

# THE PFS STEWARDSHIP PLANNING SEMESTERS™

## DELAWARE STATUTORY TRUSTS

**A white paper from the PFS Financial Planning Committee on using Delaware Statutory Trusts (DSTs) to diversify real estate income and defer taxes**

### ABSTRACT

This white paper explores the concept of Delaware Statutory Trusts (DSTs) and their significance in the realm of real estate investment. DSTs are a powerful vehicle for investors seeking to access the benefits of owning institutional-grade properties while enjoying potential tax advantages and increased flexibility. By examining the structure, benefits, considerations, and operational aspects of DSTs, this paper aims to provide a comprehensive understanding of this investment tool and its potential applications.

### BACKGROUND

The history of Delaware Statutory Trusts (DSTs) dates to the 1980s when the concept was introduced because of legislative developments in the state of Delaware, United States. Delaware, known for its business-friendly environment and robust legal framework, played a pivotal role in establishing the legal structure for DSTs.

The foundation of DSTs can be traced back to the Delaware Business Trust Act, which was enacted in 1988. This act provided the legal framework for the formation and operation of business trusts, including those specifically designed for real estate investment purposes. The legislation aimed to offer investors an alternative investment vehicle that combines the benefits of direct property ownership with the flexibility and limited liability of a trust structure.

Initially, DSTs gained traction because of changes in tax regulations, particularly the introduction of Section 1031 of the Internal Revenue Code in 1991. This provision allowed investors to defer capital gains taxes on the sale of investment properties by reinvesting the proceeds into like-kind properties. DSTs emerged as an attractive option for investors looking to take advantage of the 1031 exchange mechanism while gaining access to high-quality real estate investments.

Over the years, DSTs evolved to address the needs of investors seeking passive real estate investments with potential tax advantages. The flexibility and simplicity of the DST structure appealed to a wide range of investors, including individuals, institutional investors, and financial advisors. As the popularity of DSTs grew, the industry saw increased participation from reputable sponsors, trustees, and property managers, further enhancing the credibility and operational efficiency of DSTs.

Regulatory oversight and investor protection have also played a role in shaping the history of DSTs. The Securities and Exchange Commission (SEC) has provided guidance and regulations to ensure compliance with securities laws, promoting transparency and investor safeguards. These regulatory measures help protect investors and maintain the integrity of the DST industry.

## OVERVIEW

A Delaware Statutory Trust (DST) is a legally recognized entity established under the laws of the state of Delaware, United States. It is formed for the purpose of holding and managing real estate properties or other investment assets.

In terms of structure, a DST is set up as a trust, with one or more trustees responsible for managing the trust's affairs and assets. The trustees hold legal title to the property on behalf of the beneficiaries, who are the investors participating in the DST. Each beneficiary holds a fractional interest in the trust, typically represented by "beneficial interests" or "units."

One important characteristic of DSTs is that they enable multiple investors to pool their resources and acquire fractional ownership in income-generating properties. This fractional ownership structure provides investors with an opportunity to access high-quality properties that might otherwise be financially out of reach on an individual basis.

DSTs are commonly used in real estate investment scenarios, where the underlying properties generate rental income or potential capital appreciation. These properties can include various types, such as apartment complexes, office buildings, retail centers, or even large-scale commercial assets.

From a taxation perspective, DSTs are designed to potentially offer tax advantages, particularly in the context of 1031 exchanges. A 1031 exchange allows investors to defer capital gains taxes on the sale of a property by reinvesting the proceeds into a "like-kind" property. DSTs can qualify as like-kind properties, enabling investors to potentially defer their tax obligations while diversifying their real estate portfolios.

In terms of governance and decision-making, DSTs are managed by the trustees, who are responsible for overseeing the trust's operations and ensuring compliance with legal and regulatory requirements. Investors, as beneficiaries, typically do not have direct involvement in the day-to-day management or decision-making processes of the trust. However, certain important decisions may require the consent or input of the investors, as outlined in the trust agreement.

It's important to note that DSTs, like any investment, carry inherent risks. Market conditions, property performance, and other factors can impact the financial outcomes for investors. Additionally, DSTs are subject to regulatory oversight, including compliance with securities laws and regulations to protect the interests of investors.

Overall, DSTs provide a vehicle for investors to participate in institutional-grade real estate investments, potentially offering advantages such as diversification, professional asset management, and potential tax benefits. Understanding the legal structure, operational aspects, and associated risks is crucial for investors considering participation in a Delaware Statutory Trust.

## **KEY BENEFITS OF DSTs**

- Access to Institutional-Grade Properties
  1. Fractional ownership and diversification opportunities
- Potential Tax Advantages:
  1. 1031 exchanges and tax-deferred growth
  2. Pass-through taxation and potential deductions
- Professional Asset Management:
  1. Passive income and reduced management responsibilities
  2. Expertise and economies of scale

DSTs provide access to institutional-grade properties that would typically require significant capital investments. By pooling resources with other investors, individuals can become fractional owners of high-quality commercial properties such as office buildings, retail centers, or multifamily complexes. This access to institutional-grade properties allows investors to diversify their portfolios and potentially enjoy the benefits of stable cash flow and long-term appreciation.

Secondly, DSTs offer potential tax advantages, particularly in the context of 1031 exchanges. Under Section 1031 of the Internal Revenue Code, investors can defer capital gains taxes by reinvesting the proceeds from the sale of a property into a like-kind property. DSTs can qualify as like-kind properties, enabling investors to potentially defer their tax obligations while expanding their real estate holdings. This tax deferral mechanism can be especially beneficial for investors looking to optimize their real estate portfolios and manage their tax liabilities effectively.

Overall, DSTs provide investors with the opportunity to access high-quality properties, diversify their portfolios, and potentially enjoy tax advantages. These benefits, coupled with the professional asset management and passive income generation associated with DSTs, make them an appealing investment option for individuals seeking exposure to the real estate market.

## **OPERATIONAL ASPECTS**

- Acquiring and Managing Properties within a DST:
  1. Property selection, acquisition process, and due diligence
  2. Role of the Trustee and property management companies
- Voting Rights and Decision-Making Processes:
  1. Investors' involvement in major decisions
  2. Trustee responsibilities and fiduciary duties
- Reporting and Distribution Procedures:
  1. Transparency in financial reporting and investor communications
  2. Distribution mechanisms and frequency
- Exit Strategies and Liquidity Considerations:
  1. Potential challenges and options for selling DST interests
  2. Secondary market platforms and limitations

The operational aspects of Delaware Statutory Trusts (DSTs) involve several key considerations. Firstly, the acquisition and management of properties within a DST are typically handled by a qualified Trustee. The Trustee oversees the trust's affairs, ensuring compliance with legal and regulatory requirements, and acts in the best interests of the beneficiaries. They play a crucial role in property selection, acquisition process, due diligence, and ongoing management of the properties held by the trust. Additionally, the Trustee may engage property management companies to handle day-to-day operations, including tenant management, lease negotiations, and property maintenance.

Secondly, DSTs have voting rights and decision-making processes that involve the investors. While investors do not have direct involvement in the day-to-day management, major decisions related to the properties or the trust itself may require the consent or input of the investors. The Trustee is responsible for communicating

and seeking investor input when necessary, ensuring transparency and alignment with the investors' interests. This involvement of investors in key decisions, coupled with the fiduciary responsibilities of the Trustee, helps safeguard the interests of the beneficiaries and promotes effective governance within the DST. Additionally, reporting and distribution procedures are established to keep investors informed about the financial performance of the properties and the distribution of income generated by the trust. Regular reporting and clear communication channels help maintain transparency and accountability within the DST structure.

Overall, the operational aspects of DSTs involve the Trustee's role in property acquisition and management, investors' involvement in decision-making, and the establishment of reporting and distribution procedures to ensure transparency and effective communication among stakeholders. These operational processes contribute to the efficient functioning of DSTs and help protect the interests of the investors while facilitating the benefits of fractional ownership in institutional-grade properties.

## **EXAMPLE**

Mr. Smith is a seasoned real estate investor who owns a 15-unit apartment building valued at approximately \$3,000,000. The property generates a net yield of 5.5%, providing him with consistent rental income. However, Mr. Smith is considering ways to defer taxes and diversify his income stream.

Mr. Smith begins by researching reputable DST sponsors and identifies a suitable opportunity. He finds a DST that specializes in acquiring and managing multifamily properties in desirable locations. The DST has a solid track record, experienced management team, and a history of generating consistent returns. After reviewing the investment details, Mr. Smith discovers that the DST is acquiring a portfolio of multifamily properties across different states, providing him with instant diversification.

One of the primary reasons Mr. Smith chooses a DST is the potential tax advantages it offers. By participating in a DST through a 1031 exchange, Mr. Smith can defer capital gains taxes on the sale of his apartment building. Instead of paying immediate taxes, he can reinvest the proceeds into the DST and defer his tax obligations, allowing him to preserve more of his investment capital. This tax deferral strategy aligns with Mr. Smith's long-term financial goals, as he can potentially benefit from the compounding effect of reinvested funds.

By utilizing a Delaware Statutory Trust, Mr. Smith successfully defers taxes and diversifies his income stream. Through a 1031 exchange, he reinvests the proceeds from the sale of his apartment building into the DST, deferring capital gains taxes and



preserving more capital for future investments. The DST's diversified portfolio of multifamily properties allows Mr. Smith to benefit from potential appreciation and income generation across multiple markets. Furthermore, the passive nature of DST ownership relieves him of the burden of property management while still providing him with a steady stream of rental income. Overall, the DST investment aligns with Mr. Smith's goals of tax efficiency and income diversification, enhancing his real estate investment portfolio.

## **CONCLUSION**

Overall, DSTs have provided investors with a means to access high-quality properties, diversify their portfolios, potentially enjoy tax advantages, and passively generate income. With the ongoing growth and development of the DST industry, it is an investment vehicle that will likely continue to play a significant role in the real estate investment landscape. By harnessing the benefits of DSTs, investors can optimize their real estate investments and pursue their financial objectives with confidence.

## **PURPOSE. FREEDOM. STEWARDSHIP.**

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