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Finance Series Part III: Pros and Cons of the DST Structure

By: Michelle Napoli

New York City—While technically DST deals are not TICs—investors hold a beneficial interest in the Delaware Statutory Trust that owns a property, as opposed to being tenants-in-common in title—their use for 1031 exchanges is most certainly part and parcel with the growing property co-ownership investment business. And many of the industry's TIC sponsors welcomed last summer's Rev. Rul. 2004-86, in which the Internal Revenue Service gave its blessing to the use of multi-owner DSTs holding rental property for 1031 exchanges, so long as the trustee is limited in its activities.

The DST is considered to have several benefits, particularly when it comes to financing co-ownership investment property. Since many lenders' chief concern with tenant-in-common deals is their very nature of having multiple borrowers—and thus the possibility of serial bankruptcies stalling a foreclosure in a worst-case scenario—the DST is appealing because it represents one single ownership entity and one single borrower.

“There are advantages to this from a lender viewpoint,” notes Arnold S. Harrison, a partner in the Chicago law firm Jenner & Block. Along with a group of other attorneys and sponsor representatives, Harrison was instrumental in obtaining last summer's revenue ruling. “You have one owner of 100% of the fee and one mortgage,” he notes. “They don't have to worry about serial foreclosures, they don't have to worry about underwriting the investors, because an investor in a DST has no votes, no powers to speak of. So from their viewpoint, it's like making a loan to an entity. I've done these in dealings with PNC Bank and Allianz, and I've talked to MetLife, Bank of America, Bear, Stearns, Prudential, Deutsche Bank.”

The increased risk of a multiple-borrower loan may very well be mitigated by the use of the DST structure, says Jeffrey Lavine, senior managing director who oversees loan closing and structuring at Bear, Stearns & Co. in New York City. “We're going through a whole DST analysis: how the investors will look at it and what they are comfortable with,” says Lavine. “For the first time, we've got some TIC syndicators coming to us thinking of doing the DST saying, ‘Here's how we want to do it, are you, Bear, OK with that?’ You get your single borrower, which is good.”

Indeed, with the DST concept still in its infancy, lenders are still grasping its meaning. “It does help calm some of the banking entities,” says Marc Goldstein, principal and co-founder of Houston's Creekstone Partners, which has been co-sponsoring deals with U.S. Advisor LLC. “That's the good news, but of course, since there haven't been a ton of these done yet, they all want to look at it and make sure it really is what we say it is.”

Creekstone was involved in what is believed to be the first DST deal to follow last summer's revenue ruling: the \$23.9 million offering, with U.S. Advisor, of the Courtney Creek apartment complex in Durham, NC. Its lender was PNC Bank and the financing was arranged by **Harbor Capital Group** of Houston. PNC was “ready to sit down and focus because of our relationship with them,” says Goldstein. “Probably in the next six to 12 months, the lending institutions, the

conduit world and everyone else will focus their legal departments on how it can be a great tool for them.”

Some 40% to 50% of Creekstone’s deals going forward will be structured as DSTs, the rest as tenants-in-common, says Goldstein. He and others note that, theoretically, at least, using the DST will also make it much more plausible for sponsors to buy properties that have debt that must be assumed, thus broadening the universe of properties they can buy. But while in theory it works, in practice it isn’t necessarily the case. “We just tried to do one with Fannie,” Goldstein reports, “but Fannie still isn’t ready to get their arms around it.”

The DST has other potential benefits beyond financing considerations as well. For one, more investors—up to 100—can be brought into a DST deal, as opposed to a maximum of 35 in a TIC. A greater number of investors means either a larger property can be bought and/or minimum investment requirements can be lower, widening the field of potential investors. “That really helps out the sponsorship group,” notes **Frank Satterfield**, founder and principal of Harbor Capital. “Now if you have a very large deal, you can bring in a larger number of investors and it makes it a lot easier to meet your equity requirements.”

While the 35-investor figure for TICs comes from the revenue procedure that spelled out IRS requirements for considering a private letter ruling request on those deals, there is no tax law or policy that limits the number of investors in a DST, Harrison notes. Rather, the 100-investor limit comes from the Investment Act of 1940, he explains. Generally if you sell securities and you have more than 100 investors, unless they’re qualified purchasers—meaning they have a net worth of at least \$5 million—then you are subject to the 1940 Act, which basically makes you the same as a public company with all the reporting requirements of a public company. “That’s so burdensome, nobody’s ever going to do that,” says Harrison.

The DST also makes the paperwork much less cumbersome and less time-consuming, and thus less costly, for the investor. In a DST, the investor basically signs a subscription agreement, whereas with a TIC, each investor has to form a single-member LLC (which requires annual filings and fees) and undergo a separate underwriting by the lender. “It is very easy to sign up people to the DST agreement,” says Goldstein, “as opposed to having 25 or 35 separate closings.”

But there are limitations to the DST, particularly the limits that last summer’s revenue ruling puts on the activities of the trustee, which is generally the sponsor. The trustee is limited from doing things such as signing new leases or refinancing, and the individual investors have no say in these operational matters, nor can they be asked for additional capital to cover expenses like property improvements. Those limitations can be a cause for concern from the lender’s point of view. “From the sponsor’s point of view, they’re not limited to 35 investors,” Lavine notes. “The problem with the DST is that, to be considered a pass-through with respect to tax, it is very, very limited in what it can do.”

Agrees Goldstein, “It’s not as flexible of a tool for running the real estate.”

Meanwhile, the DST is limited in its use to triple-net leased properties or properties where a master lease is put in place. “The DST works for two types of structures,” says Harrison. “It works for the long-term credit tenant deal. It also works with a syndicator who does a master lease which is structured like a triple-net lease.”

But from the investor’s point of view, there is a significant difference in the risk-reward profile of a master lease vs. a triple-net lease with a credit tenant. “Generally your master tenant is a sponsor affiliate and usually they’re not capitalized to the same extent as when you have Walgreens on the lease,” Harrison concludes.