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Legal Briefs

TIC 2.0

DSTs are the future of 1031 real estate investing.

by Steven R. Meier

As the markets continue their recovery in 2013 and beyond, investors face a more challenging tax environment. Federal capital gains taxes have increased from 15 percent to 20 percent for high-income taxpayers, passive investment income is now subject to a 3.8 percent Medicare tax, and many states are attacking budget shortfalls through higher taxes. Separately, scores of old Section 1031 investment programs — designed to defer taxes pursuant to Section 1031 of the federal tax law — are coming full cycle in the next three to five years. This correlation of events is reinvigorating interest in new tax-deferred investment programs.

Section 1031 programs were popular in the mid-2000s, principally for high-net-worth individuals and family trusts and offices, commanding several billion dollars in invested capital. They declined dramatically between 2008 and 2011, dipping to around $100 million in invested capital in 2009. However, Section 1031 programs are beginning to rebound again, growing to roughly $250 million of invested capital in 2012, with potential growth of $1 billion to $3 billion of invested capital per year over the next three years.

DST Advantages

Prior to 2008, the predominant investment vehicle for Section 1031 programs was the tenancy-in-common, or TIC, program. Now virtually all new Section 1031 programs are being structured as Delaware Statutory Trust, or DST, programs, principally for the following reasons.

Management and control. In TIC deals, the Internal Revenue Service requires that certain fundamental decisions, such as selling or refinancing the property or entering into lease, management, or brokerage agreements, be made unanimously by investors. During the market collapse of 2008–11, numerous TIC deals were derailed because one or more rogue investors could hold up a deal.

In contrast, a DST structure takes all decision-making out of the hands of investors and places it with a sponsor affiliated trustee. Accordingly, in times of crisis, DSTs are more agile decision-makers than TIC programs.

Structural simplicity. TIC deals require each investor to form a special purpose entity, usually an LLC, to own the TIC interest and to join a co-ownership agreement (governing relations with other investors), a management agreement or master lease (governing relations with the investment program sponsor), a loan agreement, and a real estate deed. In addition, each investor must execute an environmental indemnity and a "bad boy carve-out" loan guaranty, which provides for personal recourse against the investor if he or she takes certain actions that are in bad faith or that cause a loan default. This plethora of arrangements is difficult to digest, costly to maintain, and involves a high level of investor risk.

By contrast, a DST investor executes only one document — a trust agreement. There are no deeds or loan documents for investors to sign and no environmental or carve-out guaranties for them to execute.

Enhanced scalability and diversification. Because the IRS limits the number of investors in a single TIC program to 35, they are generally limited to properties less than $25 million in total value and require large minimum investments, often at least $500,000. DSTs, however, are not subject to an investor limit under the tax law, and under the 2012 JOBS Act, can have up to 2,000 investors. Thus, DSTs can own properties with aggregate value much greater than any TIC deal, while simultaneously accommodating much smaller minimum investments, allowing diversification of investments across multiple DST programs.

DST Challenges

In certain respects, DST programs are more restrictive than TIC programs. For a DST to qualify for Section 1031 purposes, it must not violate the IRS' "seven deadly sins." That means that a DST: (1) cannot receive new capital after an offering is closed; (2) cannot renegotiate or enter into new mortgage debt unless there is a tenant bankruptcy or insolvency; (3) cannot renegotiate any of its property leases or enter into any new leases unless there is a tenant bankruptcy or insolvency; (4) cannot reinvest the proceeds from the sale of its property; (5) cannot redevelop property and, in fact, is limited to performing only normal maintenance and minor nonstructural improvements unless it is required to do more by law; (6) must hold its reserves in short-term debt obligations; and (7) must distribute all cash, other than normal reserves, on a current basis. These restrictions caused many investors and broker-dealers to prefer the TIC structure during the mid-2000s. Ironically, many property problems arise from tenant bankruptcies or insolvencies, which a DST can resolve quickly, but a TIC structure can only resolve through a long and uncertain decision process. When issues arise that a DST cannot address due to the seven deadly sins, it converts into an LLC. While this conversion inhibits investors' ability to do future Section 1031 transactions, it allows property emergencies to be dealt with appropriately. Given the restrictions on their activities, DSTs are not designed for all property classes. They are best suited for properties subject to a long-term lease to a creditworthy tenant on a triple-net basis. They can also successfully be used with a master-lease structure to hold multifamily, student and senior housing, hospitality, and self-storage facilities. With markets in full recovery, tax rates on investment income nearly 50 percent higher than they were in the 2000s, and scores of old Section 1031 investment programs coming full cycle, many real estate investors will turn to DST programs to shelter their real estate investment gains.