PERCH
WEALTH

WHY DSTS ARE A POPULAR VEHICLE FOR

REAL ESTATE INVESTORS

WHAT IS A DELAWARE STATUTORY TRUST (DST)?

A Delaware Statutory Trust, or DST, is a commonly used structure for accredited investors looking to fractionally invest in real estate.

The primary draw to investing in a DST is that it is 1031 Exchange eligible, meaning that investors who are selling a property can defer paying capital gains tax by investing those proceeds into a DST, which the IRS has ruled qualifies as a “like-kind” investment. Secondarily, due to a low required minimum investment, DSTs are an efficient way to diversify a real estate portfolio by asset type and geographical location.

DST offerings are normally “sponsored”, or brought to market and made available to accredited investors, by national real estate companies, and can be offered through independent broker-dealers. DST sponsors acquire the property(s) to be offered within the trust. The DST sponsor conducts due diligence on the property, arranges all legal work required to ensure the trust qualifies for 1031 exchange purposes and, as appropriate, secures long-term financing which is non-recourse to investors. The DST sponsor then makes the asset(s) available to accredited investors on a fractional ownership basis, and will collect a fee for structuring, overseeing, and managing the investment on behalf of investors.

THE HISTORY OF DSTS

In the early 2000s, some of the nation's largest real estate sponsors and their attorneys pushed the IRS to establish guidelines that would allow TICs, or "tenant-in-common" real estate (a co-ownership structure described in more detail below) to qualify for 1031 exchanges. As a result, investment in TICs skyrocketed. Soon, investors were confronted with some of the challenges presented by TICs, such as needing unanimous consent among investors to make certain types of decisions related to the property.

Around this same time, the concept of investing through a DST gained traction. DSTs provide more flexibility than TICs on several fronts and address some investors concerns particularly around the unanimous consent provisions.

It was no surprise, then, that investors and sponsors urged the IRS to adopt similar 1031 exchange guidelines for DSTs. In response, in 2004, the IRS issued Revenue Ruling 2004-86 allowing use of the DST structure in acquiring real estate where the beneficial interests of the trust would be treated as direct interests in replacement property for the purposes of a 1031 exchange. This is heralded as a major victory for real estate investors as they maintain the benefits of real estate ownership, add securities oversight to provide more transparency, and build in property management.

Like commercial real estate in general, TICs and DSTs were widely used up until the Great Recession in 2008, when commercial real estate values and popularity plummeted. TICs were impacted more than DSTs due to cumbersome rules requiring unanimous consent on major decisions, and the economic downturn certainly necessitated major decisions. As the economy improved, investment in real estate re-accelerated and DSTs surfaced as the preferred method of fractional real estate ownership given the complexities associated with TICs.

THE DIFFERENCE BETWEEN TICS AND DSTS

For long-time real estate investors, DSTs are a relatively new concept. Most long-time investors are instead familiar with TICs, or tenant-in-common real estate investments. Both TICs and DSTs allow people to invest fractionally in real estate. Both can be used in conjunction with 1031 exchanges. As such, it is no wonder some people confuse TICs and DSTs. However, there are some key differences between the two.

A primary difference has to do with the level of involvement of investors. The co-owners of a TIC must remain involved in major decisions at the property level. DSTs on the other hand, are truly passive investments in which the sponsor oversees the property and asset management on behalf of investors.

One of the reasons management of TICs can be so cumbersome is that major decisions require unanimous consent of co-owners on any major decisions. In fact, this is one of the challenges that led to the creation of DSTs. The unanimous consent required by TICs is a negative for many investors and creates challenges for some who had already invested in TICs. Another difference between TICs and DSTs is how they hold title to the property. TIC co-owners each hold a fractional share of the title to the property. Conversely, the DST holds actual title to the real estate asset – individual investors do not, they hold a beneficial interest in the DST. This has implications as it pertains to financing.

When debt is used to finance a TIC property, either acquisition or improvements, the individual co-owners might have to carry the liability for that debt. This also means that lenders need to underwrite each borrower individually, which can prove burdensome for most lenders and therefore, can make real estate held in TICs difficult to finance. DST investors do not carry debt directly, since the asset is held exclusively by the DST on the investors' behalf in a trust structure.

TICs and DSTs also differ in terms of the number of investors allowed to participate. TICs are limited to 35 investors (or "co-owners") versus DSTs which are capped at 499 individual investors.

Finally, because DSTs allow for more investors to participate, the minimum investment is generally lower than what is required by TICs. Many TICs require at least a $500,000 minimum investment, whereas a DST will allow investments as low as $25,000.

HOW DO INVESTORS USE DSTS?

There are two ways an investor can take advantage of the benefits DSTs offer. The first, and most popular way, is to invest using 1031exchange funds. The other option is a direct cash investment into a DST.

1031 EXCHANGES

Traditionally, an investor looking to defer paying capital gains tax on the sale of a real estate asset will do a 1031 exchange and use the proceeds from the sale to invest in another “like kind” asset. There are strict rules associated with 1031 exchanges; under current law, to qualify for a full tax deferral, investors must:

- Reinvest 100% of net sales proceeds, also known as equity, into the replacement property;
- Acquire an equal or greater amount of debt on the replacement property;
- Identify potential replacement property(ies) within 45 days of sale; and
- Close on the replacement property(ies) within 180 days of the sale.

Meeting these criteria can be difficult, particularly in today’s competitive real estate market.

DSTs offer an alternative to “whole property” 1031 exchanges.

Instead, investors can roll the proceeds of the sale of their property into a DST. Each investor will then receive a beneficial interest in the DST representing a proportionally fractional ownership interest in the property (or properties) owned by the DST. DSTs are already established (“pre-packaged,” if you will) and ready to accept investors, which allows someone selling their property to generally move quickly in accordance with the IRS 1031 exchange guidelines. All due diligence on the real estate is already complete. Moreover, the proceeds from the sale of the investors’ property will qualify for the same capital gains tax deferral, under current law, as if they had invested through a whole property 1031 exchange.

Sometimes, investors will combine strategies by investing in both whole property and a DST. This is often the case when an investor finds a suitable replacement property (or properties) but still has excess cash remaining from the sale of their other asset. The investor can take the remaining sales proceeds and invest that capital into a DST to take full advantage, under current law, of the 1031 exchange benefits.

DIRECT CASH INVESTMENTS

Accredited investors may also invest in DSTs without selling their existing real estate. This is a great way for those looking to gain exposure in passive direct real estate investments or to diversify a real estate portfolio. Most DSTs have a required minimum investment amount of $25,000 for a direct cash investment. This is a particularly attractive option for accredited investors looking to access institutional-quality and other high-value real estate that they would be unable to afford on their own.

There are many potential benefits to investing in a DST, several of which are outlined below:

Capital Preservation Tool:

As noted above, DSTs are a great way for investors to defer paying capital gains tax on the proceeds of the sale of their other real property. Rather than doing a "whole property" 1031 exchange, they can reap the same benefits by investing in a DST. Under current law, once the DST program concludes or the asset is sold, investors can reinvest in another DST or sole-ownership property to continue deferring capital gains taxes in perpetuity.

Ability To Move Quickly:

The biggest limitation to those trying to conduct a traditional 1031 exchange is generally identifying a suitable like-kind property to purchase within tight IRS timelines. This is particularly true in today's competitive real estate environment, where there are fewer available properties for an extended period of time. Investors still need to conduct thorough due diligence on every prospective opportunity, and finding a properties meeting their investment criteria within the allotted time can often be quite challenging. DSTs offer real estate that has already been thoroughly vetted and is ready for investment. This allows sellers to move quickly while still taking advantage of the tax benefits associated with doing a 1031 exchange.

More Inventory To Consider:
Many investors seeking to do a 1031 exchange find themselves pressured into trading up into a property that they might not otherwise purchase if it were not for the 1031 time constraints. Investing in a DST provides access to greater inventory—including real estate that has been carefully vetted by some of the industry's leading acquisition teams. This can help reduce the likelihood of making a "bad" investment for those who might otherwise make a snap decision given timeline pressures.

No Active Management Required:
Those who trade-up into a higher value asset with a traditional 1031 exchange still take on the burden of actively managing the real estate. Instead, those who invest the proceeds of their sale into a DST delegate management responsibilities to the DSTs sponsor, who oversees the real estate holdings on behalf of the investors. This allows an investor to cash out of properties they actively own and manage, and move into real estate that is 100% passive by design.

Easier To Finance And No Personal Liability For DST Debt:
Unlike TICs, those who invest in DSTs are not personally liable for any debt associated with the property. Instead, the sponsor is solely responsible to lenders. Real estate held in DSTs is also easier to finance because the lender is only underwriting the sponsor, usually a large and reputable institutional real estate company with a verified track record, and not each individual investor, as is the case with TICs.

Access To Institutional-quality Assets:
Those who invest in property directly are often limited to assets of a certain caliber simply due to the costs and financing associated with investing in higher-quality real estate. Those looking to invest in institutional-quality assets can do so by investment through a DST given its fractional ownership model. Through a DST, an individual investor can effectively own a small share of a high-quality asset that would otherwise have high barriers to entry.

Diversification:
There are multiple DST real estate investments available to investors from various DST sponsors and include multifamily, industrial, storage space, office, and NNN leases; to name a few. Not only can you invest in multiple property types, you can do so in several different geographic regions across the country. Diversification by asset type and geographical location is a technique designed to reduce risk and increase the probability of more consistent returns.

1031 RISK DISCLOSURE:

- There is no guarantee that any strategy will be successful or achieve investment objectives;
- **Potential for property value loss** – All real estate investments have the potential to lose value during the life of the investments;
- **Change of tax status** – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- **Potential for foreclosure** – All financed real estate investments have potential for foreclosure;
- **Illiquidity** – 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- **Reduction or Elimination of Monthly Cash Flow Distributions** – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;
- **Impact of fees/expenses** – Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits

CONCLUSION

As you can see, there are many reasons why an investor should consider investing in real estate through a DST. The DST model provides tremendous flexibility, opportunity, and investment diversity for those looking to take full advantage of benefits typically associated with traditional 1031 exchanges.

What's more, DST investments can be closed upon quickly by investors – often in a matter of days. So if you're an accredited investor looking to put your cash to work for the first time, or someone who is under a tight deadline to deploy the proceeds from a 1031 sale, investing in a DST can be a great option.

Are you interested in learning more about DSTs? Contact Perch Wealth today at 855-DST-3443 to learn more about our current DST real estate offerings and how we can possibly help you.

General Disclosure