Delaware Statutory Trusts in Like-Kind Exchanges under IRC §1031

An Executive Summary

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Introduction

A statutory trust (sometimes referred to as a "business trust") is a legal entity, created by a trust instrument under a specific state law, that holds assets on behalf of the trust's beneficial owners. The term "statutory" refers to the formal recognition and regulation of such entities by the legislatures of several states. An existing group of investors can form a statutory trust, but the structure is better known for funds seeking to raise outside capital. Statutory trust shares can be sold as registered securities or private placements.

Before receiving statutory recognition, modern common-law business trusts originated in Massachusetts to avoid then-existing prohibitions against corporations acquiring or developing real estate.[i] Indeed, the IRS tax designation "Real Estate Investment Trust" derives from the historic use of business trusts to form REITs, even though most REITs today are structured as corporations.[ii] Common-law business trusts had to rely on a complex body of case law to guide their actions. After decades of operating under relative legal uncertainty, business-trust sponsors received legislative relief in Delaware, a leading state in corporate formations.

Delaware Statutory Trust Act

The Delaware Statutory Trust Act (the "Act") was passed in 1988. The Act, and similar acts in other states, addressed some of the risks of the *common law* business-trust structure, including potential liability for trustees and possibly unfavorable tax treatment. As with Delaware LLCs and limited partnerships, the Act gave Delaware Statutory Trusts ("DSTs") "maximum effect to the principle of freedom of contract and to the enforceability of governing instruments."[iii] The Act also granted DSTs flexible control over their governance and operations.

Key features of a DST include:[iv]

- Limited personal liability of beneficial owners (as with corporate stockholders)
- Authority to delegate management functions among the trust parties or to third parties
- Ability to create separate portfolios or series within the trust
- "Bankruptcy remote" protections from creditors of beneficial owners

Since 1988, DSTs have become a favored form of statutory trust. As a result, DSTs now are used as the underlying business entity for multiple types of investment vehicles beyond REITs, including collateralized mortgage obligations, mutual funds, closed-end funds and of course, §1031-qualified properties with hundreds of beneficial owners.

IRC §1031-Qualified Delaware Statutory Trusts ("1031 DSTs")

Overview

Although many investors unknowingly own DST interests through a mutual fund, they often become aware of DSTs by investing in real estate structured as "1031 DSTs". These are statutory trusts that ostensibly qualify as like-kind real estate for purposes of completing a tax-deferred exchange under Internal Revenue Code §1031. Specifically, 1031 DSTs offer the ability to reinvest equity from a rental or business property into beneficial interests of one or more portfolios of real estate on a passive basis.

A 1031 DST is the only instance of *indirect* ownership allowed under §1031 regulations, as the name of the investor (i.e., an individual, trust or LLC) conducting the §1031 exchange is not recorded on legal title to the replacement property. Rather, the fractional owner receives a letter of beneficial interest in the DST, which is the sole recorded owner of its property.

Institutional real estate operators, through affiliates, sponsor and manage the majority of 1031 DSTs. The seven largest sponsors of 1031 DST programs have a combined two-thirds market share.[v] Investors rely entirely on these operators, as interest holders have virtually no participation in the daily or strategic management of the trusts. As beneficial owners, however, they are entitled to their *pro rata* share of any appreciation, depreciation and distributable income.

Syndication and Investing

1031 DSTs are sold as private placements under SEC Regulation D, Rule 506. In the five years from 2015 through 2019, the annual amount of equity capital invested or reinvested in 1031 DSTs has increased from approximately $1 billion to over $3.4 billion per year.[vi] 1031 DST sponsors syndicate most offerings through a network of independent broker-dealers and Registered Investment Advisors. A handful of smaller 1031 DST sponsors raise capital through crowdfunding portals under the JOBS Act of 2012.[vii]

While the typical minimum investment is $100,000 for investors using §1031 exchange equity, the average investment amount is approximately $500,000.[viii] Most investors use their entire §1031 exchange proceeds to invest in one or more DSTs. In larger §1031 transactions, some buyers allocate only a partial amount of equity to a 1031 DST when their primary replacement property has a lower value than their relinquished property. In this situation, 1031 DSTs offer a home for uninvested exchange proceeds that otherwise would trigger taxable "boot".[*]

1031 DSTs hold between one and a dozen properties. Typical portfolio values range from $50 million to $100 million, though some larger DSTs have up to $500 million in total real estate value. Established 1031 DST sponsors often secure capital commitments for an entire offering in just a few weeks. Financial representatives initially secure a verbal "reservation" from sponsors on behalf of a client, followed by a signed application and finally a wire transfer from an investor's exchange accommodator. As a practical matter, neither the DST nor the investor is committed to the transaction until the DST receives and accepts the funds.[**]

[*] "Boot" is the term given to cash or debt forgiveness received in a §1031 exchange that is not reinvested in a qualified replacement property.

[**] Among top 1031 DST sponsors, under normal conditions there is more demand for equity than supply. Signed subscription documents are routinely canceled without consequence to the buyer.

IRS Revenue Ruling 2004-86

On July 20, 2004, the IRS issued Revenue Ruling 2004-86, which held that (assuming the other requirements of §1031 are satisfied) an exchange of real property for an interest in a 1031 DST will qualify for a §1031 exchange, provided the DST[ix]:

- Only purchases real estate and short-term obligations (e.g., money market accounts)
- Does not initiate additional "capital calls"
- Does not renegotiate or refinance the loan; such action likely will eliminate the possibility of a future §1031 exchange
- Does not renegotiate leases or enter into new leases[*]
- Does not make major improvements to the real estate
- Distributes all cash, other than the necessary reserves, to the beneficiaries (investors)
- Does not sell or exchange the property and reinvest the proceeds (i.e., no turnover allowed within the portfolio)

In addition to the above requirements, the IRS based its 2004 holding on the following elements of a valid 1031 DST[x]:

(1) The DST is a s*eparate* entity... The DST is treated as an entity separate from its owners, and not as a coownership or agency arrangement.

(2) but not a *business* entity... The DST is an "investment" trust and not a "business entity" for federal income tax purposes. This is important because the IRS defines "business trusts" as entities created "simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships"—an investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power under the trust agreement to vary the investment of the certificate holders.

(3) and is a *grantor* trust... The DST is also a "grantor trust" for federal income tax purposes, with the holders of interests in the DST treated as the grantors of the DST. Investors do not grant the underlying real estate to the trust, but they do grant their exchange equity or cash.

(4) with the beneficiaries treated as *direct owners*. The holders of interests in the DST are treated as directly owning interests in real property held by the DST. This is perhaps the most relevant distinction for §1031 purposes, as ownership shares in a business do not qualify as like-kind real estate.

Although a DST is a legal entity separate from its beneficial-interest holders, the IRS accepted trust interests as like-kind real estate because a valid 1031 DST does not operate like a typical fund. While the ownership experience is passive, there are also restraints on management—for example, the DST cannot renegotiate the master lease or the loan. Investors receive the same liability protection as corporate shareholders under Delaware law, yet they are treated as direct owners for tax purposes. And while the SEC regulates DST interests as private securities, a 1031-qualifying DST is *not* a security interest for IRS purposes.[xi]

[*] Residents of a DST-owned apartment building are all technically sub-leasing from the Master Tenant.

Safely walking the line between these seemingly contradictory aspects of a 1031 DST requires that sponsors have experienced legal counsel. Syndicated offerings typically include 25-page legal opinions to provide comfort that a particular DST's beneficial interests qualify as replacement property in a §1031 exchange. Of course, the last page of these letters typically states:

> *Although this opinion represents our considered legal judgment, it has no legally binding effect and, therefore, there can be no assurance that the IRS will not be able to successfully challenge our opinion expressed herein.*

1031 DSTs Supplant TICs

As when the Wyoming legislature created the first limited liability companies ("LLCs") in 1977, 1031 DSTs did not become an overnight sensation.[xii] Revenue Ruling 2004-86 is light on specific details, and some practitioners initially were concerned that the IRS could reverse itself, as the logic of the ruling was not entirely consistent with Revenue Procedure 2002-22, issued only two years previously.[xiii] To further impede the momentum of 1031 DSTs, the real estate crash of 2008 caused a dramatic decline in §1031 exchange transactions. This pause in syndicated 1031 programs gave the industry an opportunity to reassess tenant-in-common (TIC) offerings, which had grown increasingly popular from the late 1990s until the crash. Under IRS rules, up to 35 investors could invest in 1031 TIC properties to own fractional, undivided interests in real estate managed by third parties, subject to certain unanimous voting requirements. TIC investors also are parties to any loan secured by the property.

The advent of 1031 DSTs solved a handful of perceived 1031 TIC limitations. First, there was no IRS limit on the number of 1031 DST owners. Second, the IRS did not impose voting requirements on 1031 DST investors, thereby eliminating the inevitable dead-locking seen among TIC owners. Third, financing became much easier to secure, as banks were more comfortable lending to a single bankruptcy-remote DST entity, rather than 35 unrelated individuals. On average, DST programs today raise much higher capital per offering than the TIC programs of the early 2000s.[xiv] Broadly-syndicated 1031 TICs now are rare.

Built-in, Non-Recourse Financing

Under basic §1031 rules, to execute a fully tax-deferred exchange a taxpayer must replace all of the equity and all of the debt from her relinquished property. Most exchangers have some outstanding debt on their rental or business properties, which means they need a new loan for their replacement property (unless a taxpayer is willing to replace the loan with out-of-pocket cash). To meet the investing public's need for replacement financing, most 1031 DSTs are structured with in-place debt before the first investor subscribes to the offering.

The debt used in 1031 DSTs is considerably different than the loan an individual taxpayer would obtain to acquire a replacement property. In a typical 1031 DST, the borrower is the trust, not the beneficial interest holders. The only collateral for the DST loan is the real estate. There is no recourse to the investors, who are not parties to the loan agreement. There is no qualification or application for investors; indeed, the bank has no information about the DST owners. The terms that top DST sponsors negotiate likely are more favorable than an individual investor could secure. The duration for most 1031 DST debt is ten years, with five, seven or ten-year interest-only periods on usually fixed-rate loans. Pre-payment penalties are the norm, usually with a 1% floor. Most loans have initial and/or ongoing reserve requirements. Pre-arranged 1031 DST loans do not appear on investors' credit reports, thereby improving their balance sheets upon sale of their relinquished properties.

Other General 1031 DST Characteristics

1031 DSTs invest in various sectors of real estate, but multifamily is the most common. Single-tenant properties typically have triple-net leases, while multi-tenant properties are subject to master leases of which a sponsor affiliate is the master tenant. Base rent is often set, at minimum, to cover initial debt payments. Texas and Florida are the two most popular property locations for 1031 DSTs, along with the sun-belt and Midwest states.

Almost all 1031 DSTs pay monthly distributions to investors. 1031 DST agreements typically include provisions for a "springing LLC" to replace the trust entity if the DST somehow becomes disqualified. Many 1031 DSTs involve an option for a REIT, structured as an "umbrella partnership REIT" or "UPREIT", to acquire the DST property in exchange for units in the REIT's operating partnership.[xv] Some 1031 DST sponsors routinely offer programs that *require* such a transfer. In these programs, investors agree at the outset to ultimately exchange their rental property—via a DST investment—for shares of a REIT.

Considerations for 1031 DSTs in Lieu of Conventional Replacement Properties

§1031 Regulatory Compliance

No legal authorities, other than Revenue Ruling 2004-86, directly address the tax treatment of 1031 DSTs. The ruling's author certainly did not envision that a multi-billion-dollar industry would spawn from the publication. In the absence of greater regulatory specificity, sponsors employ expensive tax lawyers from large law firms to carefully construct all of the agreements that make up a 1031 DST. Yet it is possible, albeit unlikely, that the IRS could revoke 2004-86 or determine that certain DSTs do not comply with the requirements of that ruling. Further, it is possible the IRS could find that certain DSTs are not taxable as "investment trusts" within the meaning of Treasury Regulation §301.7701-4. Or the IRS could determine that the master lease in a multi-tenant DST portfolio does not constitute a "true lease" under IRS Revenue Procedure 2001-28.

These seemingly esoteric risks stem from very thin IRS guidance, and it is not practical to seek a Private Letter Ruling from the IRS for specific DSTs. However, several hundred DSTs have followed the same basic template since the late 2000s, and the IRS has not issued any published guidance to contradict its 2004 ruling nor challenge a 1031 DST.[xvi] Considering the audit attention paid to §1031 exchanges, if the IRS were going to disrupt the standard operating procedure for 1031 DSTs, such action presumably would have happened by now.

IRS action is not the only compliance factor to consider. The typical trust agreements expressly deny the 1031 DST manager any power or authority to take actions that would cause the DST to cease to constitute an "investment trust", and expressly prohibit any parties from exercising any of the enumerated powers that are prohibited under Revenue Ruling 2004-86. Nevertheless, people do make mistakes and unforeseen events do occur. It is remotely possible, for example, that a lender could become insolvent and force a DST loan to be assigned to a new creditor. Would such an event violate the IRS prohibition against 1031 DST refinancing? We simply do not know, which is why the financial strength of the *lender* is an important issue that most real estate investors would not consider outside the context of a 1031 DST. Of course, the experience and credibility of DST sponsors and their affiliates are also important.

Liquidity and Control

A 1031 DST investment is truly passive. Owners have no control over leasing, financing, management or disposition. Most programs illustrate a *pro forma* hold period of 10 years, but there is no guarantee of a liquidation date. There is no public market for program interests. Once invested, there is only remote possibility of finding a buyer for one’s interests from among the other owners, and likely only at a significant discount to current value. Owners should assume their invested funds will be unavailable for the duration of the program (up to 10 years). There is no specified time at which any DST portfolio will be liquidated.

Fees and Expenses

An investment in a 1031 DST property includes fees and expenses that an institutional buyer would not incur to acquire and own the same property. These additional fees and expenses vary among DST offerings, but can be summarized as follows:

- Syndication costs and commissions
- Sponsor acquisition and financing fees

“Sales load”

- Asset management fee
- Revenue participation by Master Tenant
- Trust administration expenses
- Disposition fee

The initial “Sales Load”, not including reserves, can be 8-12% of the original purchase price of the property, and up to 20% of the equity raised, depending on the leverage. Unlike a conventional real estate transaction, the Sales Load and reserves are incorporated into the offering price. 1031 DST investors effectively are buying a property that is “marked up” to reflect costs and fees that will be paid indirectly from investment proceeds.

During the hold period, affiliates of the sponsor typically will receive annual revenue via a combination of periodic management fees and incentive-based rent participation. The structure of these fees varies greatly depending on the property type and lease structure, but they generally range from 40 to 75 bps of the property value on an annual basis. At sale, the DST usually will pay the sponsor a disposition fee that is typically 2.5% to 3.5% of the sales price.

Taxable “Boot”

As noted above, a 1031 DST investment includes line items that are not typical in a conventional replacement-property transaction. Although a 1031 DST property may otherwise qualify as like-kind real estate, it is possible the IRS could find that certain uses of investment proceeds constitute “boot” (i.e., an expenditure or asset that is not like-kind real estate). If the IRS reviewed a particular 1031 DST and determined that a percentage of its investment proceeds had been applied toward “boot”, a 1031 DST investor would be required to pay capital gains tax on his/her pro rata share of such items. Until the IRS publishes guidance on this topic, there will be lingering uncertainty regarding certain 1031 DST line items such as reserve accounts.

General Disclosures

1031 Exchange Risks. Failing to properly meet all of the 1031 exchange requirements could lead to significant unwanted taxes. Investing in a DST presents additional tax risks. Investors should consult their legal and tax professionals before engaging in a 1031 exchange, including a 1031 exchange into a DST.

Real Estate Risk. Investing in real estate involves a variety of risks, including but not limited to economic risks, market risks, tenant default risks, interest rate risks, and environmental risks. Investing in a DST carries all of these same risks. Investors should not invest in real estate or real estate securities, including DSTs, unless they can withstand the loss of all of their principal.

No Guarantee of Income or Growth. As with all investing, there is no guarantee that a DST will continue to pay distributions to investors or that there will be any increase in the investors' account value. There is no guarantee that investors will not lose some or all of their investment.

Illiquidity. Real estate investments, including DSTs, are illiquid. DSTs are especially illiquid due to the fact that there is no national market through which an investor may sell his/her interests. Only investors with a long-term time horizon should consider investing in a DST.

Fees & Expenses. There may be significant fees and expenses associated with the purchase and ownership of a DST. In some cases, the fees and expenses may outweigh the benefits of conducting a 1031 exchange and purchasing a DST. Analysis should be done by the investor to determine if the benefits of a DST are sufficient to justify the fees and expense.

Leverage Risk. The use of debt to purchase real estate increases volatility and introduces a risk of foreclosure by the lender.

Lack of Control. Investors in a DST have limited rights and no control over important aspects of the management and sale of the underlying property.

Conflicts of Interest. Conflicts of interest may exist that could adversely affect the investment.

Other Risks. This is only a partial list of the risks associated with investing in DSTs. A list of risks can be found in the Private Placement Memorandum. This should be read and understood before investing in any DST.

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[i] State Street Trust Co. v. Hall, 31 Mass. 299, 41 N.E. 2d 30, 34 (1942).
[ii] The Tax Reform Act of 1976 allowed REITs to be established as corporations in addition to business trusts.
[iii] 12 Delaware Code §3801 et seq.
[iv] *Ibid*.
[v] https://www.ipa.com/wp-content/uploads/2021/03/PHXA-1031-White-Paper.pdf
[vi] https://www.ipa.com/events/1031-market-equity-update-in-partnership-with-mountain-dell-consulting/
[vii] https://www.sec.gov/smallbusiness/exemptofferings/rule506c
[viii] https://www.ipa.com/wp-content/uploads/2021/03/PHXA-1031-White-Paper.pdf
[ix] https://www.treasury.gov/press-center/press-releases/Documents/rr0486.pdf
[x] *Ibid*. and https://www.law.cornell.edu/cfr/text/26/301.7701-4
[xi] Internal Revenue Code §1031 et seq.
[xii] https://www.incnow.com/blog/2018/01/18/llc-history/#:~:text=In%201977%2C%20the%20state%20of,to%20one%20compared%20to%20corporations.

[xiii] https://www.irs.gov/pub/irs-drop/rp-02-22.pdf
[xiv] https://www.ipa.com/events/1031-market-equity-update-in-partnership-with-mountain-dell-consulting/
[xv] Internal Revenue Code §721
[xvi] To the knowledge of this author.