

IS THE DELAWARE STATUTORY TRUST THE RIGHT STRUCTURE FOR REAL ESTATE FUNDS LOOKING TO USE LIKE KIND EXCHANGE FUNDS TO PROVIDE CAPITAL FOR ACQUISITIONS OF REAL ESTATE INVESTMENTS? ¹

Attracting 1031 Investors Will Require a Fund to Adopt a Structure that Causes the Investment to Qualify as Replacement Property under the Like Kind Exchange Rules.

Under the like-kind exchange rules of Section 1031 of the Internal Revenue Code of 1986, as amended (the “Code”), the owner of real estate can avoid the recognition of taxable gain on the sale of property by acquiring “like-kind” property under the conditions set forth in Code Section 1031. Because the like-kind exchange rules provide a “Code approved” tax-deferral structure, there has traditionally been a significant amount of capital seeking real estate investment opportunities that can qualify as replacement property under the Code Section 1031 rules.

The issue, however, is that the acquisition of a membership interest or a limited partner interest in a real estate fund will not qualify as replacement property under these like kind exchange rules. Accordingly, a real estate fund seeking capital from a like-kind exchange investor must adopt a more complex structure for the investment to be treated as replacement property.

Real estate funds and sponsors have traditionally used tenant-in-common structures (a “TIC Structure”) to attract like-kind exchange equity. A Delaware statutory trust structure (a “DST Structure”), however, accomplishes the same goal but with less complexity and a substantially lower tax risk of not qualifying for like kind exchange treatment.

Complications with the TIC Structure

In a TIC Structure, the property is owned by separate tenants-in-common that enter into a tenancy-in-common agreement to govern the ownership of the property. Tax-compliant TIC Structures are notoriously complex and if a TIC Structure is not properly structured, the 1031 investor will face significant tax risks. For example, among the requirements for treatment as a qualifying replacement property under the Code Section 1031 rules, is that unanimous consent of each co-owner is required to sell the property, lease the property or to re-finance the debt on the property. In addition, to obtain treatment as a qualifying replacement property under the Code Section 1031 rules it is recommended that each co-owner (through its wholly-owned LLC) be a borrower on the mortgage financing.

Other risks include:

- **Increased Risk to Investors:** Since each co-owner of the property owns a direct interest (through a single member LLC) in the property and is a



¹ Mr. Hannon is a shareholder in the national tax practice and Mr. Eichenlaub is a shareholder in the national real estate practice at Polsinelli, PC. Mr. Hannon and Mr. Eichenlaub are leaders at Polsinelli in providing DST services to clients. Mr. Eichenlaub worked on the first Delaware statutory trust offering after Revenue Ruling 2004-86. Since then, Mr. Hannon and Mr. Eichenlaub have worked on hundreds of DST offerings, representing more than \$1 billion in raised equity.

IS THE DELAWARE STATUTORY TRUST THE RIGHT STRUCTURE FOR REAL ESTATE FUNDS LOOKING TO USE LIKE KIND EXCHANGE FUND TO PROVIDE CAPITAL FOR ACQUISITIONS OF REAL ESTATE INVESTMENTS?

borrower on the mortgage financing, Lenders generally require the principal of each co-owner to sign a non-recourse carve-out guaranty in favor of the lender.

- Restrictions on Transfers: Since each co-owner of the property is a borrower and a mortgagor, transfers of TIC interests are complicated and require lender involvement even when permitted, including a new set of ownership and loan documents.

TIC Structures are inherently complex. Even though it has been widely used by real estate funds to attract 1031 investors, if the TIC structure deviates from Code requirements, the 1031 investor could face substantial risk that the IRS could determine that the investment made through the structure does not qualify for like-kind exchange treatment, which would cause the sale of the relinquished property to be a taxable transaction.

The DST Structure Provides a Less Complexity and Less Tax Risk.

Over the past year, we have seen increased use of the Delaware Statutory Trust Structure (the “DST Structure”) as an alternative to the TIC Structure by real estate funds that are seeking a structure to take in like-kind exchange funds.

The benefits of the DST Structure include:

- Control: Unlike in the TIC Structure, unanimity of investors is not required and investors are truly passive. Under the DST Structure, the sponsor or fund entity that controls the DST is entitled to make all decisions, including the decision to sell the property and at what price. The investors have no voting or other control rights.
- Simplicity of Loan Structure: Unlike the TIC Structure, the DST Structure is simple – there is one owner of the property (the DST), one borrower under the financing (the DST) and one mortgagor of the property (the DST).
- Transferability: Since the investors are truly passive in the DST Structure, transfers of beneficial interests in the DST should be permitted without notice to or consent of lenders (subject to ongoing compliance with loan



IS THE DELAWARE STATUTORY TRUST THE RIGHT STRUCTURE FOR REAL ESTATE FUNDS LOOKING TO USE LIKE KIND EXCHANGE FUND TO PROVIDE CAPITAL FOR ACQUISITIONS OF REAL ESTATE INVESTMENTS?

covenants and the provision of KYC information for investors over certain thresholds).

- No Borrower Risk to Investors: Unlike in the TIC Structure, investors are not required to execute any guaranty agreements in the DST Structure because the investors are passive.
- Less Tax Risk to Investors: The DST structure is much easier to make “1031 compliant” than a TIC structure, which gives a 1031 investor more tax certainty on its like kind exchange treatment.

As discussed below, the DST Structure does not work in all situations. It is not appropriate for value-add properties or development properties. In addition, under the DST Structure, there are restrictions imposed on the types of loan structures that can be adopted. Nonetheless, if a fund is going to acquire a property that is appropriate for the DST Structure and the term of the loan is at least as long as the term of the expected in which the property will be owned by the DST period, the DST Structure should be strongly considered because it will be less complicated than a TIC structure while creating little or no tax risk to the 1031 investor.

Overview of the DST Structure

The IRS set forth the general conditions required for a tax-compliant DST Structure in Revenue Ruling 2004-86. The requirements are:

1. No new capital can be raised by the DST after its initial capitalization.
2. All cash must be distributed on a current basis with identical distribution rights.
3. The DST cannot redevelop property or make capital repairs except for (a) normal repair and maintenance, (b) minor non-structural capital improvements and (c) those required by law.
4. The DST cannot enter into new leases or renegotiate current leases (except in the cast of a tenant bankruptcy or insolvency).



IS THE DELAWARE STATUTORY TRUST THE RIGHT STRUCTURE FOR REAL ESTATE FUNDS LOOKING TO USE LIKE KIND EXCHANGE FUND TO PROVIDE CAPITAL FOR ACQUISITIONS OF REAL ESTATE INVESTMENTS?

5. The DST cannot renegotiate the terms of existing loans or borrow new funds (unless a loan default exists as a result of a tenant bankruptcy or insolvency).
6. The DST cannot reinvest sales proceeds.
7. The DST must hold its reserves in short-term debt obligations.

Since the release of Revenue Ruling 2004-86, legal advisors to parties that are forming DSTs that will qualify as replacement property under Code Section 1031 have utilized various methods of satisfying the ruling, including the following:

- Springing LLC: If the DST is in danger of violating Revenue Ruling 2004-86, the trust agreement of the DST will provide that the DST will convert to (or “spring” into) a limited liability company (a “Springing LLC”), which can then perform the act that the DST was prohibited from performing. Loan documents will require the conversion. Each owner of beneficial interests in the DST would own the same ownership percentage in the Springing LLC and the sponsor or fund entity that controlled the DST will continue to control the Springing LLC. It is worth noting that, under Delaware law, a DST conversion to a Springing LLC is considered a “single entity” reorganization and thus does not create a transfer of the property.
- Master Lease: For properties with short-term lease cycles (multi-tenant retail and office, multifamily, student housing, self-storage and mobile home communities), the DST will enter into a master lease with an affiliate (the “Master Tenant”). The Master Tenant then subleases the property to the property tenants. The master lease structure requires additional tax structuring so that the master lease is treated as bona fide lease rather than as a partnership between the DST and the owner of the master lease. If the master lease was treated as a partnership or as something other than a bona fide lease, the 1031 investor would face substantial risk that the IRS could determine that the investment made by the 1031 investor through the structure does not qualify for like-kind exchange treatment.
- Reserves: Since the DST cannot raise additional capital, it is important to create adequate reserves at the initial outset in addition to any reserves



IS THE DELAWARE STATUTORY TRUST THE RIGHT STRUCTURE FOR REAL ESTATE FUNDS LOOKING TO USE LIKE KIND EXCHANGE FUND TO PROVIDE CAPITAL FOR ACQUISITIONS OF REAL ESTATE INVESTMENTS?

required by the lender. Reserves often include a working-capital reserve and a capital expenditures reserve.

Use of the DST by a Real Estate Fund

Because the DST Structure does not require each investor to be a co-borrower and does not require unanimous consent of each investor, the use of the DST Structure is less complex than the TIC Structure and should provide more tax certainty for like-kind exchange treatment. From the fund's point of view, the fund can use the DST structure in two ways:

1. Exchange-Preservation Structure: The fund could bring in a 1031 investor as a co-investor in the property held by the DST (which is co-owned by the fund and the 1031 investor), enabling the investor to undertake a like-kind exchange out of the property in the future.
2. Conversion Structure: The fund could bring in the 1031 investor under a structure in which its DST interest can be converted into a membership interest in the fund after the passage of the requisite period of time.

Note that if the fund is using the Conversion Structure (i.e., as a vehicle to convert the 1031 investor's DST interest into a membership interest in the fund), the following issues will need to be addressed: (i) how is the conversion value to be determined, (ii) will there be a true-up mechanism to put the 1031 investor on the same economic footing as investors that contributed cash directly into the fund, (iii) how will the tax liability arising from the 1031 investor's "built in gain" be handled when the property is subsequently sold by the fund, (iv) how much of the DST ownership interest should the 1031 investors own in each DST-held property (e.g., less than 40%) and (v) what term should be set for the DST (i.e., when should the DST structure self-terminate so the property can be held in a traditional SPE structure).

If the Conversion Structure is used, the mechanics of the conversion will need to be built in to the loan documents so that the DST will not be required to obtain lender consent for the conversion and into the offering documents issued to the fund's direct investors. We are starting to see the emergence of "market" terms with respect to each of these issues. Nonetheless, there are many available solutions that can be considered so that the structure can be tailored to the investment requirements of the fund.

