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Using Delaware Statutory Trusts in Real Estate Investments: Opportunities and Legal Risks

Structuring and Financing the DST, Advantages Over TIC Ownership, Preserving 1031 Tax Treatment

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Today's faculty features:

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Using Delaware Statutory Trusts in Real Estate Investments: Opportunities and Legal Risks

September 26, 2019

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Your Presenters – Ed Hannon

Edward Hannon is a shareholder and a member of the tax practice group in the Chicago office of Polsinelli PC. Polsinelli is an AmLaw 100 law firm with more than 875 attorneys in 21 offices nationwide. Polsinelli's Chicago attorneys have been recognized for their outstanding work by numerous organizations including The Best Lawyers in America, Chambers USA, Illinois SuperLawyers and Leading Lawyers Network.

Ed concentrates his practice on the development and implementation of tax savings structures in real estate projects including development joint ventures, investment programs for real estate projects and foreign investment in U.S. real estate and Mr. Hannon has been extensively involved in designing and implementing various structures for the use of like kind exchange equity. Ed has been recognized by Leading Lawyers and SuperLawyers in the areas of international business and trade law, real estate law and tax law and is a frequent speaker on various issues in tax and structural planning for real estate transactions.

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Your Presenters – Steven Meier

Steve Meier is a partner in the Corporate Department of Seyfarth Shaw LLP, where he is Chair of the Firm's Corporate Department and Co-Chair of the Firm's National Tax Practice.

Mr. Meier regularly advises investment program sponsors on the tax, securities and business aspects of the design, implementation, disposition and workout of real estate investment programs, including real estate investment funds, Qualified Opportunity Funds and complex like-kind exchange programs. He also acts as lead tax counsel in domestic and cross-border transactions for a diverse client base that includes public companies, private equity firms and entrepreneurs, and as outside general tax counsel to numerous public and private companies. Mr. Meier is recognized by *Legal 500* for his tax practice, and is a frequent speaker on tax and business issues in real estate securities programs, mergers and acquisitions transactions, and executive compensation.

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Topics Covered Include:

- Trends in the use of Delaware Statutory Trusts for real estate investments
  - Advantages of Section 1031
  - Tax issues
  - Alternative to TICs
  - Section 1031 exchanges
- Structuring the DST
- Assets for DST Programs
  - Credit Tenant vs Master Tenant
  - Specific Asset Classes
- Financing of DST investments

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Topics Covered Include:

- DST Governance
  - Trustee Powers and Duties
  - Indemnification Provisions
  - LLC Conversion Provisions
- Workouts of DST Programs
  - Springing LLC
  - Other Workout Strategies
  - Lend Consent Issues
  - Comparison to TIC structure restructurings
- Non-Traditional Uses for DSTs - REITs/Funds vs Direct Investment

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Goals of Presentation

- The issues we will address include the following:
  - What are the trends in using DSTs as real estate investment vehicles?
  - What opportunities exist for using DSTs and what are some of the legal pitfalls?
  - What types of investment properties are DSTs well-suited as an investment structure?
  - What challenges do DSTs present for lenders and how should these problems be addressed?

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What is a DST and What Makes it Special?

- A DST is a Delaware statutory trust
- Revenue Ruling 2004-86
  - An interest in a DST that holds real estate and satisfies certain passivity and other tax law requirements can be treated as replacement property for purposes of Code Section 1031
- Code Section 1031 and Real Estate
  - Code Section 1031 permits real estate held for investment to be exchanged for other real estate of "like kind" without recognition of gain inherent in the relinquished real estate.
  - Property of "like kind"
    - The tax law is very taxpayer-friendly when it comes to determining what kind of property is of "like kind" to real estate.
    - Almost all direct ownership interests (and even long leasehold interests) in real estate are considered to be of "like kind" to each other

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What is a DST and What Makes it Special?

- Thus, an interest in a properly structured DST that holds real estate can be "like kind" property with almost any other kind of direct real estate investment
- This creates a "best of both worlds" situation:
  - Investors can invest in professionally managed real estate investments via a Code Section 1031 exchange
  - In contrast, investors CANNOT receive REIT interests, UPREIT partnership units or units in a real estate fund via a Code Section 1031 Exchange
  - Investing via a Code Section 1031 exchange allows investors to increase the amount of capital available for investment between 20%-30% (as compared to equivalent capital exiting a prior real estate investment)

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Section 1031 as an Investment Strategy

- Current Tax Regime Facing Investors
  - Federal Capital Gains Tax Rate: 20%
  - Net Investment Income Tax: 3.8%
  - Depreciation Recapture Tax Rate: 25%
  - State taxes: Up to 13.1% (highest marginal California income tax rate)

  – Example:
  - In Year 1, Investor acquires multifamily investment property for $11 million
    - $1 million attributable to land (non-depreciable), $10 million attributable to improvements
    - After 10 years, Investor has taken roughly $3.6 million in depreciation deductions
  - In Year 10, Investor seeks to sell property for $15 million
  - Investor is a California resident and is subject to the highest marginal California income tax rates

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Section 1031 as an Investment Strategy

- Tax Outcome (simplified for illustration purposes):
  - Total Capital Gain: ($15 million sales price minus $7.4 million basis equals) $7.6 million
  - Federal Taxes:
    - Deprecation Recapture: $3.6 million x 25% = $840,000
    - Capital Gain: ($7.6 million total gain minus $3.6 million depreciation recapture equals) $4 million x 20% = $800,000
    - Net Investment Income Tax: $7.6 million x 3.8% = $288,800
    - Total Federal Taxes = $1,928,800
  - State Taxes:
    - California: $7.6 million x 13.1% = $995,600

Section 1031 as an Investment Strategy

- Tax Outcome (simplified for illustration purposes):
  - So what happened?
    - $15 million gross sales proceeds became $12,075,600 after income tax
    - $2,924,400 in income taxes
    - Let's assume $500,000 in selling expenses
  - Consider the alternatives for a real estate investor:
    - Invest $11,575,600 in real estate
    - Invest $14.5 million in real estate via a Section 1031 exchange
  - Thus the appeal of the Section 1031 Exchange for the real estate investor
    - Investing via a Section 1031 exchange allows investors to increase the amount of capital available for investment between 20%-30% (as compared to equivalent capital exiting a prior real estate investment)

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What is a DST and What Makes it Special?

- Code Section 1031 vs. Code Section 721
  - Tax free exchange (Code Section 1031) vs. tax free contribution to a partnership or LLC (Code Section 721)
  - Both are tax free, so what makes Section 1031 so special?
- The Difference? The Endgame….
  - Inbound transactions via Code Section 1031 or Code Section 721 are both tax free, but….
  - Outbound transactions are not:
    - Code Section 1031 can continue to roll their investment into other, new Code Section 1031 investment programs in perpetuity
    - Estate planning – Step up in basis upon death.
    - Code Section 721 investors do not have this flexibility

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What is the Catch with the DST?

- All interests in a DST must be pro rata; no multiple classes of interests, no preferences
- No active trade or business – purely passive
- The "Seven Deadly Sins" – Tax law restrictions on the DST:
  - No new capital after completion of the DST's capitalization
  - No lease amendments or new leases unless there is a tenant bankruptcy or insolvency
  - No mortgage modifications or new mortgage debt unless there is a tenant bankruptcy or insolvency
  - Only minor, nonstructural modifications to the real estate (unless required by law)
  - Reserves and cash can only be invested in short-term obligations
  - Cash, other than necessary reserves, must be distributed
  - No reinvestment of sales proceeds in new investments

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Mitigation of the DST's Limitations

- Acquire only new or recently rehabilitated properties
- Avoid loans and leases which require mid-deal renegotiations
- No development deals! Avoid real estate that will require material mid-deal revisions
- Acquire properties subject either to a NNN lease with a creditworthy tenant
  - For properties with continuous leasing activity, use an NNN Master Lease
- Have debt term that is materially shorter than the term of the property lease(s)
- Provide for reserves up front (out of loan proceeds) or out of cash flow (do not leave the DST vulnerable to cash shortages)
- Last but not least, provide for a "Springing LLC" in the DST's trust agreement ….

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Assets for DST Programs

- Fundamental Issue – Managing the "Four Pillars of DST Investing"
  - Subset of the Seven Deadly Sins
    - No New Capital
    - No Refinancing
    - No Releasing
    - No Redevelopment
- Credit Tenants/Long-Term Leases
  - Clear advantages for managing the "Four Pillars"
    - Large pool of "digestible" sized properties
    - Rated corporate credit of tenants

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Assets for DST Programs

- Issues with Credit Tenants
  - Limited rent escalations
  - Property abandonment/substitution rights
  - Tax exempt tenant issues
    - Section 470
    - In certain circumstances, property leased to tax exempt tenants does not qualify for Section 1031 treatment
    - Avoid the issue by looking for typical commercial lease terms
    - Look out for lease provisions that put risk of loss in part back on tenant
    - LTV must at all times be below 80%

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Assets for DST Programs

- Master Leased property as an alternative to Triple Net Leased property
  - Contemplated in Rev Rul 2004-86
    - "Z may sublease Blackacre."
  - First DST deal done in December 2004 was a multifamily deal subject to a Master Lease
  - Solves one of the Four Pillars
    - Permits ongoing leasing activity at the property
    - As a result, can take advantage of rent escalations thus preserving and even improving property value
    - Master Lease should not be treated as additional class of interests (which would breach one of the seven deadly sins).

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Assets for DST Programs

- Issues to work through with Master Leases
  - Sponsor and Master Tenant are affiliates
    - Potential conflicts issue not present in Triple Net Lease deals
  - Master Lease design
    - Legally and economically, must avoid characterization as:
      - a partnership between the DST and the Master Tenant
      - a management agreement between the DST and the Master Tenant
      - a financing arrangement
    - Easier said than done, particularly in light of affiliation issue
  - Reserves and capital expenses
  - Tenant improvements and leasing commissions
  - Competing properties
  - Furniture, fixtures and equipment

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Revisiting The Master Lease Structure

- If Master Lease is re-classified for income tax purposes as a "partnership" between owner of the master tenant entity and the DST, Code Section 1031 treatment for the beneficial interests in the DST will not be available.
- Key Factors to consider:
  - Does master tenant have commercially reasonable opportunity for profit (i.e., how big must the spread between projected rents to be received and the master lease rent be).
  - What if "additional rent" is not timely paid and the master lease agreement does not provide for a catch-up mechanism.
  - What if the lender wants to have the Master Tenant provide the lender with a security interest in the underlying rents.

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DST Financing

- Senior Debt and Debt Free DST Offerings exist
  - Agency debt (Fannie, Freddie), CMBS debt are available
  - Issues
    - Who is the borrower? Master Lease structures present potential issues that need to be avoided (e.g., Master Tenant as co-borrower on the note)
    - Carveout guaranty vs. payment guaranty
- "Gap Equity" (or Mezzanine Debt)
  - Generally needs to be outside of the DST entity
    - Sponsor beneficiary as mezzanine borrower
    - Capital contribution to DST that is redeemed through interest sales

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Other Structural Issues

In Rev. Proc. 2004-86, the property was acquired before beneficial interests were sold to 1031 investors.

Does an issue arise if the sponsor uses cash from the initial 1031 investors to fund the purchase of the property by the DST?

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DST Governance -- Duties of Trustee

- Two Trustees: Delaware Trustee and Signatory Trustee
- Under Delaware Law, the trust agreement may expand or restrict the duties of the trustee, including fiduciary duties.
- Typically, the Trust Agreement in a DST will limit the duties of the Trustees.

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DST Governance -- Duties of Trustee

- Duty of signatory trustee is to conserve and protect the trust estate
- In a DST with a master lease, the master tenant hires the property manager.
- In master lease, consent of only the signatory trustee is required for assignment of master tenant to another party.
- In master lease, election to terminate the master lease upon an event of default is made solely by the signatory trustee.

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The "Springing LLC"

- Trust Agreement provision:
  - Triggered if property is in jeopardy of being lost or if there is a loan default and the Trust cannot take action due to the "seven deadly sins"
  - In that situation, the DST is required to convert itself into an LLC
  - The form LLC agreement for the "Springing LLC" is an exhibit to the trust agreement of the DST
- Most property problems arise from tenant bankruptcy or insolvency, so the "Springing LLC" rarely comes to pass
- Disadvantage: Converting to the "Springing LLC" inhibits investors' ability to do Code Section 1031 exchanges with their equity interests
- However, small price to pay to save the property

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DST Agreement Provisions on the Springing LLC

- Obligation to convert to an LLC is as set forth in the trust agreement (if not permitted in the trust agreement in the particular circumstances, LLC conversion cannot happen).
- Triggered if property is in jeopardy of being lost to lender and trustee cannot take actions because of the “seven deadly sins.”

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Sample – "Springing LLC" Language

- Master Tenant fails to timely pay rent due under the master lease after the applicable cure period.
- Signatory Trustee determines that trust estate is in jeopardy of being lost due to default on the loan and the trustee is prohibited from acting under the "seven deadly sins."

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Sample – "Springing LLC" Language (Continued)

- An Event of Default has occurred under the Financing Documents.
- The Property or any portion thereof is subject to a condemnation casualty or similar event.
- Master Tenant files for bankruptcy.

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When to Spring to the Springing LLC?

- When to spring to the Springing LLC?
  - Mandatory or only if it will achieve a goal?
  - Reasons to not Spring even if foreclosure is approaching
    - Springing would not achieve any objective
      - Property cannot be refinanced; no new capital forthcoming; tenants not available/won’t renegotiate
    - Springing would damage a potential Section 1031 exit for investors
      - If DST is converted and foreclosure occurs, Investors cannot exchange their LLC interests in a Section 1031 Exchange and will generally suffer adverse tax consequences
      - If DST is not converted, Investors may be able to do a Section 1031 Exchange into highly leveraged property
  - Partnership formation transaction for tax purposes

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The DST Interest as a Security

- DST deals are tax-driven real estate deals sold as securities
  - They are real estate deals because, unlike many funds, they are sold based on specific real estate assets they own (there can be no “blind pool” DST deal)
  - They are tax driven because a DST interest is carefully designed to constitute replacement property for purposes of Code Section 1031
  - However, because the DST sponsor has arranged financing and typically stays in the deal in some meaningful managerial capacity, DSTs are sold as securities for securities law purposes
    - Reg D/Rule 506 private placements – JOBS Act!
    - State securities law preemption
    - Accredited investors only
    - Almost always sold through Broker/Dealers subject to FINRA rules
    - “Blue sky” filings in connection with sales of DST interests
- Thus, the DST offering memo is an amalgam of real estate, finance, environmental and tax disclosure packaged and sold in a securities law wrapper

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The Beneficial Interest in a DST is a Security

- Notwithstanding the tax treatment provided in Rev. Proc. 2004-86, the sale of beneficial interests is a security for purposes of Federal and State securities laws.
- Typically, sales are made solely to "accredited investors" and are accompanied by a private offering memorandum that complies with a applicable securities laws and best practices standards.
- State filings may also be required.

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Distressed DSTs

- Master Lease Default – non-payment of master lease rent.
- Loan Default – non-payment of amounts due under the loan.

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Work-Out Options

- Amend master lease for “flow-through” of net cash.
  - NOTE: Most “modern” master leases are relatively efficient from a cash flow perspective, thus limiting the benefits of amendments
- Amend trust agreement to allow LLC conversion if not otherwise permitted under the trust agreement. (This requires the consent of the beneficial owners).
- Sell beneficial interests to a third party. (Consider if the cooperation of the signatory trustee is required.)

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Tax Deferral on Sale

- Sale of beneficial interest for cash and/or loan assumption can qualify for like kind exchange treatment if replacement property is purchased.
- Contribution of beneficial interest to LLC in lieu of cash payment can also facilitate gain deferral.

Tax Deferral on Sale (Continued)

Tax considerations in Contribution to LLC

- shift in "partner's share of partnership liabilities" can cause taxable gain recognition
- increased tax cost arising from Code Section 704(c) allocations
- tax protection Agreement is needed to address these tax cost events

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Other Uses for DSTs

- Non-syndicated structures – existing ownership group forms DST to own property in lieu of using a co-ownership structure
- REITs as an alternative/supplement to the UPREIT structure
- As acquisition entity for build-to-suit properties.

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