Entity ("SPE") and bankruptcy remoteness provisions as the DST (for the lender's benefit), but it will not contain the prohibitions against accepting contributions, renegotiating the terms of existing loans, borrowing new funds or entering into a new or modified master lease.

The only minor concern is that once the DST is converted into a LLC, it will be treated as a partnership for federal income tax purposes. As a result, the investors would not be able to perform a tax free exchange if the LLC were to sell the real estate. However, this can be ameliorated because nothing prevents the LLC, once the problems triggering the Springing LLC are dealt with, from converting back into a DST.

Lender Benefits

One huge benefit of a DST is that lenders view the trust as only one borrower, rather than the 10 to 25 commonly found in a TIC structured offering. Therefore, financing can be done with much more ease and less expense.

Since the beneficiaries' only right with respect to the trust is to receive distributions and they have no vote or say in the operation of the property, the need for "bad boy carve outs" is eliminated. The lender need only look to the sponsor with respect to such carve outs from the non-recourse provisions of the note.

The trustee of the DST will be the sponsor or an affiliate of the sponsor. Unlike a TIC deal, there is no one year time limit on the trusteeship or the term of the management agreement. This provides the lender comfort that the sponsor will continue operating the property.

Investor Benefits

Unlike a TIC structured offering, there is no need to set up an individual single member limited liability company ("LLC") for each investor. Each investor owns a beneficial interest ("BI") in the DST which is the bankruptcy remote SPE.

The DST itself shields the investors from any liabilities with respect to the property. This saves the investors substantial money with respect to the formation costs and annual fees for the LLC. It also provides for a less complex structure for the investor.

Unlike the TIC structure, which requires that investors unanimously approve all major decisions, a BI in a DST is not permitted to vote. Therefore, the concern over the "hold-out investor" is eliminated.

Because the DST (and not 10 to 25 TIC investors) is the borrower, there is no need for the lender to qualify individual investors as a borrower. As a result, the sponsor need not collect tax returns, financial statements, and credit authorizations from the investors for the purpose of securing the loan.

As noted above, the investors should not be liable on any "non-recourse carve outs" and should not be required to sign any associated indemnifications or guaranties.

While not a deeded interest in the property, a DST beneficiary is permitted to perform a tax free exchange on its pro rata share of the DST property when it is sold.

Since the transaction is less complicated and lenders are provided better protection from the potential bad acts of individual investors, the loan rates and other terms may be more favorable than with a TIC structure.

Also note that the number of participants is not limited to 35 (e.g. maximum number in a TIC). As a result, an offering may require a much smaller minimum investment - a potentially huge benefit for those investors with sufficient equity available to diversify their investment over multiple offerings.