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DST 1031s: An Investment Structure that Can Defer Taxes and Property Management Headaches

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A Delaware Statutory Trust (DST) is an investment structure used by investors to take advantage of the benefits of a 1031 or ?like-kind? exchange and allow them to buy a fractional interest in commercial real estate without the burdens associated with maintaining and operating a property.

Section 1031 of the Internal Revenue Code or ?IRC? allows investors to defer taxes on capital gains by using the profits earned from the sale of an investment property to buy another similar property. Under a DST, an investor can use this exchange to purchase a share of a commercial or ?like-kind? property and reap the income, appreciation and tax benefits that may occur.

With minimum investments between $50,000 and $100,000, DSTs allow investors with smaller commercial real estate holdings an opportunity to trade up to larger-scale investments traditionally only available to institutional investors.

A Passive Interest

Rules promulgated under the IRC prohibit investors from actively managing a DST?s property. Management is handled by the trust itself, through its trustees, rather than the investors. To ensure the investment constitutes a valid replacement under IRS rules, a DST?s actions regarding the property may be extremely limited. Often, in fact, the trust turns over day-to-day responsibilities to a master leaseholder.

For example, a DST can make no future contributions to the cash or equity of the trust once closing on a property has occurred. It cannot take on new debt or renegotiate loans, except in the limited circumstances of a tenant?s bankruptcy. Capital spending is largely limited to normal repairs and maintenance. In addition, the trust cannot renegotiate leases or enter into new ones, unless, again, the tenant is in bankruptcy.

The restrictions give investors an opportunity to avoid the hassle of managing and maintaining rental properties while deferring capital gains, and they may reduce their risk by investing in a property, or a portfolio of properties, collectively with other fractional owners.

Master Lease Agreements

The restrictions on property management do not apply to a tenant under a long-term lease. This is a key reason why most DSTs arrange for a master lease agreement where the lessee is owned by the sponsor of the real estate transaction.

Through this arrangement, the master lessee is able to manage the property in ways a signatory trustee cannot. Such leases are fully subordinated to the loan on the property, and the lessee is structured as a single-purpose entity with customary separateness covenants.

The master lease arrangement curtails the DST?s role in the property?helping ensure that investors receive the full tax benefits of the 1031 exchange. And lenders can benefit as well, because they are able to rely upon a solidly structured entity, and reduce the risk that loan terms may need to be altered in the future. They also gain a single point of contact on the loan, rather than being forced to interact with several fractional owners for a single property.

One Voice for the Trust

DST 1031s have become a popular structure for commercial real estate investment since the Great Recession of 2007-2009. It has largely taken the place of the tenancy-in-common (TIC) structure, which was the most popular fractional ownership structure prior to the recession.

TIC?s require owners to approve decisions related to the property, and gaining a consensus among multiple owners can be difficult. This can create substantial problems when the economic climate shifts and quick decisions about the property and its finances must be made.

In a DST, however, a signatory trustee serves as the voice of the trust. The trustee is the only party that can act on the DST?s behalf with a secured lender and serves as the sole contact for the lender for the entire lifespan of the loan. For their part, investors with a beneficial interest in the property are only entitled to distributions from the trust.

While the signatory trustee is empowered to act for the DST, there are limits to their actions. Under Delaware law, each DST must have a Delaware trustee as well. This provides an additional layer of protection for investors and lenders, and helps prevents the trust from jeopardizing investors? preferential tax treatment or terminating without warning.

DST 1031s can be a good fit for investors who are focused on income and tax deferment, and a poor one for active investors who want a say in how the property is managed. Another disadvantage can be lack of liquidity. A DST is generally a longer-term investment of five to 10 years, and unlike a wholly-owned piece of real estate, the investor does not have control over when the property should be sold. In addition, investors should conduct the appropriate due diligence to understand the risks they may face.

To learn more about pros and cons of DST 1031s, and how we can help with the investment process, contact us for a consultation.

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