BREAKWATER
1031

History of Delaware Statutory Trusts (DSTs)

Commercial real estate, long considered an "alternative" asset class, has historically had significant barriers to entry. The cost, lack of widely-accessible property information, and risk associated with buying properties individually has meant that only the most well-off could enter the space. This includes institutional investors such as life insurance companies, endowments and pension funds as well as family offices and extremely high-net worth individuals.

However, the advent of Delaware Statutory Trusts, or DSTs, has begun to level the playing field. Today, DSTs provide a way for individuals to fractionally invest in the assets of a trust, with those assets being one or more pieces of commercial real estate. The sponsor of the DST then oversees all day-to-day management of properties within that trust on behalf of its collective investors.

The History of DSTs

Trusts have long been a tool used by wealthy Americans to transfer property from one generation to another. Doing so through a trust has specific tax and security advantages that would not otherwise exist.

Moreover, unlike investing in a syndication or fund, DSTs have been deemed "1031 Exchange eligible," meaning that individuals can sell their personally owned investment property and re-invest the proceeds into a DST to defer paying capital gains tax. It's no wonder then that DSTs are rapidly growing in popularity.

DSTs did not just emerge overnight. Their arrival was long in the making. In this article, we look at the history of DSTs and how they came about. Many of these trusts are held in Delaware, a state that is known to be pro-business and tax friendly. Since at least 1947, business trusts have been recognized by Delaware common law. This is why many Fortune 500 companies have located their headquarters in the state. For decades, trust income, including capital gains, have not been taxed – including those owned by non-residents. In other words, someone who lives out of state can just as easily take advantage of Delaware's trust tax provisions as those who reside there.

Several other states have since adopted legislation that governs trusts, but Delaware remains a preferred location among trustees given the breadth and clarity of the laws governing business entities. Moreover, Delaware's Court of Chancery and the Delaware Supreme Court have earned a reputation for excel-lence—specifically, their wide-ranging experience with business issues that result in efficient, prompt, and fair resolution of disputes. Today, there is a tremendous body of Delaware case law that can be drawn upon for those seeking trust-related guidance.

In 2002, the Delaware Business Trust Act was changed to the Delaware Statutory Trust Act (DST Act) (Title 12, Ch. 38 of the Delaware Code). The DST Act explicitly authorized the creation of DSTs and provides express rules governing their internal affairs. The DST Act identifies DSTs as a separate legal entity that may conduct any lawful business or purpose. The regulations also stipulate that a DST will not terminate or dissolve as a result of the death, incapacity, dissolution, termination or bankruptcy of a beneficial owner unless otherwise stated in the Trust Agreement. DSTs are also allowed to secure financing under their own name rather than under the names of its individual trustees.

The DST Act also expressly limits the liability of any trustee. The Act states that, except to the extent otherwise expressly provided in the trust's governing documents, a trustee "shall not be personally liable to any other person other than the statutory trust or a beneficial owner for any act, omission or obligation of the statutory trust or any trustee thereof." This provision offers substantial protection to trustees—they can rest easy knowing that the potential liabilities they may face associated with investing in a DST are strictly limited, whereas the protections afforded to them by indemnification are very broad.

DSTS vs TICS

The 2002 DST Act effectively provided the guidance and protections needed for those looking to fractionally invest in commercial real estate. Until this point, most people would co-invest in real estate through a tenant-in-common (or "TIC") structure.

Those who invest in a TIC hold a fractional share of the title to the property. As such, each individual owner becomes personally liable for any debt needed to purchase or improve property held in a TIC. TICs may have up to 35 individual co-owners, so as one might imagine, the process for underwriting each individual investor can make financing a TIC rather cumbersome compared to financing DST investments, since the loan is secured by the DST itself and not individual investors.

Moreover, any major decision pertaining to TIC investments requires unanimous approval among co-investors. Decision-mak-ing, even in the best of times, therefore becomes a challenge. One hold-out can stall important decisions needed to advance the TIC's business plan and investment direction.

Despite the clear advantages to investing in a DST versus a TIC, many continued to opt for the latter until the mid-2000s. This is because in the early 2000s, industry groups, including some of the nation's largest commercial real estate sponsors, pushed the IRS to establish guidelines that would allow TIC real estate to qualify for 1031 exchanges (IRS Revenue Procedure 2002-22). In turn, those who sold individually-owned investment property could reinvest the proceeds from the sale into a TIC to defer paying capital gains tax (sometimes, indefinitely).

This led to more people investing in TICs than ever before. The TIC industry grew to its height in 2007 when almost $4 billion of equity was invested using the TIC structure. But before long, many of these investors gained first-hand insight as to the TIC structure's shortcomings.

Around this same time, and largely due to the inefficiencies of the TIC model, DSTs gained traction. In 2004, the IRS adopted similar 1031 exchange guidelines for DSTs. Revenue Ruling 2004-86 allowed the use of the DST structure to acquire 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. Real estate investors across the U.S. rejoiced.

Real Estate Co-Investment During the Great Recession

Both TICs and DSTs were dealt an enormous blow when the Great Recession hit in 2008. Investment in syndicated real estate fell off a cliff. TICs suffered more than DSTs. By 2009, less than $250 million was invested in TICs – roughly 6.25% of the equity invested just two years prior. Across the board, lenders became conservative. Very few, in particular, wanted to invest in TICs given the need to under-write each investor's creditworthiness. The work to establish loans on TICs (which again, could have up to 35 individual investors) simply became too much of a bother for banks.

Investment in both TICs and DSTs remained in a lull through the better part of 2013. As the economy began to recover, DSTs quickly became the preferred co-investment structure. By 2015, DST investment had rebounded to its pre-recession level and has continued to climb ever since.

In 2020, roughly $3.20 billion in equity was raised for DST investments – a staggering number, especially given the lingering uncertainty among investors brought on by COVID

The Future Outlook for DSTs

Looking forward, investment in DSTs could continue to remain strong. There is a backlog of investors who have been eagerly waiting for the pandemic to pass before listing their property for sale. Many of these investors may utilize 1031 exchanges to defer paying capital gains tax, and many will do so by investing in DSTs. Cash investors, too, are increasingly investing in DSTs as a way of diversifying their portfolios. Accredited investors seeking to invest in truly passive real estate may find DSTs as a tremendous option given the myriad of associated potential benefits, including asset and geographic diversification.

2021 was a banner year for DST equity investment. Barring any unforeseen circumstances, this may continue in the months and years to come.

Are you interested in learning more about DSTs? Contact us today to learn more about our investment strategy and current 1031 exchange and DST offerings.

BREAKWATER1031.COM
(310) 940-9430
9940 RESEARCH DR. SUITE 200
IRVINE, CA 92618

GENERAL DISCLOSURE

Not an offer to buy, nor a solicitation to sell securities. Information herein is provided for information purposes only, and should not be relied upon to make an investment decision.

All investing involves risk of loss of some or all principal invested. Past performance is not indicative of future results. Speak to your finance and/or tax professional prior to investing.

Securities offered through Emerson Equity LLC Member: FINRA/SIPC. Only available in states where Emerson Equity LLC is registered. Emerson Equity LLC is not affiliated with any other entities identified in this communication.

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 – Because 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