

## DELAWARE STATUTORY TRUSTS: THE SEVEN DEADLY SINS FOR SECTION 1031 INVESTMENTS

In a recent report, Deloitte Tax indicated that 98% of all Section 1031 transactions involved real estate, and approximately 50% of those transactions involved equity of over \$500,000<sup>1</sup>. For 2007, these transactions collectively accounted for approximately \$150 billion worth of real estate transactions<sup>2</sup>. In recent years many Section 1031 investors looked to combine their funds with other investors to purchase a higher grade of property than would be possible as a single owner. Since 2001, the most common form of joint ownership has been ownership through Tenancy-in-Common, more commonly referred to as “TICs”. More recently Delaware Statutory Trusts (“DSTs”) have received IRS approval for multiple ownership in the context of Section 1031 exchanges.

DSTs represent Delaware’s attempt to put into statute the previously common law concept of a business trust<sup>3</sup>, which was an unincorporated business entity used to avoid certain technical restrictions on corporate business activity in Delaware. The Act was passed in 1988 and DSTs quickly gained popularity for ownership of real property.

Outside Section 1031, the DST is an incredibly nimble ownership structure, allowing title to be unified in one name and lending to be undertaken by one entity rather than numerous fractional owners. Moreover, beneficial owners may keep relatively unfettered control over the actions of the Trustee, while being fully removed from third party liability with respect to the operation of the property.

Much like other pass through entities, a DST is fairly easy to form with the filing of a simple Certificate of Trust with the Delaware Secretary of State. One of the few statutory requirements is that each DST must have at least one Delaware Trustee. Despite the relative ease of formation and lack of required structure, most DSTs have extensive trust agreements detailing the contribution, operation and liquidation of the trust.

When properly formed and operated, DSTs are eligible to be treated as investment trusts and as a grantor trust under the Internal Revenue Code<sup>4</sup>. Accordingly, a beneficial interest in a qualifying DST will be treated as an interest in the underlying assets for tax purposes. Prior to 2004, questions existed as to what power could be given to the beneficial owners and the trustee while maintaining the disregarded entity treatment necessary for Section 1031.

In Revenue Procedure 2004-86, the Service finally announced the factors it deemed necessary for a beneficial interest in a DST to qualify as replacement property for purposes of Section 1031. Rev. Rul. 2004-86 provided clarity for taxpayers but also severely limited the use of DSTs for purposes of Section 1031.

The Service consented to the treatment of a DST as qualified replacement property only if the trustee(s) did not have the power to vary the investment of the Trust<sup>5</sup> nor any of seven other enumerated powers—commonly referred to as the Seven Deadly Sins. They are as follows:

1. The trustee can not dispose of the trust assets and reinvest them in other

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<sup>1</sup> Size of the 1031 Marketplace, Lou Weller, Deloitte Tax, LLP May 2008.

<sup>2</sup> *Id.*

<sup>3</sup> 12 Del. Code §3801 *et. Seq.* The Delaware Statutory Trust Act (the “Act”).

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<sup>4</sup> I.R.C. §671.

<sup>5</sup> This includes the receipt of additional property or capital from the beneficial owners.

- assets, although the trustee can dispose of the trust assets and liquidate the trust;
2. The trustee may not negotiate extensions of leases for tenants;
  3. The trustee may not enter into new leases;
  4. The trustee can not negotiate or enter into new debt on the property;
  5. The trustee may not renegotiate any existing debt;
  6. The trustee may not invest cash received from the property in anything other than short term Treasuries or CDs that must be distributed at least quarterly; and
  7. The trustee may not make any modifications (other than those required by law) to the trust assets other than minor repairs and upkeep.

Not only must the trustee not commit any of the seven deadly sins, he may not even have the power to do so. These severe restrictions greatly diminish the flexibility of the DST when used for a 1031 exchange. For example, a DST would be unlikely to own a residential apartment complex as replacement property because no new leases could be negotiated. Similarly, retail facilities which have high turn-over or property which will require significant capital improvements would not work for a DST. Finally, a DST purchasing replacement property should only use long-term purchase debt because the Trustee will have no power to negotiate new debt or refinance old debt once the structure is put in place. In certain circumstances the owners may originally buy into the DST as replacement property, then discover a need for funding or refinancing later in the ownership period. In that event, they can liquidate the DST into a partnership or LLC for purposes of refinancing or making capital improvements.

Despite the limitations on DSTs, they do have their place in the realm of 1031 exchanges. They work well for new properties with a single tenant subject

to a long-term lease. DSTs also work well for all cash investments involving land speculation.

One solution to the leasing issue offered by certain sponsors<sup>6</sup> is the use of a master lease with the DST. In this format, the DST owns a property and net leases the property to the sponsor to operate. The sponsor and master lessee/sub-landlord then negotiates all leases or makes necessary capital improvements. Investors in a DST with a master lease in place should be cautious in reviewing the financial capacity of the master tenant. Not only must the sponsor be capable of funding the lease payments to the DST regardless of cash flow from the sub-tenants, it must also be able to cover the cost of any capital improvements. The sponsor generally tries to calculate the amount of capital necessary in advance to protect against these risks, thus decreasing the net return to the investor.

In the proper situation, a DST provides a group of investors interested in a similar property a versatile and fluid structure to take title to the property. However, the stringent guidelines governing DSTs in conjunction with Section 1031 must be carefully reviewed for compatibility with each property. Taxpayers should look to long term net lease properties when using the DST structure and seek alternative ownership vehicles for other types of property.

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<sup>6</sup> In the TIC industry the companies that coordinate the location, financing and acquisition of property and the preparation and distribution of private placement memorandums for the purchase of the property by Section 1031 investors are called sponsors.