1031 EXCHANGE

INVESTING IN

DELAWARE STATUTORY TRUSTS



Presented by REAL ESTATE TRANSITION SOLUTIONS

Thank you for your interest in Real Estate Transition Solutions. For over 20 years, we have helped investment property owners understand, select and acquire suitable 1031 Exchange properties that meet both their financial and lifestyle objectives.

Our approach is grounded in education, transparency, and putting our clients' best interests first. We strive to provide real estate investment owners with as much information as possible so that, with our help, their investment real estate is best positioned to meet their unique individual objectives.

We hope you enjoy reading our free guide and welcome any questions you have regarding Delaware Statutory Trusts (DSTs) and how they work. To schedule a complimentary consultation to discuss your specific situation and what tax-deferred 1031 Exchange DST options are available to you, simply call us at **206-909-0037** or email us at info@re-transition.com.

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Delaware Statutory Trusts

What is a Delaware Statutory Trust (DST) Replacement Property?

Delaware Statutory Trusts, also referred to as “DSTs”, are a popular 1031 exchange replacement property for **accredited** investment property owners who do not want the burden of active property management. DST investors own a “beneficial interest” in the trust, which allows them to have an “undivided fractional interest” in the investment property owned by the trust. Typically, DSTs own high-quality institutional property.

An individual DST may own multiple properties, however, each trust owns only one property type. Generally, DST property is held for 3-10 years. Once the DST property is sold, the investors receive all sales proceeds including any potential appreciation and can either perform another exchange, pay tax or a combination of the two.

What are the Benefits?

For real estate investment owners considering selling their appreciated property, it may be beneficial to consider a DST as replacement property when utilizing a tax-deferred 1031 exchange. DSTs may provide a unique and flexible solution to investment real estate owners looking to defer tax and continue to own investment real estate, yet seek to eliminate the active management of directly owned fee-simple property.

DSTs Qualify for a 1031 Exchange

First and foremost, Delaware Statutory Trusts are considered a qualified replacement property for 1031 exchanges, as established by IRS Revenue Ruling 2004-86.
DSTs can be identified either as 'primary replacement properties' or as a sort of 'insurance' in case a fee-simple property cannot be found and closed within the mandated exchange timeline.

Defer Capital Gains Tax

Delaware Statutory Trusts allow real estate investors to defer paying taxes on the sale of an investment property, which can be very expensive. In some states, the total amount of tax can be as high as 37%.

Federal Capital Gains Tax: 15% - 20%
State Capital Gains Tax: 0% - 13.3%
Depreciation Recapture Tax: 25%
Net Investment Income Tax: 3.8%

However, by utilizing a 1031 Exchange, an investment property owner can defer their tax, as long as they acquire a replacement property or properties of equal or greater value.

Eliminate Active Property Management

Beyond deferral of the taxes, unlike most investment real estate, ownership of DSTs is entirely management free. The only responsibility of an owner is to select which DSTs they would like to exchange into. We have developed a very well-received approach to best determine our client's objectives and assist them in selecting the appropriate DSTs among the offerings we have vetted and approved.

Potential for Competitive Cash Flow

Typically, DST properties are structured with an emphasis on cash flow for the investors and because Delaware Statutory Trusts acquire high-quality institutional property in cities with strong projected growth, DSTs can focus on preserving investment value and producing income potential for their owners. Annual cash flow to the investors vary from trust to trust depending on the property type and sponsor, however investors may have the potential to experience greater cash flow through the ownership of the DST property than that of their relinquished property.

Low Minimum Cash Investments

Investment minimums for Delaware Statutory Trusts are quite low, typically $100,000. Low minimums allow for exchangers to acquire multiple DSTs – effectively creating their own personal property portfolio, diversified among multiple property types, geographic areas, and DST sponsors.

High-Quality Investment Property

The underlying real estate held by DSTs tends to be high-grade institutional property. Due to the rigid criteria established by the IRS for a DST property to qualify for exchange purposes, rarely is any other type of property, other than high-grade investment property, considered for the trust. It is common for a DST property to be leased to credit-worthy Fortune 1000 companies. In fact, a number of DST sponsoring firms require long-term leases with Fortune 1000 companies, or privately held companies with assets in excess of $100 million, to be in place before formation of the trust. DST ownership provides investors access to properties held traditionally by pensions, REITs and large institutional investors.

Low Cost Non-Recourse Debt Matching

Most investors have debt that must be matched in their exchange (for further detail on debt-matching rules see our FREE Guide "**Understanding 1031 Exchanges** "). DST sponsors understand this and, as a result, many DSTs are structured with debt in place.

Access to low-cost non-recourse debt is a major benefit of DST ownership, one that serves to enhance potential cash flow and appreciation. Delaware Statutory Trusts also provide liability protection for their owners, further reducing risk of ownership.

Increase Annual Depreciation to Offset Income Tax

There are a number of key tax benefits associated with DSTs including the potential to increase annual depreciation to offset taxable income and the ability to own DST property in non-income tax states.

Opportunity for Appreciation

Ownership of an interest in a DST share many similarities with ownership of fee-simple property, including the opportunity for appreciation. Furthermore, the Delaware Statutory Trust distributes all potential appreciation to the DST owners, consistent with their percentage ownership.

Eliminate Tax for Estate Beneficiaries

The benefit of increasing cash flow and invested dollars is clear, but perhaps the biggest benefit of a 1031 Exchange is that it allows for a "step-up in basis" upon the passing of an owner. “Step-up in basis” refers to the IRS’s elimination of Capital Gains, Depreciation Recapture, and Net Investment Income Tax upon the death of an owner. In "community property" states, a surviving spouse receives a full step-up in basis to the properties fair market value.

From an estate planning standpoint, DSTs are a particularly attractive solution due to their ability to be seamlessly divided among beneficiaries – whether that be family, charities or any other beneficiaries. Furthermore, because DSTs are considered illiquid and owned as a non-controlling interest, ownership of DSTs can be discounted by an investor’s CPA when calculating total estate value upon death. It is not uncommon to see discounts ranging from 20%-30% for estate calculation purposes.

Limited Liability for Trust Beneficiaries

DST properties provide limited liability for trust beneficiaries. Ownership of an interest in a DST property is analogous to a LLP or LLC from a liability standpoint. Financing debt held on the property is previously arranged by the DST sponsor and is non-recourse to the investors, personal guarantees are not allowed or required, and the only financial qualification on an individual investor basis is to be an accredited investor.

Exchange Proceeds can be Diversified Among Multiple DST Properties

Due to the replacement property identification rules established by the IRS, multiple DST properties can be combined as replacement property. Furthermore, many DSTs are comprised of multiple properties, thus providing additional diversification. Due to the low minimum investment requirement, additional diversification can be achieved by selecting multiple DST sponsors, property types and geographic areas.

Benefit from DST Sponsor Expertise

Last, and certainly not least, ownership of Delaware Statutory Trusts allows for access to the expertise of the DST sponsor throughout the acquisition, management, financial reporting and eventual sale process. Vetting these sponsors and their offerings is something we take very seriously at Real Estate Transition Solutions.

If you are interested in hearing about our process of vetting, on-boarding and monitoring our approved DST sponsors, we would be pleased to discuss it with you. Simply call 206-909-0037.

How are DSTs Structured?

Understanding the Structure of Delaware Statutory Trusts & How They Work

IRS Revenue Ruling 2004-86 established the structure DSTs must adhere to in order to qualify as 1031 exchange property. As a result, all DSTs have consistent structures, with the main differences being what types of property they acquire, how many properties are held within the DST, and the terms of the DSTs' master lease agreements. All DSTs share the following seven attributes:

- Once the trust offering is closed, there can be no additional capital contributions made by either existing or new beneficiaries.
- Trustees cannot renegotiate existing loan terms unless a default exists as a result of tenant bankruptcy/insolvency.

- Trustees (DST sponsors) cannot reinvest proceeds from the sale of the trust's real estate - it must be distributed to the investors.
- Trustees can only make capital expenditures to the underlying real estate for purposes of normal maintenance/repair and/or non-structural capital improvements.
- Cash reserves held by the trustee can only be invested in short-term debt. Any unused cash reserves held upon the sale of the property must be distributed to the trust investors
- All cash, other than necessary reserves and working capital, must be distributed to beneficiaries on a current basis.
- The trust cannot enter into new leases or restructure leases unless due to tenant bankruptcy/insolvency.

The requirements put forward by the IRS steer DSTs toward addressing three main objectives: preservation of capital, stable potential cash flow, and eliminating active management. In 2018 there were 83 fully funded DST offerings, raising just under $2.5 billion in total equity.

There are many steps required before DST property is made available to investors. Familiarity with the process is important for both analyzing the properties and understanding what value is provided to the investors through the structuring process and costs. A typical DST goes through the following steps:

1. The DST sponsor actively searches for investment real estate that can be purchased and held while adhering to the IRS' seven rules. DST sponsors target properties that seek to provide both meaningful cash flow and a meaningful return to its investors. It is not uncommon for this step to include analyzing hundreds of properties, with only a handful receiving acquisition offers from the sponsor, fewer making it through full contract due-diligence and ending in an acquisition. Any property resulting in an acquisition will be acquired with the DST sponsor's funds and will be owned by the sponsor until investors' exchange dollars replace the sponsor's dollars.

2. Next, the Delaware Statutory Trust itself is structured. There are many aspects to this step, including:
    - Establishing the trust
    - Quantifying the reserves to be collected in the offering (DST attribute #1)
    - Establishing the master-lease agreement (DST attribute # 7)
    - If there is to be debt on the property, then typically 10-year fixed rate debt is secured (DST attribute #2)
    - The offering documents are written and submitted to the SEC
    - A tax firm issues an opinion letter on whether the offering should be considered qualified 1031 exchange replacement property by the IRS
    - An independent entity performs third-party due diligence on the offering and its projections

3. Once fully structured, the offering is made available to our Broker-Dealer to perform a second round of due diligence.

4. Next, the offering is made available to our office to perform a third round of due diligence.

5. Lastly, if the offering is approved in both steps three and four, we will recommend the offering to clients for which the DST is suitable for based on their own unique financial situation and objectives. When an investor exchanges into a DST, they receive an "undivided fractional interest" in the DST property and replace the sponsor's capital used to initially acquire the property.

DST Property Types

What types of property do DSTs own?

DST sponsors focus on property types that seek to produce stable, potential income for the DST investors. Generally, we see the following property types held within DSTs:

Multi-Family Unit

Net Lease Retail

Self-Storage

Medical Office

Industrial

Senior Housing

Each property type has its respective strengths and weaknesses. Based on a client's objectives, multiple property types can be blended together to create an ideal replacement property portfolio.

How long are DST properties held?

Delaware Statutory Trusts are considered illiquid investments, meaning the DST Sponsor will determine when the property is to be sold. The IRS required DST framework states that a DST Sponsor cannot refinance the property; the property must be sold before the loan's maturity date. There are DSTs available with no debt, in which case there is no required timeline for the property to be sold, however most DSTs have 45% - 55% loan-to-value (LTV) and utilize 10-year fixed rate debt. Therefore, the longest these properties could be held as a Delaware Statutory Trust is 10 years. Typically, DSTs are held for 3 – 9 years. The hold period is long enough to reduce prepayment penalties associated with the debt, yet short enough that the DST Sponsor is not forced to sell the property due to a pending debt maturity date.

The illiquid nature of Delaware Statutory Trusts is what enables the DST Sponsor to monitor market conditions and select a sales date that is most advantageous for the investors. The sponsors we have vetted and work with monitor the properties financial performance, forecasts, rental demand, and competing inventory to select a sale date that benefits the DST owners.

What are the Risks?

What to consider before investing in a DST

Delaware Statutory Trusts are not suitable for every real estate investor. We work diligently to understand investors' objectives and recommend replacement property options that will position them to accomplish their financial and lifestyle goals. For those in which DSTs are a suitable replacement property option, it is very important to select a 1031 Exchange Company that has expertise in tax, real estate, and securities. We encourage all our clients to ask about our proven track record of navigating complex ownership structures, exchanges, implementation of tax strategies, due diligence of DST sponsors and offerings. Many firms that provide financial advice can also recommend DSTs, however, it is unlikely that they would have the deep knowledge, experience, and familiarity with real estate investing that our firm specializes in.

We take due diligence of both the DST sponsors and DST offerings very seriously. Our firm has an established and involved process through which we vet DST sponsors before we recommend them to any suitable investor. We dive deep into each offering's market assumptions, projections, forecasts and purchase terms. While our due diligence cannot guarantee returns, it does allow us confidence in recommending approved offerings to our clients.

Ownership of Delaware Statutory Trusts is still very much ownership of investment real estate. Due to the structure of Delaware Statutory Trusts as a passive ownership entity, a beneficial ownership interest in a DST presents additional risks that the investor should be aware of. The following risks should be fully understood and carefully considered when assessing an investor's suitability for ownership of a Delaware Statutory Trust:

- **Lack of liquidity and timing of exit:** Generally DSTs have a target property hold period ranging from 3 – 10 years. The hold period may differ significantly from the targeted timeline based on market conditions. The investment should be viewed as illiquid while invested in the property. Early exit by the investor for liquidity purposes may not be possible or may be only possible at a significant discount to the trust's net asset value.

- **Lack of control:** Owners of a beneficial interest in Delaware Statutory Trust have little control over management decisions and eventual sale of the underlying property. The real estate investment company managing the trust is responsible for all operating decisions.

- **Failure of due diligence and non-compliance**: All DSTs presented by Real Estate Transition Solutions are subject to a rigorous due diligence process in which the real estate investment company's management are thoroughly reviewed, as are each individual DST offerings made available. However, failure to identify an issue may result in mismanagement or non-compliance in adhering to the IRS criteria established for a DST to qualify for tax-deferred exchange treatment.

- **Loan modifications may not be possible:** Due to the structure of a DST, restructuring the financing of the property may not be possible without changing the legal ownership structure. DSTs mitigate this issue by utilizing master lease agreements between the trust and the real estate investment company.

- **Projected cash flow may not be consistent with actual performance:** As with any real estate property investment, cash flow levels are subject to market, economic, tenant and location risk. Projected cash flows are typically conservative in nature; however, they are not guaranteed.

- **Projected appreciation may not occur:** As with any real estate property investment, asset appreciation is subject to market, economic, tenant and location risk. Appreciation may not occur at the end of the trust's property holding period or the holding period may be extended beyond stated projections.

- **Interest rate risk:** The value of real estate is heavily impacted by the current interest rate environment. Changes in current interest rates may increase uncertainty surrounding financing, leasing and appreciation.

- **Regulatory risk:** DSTs are susceptible to changes in the IRS's treatment of tax-deferred exchanges. Furthermore, the advantages of ownership of a beneficial interest in a DST for estate planning purposes may be eliminated based on changes in the Internal Revenue Code.

- **DST management costs and fees:** DST structure provides for management fees to the sponsoring real estate investment company. These fees, while thoroughly disclosed upfront could serve to reduce cash flow levels below that of the stated projections.

One of our main objectives is the ensure any prospective DST investor is comfortable with the DST structure and is fully informed. Beyond our educational materials and conversations, all DST properties presented to clients will be accompanied by a Prospectus. This full disclosure document will provide detailed information on all relevant matters pertaining to the DST, including risk disclosures. At any point along the process, do hesitate call or email us with any questions you may have when considering ownership of a beneficial interest of a DST.

DST Process & Timing

What is the process and timing?

The first step is to determine whether a 1031 exchange is right for you. This decision is based on your financial and lifestyle objectives, the subject property and your tax liability, were a sale to occur. There are number of key pieces of information that go into determining whether an exchange is worth considering. If an exchange is appropriate, then your objectives must be thoroughly discussed to understand whether DST ownership may be suitable. Generally, DST ownership can serve to address any of the following objectives:

- Diversify real estate holdings
- Increase potential income
- Increase depreciation to offset tax from income
- Reduce management time and effort
- Simplify real estate for estate planning purposes
- Continued tax-deferral
- Own higher quality real estate

We are available for a consultation to assist you in determining whether DST replacement properties are suitable for you. It is important to note that due to the DST's registration as a "Regulation D" security with the SEC, only accredited investors can exchange into DSTs. Accreditation is considered based on the owner of the property. If an individual owns the property, they must meet the individual accreditation threshold. If the property is co-owned, either all co-owners must be accredited or the owning entity must meet the entity accreditation threshold.

Next, your relinquished property must be sold. Before the sale has closed, an exchange must be opened with a Qualified Intermediary. Selecting a capable and reputable Qualified Intermediary is very important – if you would like an introduction to one of our preferred "QIs" do not hesitate to ask. Once the property closes, the sales proceeds will move to the QI.

We work with clients both before their property has closed and during their 45-day identification period to select DST offerings that have been rigorously vetted and will serve to meet their objectives. If you are contemplating DSTs as a replacement property option, we would be pleased to assist you in the process of determining which DSTs would best position you to realize your objectives.

Once the DST replacement properties have been selected, we take care of preparing all required paperwork. Selected DSTs can close in at little as 5-7 days, allowing for nearly continuous cash flow following the sale of a relinquished investment property. After the purchase of the DST replacement properties, we will verify all deposits are made into the appropriate accounts and communicate with your tax-preparer so they are ready for the year-end tax reporting.

Along the way, we focus heavily on education. It is very important to us that you feel comfortable and confident with not only DSTs, but our process, due diligence, and the sponsors we recommend. There are multiple education focused steps we take to assist a client in navigating this transition.

Fee Structure

There are underwriting and structuring costs associated with acquiring institutional real estate and structuring the trust. These costs include:

- Sponsor property acquisition due diligence
- Structural reports to quantify reserves
- Loan origination costs
- Marketing and distribution costs (commissions)
- Sourcing a tax opinion letter (to establish comfort the trust qualifies for 1031 purposes)
- Commissioning a third-party due diligence report

DST sponsors are reimbursed for their costs incurred in structuring the trust at the time of the offering. Additionally, the IRS mandated framework for Delaware Statutory Trusts states that the sponsoring entity cannot participate in any potential appreciation of the trust's real estate upon sale. Therefore, as compensation, DST sponsors receive both an acquisition fee for acquiring the property and structuring the trust, as well as a percentage of the properties' ongoing Net Operating Income.

Real Estate Transition Solutions' (RETS) compensation is paid through the allocated marketing and distribution costs built in to the offering price. There are three different ways RETS can be compensated for our due diligence and underwriting efforts, depending on the owner's objectives. Some exchangers prefer paying a one-time commission, consistent with traditional purchases of investment real estate with a broker. Other exchangers prefer to spread the commission out over the DST's hold period in the form of an ongoing advisory fee. Lastly, exchangers can select a "hybrid approach" consisting of a reduced commission and a reduced advisory fee. We feel the third approach best represents the economics of our services and monitoring of the replacement properties – however we are comfortable working within whichever approach is preferred by our clients.

How to Get Started

Schedule a Complimentary Consultation

Congratulation! You have already taken the first step by reading our Guide to Investing in Delaware Statutory Trusts. If you are interested in learning more about DSTs and whether they may be a good 1031 exchange option for you, the next step is to contact us to schedule a complimentary consultation. This can be done either via phone or an in-person meeting at our office. Either way, we would be pleased to educate you further on Delaware Statutory Trusts, discuss our process for performing due diligence on DST sponsors and their individual offerings, and assist you in selecting the offerings that will best position you to meet your objectives.

With over 20 years' experience working with 1031 Exchanges, DSTs, complex real estate investments, securitized real estate, and tax planning strategies, Real Estate Transition Solutions is one of few fully-integrated 1031 Exchange companies in the Pacific Northwest. Our team of dedicated Exchange professionals will help you select and acquire suitable 1031 Exchange DST properties that meet both your financial and lifestyle objectives.

Call 206-909-0037 today!

Frequently Asked Questions

What is an "Accredited Investor?"

As defined by the SEC, an accredited investor is an individual who has either a $1 million net worth excluding their primary residence or $200,000 of income individually or $300,000 joint income for each of the last two years with a reasonable expectation for the same in the current year.

How long are DSTs held?

Generally speaking, DSTs are held for anywhere between 3 – 10 years. Should investors want to exchange out of the property, conservatively, the DST property should be held for a minimum of two years. Typically, the DST loan's prepayment penalties become palatable after year 3. DSTs with debt in place are not allowed to refinance, as such with 10-year fixed rate commercial debt, 10 years becomes the maximum hold period.

Can I sell my DSTs at any time?

Should you be interested in selling your position in a DST, there is a mechanism to do so. However, it cannot be guaranteed that you will be able to sell the DST investment, nor receive your entire investment back unless the market conditions support it.

Are DSTs returns guaranteed?

DST ownership is very much direct ownership of investment real estate. Therefore, returns are not guaranteed. There are certain offerings that focus on the predictability of potential income, such as net lease offerings, due to the duration of the lease and the fact that the leases are corporate guaranteed. However, DSTs returns are never completely guaranteed.

What makes your firm unique?

Our extensive industry experience, both in the real estate and securities world, coupled with our emphasis on education, focus on client's objectives and rigorous DST sponsor and replacement property due diligence.

What happens after the DST property sells?

Once a DST property sells, all DST investors will receive their pro-rata share of the sales proceeds consistent with their initial investment, including any potential appreciation. At that time, investors will have the option of either exchanging into more DSTs, exchanging into any other investment property, paying tax, or a combination of.

Can I speak to previous clients of yours?

Absolutely. Hearing from our previous clients is a great way to gain insight into our client focus, process and the replacement properties we have recommended in the past.

Information and numerical examples are for educational purposes only and do not constitute an offer to purchase or sell securitized real estate investments. DST 1031 properties are only available to accredited investors (typically have a $1 million net worth excluding primary residence or $200,000 income individually/$300,000 jointly of the last three years) and accredited entities only. If you are unsure if you are an accredited investor and/or an accredited entity please verify with your CPA and Attorney. There are risks associated with investing in real estate and Delaware Statutory Trust (DST) properties including, but not limited to, loss of entire investment principal, declining market values, tenant vacancies and illiquidity. Potential cash flows/returns/appreciation are not guaranteed and could be lower than anticipated. Photo examples do not represent current offerings. Future offerings will vary and may be significantly different than pictures shown. Because investors situations and objectives vary this information is not intended to indicate suitability for any particular investor. This material is not to be interpreted as tax or legal advice. Please speak with your own tax and legal advisors for advice/guidance regarding your particular situation.

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