August 2014

Delaware Statutory Trusts

<u>An Introduction to Delaware Statutory Trusts (DSTs)</u> – A Delaware Statutory Trust (DST) is a trust entity formed under Delaware law that, subject to meeting certain requirements, may be used as a tax savings vehicle under Section 1031 of the Internal Revenue Code (IRC).

The DST entity will acquire and own the real property, and each owner in the DST (also called beneficial owners, beneficial investors, or beneficiaries) will be deemed, pursuant to Section 1031, to have acquired an undivided interest in the property held by the DST (beneficial ownership). The beneficial owners are thereby deemed to own a direct interest in the real property (in proportion to their beneficial ownership interest in the DST) and this will enable the beneficial owners to qualify their acquisition of the beneficial ownership in the DST as replacement property under a like-kind exchange under Section 1031.

The DST will be managed by a trustee referred to as a signatory trustee, which in turn, is managed by the sponsor. The sponsor is the entity that has created the DST and solicited investors. Due to limitations placed on the DST as described below, a triple net master lease will be established at the time the DST is created and will be entered into by and between the DST and the entity designated to be the maser tenant. The sponsor will typically have control over the master tenant and any property manager who will then manage and operate the property, which includes overseeing the leasing of units at the property as well as for paying all property expenses and making the majority of repairs and renovations that may be required at the property.

<u>DST as a Tax Savings Vehicle</u> – In order for a DST to qualify for the tax benefits under Section 1031, a DST must be a Fixed Investment Trust, which means it satisfies the following requirements:

> Special Purpose Entity

> Bankruptcy remote

> A passive holder of real estate:

- Beneficial owners do not have any power to control or operate the property.
- DST trustee has minimal powers with respect to the property and is prohibited from doing any of the following “Seven Deadly Sins:”
    - ❖ Accept contributions to the DST after the offering period for soliciting investments has closed.
    - ❖ Renegotiate the terms of existing loans or borrow new funds unless a default exists as a result of any master tenant bankruptcy or insolvency at the property.
    - ❖ Reinvest the proceeds from the sale of the real property or acquire new real property.
    - ❖ Invest any reserves or cash received to profit from market fluctuations.
    - ❖ Fail to distribute all cash other than reserves on a regular basis.

- ❖ Make more than minor non-structural modifications to the property not required by law.
- ❖ Renegotiate any master lease on the property or enter into a new master lease on the property unless there is a master tenant bankruptcy or insolvency.

Additional DST Structure Features – A DST will also:

> Be a separate legal entity subject to the terms of a trust agreement with its own Tax ID Number.
> Have at least two trustees:

- Signatory trustee that will manage the business affairs of the DST trust, including making payments on its mortgage and distributions to investors. The signatory trustee is usually the sponsor or an affiliate of the sponsor.
- Delaware trustee that maintains a Delaware address for service of process and will prevent the dissolution of the DST in the event something were to occur to the signatory trustee. The signatory trustee may also be the Delaware trustee if it meets the requirements for the Delaware trustee.
- Independent trustee that serves for the benefit of the lender in the event the signatory trustee either fails or is unwilling to act in the best interest of the lender.

> Permit an unlimited number of beneficial owners in the DSTs though frequently capped at anywhere between 99 to 499 beneficial owners.

> Enter into a long-term triple net master lease with a master tenant to operate and manage the real property, including entering into a property management agreement with a property manager who may, among other things, lease the residential and commercial units to subtenants and repair the real property. The sponsor will typically control the master tenant and the property manager.

> Have a Springing LLC conversion feature in place so that if the DST is in jeopardy of losing the real property, the DST may convert to a limited liability company in accordance with the trust agreement. The trustee will be the managing member of the Springing LLC.

Investor Benefits – Similar to 1031 Exchanges and tenants in common structures (which is the resulting ownership structure from a traditional 1031 Exchange), a DST permits real estate investors to defer capital gains tax earned on profit received from the sale of one investment property by investing that profit into another investment property of equal or greater value. However, unlike the standard 1031 Exchange and tenancies-in-common, the IRC permits beneficial owners to invest in the DST trust entity and not the real property itself in order to obtain the tax benefits. The DST entity will receive payments from the real property, and the beneficial owners will receive distributions through the DST entity. Some of the benefits of this structure to investors include:

> The bankruptcy of or an order of relief against any one beneficial owner will not impact other beneficial owners' interest in the property or the property itself as the creditors of each beneficial owner are limited to such individual beneficial owner's interests in the DST entity (beneficial interests).

> Beneficial owners are not restricted from transferring or pledging their beneficial interests.

> Guarantors are typically limited to those in the organizational chain of the sponsor.

> Beneficial owners are passive investors in the ownership of the real property:

- Will not be involved in management and/or operation of the real property.
- Will not have to make any additional investment into the real property.

Lender Benefits – In comparing a DST loan structure to a tenancy-in-common structure, the benefits to the lender include:

> Only the DST borrower, sponsor, and related entities (*i.e.,* guarantor, master tenant, and entities in the master tenant's organizational structure, etc.) need to be underwritten.

> Lender only has to deal with the DST trustee and related persons/entities.

> Real property is not at risk of any one beneficial owner's creditors or bankruptcy filing.

> No monitoring of transfers of beneficial ownership interests in general.

> Reduced transaction costs as the lender only needs to underwrite and monitor one borrower, and typically one guarantor.

Lender Risks – The DST loan structure poses the following risks to a lender:

> Inability of the DST to actively operate and manage the property.

> Inability of the DST to refinance at end of loan term (DST borrower will have to take some action that will eliminate tax savings benefit to beneficial owners such as convert to a LLC or sell the property).

> Possibility of sponsor electing to walk away from the real property instead of working out a troubled loan or converting the DST owner to a LLC. NOTE: To mitigate this concern, a sponsor with significant experience as a DST sponsor may argue that abandoning a property has the potential to result in irreparable harm to its reputation so that abandoning a property would be an unlikely occurrence.

Standard Loan Requirements – In order to address the risks noted above, a lender will require, among other things, the following:

> DST Trust and master tenant must each be a SPE entity.

> Sponsor and its related entities (i.e., guarantor and master tenant) must be underwritten.

> Signatory trustee typically required to retain a minimum interest in the DST Trust.

> Beneficial owners not typically underwritten unless any one owns in the aggregate 25 percent or more of a beneficial interest in the DST owner.

> Master lease term must extend beyond the term of the mortgage.

> Establishment at origination of mortgage of a sufficient replacement reserve from which the master tenant will be able to access funds to address repairs and renovations of the property.

> Escrow for taxes, insurance premiums, and other assessments.

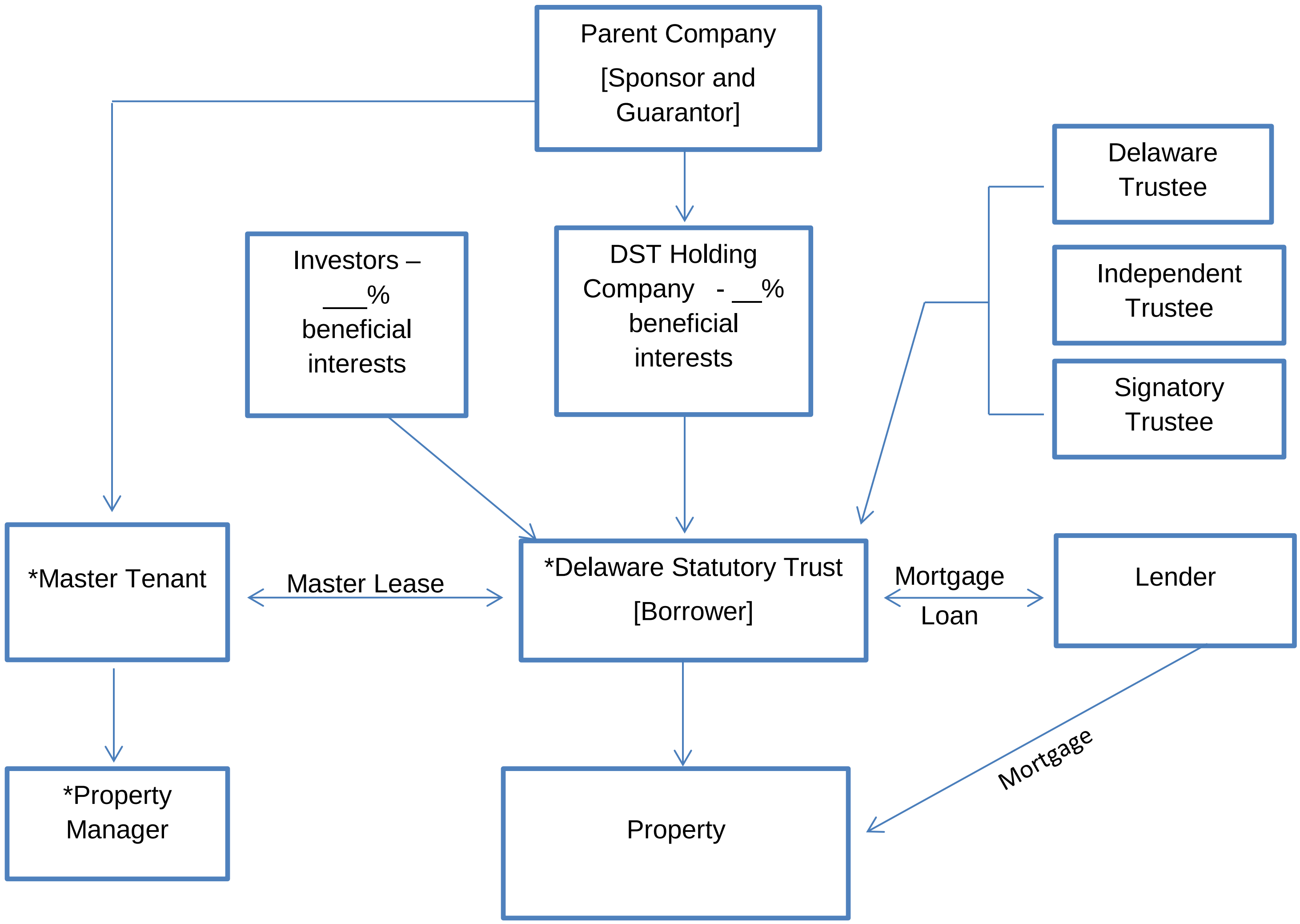
> Bankruptcy of the sponsor and related persons/entities will result in an Event of Default under the mortgage.

> Master tenant and any property manager must enter into a subordination, assignment, and security agreement with lender and DST borrower (commonly referred to as a Four Party Agreement).

> Springing LLC conversion with the sponsor to be the managing member to be a pre-approved transfer.

- Restrictions on the transfer of beneficial ownership interests limited to any transfer to an individual or entity of 25 percent or more of the aggregate interest in the DST.

Sample DST Organizational Structure



* Parties to Four Party Agreement (SASA)