

DST 1031 Properties - The Basics

A Delaware Statutory Trust (DST) is an entity that is used to hold title to investment real estate. In some ways, this is similar to how a Limited Liability Company (LLC) can hold title to real estate; however, unlike an LLC, a DST 1031 property will qualify as “like kind” exchange replacement property for a 1031 exchange. This qualification as “like kind” property is pursuant to the Internal Revenue Code Section 2004-86.

The DST entity can be used to hold title to most types of real estate; however, a typical DST 1031 property is a triple net (NNN) leased retail or office property or a multifamily apartment community. A NNN leased property is a property whereby the tenant (and not the landlord) is typically responsible for property maintenance costs, insurance premiums and property taxes.

Other types of DST 1031 properties that have been available to investors have included shopping centers, government leased buildings, self-storage facilities, senior living communities, warehouses, distribution facilities, medical office buildings, fast food buildings, pharmacies and grocery stores.

Typically, at any given time, various companies will have 10 to 15 DST 1031 properties available to our qualified accredited clients, with a typical minimum investment of \$100,000.

The following are hypothetical examples of DST 1031 properties, and actual properties, tenants, lease terms and financing structures may vary greatly. Please note that names listed below are independent and an example from various properties and belong to their respective copyright and trademarked companies. Please also note that there are material risks associated with investing in real estate and DST properties, including but not limited to loss of the entire principal amount invested. Please review the risk section of the private placement memorandum for any potential DST offering that you are considering and speak with your CPA and attorney prior to investing. These are examples not actual properties.

- A 300-unit class-A multifamily community located in Austin, Texas. The property is 97 percent occupied and financed with a long-term non-recourse loan provided by Fannie Mae.
- A portfolio of four Walgreens throughout the United States that are 100 percent occupied on an absolute-NNN lease by Walgreens corporate.
- An all-cash, debt-free CVS pharmacy on a corporate-backed, long-term 25-year absolute-NNN lease.

- A 15-story office building that is 100 percent occupied as the headquarters of a major Fortune 500 company on a long-term NNN lease.
- A 100 percent occupied, NNN leased BJ's Wholesale Club located in New York metropolitan area.
- A 478-unit, class-A self-storage facility located in Dallas, Texas.
- A portfolio of 12,100 percent occupied, single tenant, freestanding net lease properties located throughout the country. Tenants include CVS, Walgreens, McDonald's, Tractor Supply Company, AutoZone, 7 Eleven, Dollar General, Kentucky Fried Chicken (KFC), Taco Bell, Applebee's, Sherwin Williams and KinderCare.
- A 250-unit, class-B plus multifamily apartment community located in Boston Massachusetts and 95 percent occupied.
- Lastly, a medical office building, 100 percent leased to the University of California, Los Angeles Health Care System on a 15-year NNN lease.

DST 1031 properties also have various financing ratios to satisfy an investor's exchange requirements of taking on "equal or greater debt," as defined by the Internal Revenue Code Section 1031. However, some DST 1031 properties are offered all-cash, debt-free in order to mitigate the risk of using financing when purchasing real estate.

The financing used on DST 1031 properties is typically non-recourse to the investor. Non-recourse financing is typically defined as financing whereby the lender's only remedy in the case of a default is the subject property itself.

The lender is not able to pursue the investor's other assets beyond the subject property. So, investors could lose their entire principal amount invested in the property in the case of a major tenant bankruptcy, market-wide recession or depression, but their other assets would be protected from a lender.

The non-recourse financing used on DST 1031 properties is typically long-term (usually seven to twenty years) and already locked and in place with the lender. This can greatly help to reduce 1031 exchange closing risk for investors that must be able to identify a property within their 45-day identification period that they know they are going to be able to close on.

From our observation the typical loan to cost of a DST 1031 property ranges between 40-65 percent as of this writing in 2015. A DST 1031 property with a 50 percent loan to cost is a

property wherein the investors are putting down half of the required equity or cash amount to purchase the DST property and the lender is providing the other half, in the form of a mortgage.

As an owner of the DST 1031 property, you will typically receive 100 percent of your pro-rata portion of any potential principal pay-down from the loan on the property, thereby potentially building equity in the property. It is important to note that some DST 1031 properties are structured with principal pay-down beginning in year two to five and others that are interest-only financing for the life of the loan.

DST 1031 properties are structured whereby the investors in the DST receive 100 percent of their pro-rata portion of the potential rental income generated by the property's tenants. DST investors receive 100 percent of their pro-rata portion of any potential net appreciation of the property over the hold period. This is an area that truly differentiates DST 1031 properties from partnerships. With a partnership, the offerings sponsor is typically entitled to a portion of the potential rental income and potential appreciation.

Investors are keenly interested in the fact that when a DST 1031 property is sold, they are free to do another future 1031 exchange into any type of "like kind" replacement property. Typically, our clients do further 1031 exchanges into more DST 1031 properties; however, you are free to invest in any other type of "like kind" property that you choose to upon the sale of your DST property.

From our observations we see DST 1031 properties, as of this writing in 2015, providing a projected cash-on-cash return of between 5 and 8 percent. The cash-on-cash return is a metric used in real estate to determine return on equity and is commonly referred to as cash flow. The variation in projected cash flows is due to a number of factors such as asset class (commercial properties typically provides a higher projected cash flow than multifamily apartments), location (strong primary markets like New York City and San Francisco typically have lower projected cash flows than smaller secondary or tertiary markets), age of the buildings, years remaining on the primary lease term and strength of the tenant (Are they considered investment-grade by Standard and Poor's or non-investment grade? Is it a public or private company? Does the company have a positive growth outlook or is it a contracting industry?). These are just some of the factors that can influence projected cash flows on DST 1031 properties.

The projected cash flow on DST 1031 properties is a “net” number to DST investors. This means the projected cash flow is “net” of all management fees, debt service payments and property expenses. For example, if an investor invests \$1 million into a DST 1031 property with a projected cash flow of 7 percent, the net amount projected to be sent to the investor that year is \$70,000. DST 1031 properties' projected cash flow is typically paid to the DST owners on a monthly basis via either ACH direct deposit straight into the investors checking or savings accounts or a physical check (whichever the investor prefers).

It is important to note that cash flow from real estate and DST 1031 properties, as well as past performance, is not guaranteed, as it is a function of the underlying real estate and tenants and their economic performance. Just as with all other types of real estate, projected cash flows could be lower than anticipated. It is very important for you as an investor to believe in the property, its location and its tenants before investing, as well as to review the risk factors of the offering materials in their entirety.

With DST 1031 properties investors are able to utilize depreciation and interest write-offs to partially shelter their projected cash flow from taxes. This allows for tax-advantaged potential rental income to the investor. This is another reason why many of our clients have invested non1031 exchange discretionary funds into DST 1031 properties, (which we will look into further in the section below titled “Why Do 1031 Investors Choose DST Properties Over Traditional NNN Properties”).

A typical DST 1031 property can be closed on within five business days after submitting subscription documents. DST 1031 properties can be closed on this quickly because typically all of the appraisals, environmental reports, property condition reports, financing, tenant estoppels, etc. have already been completed, as DST 1031 properties are “pre-packaged” for 1031 exchange investors. This is one of the reasons why DST 1031 properties have become very popular with investors that are in their 45-day identification period and close to running the risk of a failed 1031 exchange and a major tax consequence. They like the fact that they can close on DST 1031 properties quickly and complete their 1031 exchange within IRS guidelines.

DST 1031 investors do not receive a K-1 or 1099 at the end of the year for tax purposes. At the end of the year you will receive an operating statement (sometimes referred to as a substitute 1099). This will show your pro-rata portion of the DST properties rental income and expenses.

You will then provide this to your CPA, who will take this information and input it into Schedule E on your tax return, the same as all of your other commercial and rental properties.

DST 1031 properties are only available to accredited investors. An accredited investor (1) is generally defined as an investor with a net worth (assets minus liabilities) of greater than \$1 million, exclusive of primary residence. That being said, there are a number of ways that an entity can potentially qualify as an accredited investor, and we encourage all investors to speak with their CPA and attorney before considering a DST 1031 investment to fully ascertain if you and your investment entity (trust, partnership, LLC, etc.) qualify as an accredited investor.

<http://www.investor.gov/news-alerts/investorbulletins/investor-bulletin-accredited-investors>

What Are the Potential Benefits of Exchanging into a DST Property?

There are a number of potential benefits of exchanging into DST 1031 property. It is important to note that these should be carefully weighed with the potential risks that we will outline in the next chapter. You should also read the risk section of each DST 1031 property's offering materials in detail prior to investing.

Eliminating the day-to-day headaches of property management

Many of our clients are at or near retirement, and they are tired of the hassles that real estate ownership and management often bring. They are tired of the tenants, toilets and trash and are wanting to move away from actively managing properties. The DST 1031 property provides a passive ownership structure, allowing them to enjoy retirement, grandkids, travel and leisure, as well as to focus on other things that they are more passionate about instead of property management headaches.

Tax deferral using the 1031 exchange

Many of our clients have wanted to sell their apartments, rentals and commercial properties for years but haven't been able to find a property to exchange into and just can't stomach the tax bill after adding up federal capital gains tax, state capital gains tax, depreciation recapture tax and the Medicare surtax. The DST 1031 property solution provides investors an ability to move from an active to a passive role of real estate ownership on a tax-deferred basis.

Increased cash flow potential

Many investors are receiving a lower amount of cash flow on their current properties than they could be, due to their properties having under-market rents, properties that have multiple vacancies and/or that are raw or vacant land sitting idle. DST 1031 exchange properties provide an opportunity for investors to potentially increase their cash flow on their real estate holdings via a tax deferred 1031 exchange.

Portfolio diversification by geography and property types

Often times, 1031 investors are selling a property that comprises a substantial amount of their net worth. They want to reduce their potential risk and instead of buying one property (such as another apartment building) or one NNN building (such as a Walgreens pharmacy or Taco Bell restaurant) they decide that investing into a diversified portfolio of DST 1031 properties with multiple locations, asset classes (property types) and tenants is a better fit for their goals and objectives.

This is similar to how investors tend to invest retirement funds in mutual funds and Exchange Traded Funds (ETFs), as opposed to placing their entire retirement savings into the stock of one particular company. However, it is important to note that there are no assurances that diversification will produce profits or guarantee against loss.

Long-term non-recourse financing locked and in place to satisfy debt replacement requirements of the 1031 exchange

One of the requirements for a 1031 exchange is to take on "equal or greater debt" in the replacement property to what you had in the relinquished property (the property you are selling). In today's lending environment, it is often hard for investors to obtain non-recourse financing at an acceptable interest rate and terms. Due to the DST 1031 properties' sponsors typically having strong lending relationships, they are able to secure non-recourse financing at some of the best terms available in the marketplace. The DST 1031 investors are the direct recipient of these financing terms that they would otherwise often not be able to obtain on their own.

Access to Institutional Grade Real Estate

DST 1031 properties provide access to large, institutional-grade real estate that is often otherwise outside of an individual investor's price point. With the typical minimum investment of

\$100,000, investors are still able to purchase an ownership interest in large \$20 million-plus apartment communities, \$5 million-plus pharmacies or \$15 million grocery stores, for example. This allows investors access to a level of real estate that they just would not have been able to exchange into before.

That being said, we also have had many clients with very large 1031 exchanges opt to invest in DST 1031 properties because they did not want to place "all their eggs into one basket" by purchasing one single, large investment property

Unlocking trapped equity

For those investors that have a substantial amount of equity in raw or unimproved land (as well as investors with vacant properties that are not producing any cash flow), the DST 1031 property allows them the opportunity to sell, defer taxes via a 1031 exchange and unlock the trapped equity that they have in their properties. Now this trapped equity is free to produce for the investor potential cash flow on a monthly basis.

Ability to typically close on a DST 1031 property typically within three to five business days of completing and returning subscription documents

This is one of the main reasons why investors in their 45day identification period "time crunch" often turn to DST properties. They are able to close quickly and complete their exchanges due to the properties being pre-packaged, as opposed to waiting 30, 60 or 90 days to purchase another outside property.

Increased tax efficiency due to depreciation deductions on replacement property

Investors that have owned their apartments and rental properties for longer than 27.5 years and commercial properties for longer than 39 years have fully depreciated the properties, with no more deductions to help shelter the rental income. By purchasing DST 1031 properties that have a greater amount of financing than their relinquished (sold) properties, those investors are creating for themselves a new basis to shelter rental income through. We encourage all investors to speak with their CPA and tax attorney regarding this prior to investing in DST 1031 properties for details regarding their particular situation.

Increased tax efficiency due to interest write-offs

For investors that have fully paid off their properties, the DST 1031 properties with financing in place provide for interest write-offs to help shelter potential cash flows. Many clients in today's environment are looking for a way to increase tax efficiency due to the burdensome tax system in place in the United States. The DST 1031 can help to potentially solve some of these tax problems.

What Are the Risks of DST 1031 Properties?

DST 1031 properties are comprised of real estate and contain the same risks that all other forms of real estate entail. The following discussion on risks is meant to be an overview of potential risks and not an exhaustive list. We encourage investors to review the risk section of each potential DST 1031 property's offering materials before investing.

All forms of real estate investing, whether buying homes, duplexes, apartment buildings, commercial properties, including DST 1031 properties, are speculative and involve a high degree of risk. They are considered speculative because there are no guarantees with real estate investing. Investors should be able to bear the complete loss of an investment. All real estate and DST 1031 properties are subject to the risks of increased and ongoing vacancy, tenant bankruptcies, problematic tenants, economic downturns, physical damage, unexpected repairs and maintenance, eminent domain, negative rezoning, blight, environmental damage and liability and overall valuation fluctuations.

Further risks of real estate and DST 1031 properties include (but are not limited to) no guarantees for projected cash flows, no guarantees for projected appreciation, illiquidity, loss of day-to-day management control, interest rate risk and potential loss of entire principal amount invested

The use of leverage in real estate investments may increase volatility and the overall risk of loss. Furthermore, real estate investments and DST 1031 properties entail fees related to the acquisition, syndication, ongoing management and eventual disposition of the properties. These fees could materially impact the performance of an investment.

Again, please do speak with your CPA and attorney regarding the risks of investing in DST 1031 properties. along with reviewing the entire offering materials, which provide a full discussion of risks.

IRS Guidelines for DST 1031 Compatibility

When the IRS issued the Revenue Ruling 2004-86 (1), it allowed a properly structured DST to qualify as a like kind 1031 exchange replacement property. Along with this Revenue Ruling, the IRS issued seven "deadly sins," as we call them, which placed limitations on the trustee of any DST property

These limitations are:

1. Once the offering is closed, there can be no future contributions of capital to the Delaware Statutory Trust or DST by either current or new co-investors or beneficiaries.
2. The Trustee of the Delaware Statutory Trust or DST cannot renegotiate the terms of the existing loans, nor can it borrow any new funds from any other lender or party.
3. The Trustee cannot reinvest the proceeds from the sale of its real estate.
4. The Trustee is limited to making capital expenditures with respect to the property to those for (a) normal repair and maintenance, (b) minor non-structural capital improvements and (c) those required by law.
5. Any liquid cash held in the Delaware Statutory Trust or DST between distribution dates can only be invested in short-term debt obligations.
6. All cash, other than necessary reserves, must be distributed to the co-investors or beneficiaries on a current basis, and
7. The Trustee cannot enter into new leases or renegotiate the current leases.

The seven deadly sins can be problematic for 1031 exchange investors and potentially trigger unforeseen tax consequences to investors. Most sponsors have structured the DST with master leases, allowing them the flexibility to address some of the issues that the seven deadly sins can create. Also, most sponsors will typically use long-term financing that will potentially allow a DST property to be sold prior to the need to either pay off or refinance the loan on the property. However, there are no guarantees that a master lease or long-term financing can protect investors from unforeseen tax consequences.

Investors should speak with their CPA and attorney for a full discussion of the implications of the DST structure, including the seven deadly sins, prior to making an investment into any DST offering.

All real estate and DST properties entail fees and costs that investors should review and consider carefully with their CPAs and attorneys prior to making an investment. Fees and costs should be weighed carefully against the potential for tax deferral using a 1031 exchange. All fees and costs are outlined in each offering's Private Placement Memorandum for investors to review and agree to prior to making an investment.

Loan Securitization Risk

Some of the DST 1031 properties are financed with commercial mortgage-backed security (CMBS) financing. This is financing wherein a financial institution will make a loan to a borrower and then package that loan with many other loans in a trust, which is then typically sold to institutional investors looking for income. CMBS financing can pose substantial risks to DST 1031 investors due to the unique structure of CMBS financing and special servicers typically being very aggressive against CMBS borrowers that are in any type of default of the loan provisions. Many institutional buyers of commercial real estate utilize CMBS financing due to the competitiveness of the loan terms and rates offered; however, it is important to note that if an investor is uncomfortable with CMBS financing, he or she should not invest in a DST 1031 property that will be using it. All investors should review with their attorney and CPA the loan details found in the PPM as well as the loan documents provided upon request by the sponsor company regarding any DST 1031 offering.

Again, the risks discussed above are not meant to be an exhaustive list of risks involved with real estate investments and DST properties. We do encourage investors to read each offering's Private Placement Memorandum (PPM) completely and pay careful attention to the risk factors *section*.

(1) http://www.irs.gov/irs.gov/irb/2004-33_IRB/ar07.html

Illiquidity and Exit Strategies

Two of the questions that often come up from our clients considering a DST 1031 exchange property are 1) How liquid are DST 1031 properties? and 2) What are the exit strategies?

First off, it is important to note first and foremost that DST 1031 properties are real estate, and like all other types of real estate they are inherently illiquid. You are not buying shares of stock listed on a public exchange that you can sell in 10 seconds by logging into your online brokerage

account. This is a fractional beneficial interest in a trust that owns a large piece of illiquid real estate. Investors should be able and willing to hold their investment in a DST 1031 property for the full life of the program, which could last for seven to ten years or even longer.

That being said, we have heard of investors selling their DST 1031 interest in a property before. One of the main issues is finding another buyer and agreeing on a price. Typically, if an investor wants to sell their interest in a DST 1031 property, the sponsor will send a letter to all of the other DST investors in the property notifying them that a fellow investor wants to exit their interest in the property.

There is no guarantee that an investor will be able to find another investor that wants to buy his or her DST interest and that they will be able to agree to a price. Therefore DST 1031 properties are again to be considered illiquid investments and should only be purchased if an investor able and willing to hold the investment for the full life of the DST offering.

The second question is "What is the exit strategy?!" This answer is always unknown until a particular DST actually goes "full cycle." Full cycle is a term used to describe a DST property that is purchased on behalf of investors and then after a period of time is sold on behalf of investors. The following are various exit strategies that could potentially take place; please note that this is not an exhaustive list of potential exit strategies but merely a list of examples for illustration purposes only:

- 1) A Real Estate Investment Trust (REIT) purchases the DST property.
- 2) A large institution, such as a pension fund or foreign investor, purchases the DST property.
- 3) Another real estate company on behalf of their investors purchases the DST property.
- 4) An ultra-high net worth buyer will purchase the DST property via a 1031 exchange or as an outright purchase.
- 5) The investors in a DST property are potentially given

an option to utilize the Section 721 exchange to exchange into a larger portfolio of properties (such as a REIT) on a tax-deferred basis. This potential exit strategy is examined further below in the section titled *The Section 721 Exchange*.

Who Is Who - The Roles of DST Industry Players

Many investors find it hard to keep the players in the DST 1031 industry straight in their minds. Who is the sponsor, the broker dealer, and the registered representative? This chapter seeks to answer these questions and provide a background for potential DST 1031 investors on “who is who.”

DST Real Estate Sponsor Companies

A real estate sponsor company creates the DST 1031 property for investors to be able to invest in. The creation of a DST 1031 property is a very complex process that involves many different facets.

The role of the DST sponsor company is to locate potential properties to be used in a DST 1031 offering. The DST sponsor will typically review and analyze dozens and dozens of potential properties before finding a property that fits.

Once finding a property that potentially fits, the sponsor company begins to run financial models on the property to decide if it will work as an actual DST offering.

The DST sponsor company will from there begin to open up negotiations with the prospective property's seller via a letter of intent, due diligence period and then entering into a Purchase and Sale Agreement.

During due diligence the DST sponsor company will typically order all environmental reports, appraisals and property condition/engineer reports, as well as conduct an analysis of the property's lease and market/submarket.

The DST sponsor will also (if the property is not going to be an all-cash property) begin to arrange and negotiate financing and terms with potential lenders.

From there, the DST sponsor company will begin to market the DST 1031 offering to broker dealers and registered representatives in an effort to raise the required equity to fully fund the offering.

Once the offering is fully funded, the DST sponsor company will typically continue to have an active role with the property and investors, typically as the property asset manager. An asset manager's role is to manage the properties and their tenants from a financial and legal perspective. The asset manager is often considered the manager of the property manager.

Some sponsors will act as the property manager of the DST 1031 property, and others will outsource the property management function to a third-party firm. This is a matter of preference as well as a matter of asset class, as many sponsors that will outsource property management functions for more management-intensive asset classes (such as multifamily apartments and senior care) will do in-house property management on asset classes with fewer moving parts, such as long-term NNN lease properties.

To best sum up a DST sponsor's role, the DST sponsor is the business of sourcing, financing, structuring and packaging properties to provide a pre-packaged 1031 exchange solution for 1031 investors.

Broker Dealers

The broker dealer is a securities company that is involved in marketing and sales of DST 1031 offerings to investors. As noted earlier, the broker dealers will often have a group of registered representatives that hold their securities licenses with the broker dealer. The broker dealer's role is to supervise their registered representatives and to provide support on securities-related matters.

The typical role of the broker dealer in a DST 1031 property is to analyze and provide due diligence on DST sponsor companies and their DST 1031 offerings. Broker dealers perform this function with either an in-house due diligence team or outsourcing due diligence work to third-party due diligence providers.

Upon the broker dealer determining that a particular DST 1031 property is appropriate for their

registered representatives to offer to clients, the broker dealer will enter into and sign a selling agreement with the DST 1031 sponsor company. This in turn allows the broker dealer's registered representatives to offer to their clients the ability to invest in a particular DST 1031 property.

It is important to note that just because a broker dealer has conducted due diligence on a DST 1031 property (some actually conduct very little to no due diligence) and/or has outsourced due diligence to a third-party provider, this does not guarantee that a particular DST 1031 offerings is "safe". Due diligence does not guarantee profits, returns or safety of a particular offering. Investors should be aware that due diligence does not mean an offering will not have problems or issues and that even offerings with thorough due diligence conducted on them could result in an investor's loss of their entire principal amount invested. This is real estate, and there are no guarantees.

Registered Representatives

As noted earlier, the broker dealer will often hold the securities licenses of a group of registered representatives. The registered representatives are securities professionals who have successfully obtained certain securities licenses (e.g., Series 7, 22 and 63) to be able to offer to qualified investors the ability to purchase a 1031 DST property.

Many investors often ask if a real estate agent or broker is able to sell DST 1031 properties, and the answer is no. This is because DST 1031 properties are considered securities by federal and state regulators, as the investor is purchasing a piece of the real estate and not the whole property.

In the DST 1031 industry, we have observed that there are two types of registered representatives who offer DST 1031 properties to their clients. The first type is what we call a specialist. This is a registered representative who specifically chooses to concentrate on DST 1031 properties for his or her clients. These registered representatives have helped many clients involved in 1031 exchanges and are often sought out by clients due to their reputation of specializing in these properties.

The specialist-registered representative typically is very active in the industry, attends industry conferences and has a strong understanding of commercial and investment real estate, as well as a strong understanding of the 1031 exchange and its rules and guidelines.

The specialist is often able to become a valuable resource to his or her clients and their CPAs and attorneys as the client is considering an investment in the DST 1031, because the specialist is involved in many, many DST 1031 property exchanges each and every year.

The other types of registered representative that we have seen offer DST 1031 properties to investors are what we call generalists. The generalist is often a financial planner who has done one or two DST 1031 exchanges in his or her career. He or she may have the proper securities licenses to offer a DST 1031 property to clients; however, they often have a very rudimentary understanding of how these properties actually work and their potential benefits and risks.

The generalist often is preoccupied with all aspects of financial services, such as stocks, bonds, mutual funds, life insurance and annuities. Often the generalist will try to be all things to all people, and when a client has a 1031 exchange ... the generalist is jumping right into DST 1031 mode for that client. The problem here is that these generalists often are not able to offer the valuable insight and experience that, in my opinion, a specialist may be able to. This is similar to how you would not want your knee surgery performed by a general practice doctor – you would want a specialist to potentially ensure the best outcome.

All inquiries regarding DST shall be through Susan & Justin. Many rules and regulations apply when discussing this 1031 option with clients. Only professionals can discuss the details of securities transactions with perspective investors.