Published on *The National Law Review* https://www.natlawreview.com

Understanding Why More Non-Traded REITs and Real Estate Funds Are Adopting a DST Structure as Part of a Capital Raise

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Over the past few years, several real estate investment trusts have made filings with the Securities and Exchange Commission reflecting the adoption of a Delaware Statutory Trust (“DST”) program. Typically, the DST program includes a conversion feature where the investors in the DST program have their beneficial interests in the DST converted into limited partner interests in the REIT’s operating partnership (which in turn can be converted into REIT shares or cash). In many cases, the purpose of the DST program is to allow the REIT an opportunity to expand and diversify its capital-raising strategies by offering an investment product for investors seeking replacement property to complete a like-kind exchange under Section 1031 of the Internal Revenue Code (the “Code”).

What is the Benefit of a DST Program to a REIT?

The benefit to the REIT is that the DST program provides a path for potential investors seeking to complete a like-kind exchange under Section 1031 of the Code to invest in REIT-owned properties. Under the tax rules that apply to like-kind exchanges under Section 1031 of the Code, neither the acquisition of REIT shares nor the acquisition of limited partner interest in the operating partnership would qualify as replacement property for purposes of a like-kind exchange. By adopting a DST program, the REIT creates the ability to use the net proceeds received from investors seeking to complete a like-kind exchange to provide liquidity to the REIT, which can be used to make future investments, repay debt or fund distributions.

Because neither the traditional REIT structure nor the use of an operating partnership in an UPREIT structure allows the REIT to offer an investment product for investors seeking replacement property to complete a like-kind exchange, the DST program increases the ability to raise capital. However, the DST program is a tax-driven program that requires the satisfaction of specific conditions, some of which are more restrictive than the tax rules that apply to REITs. As a result, sponsors of non-traded REITs that are contemplating the adoption of the DST program must understand the mechanics of the DST structure and the conditions that must be satisfied to qualify as replacement property to complete a like-kind exchange in order to access this new source of investor capital.

DST and Like-Kind Exchanges

Section 1031 of the Code sets forth the rules that apply to like-kind exchanges. Under these tax rules, an owner of real property can “exchange” the real property for other real estate of “like kind” without recognition of the gain inherent in the relinquished real estate. For purposes of the like-kind exchange rules, the tax law is very taxpayer-friendly when it comes to determining what kind of property is of “like-kind” to real estate. Under Section 1031 of the Code, almost all direct ownership interests (and even long leasehold interests) in real estate are considered to be of “like-kind” to each other.

Notwithstanding the broad application of the term “like kind,” Section 1031 of the Code specifically excludes certain types of assets. For example, a membership interest in a multi-member limited liability company, an interest as a partner in a limited partnership and a share of stock in the REIT are not considered “like-kind” notwithstanding that all of the assets held consist of real property. As a result, neither the use of the traditional REIT structure nor the use of an operating partnership in an UPREIT structure provides an opportunity to satisfy the “like-kind” requirement of Section 1031.

Revenue Ruling 2004-86

In 2004, the Internal Revenue Service released guidance that set forth the conditions under which beneficial interests in a Delaware statutory trust can qualify as replacement property for purposes of the like-kind exchange rules. Under this guidance, which is set forth in Revenue Ruling 2004-86, the real estate owned by the Delaware statutory trust will be used to determine whether the like-kind requirement is satisfied, and the acquisition of the beneficial interest in the Delaware statutory trust will be treated as the acquisition of an undivided fractional interest in the real estate for purposes of the replacement property requirements.

Not every Delaware statutory trust will fall within this tax treatment. As outlined in the Revenue Ruling, in order for the beneficial interest in the DST that owns real property to qualify as replacement property in a like-kind exchange, the following conditions must be met after beneficial interests in the DST are issued to investors:

(i) the DST cannot engage in the conduct of an active trade or business;

(ii) the DST cannot raise additional capital;

(iii) the DST cannot amend existing leases or enter into new leases unless there is a tenant bankruptcy or insolvency;

(iv) the DST cannot modify any existing debt, refinance any debt or obtain debt unless there is a tenant bankruptcy or insolvency;

(v) the DST is prohibited from making anything other than minor, nonstructural modifications to the real estate (unless required by law);

(vi) the DST must distribute its cash, other than amounts needed for reasonable reserves, pro rata among the holders of the beneficial interests based on the percentage interest held; and

(vii) upon the sale of the real estate, the DST cannot reinvest the sales proceeds in new investments.

Using a Master Lease Structure to Address the Requirements of Revenue Ruling 2004-86 Can Create Additional Tax Issues

Because of the limitations imposed under Revenue Ruling 2004-86, a master lease structure is typically used in connection with a DST structure, with an affiliate of the REIT acting as the master tenant. The master lease must be a true lease for tax purposes and must provide the master tenant entity with a reasonable expectation of realizing an economic profit. As a result, the master tenant cannot act merely as an agent of the Delaware statutory trust. In addition, the master tenant cannot undertake actions that would cause it to be a partner of the Delaware statutory trust for income tax purposes.

One action that could cause the creation of such partnership treatment is the master tenant becoming a co-borrower with the DST under the DST's financing or the co-borrower with the DST by pledging an assignment of the property rents directly to the lender. Accordingly, the conditions set forth in Revenue Ruling 2004-86 must be viewed as only setting forth some, but not all, of the conditions that must be satisfied in order to obtain the desired like-kind exchange treatment. As noted above, the terms of the loan obtained by the DST to acquire the real property and the terms of the master lease between the DST and the master tenant can impair this tax treatment.

Governance of the DST

In addition to satisfying the tax conditions, the DST must also operate in accordance with the requirements of the Delaware Statutory Trust Act. In general terms, each Delaware statutory trust must have at least one trustee resident in Delaware (the "Delaware Trustee"). However, the Delaware statutory trust can have additional trustees and these additional trustees can have substantially all of the governance powers over the trust (the "Signatory Trustee"). Under the typical DST program, an affiliate of the REIT is the Signatory Trustee and the DST retains a service company located in Delaware to act as the Delaware Trustee.

Additional Considerations under a DST Program

1. **Structure for the Loan**

Because the debt incurred by the DST to acquire the property cannot be refinanced or extended, the debt should not have a maturity date that is materially shorter than the anticipated holding period for the asset (renewals or extensions of the loan term at the option of the borrower is not permitted, but automatic renewals or extensions based on objective criteria might be permitted). In addition, because the DST cannot call additional capital and must make distributions solely on a pro rata basis, the DST must fund for reserves up front or out of cash flow. In addition, a DST cannot use a carried-interest or promote structure. However, in lieu of a promote, there can be a disposition fee as long as the fee is not based or measured by net income or profit (e.g., a disposition fee based on a fixed percentage of gross sale proceeds is permitted).

2. **Fees and Master Lease Profit**

In addition to the disposition fee, the DST is typically charged an asset management fee. The spread between the net rental income received by the master tenant from the property and the amount required to be paid by the master tenant to the DST in master lease rent will also provide funds from the use of the DST program.

3. **Conversion Mechanics**

The mechanics for the conversion of the beneficial interest in the DST into limited partner interests in the operating partnership will be set forth in the trust agreement governing the DST and in the limited partnership agreement for the operating partnership. Typically, the conversion price will be based on the fair market value of the beneficial interest at the time of conversion as determined by multiplying the fair market value of the underlying real estate by the percentage interest held by the converting investor, without discount.

4. **Additional Conversion Issues**

Typically, once the conversion occurs, the DST will be converted into a Delaware limited liability company (as provided in the DST's trust agreement once it becomes wholly owned) and the restriction set forth in Revenue Ruling 2004-86 will cease to apply. Because the DST is the sole borrower under the DST's loan agreement, the loan agreement should provide that lender consent is not required either for the conversion by the investors of the beneficial interests in the DST into limited partner interests in the operating partnership or the conversion of the DST into a Delaware limited liability company once the DST is wholly owned by the operating partnership.

5. **Tax Considerations on the Conversion**

In general terms, the conversion of the beneficial interest in the DST into limited partner interests in the operating partnership will qualify for tax-free treatment under Section 721 of the Code. This tax treatment is similar to the tax treatment that applies when an owner of real property contributes the property to the operating partnership under the UPREIT structure. Under the UPREIT structure, the tax deferral will end when the real estate owned by the DST is sold. Accordingly, a tax protection agreement, similar to those used for contributions of property to the operating partnership, should be used upon the conversion of the beneficial interests in the DST.

Benefits Created by a DST Program – The REIT Perspective

Typically, if a REIT adopts a DST program, it will offer beneficial interest in the DST through a private placement exempt from registration under Section 506(b) or Section 506(c) of the Securities Act of 1933, as amended. For non-traded REITs, the private placement memorandum for the DST program will be drafted as an addendum to the private placement memorandum for the shares of REIT stock and the limited partner interests in the DST. Because the DST is controlled by an affiliate of the REIT and the property owned by the DST is leased to an affiliate of the REIT under the master lease, the REIT should have the same level of control over the property as under a typical SPV borrower structure (albeit without the ability to refinance or to make disproportion distributions to fund a promote).

The benefits to the REIT should outweigh the restrictions imposed under the tax rules that apply to a DST program. Specifically, because shares of REIT stock and limited partner interests in the operating partnership can never qualify as replacement property under the like-kind exchange rules, the use of a DST provides the REIT with the ability to raise capital from investors that are in the middle of a like-kind exchange and looking for replacement property.

Benefits Created by a DST Program – The 1031 Investor Perspective

Unlike a stand-alone DST structure, the use of a DST program by a REIT provides an opportunity for

an investor seeking to place like-kind exchange proceeds with the opportunity to obtain diversification when the investor converts its beneficial interests in the DST interests into limited partnership interests in the operating partnership. Because the DST program allows the investor to obtain this diversification on a tax-free basis under Section 721 of the Code, the REIT-sponsored DST program provides a benefit that a stand-alone DST cannot.

The shortcoming of the DST program by a REIT is that a stand-alone DST program ends the ability of the investor to undertake a subsequent like-kind exchange. However, the inability of the investor to engage in future like-kind exchanges upon the sale of the DST interest must be weighed against the tax deferral on the conversion into the operating partnership (and the protections set forth in the tax protection agreement) and the diversification obtained when the interests in the operating partnership are acquired. As a result, the target investor for a DST program by a REIT is likely looking for the ability to be in a position to convey a more liquid, diversified holding to his or her heirs.

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National Law Review, Volumess XIII, Number 257

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