Acquisition, Disposition & Structuring Techniques Corner

The Do's and Don'ts of DSTs (Part I)

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Introduction

The real estate syndication industry's collective sigh of relief was nearly audible as the Republican tax reform plan in the House of Representatives and Senate preserved Code Sec. 1031 like-kind exchanges for real property.[1] Regardless of what, if anything, is accomplished in terms of tax reform in the coming months, this preservation at a minimum illustrates the Ways and Means Committee's intended commitment to, and appreciation of, like-kind exchanges of real property as important means of capital preservation and redeployment in the economy.

While the industry is not yet approaching its 2006 peak,[2] it has been in a definite upswing in recent years and the affirmation of support for like-kind exchanges in the early-stage tax reform plans will only serve to bolster industry confidence and will likely add to the already increasing ranks of active sponsors. While the increasing competition will bring greater reinvestment in American real estate, greater diversification for investors and a deeper and more innovative knowledge base, it will also put increasing pressure on established sponsors and new entrants alike to distinguish themselves and stay "cutting edge." With the confidence and optimism that this opening salvo of tax reform should bring to the industry, now is an appropriate time for market participants to recall the 2006 heyday and its lessons and perhaps commit to a thoughtful and consistent approach to the current industry favored structure for like-kind exchange focused real estate syndications—the Delaware statutory trust ("DST"). This column—the first in a two-part series—is intended to provide a high-level refresher on the "do's and don'ts of DSTs" in order to assist with that endeavor and guide practitioners in properly structuring DSTs in an increasingly competitive marketplace.

DST's Background

Subsequent to the 2006 peak, DSTs surpassed tenancy-in-common as the industry favored like-kind exchange driven structure. In Rev. Rul. 2004-86 (the

"Ruling"),[3] the IRS provided guidance for the use of a DST as a vehicle to facilitate the fractional ownership of replacement property by taxpayers completing like-kind exchanges. In a nutshell, if an entity is classified as an investment trust,[4] interests in that trust will be treated as interests in the underlying real property owned by the trust (as opposed to beneficial interests in the trust itself) for purposes of applying the like-kind exchange rules.[5] By effectively treating interests in a DST as interests in real property, the Ruling allows taxpayers disposing of real estate in an otherwise-qualifying like-kind exchange to acquire DST interests as qualifying replacement property, and vice versa. In contrast, if a trust is treated as a business entity[6] and not an investment trust, the trust interests will be treated as interests in a partnership and, therefore, will not constitute valid replacement or relinquished property pursuant to Code Sec. 1031(a)(2)(D). With this latter treatment resulting in catastrophic failure for an intended like-kind exchange, it is crucial that a DST be properly structured and executed within not only the framework of the Ruling (including the so-called "seven deadly sins") but also the relevant case law and judicially created doctrines.

Do's and Don'ts of DSTs

Limitation of Powers

A "gatekeeper" issue and strategy for ensuring a Ruling-compliant DST is the limitation of the powers of the trust, trustees (and their designees, such as a trust manager) and beneficial owners under the DST's trust agreement. In the Ruling, the governing instrument of the example DST specifically forbade the DST from undertaking certain prohibited transactions. Importantly, the DST actually lacked the power to undertake such actions—it was not simply a matter of the DST avoiding such activities. In order to ensure that a DST does not unintentionally create a business entity (*e.g.*, through an agency relationship, deemed partnership or otherwise), the DST's trust agreement should affirmatively limit the power and authority of the relevant parties and expressly prohibit the various parties from taking actions in violation of the guidance in the Ruling. It is clear that it is the existence of the power and not the exercise of the power, which is critical to accomplishing the desired DST result.

To that end, trust agreements should contain language expressly prohibiting trustees and managers from undertaking the typical "seven deadly sins," as well as additional "catch all" language forbidding action that would cause the DST to be treated as a business entity for federal income tax purposes, if the effect would be that such action would constitute a power under the trust agreement to "vary the investment of the certificate holders." The trust agreements also should contain even more restrictive language outlining the extremely limited nature of the beneficial owners' rights and powers due to the passive nature of an investment in such a structure, effectively limiting them to the right to receive distributions and providing no voting rights. A properly structured trust agreement will effectively limit the DST's activities to little more than the collection and distribution of income from the underlying property, allowing only for engagement in ministerial activities to the extent required to maintain and operate the DST under local law.

Varying the Investment

An investment trust will not be classified as a trust if there is a power under the trust agreement to "vary the investment of the certificate holders."[7] A power to vary the investment of the certificate holders exists where there is a managerial power under the trust agreement that enables a trust to take advantage of variations in the market to improve the investment of the beneficial owners. As noted above, a well-drafted trust agreement will expressly and affirmatively limit this power. However, a mere statement reciting this prohibition is meaningless, if in practice the DST engages in activities that cross the line.

Investment of Cash

A key issue is the DST's handling of cash, such as rental income generated by the DST's property or proceeds from the disposition of same. A DST should distribute such cash, and its trust agreement should provide for the required timing of such distributions.[8] In between such distributions, all cash should be invested only in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital.[9] The trustee should be permitted to invest only in such obligations maturing prior to the next distribution date and should be required to hold such short-term obligations until maturity. In essence, the trustee may only temporarily deploy the DST's cash in low-risk investments prior to sweeping such cash to the beneficial owners *via* periodic distributions. The DST also should be cognizant that lenders sometimes invest DST reserves for the benefit of the DST. The investment parameters of the lenders should be limited to comply with the DST guidelines or the reserves should not be invested.

Exchange, Disposition and Acquisition of Property

In addition to outlining what can be done with a DST's cash between distributions, the trust agreement also should prohibit various actions that would result in varying the beneficial owners' investment.[10] For example, the trust agreement should prevent the exchange of the DST's property for other property, or the disposition of the DST's property and the use of such proceeds to acquire assets other than the short-term investments noted above.

Modifications of the Property

In addition, the trust agreement should limit modifications to the DST's property to no more than minor, non-structural modifications (unless otherwise required by law). This restriction on "modifications" is the cause of much consternation for market participants, particularly due to its lack of bright line guidance as to what will or will not violate the rule. Despite such lack of guidance, many practitioners apply this rule by analogy, looking to the REIT "prohibited transaction" rules and applying a 30% of property value test in determining what constitutes "minor."[11] In addition, the prevailing view is that common repairs, replacements and maintenance are distinguishable from "modifications" contemplated in the Ruling. For example, common unit turns such as replacing carpeting, cabinetry and other fixtures in need of repair or replacement should not violate this restriction. Other significant projects arguably also could be treated as a replacement or maintenance and not a structural modification, though the facts of each case should be considered carefully. For example, compare a typical, periodic roof replacement (arguably permitted replacement and maintenance) to a full roof tear off and modification of the roofline profile or addition of a new floor or room (likely a structural modification). In addition, depending upon the facts and circumstances, the installation of new equipment within a reasonably short period of time after the acquisition of the property may be acceptable to the extent such work was completely negotiated, agreed to and documented prior to acquisition and is simply being installed by an unrelated party as a post-closing "punch list" type item. The key consideration is that a Ruling-compliant DST should be locked in from the time it becomes an investment trust and cannot invest (or vary its existing investment) to profit from market fluctuations.

Leasing and Operating of Property

A DST that intends to be classified as a fixed investment trust and be compliant with the Ruling should refrain from operating in a manner that that exceeds the prohibitions set forth in the Ruling or otherwise varies the investment of the beneficial owners. As noted above, limiting the powers and authority of the various parties to do so is a key element. However, DSTs must also practice what they preach and actually conduct their business in a manner that is consistent with and confined by such limitations, particularly once a DST constitutes an investment trust for federal income tax purposes. This includes handling the leasing and operations of the DST's property consistent with the Ruling and any limitations imposed by the trust agreement.[12]

> *While the increasing competition will bring greater reinvestment in American real estate, greater diversification for investors and a deeper and more innovative knowledge base, it will also put increasing pressure on established sponsors and new entrants alike to distinguish themselves and stay "cutting edge."*

Leasing and Operations Considerations

From a leasing and operations perspective, practitioners should structure the DST and its trust agreement and other ancillary documents to put the DST in as passive of a position as possible (essentially collecting and distributing income and other ministerial activities only). Although the operation of a rental property is a trade or business, a DST should not be involved in active management of the property beyond the level of activity customary for a rental property, *e.g.*, a DST would normally not operate a shopping mall but would master lease the mall to its operator.[13] Because an interest in a Ruling-compliant DST is intended to constitute an underlying fractional interest in the DST's property for purposes of Code Sec. 1031, due to the limitations on investment discussed above, a DST must have closed on the acquisitions of its property or properties prior to or concurrent with such time that the DST becomes an investment trust. It is advisable to enter into a "net" lease of some degree, pushing various operational matters and costs on to the tenant. It should be noted, however, that generally a tenant cannot undertake

actions that the DST, as landlord, would not otherwise be able to undertake without violating the Ruling.[14]

The terms of leases should be carefully negotiated and locked in place at least at such time that the DST becomes an investment trust (and for the entire time the DST will be an investment trust), because from that point forward the DST cannot renegotiate the terms of leases with the existing tenant or enter into new leases with other tenants (subject to the limited tenant bankruptcy/insolvency exception in the Ruling). Even potentially variable terms must be set in stone to a certain extent, with the formula or mechanism for determining the variable aspect of the term being agreed to at such time the DST becomes an investment trust (for example, a fair market value purchase option with a price determinable at the time of exercise, the means for such determination set forth at the outset in the lease). This also means that the trust manager cannot take action on behalf of the DST that the DST could not take directly.

However, business realities and an ever-evolving marketplace require a thoughtful approach to the broader intent and context of such framework (and any ambiguity on the face thereof).

One means of addressing this restriction (particularly in the multifamily asset class where dwelling unit-level tenants may be coming and going on a monthly basis) is to interpose a "master lease" with a master tenant entity. The DST and master tenant enter into a master lease that complies with the Ruling and which cannot be modified (other than as specified in the Ruling), while the master tenant then serves as landlord to sub-tenants and is free to operate and maintain the property, enter into new leases with new sub-tenants, *etc.*, all without causing the DST (as master landlord) to violate the Ruling. A key consideration with a master lease structure is that the DST and master tenant must be careful to structure the master lease, ancillary documents with asset/property managers, or financing documents in a way that creates a "true lease" and not a deemed partnership or deemed financing for federal income tax purposes.[15] "Cash-flow" leases are problematic. It is also important that the master tenant have economic substance in its own right, which is often accomplished *via* some combination of participation in the gross revenues generated by the DST's property and a capital contribution or demand note providing capital to the entity. Such participation by the master tenant in gross revenues must truly be based on "gross rents" and not a net amount (whether net income or otherwise) in order to avoid potential deemed partnership treatment.[16] Most practitioners apply the policy set forth in Reg. §1.856-4(b)(3) relating to REITs to DSTs.

Finally, the importance of using gross numbers as a benchmark extends even beyond leases and the sharing of rents from the property and should also be applied to other items that must be pegged to a property-related benchmark. For example, various fees (such as disposition fees upon the sale or other disposition of the property) do not in and of themselves create an impermissible sharing in the performance of the property, though such fees should be based on gross numbers (for example, gross sales price of the property) as opposed to a net amount.

Conclusion

The Ruling and the oft-simplified recitations of the seven deadly sins provide the basic framework for classification of a DST as an investment trust. However, business realities and an ever-evolving marketplace require a thoughtful approach to the broader intent and context of such framework (and any ambiguity on the face thereof). The foregoing "do's and don'ts" aim to provide practitioners with a deeper practical knowledge of certain DST structuring and operations considerations in the context of the framework. The authors hope that this will prove to be useful guidance to an industry seeking to build a more sustainably successful environment than the 2006 peak. With at least temporary Congressional blessing at hand, the real estate syndication industry must proceed with care and commit to thoughtful innovation, as not all "game changers" are for the better. After all, "game over" is a game changer, too.

ENDNOTES

1 Tax Cuts and Jobs Act, H.R. 1, 115th Cong. §3303 (2017).

2 Mountain Dell Consulting, LLC, *Market Report: Securitized 1031 Industry*, 3Q 2017. In 2006, the real estate syndication industry peaked at 71 total sponsors raising equity, with over 300 offerings closed and over $3.65 billion in equity raised. To be sure, like-kind exchanges are beneficial to the economy at large and more broadly applicable than to the real estate syndication industry alone; however, as an example, the authors have focused thereon as like-kind exchanges are a key aspect of the industry's structuring and business model.

3 Rev. Rul. 2004-86, 2004-2 CB 191. The Ruling is still the primary guidance concerning the use of DSTs in connection with like-kind exchanges.

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