SPECIAL REPORT

An In-Depth Guide to Legal Entities

Including TICs and DSTs

Syndication Attorneys PLLC

www.investormarketingmaterials.com
844-SYNDIC8 (844-796-3428)
info@syndicationattorneys.com

Introduction

Whether you borrow funds from multiple investors or sell interests to a group of investors, you will need to have a place to pool the money other than your personal bank account.

You will also need a means to take title to the real estate in something other than your personal name. This is usually accomplished by forming a legal entity, such as a corporation, limited liability company (LLC), limited partnership (LP), or owning fractional interests in real estate in a tenants in common (TIC) structure.

The reasons to form a company rather than conduct business in your own name are two-fold: 1) to protect your personal assets from liability for the acts of the company; and 2) to create a structure where multiple individuals can operate as a single entity.

A table summarizing the different corporate structures and associated terminology is available at the following link:

https://howtolegallyraiseprivatemoney.com

This table may be a sufficient overview for some readers but this special report is meant for others who desire a more in-depth discussion of the characteristics associated with each of the corporate structures described below.

Of note is the purposeful omission of any reference to the sole proprietorship as a business structure. While this structure may be viable for certain licensed or individual activities, it is not recommended for any purpose involving raising investor funds. It does not afford the sole proprietor with any limited liability.

CHARACTERISTICS OF SPECIFIC LEGAL ENTITIES

Corporations

Corporations are the oldest form of legal entity. They have an established limited liability framework on which all other legal entities are based. Once you have a basic understanding of corporations, you will be able to understand the distinctions between different types of legal entities and be able to make smarter choices when forming your own legal entities. Entrepreneurs who don't have this foundation often confuse terminology between the different types of legal entities, making themselves appear uninformed to investors who do know the correct terminology. Taking the time to understand the differences between the types of entities you may encounter in your syndication business, and gaining familiarity with the terminology associated with each of them, will help you avoid this common pitfall.

Participants. A corporation is governed by board of directors who hire or appoint officers, typically including a president, vice president, treasurer and secretary. They may have other titles such as Chief Executive Officer (CEO), Chief Operations Officer (COO) or Chief Financial Officer (CFO). The officers implement the policies and procedures of the company. The president or CEO usually has the exclusive right to cause the corporation to enter into binding contracts.

The vice president usually only acts if the president is unavailable. The treasurer or CFO oversees the company's finances, and the secretary is responsible for maintaining the corporate books and records. A COO may oversee the company's business operations. The rights and duties of the participants in a corporation are prescribed in each state's corporations code or equivalent statutes, and further defined by case law precedent.

Stakeholders in a corporation purchase or own shares or stock and are called shareholders or stockholders (these terms are used synonymously throughout this book). A corporation may have multiple classes of shares, with different rights and duties associated with each class. Shareholders may have the right to participate in certain votes, as described in the company's governing documents.

CHARACTERISTICS OF A CORPORATION

PARTICIPANTS

- Board of Directors
- Officers
- Shareholders

DECISIONS / OPERATIONS

- Directors make major decisions
- Officers run day-to-day operations
- Shareholders provide capital and vote on certain decisions

ORGANIZATIONAL DOCUMENTS

- Articles of Incorportion
- Bylaws
- Optional Shareholder Agreement

TAXATION

- C-Corp earnings (called dividends taxed at corporate level and on distributions)
- S-Corp taxes pass-through to individual owners

LIMITED LIABILITY / CORPORATE VEIL

- Applies to all participants
- Officers and directors can lose this if they exceed their authority when acting in the name of the company

Organizational Documents. Each state maintains its own corporations code. To initiate formation of a corporation, an organizer will file the articles of incorporation and pay a fee to the applicable state department. The corporation is then *duly formed* and can begin operations once the state file-stamps and issues the articles of incorporation. The articles of incorporation are also sometimes called the corporate charter.

The organizer typically generates a set of corporate bylaws. These are the governing rules regarding the way in which the corporation will be operated. Corporate bylaws describe the corporation's business purpose, the parties associated with the governance and ownership of the corporation such as officers, directors, shareholder classes, voting rights and how certain decisions will be made, how the participants will be compensated, and the process for sharing profits and losses.

Taxation. On formation, a corporation may choose to be taxed as an S-corporation or C-corporation. An S-corporation is a pass-through entity for tax purposes.

However, the U.S. Internal Revenue Service (IRS) places a limit of 20% on the amount of an S-corporation's earnings that can be derived from passive investments, which could subject passive earnings exceeding that threshold to ordinary income tax rates. Additionally, non-U.S. persons are typically prohibited from owning an S-corporation.

A C-corporation will be taxed at the corporate level and its shareholders will also be taxed on their earnings from the corporation at the personal level. This is the origin of the double taxation stigma associated with C-corporations.

Corporations are rarely used as a title holding entity for real estate primarily due to tax reasons, but consultation with a certified public accountant (CPA) is always recommended before determining your corporate structure. You should only make these elections after consultation with a CPA or tax adviser who understands the specific purpose of the company you are forming.

Compliance with Securities Laws. In a corporation where the shareholders are contributing capital and the officers and directors are running the company, the company is selling investment contracts. Because the shareholders rely on the officers and directors to generate profits on their behalf, the sale of corporate shares are considered investment contracts, and therefore securities, so compliance with securities laws is required for the sale of shares or stock in a corporation. As we learned earlier, to offer or sell such investment contracts, the offering must be registered or exempt from registration; thus, compliance with securities laws is required.

Once you have all of these things in order, the organizer will hold an initial organizational meeting and start business operations. But that's not all you have to do…

Maintaining the Corporate Veil. The entity must do certain things to demonstrate to the state and the public that the corporation is acting as a distinct and separate company and not as an alter ego of the individual(s) running the company.

These requirements are set in each state's corporation or business code, and common law established by the outcome of previous lawsuits.

The states and numerous court cases have determined that observing certain formalities will help to establish your business's separate corporate identity that is necessary to maintain its corporate veil, including, but not limited to:

- The organizer must hold an organizational meeting and appoint a board of directors.
- The board of directors should appoint or elect officers with specific titles and duties who will run the corporation.
- The corporation must maintain written minutes of all corporate meetings.
- The corporation should obtain a federal tax identification (tax ID) number.
- The corporation must file and pay both state and federal taxes.
- The corporation should physically issue any shares of stock described in its bylaws and/or stockholder agreement by having its officers create and deliver the appropriate stock certificates.
- The corporation must have a bank account in its name.
- The corporation cannot co-mingle personal funds and corporate funds. The corporation checkbook or ATM card should not be used to purchase personal items, nor should personal funds be used to pay for company expenses unless there is a clear and written procedure and record of reimbursement.
- The corporation may need to obtain a business license, depending on local requirements.
- The corporation should have telephone service separate from personal telephone service.
- Any written lease should be in the corporation's name.
- The corporation should hold annual meetings of the shareholders and board of directors.
- All leases, contracts and letters must be signed by an officer or director with authority to do so, who must always sign in the capacity in which the person is acting (such as Jim Smith, President).
- All decisions made at meetings should be documented in the form of a corporate resolution and maintained in the corporate records.
- Meetings should only be called and held in the manner described in the corporate bylaws.

The more of these things you do, the greater the likelihood that the corporation will be able to survive a challenge that seeks to pierce the corporate veil. If you own a corporation and you haven't done any or only a few of these things — even if you are the sole officer, director and stockholder — you should talk to your attorney about converting your company to a limited liability company, which will offer the same corporate veil protection without requiring the formalities listed above.

Partnerships

What is a partnership?

> *A partnership is "A voluntary association of two or more persons who jointly own and carry on a business for profit." – Black's Law Dictionary, 7th Edition*

General Partnership

Two or more individuals or entities that join together for a common purpose will be deemed by default to be a general partnership. This may also be called a joint venture.

You may use general partnerships to manage your syndications and for some small offerings when there are less than 3-4 participants. In order to call something a joint venture, where there are funds involved, every partner must stay in control of generating their own profits.

The rights and duties of general partners are defined in common law. The disadvantage of this structure is that each general partner can be held personally liable for acts of all other general partners. Additionally, depending on the agreement between the partners, if any, unanimous consent may be required for certain decisions. If there is no written agreement between the partners, the interests of all general partners are presumed to be equal.

CHARACTERISTICS OF A LIMITED PARTNERSHIP

PARTICIPANTS
- Two or more partners
- One or more General Partners (managers)
- One or more Limited Partners (passive investors)

DECISIONS / OPERATIONS
- General Partners make day-to-day decisions
- Limited Partners may vote on major decisions

ORGANIZATIONAL DOCUMENTS
- Certificate of Partnership
- Limited Partnership Agreement

TAXATION
- Earnings pass through to each partner

LIMITED LIABILITY / CORPORATE VEIL
- None for the General Partner
- Limited Partners enjoy limited liability unless they get too involved in management

While you can form a general partnership or joint venture by simply behaving as a common entity without filing any organizational documents and becoming legally recognized entity such as a limited liability company, a limited partnership, or corporation, that is not how joint ventures are commonly formed. The preferred method is to form a member-managed limited liability company to act as the joint venture entity. Both are more fully described below.

Limited Partnership

A limited partnership (LP) is another option for raising money for a real estate syndication or startup business. A chart showing the major characteristics of an LP is provided in the chart. A more detailed description follows here.

Participants. Limited partnerships consist of limited partners and one or more general partners. The general partner is the active manager of the LP and may be an individual or another entity. General partners have unlimited liability for acts performed on behalf of the LP. One way to alleviate this consequence is to form a limited liability company or corporation to be the general partner of an LP, affording it the limited liability associated with those entities.

The limited partners are passive investors who fund the LP and get a share of its profits and losses allocated amongst them according to their ownership interests.

These are called limited partnership interests. The limited partners have limited liability up to the amount of their investment in the LP and enjoy passive investment tax benefits. Limited partners are prohibited from participating in day-to-day decisions of the LP; otherwise they risk being reclassified as a general partner. There may be multiple classes of LPs, each with its own set of rights and duties.

Organizational Documents. Absent a contrary agreement (such as an LP agreement), the rights and duties of the participants in an LP are prescribed in each state's Limited Liability Company Act, or equivalent statutes, and further defined by case law precedent. Many states have adopted the Uniform Limited Partnership Act of 2001, most recently revised in 2013. Other states maintain their own LP acts. A limited partnership is formed by filing an application with the appropriate state governing body. An LP is duly formed and can begin operations once the state file-stamps and issues a Certificate of Partnership.

A *limited partnership agreement* is the governing document used to describe the rights and duties of the partners in an LP. Absent a contrary agreement (such as a limited partnership agreement), the rights and duties of the participants in an LP are prescribed in each state's Limited Partnership Act, or equivalent statutes, and further defined by case law precedent.

Taxation. An LP is a pass-through entity for tax purposes, so the earnings of the LP are passed through to its limited partners, each of whom reports the proportionate share of the LP's earnings on his or her own tax return. In an LP that acquires real estate, it is possible for the limited partners to enjoy capital gains tax rates on their earnings. While the general partner's fees may be taxed as ordinary income, any carried interests it retains for providing services to the company may be taxed at capital gains rates. LP interests are considered personal property and are specifically ineligible for a 1031 exchange although the company may exchange its real property for another real property.

Compliance with Securities Laws. In an LP, if the limited partners are contributing capital and the general partner is running the company, the company is selling investment contracts. Because the limited partners rely on the general partner to generate profits on their behalf, LP interests involving an investment of money are investment contracts, and therefore securities, so compliance with securities laws is required for the sale of LP interests. We learned earlier that to offer or sell such investment contracts, the offering must be registered or exempt from registration; thus, compliance with securities laws is required.

Limited Liability Company

A limited liability company (LLC) is the most commonly used entity structure for real estate syndications, and the one you are most likely to use as a syndicator.

An LLC is a hybrid entity that combines the corporate veil benefits of a corporation with the liability protection and pass-through taxation associated with an LP, without the formalities of a corporation. Like an LP, an LLC may take title to real property in its own name and is considered a pass-through entity for tax purposes.

The major characteristics of LLCs are provided in the chart below. A more detailed description follows here.

Participants. The participants in an LLC includes members and may also include a manager, in the case of a manager-managed LLC. The members own *units* or *interests*. In a syndication context, the members usually have ownership interests in the company, which gives them both the right to vote on certain company decisions and the right to a share of distributions or profits the company may generate. The manager may or may not be a member and may be separately compensated with salaries, fees, or other compensation.

Whether an LLC member-managed or manager-managed, all of its members *and the manager* have limited liability protection.

Variations

Manager-managed LLC

In a manager-managed LLC, the members are considered passive investors and may have limited or no voting rights.

CHARACTERISTICS OF A LIMITED LIABILITY COMPANY

PARTICIPANTS
- One or more members
- If member-managed, all members are presumed to be managing members
- May have one or more managers

DECISIONS / OPERATIONS
- Managers make day to day decisions if manager-managed
- Members make day to day decisions if member-managed
- In both cases, Members may vote on major decisions

ORGANIZATIONAL DOCUMENTS
- Articles of Organization or Certificate of Formation
- Operating Agreement or Company Agreement

TAXATION
- Earnings pass thru to each member

LIMITED LIABILITY / CORPORATE VEIL
- All members and managers are protected within the corporate veil

The manager, who may be an individual or another entity, generally makes all of day-to-day decisions for the company. Thus, if you are selling LLC membership interests in a manager-managed LLC to raise money, you are selling investment contracts, requiring compliance with securities laws.

Member-managed LLC

In a member-managed LLC, all of the members are considered to be managing members, each of whom has the right to legally act on behalf of the LLC, but they are simply called members. If you choose to form a member-managed LLC, securities compliance issues can be avoided *as long as each of the members actively participates in management of the LLC*. The test is whether each member is responsible for generating their own profits. If so, it's a joint venture. If not, you are selling investment contracts, which are securities, and you must follow securities laws.

Uses of member-managed LLCs include:

- Acting as the manager of a syndicate, where multiple members are consolidated into a single entity and perform management functions. Such functions can include generating the investment opportunity, organizing the company, conducting due diligence or feasibility studies, and hiring securities counsel to draft syndication offering documents, among other things.
- Small joint ventures with two or three participants. A member-managed joint venture LLC can be used if you are raising money from a small number of investors (two to three), each of whom will stay in control of their own money and generate their own profits. Be careful how you use this structure when pooling funds from private investors, because each member will have a say in how their money is spent. You will have to get the money from them or at least their permission, every time you need it. This structure can become unwieldy fast if you have too many investors calling the shots, which is why it is not the preferred structure for pooling funds from investors, unless you are doing very small deals or dealing with very large investors.
- Complex joint ventures where one of the partners is an investment bank, private equity fund, family office, or where the entire offering will be funded by a single, large investor. When used this way, the syndicate will be one of the members and will be responsible for raising part of the funds needed. The funding source is the second member who will bring in the rest of the funds. For startup companies and real estate ventures, it is typical that the syndicate would raise some of the funds. If additional funds are needed beyond what the syndicate can raise on its own, they may come from an outside funding source, such as one of these joint venture partners or crowdfunding. Joint venture partners at this scale typically want management takeover rights for the joint venture if the syndicator fails to properly manage the company or provide them with their required returns. They may also sign on a bank loan, enhancing the syndicator's ability to acquire bigger properties or allowing a startup company to expand faster than they could have done without the extra funds generated by the joint venture.

Organizational Documents. Absent a contrary agreement, the rights and duties of the participants in an LLC are prescribed in each state's Limited Liability Company Act, or equivalent statutes, and further defined by case law precedent. Many states have adopted the model Uniform Limited Liability Company Act of 1996, most recently revised in 2013.

An LLC is formed by filing an application with the secretary of state or other governing body and obtaining Articles of Organization or a Certificate of Formation, depending on the state. In the LLC application you will make an election to have the LLC be governed by its members or by a manager as further described below.

The governing document used to describe the rights and duties of the participants is commonly called an Operating Agreement or Company Agreement as defined in each state's LLC Act.

Taxation. Like an LP, an LLC is a pass-through entity for tax purposes, so the earnings of the LLC are passed through to its members, each of whom reports his or her proportionate share of the LLC's earnings on his or her own tax return.

The company reports this information by annually filing an IRS Form 1065 and providing an IRS Form K-1 to its members. Like an LP, LLC interests are considered personal property and are thus ineligible for a 1031 exchange.

In an LLC that acquires real estate, it is possible for the members to enjoy capital gains tax rates on their earnings. While the manager's fees may be taxed as ordinary income, if structured correctly, any carried interest it retains for providing services to the company may be taxed at capital gains rates. Additionally, LLC interests are considered personal property and are specifically ineligible for a real property 1031 exchange, although the company may exchange its real property for another real property.

Compliance with Securities Laws. To avoid having to comply with securities laws, in a member-managed LLC every member who contributes capital *must stay actively involved in generating his or her own profits*. In a manager-managed LLC, if the members are contributing capital and the manager is running the company, the company is selling investment contracts, *which makes it a syndicate, not a joint venture.* In such case, compliance with securities laws is required.

CHARACTERISTICS OF A TENANTS IN COMMON STRUCTURE

PARTICIPANTS
- One or more tenants (owners); limit 35 if 1031 Exchange is desired
- May hire an asset manager or property manager

DECISIONS / OPERATIONS
- Asset manager or property manager makes day-to-day decisions
- Tenants must vote on major decisions

ORGANIZATIONAL DOCUMENTS
- No formation document filed on behalf of the group of co-owners
- TIC Agreement
- Asset Management Agreement (optional)
- Property Management Agreement

TAXATION
- Earnings pass through to each co-owner according to their respective co-ownership interests

BENEFITS
- Limited Liablity: None for the collective ownership group but individual co-owners may take title in a limited liability entity to avail themselves of the corporate veil
- Individual co-owners may 1031 Exchange in or out of a TIC

Tenants In Common

Another option that you may consider for taking title to real estate in which profits are to be split among investors is to form a tenants in common ownership (a TIC). The primary reason real estate investors choose this structure is because it allows them to freely transfer in and out of the property using tax-deferred 1031 exchange rules; but there are some limitations to this structure for syndicators.

The chart provides a list of the major characteristics of a TIC ownership structure that wants its interests to qualify for 1031 Exchange. A more detailed discussion follows here.

TIC ownership is a non-statutory common law concept related to how multiple persons take title to real or personal property. It is most commonly used for taking title to real estate where multiple co-owners will have unequal ownership interests and want the ability to freely sell or transfer their interests. There are some limitations imposed by the IRS that make them less favorable than LLCs or LPs for syndicating real property.

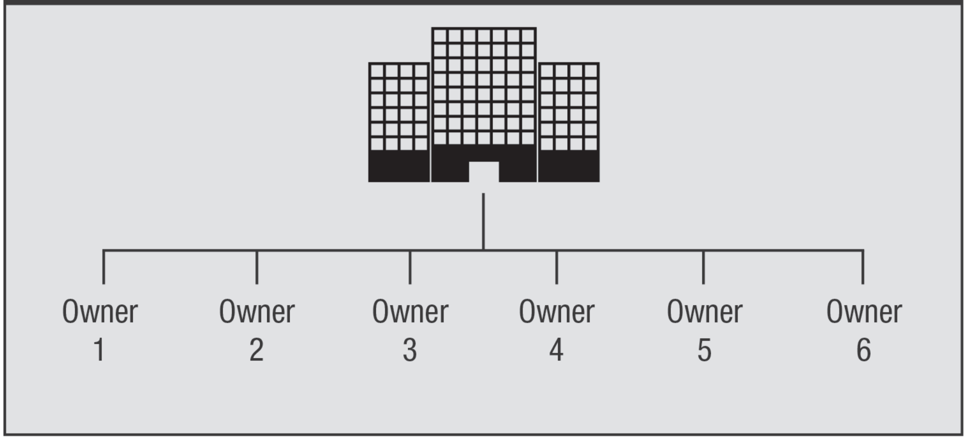
Participants. The sponsor is the person who finds the property and promotes it to the other co-owners. The co-owners or tenants acquire a deeded, fractional interest in the subject property proportional to their investment. All co-owners in a TIC must be underwritten on any loans obtained to finance the property acquisition or refinance.

Organizational Documents. A TIC is not a legal entity so no formation documents are filed to create one, although the individual members may create their own legal entity, such as an LLC, to take title to their fractional ownership interest.

A TIC is governed by an agreement that describes the rights and duties of the co-owners. A well-drafted TIC agreement will include a buy-out clause allowing the co-owners reciprocal buyout rights in the event unanimous consent cannot be reached on a major decision.

This way, if one co-owner holds out on a decision agreed on by the other co-owners, the promoting owners can offer

TENANTS IN COMMON ORGANIZATION CHART



to buy out the dissenting co-owner(s) for fair market value. If the dissenting co-owner(s) don't want to comply, they could be forced to buy out the promoting co-owners at the same proportionate price offered for their interests.

There is also usually a property management agreement. Per IRS rules, the property management agreement must be renewable annually to qualify for a 1031 exchange.

The owners may elect one of them to act as the asset manager to oversee the property manager on their behalf. In this case, there should be a separate asset management agreement describing the rights and duties of the appointed owner, and any compensation they may receive. Compensation is limited by the IRS to a reasonable amount associated with performing such services.

Taxation. The primary benefit of TIC ownership is the ability for individual co-owners to use IRS Tax Code 26 USC § 1031 that allows a taxpayer to postpone paying tax on the gain from the sale of a business or investment property, as long as they reinvest the proceeds in similar property in a *like-kind* exchange. This is commonly known as a 1031 exchange.

A common problem is that the interests in an LLC or LP are legally considered personal property interests, while interests in real estate are considered real property interests. If someone sells real estate and wishes to exchange the proceeds for interests in a syndicate, the exchange won't qualify because it is not a like-kind exchange. The IRS classifies LLC interests as partnership interests, which are specifically disallowed from being exchanged under 1031 exchange rules.

The limitations for TICs that want to avail themselves of IRC §1031 benefits are described in IRS Revenue Procedure 2002-22. The relevant text of is excerpted below:

Tenancy in Common Ownership. Each of the co-owners must hold title to the property, either directly or through a disregarded entity, as a tenant in common under local law.

Number of Co-Owners. The number of co-owners must be limited to no more than 35 legal entities or individuals.

No Treatment of Co-Ownership as an Entity. The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity. Co-owners may not hold themselves out as partners, shareholders, or members of a business entity.

Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value before exercising any right to partition. It may provide that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the property.

Voting. The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases of a portion or all of the property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract must be by **unanimous approval** of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the property.

Restrictions on Alienation. In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited.

Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

Sharing Proceeds and Liabilities upon Sale of Property. If the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

Proportionate Sharing of Profits and Losses. Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner, where the co-owner is a disregarded entity, the owner of the co-owner, and is not for a period exceeding 31 days.

Proportionate Sharing of Debt. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

Options. A co-owner may issue a call option to purchase his/her undivided interest, provided that the exercise price for the call option reflects the fair market value of the property determined as of the time the option is exercised.

For this purpose, the fair market value of an undivided interest in the property is equal to the co-owner's percentage interest in the property multiplied by the fair market value of the property as a whole. A co-owner may not acquire a put option to sell his/her undivided interest to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

No Business Activities. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property.

Management and Brokerage Agreements. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. In any case, the manager must disburse to the co-owners their shares of net revenues within three months from the date of receipt of those revenues.

Payments to Sponsor. Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest, and the amount of any fees paid to the sponsor for services, must reflect the fair market value of the acquired co-ownership interest or the services rendered. It may not depend, in whole or in part, on the income or profits derived by any person from the property.

Compliance with Securities Laws. TIC interests will be considered to be investment contracts if the co-owners are contributing capital and the promoter is overseeing property operations on behalf of all co-owners, and the co-owners are relying on the promoter to generate profits on their behalf. Investment contracts are securities, so compliance with securities laws is required for the sale of such TIC interests. As we learned earlier, to offer or sell such investment contracts, the offering must be registered or exempt from registration.

Delaware Statutory Trust

A Delaware Statutory Trust (DST) is an unincorporated association recognized as an entity separate from its owners. A list of the major characteristics of a DST ownership structure that wants its interests to qualify for 1031 exchange is provided in the chart on the following page. A more detailed discussion follows here.

Participants. DSTs are an alternative group investment structure that includes a trustee who manages the assets of the DST and beneficiaries or owners. This structure is the only group investment structure that allows the trust to own real estate and the beneficiaries to acquire interests and defer taxes on sale of their interests under Section 1031 of the IRS Code.

Organizational Documents. A DST is formed by filing a Certificate of Trust with the Delaware Department of State, Division of Corporations. A DST is governed by a trust agreement describing the rights and duties of the trustee and beneficiaries. Additional documents associated with a DST are further described below.

Law. The problem with DSTs is that they are very restrictive. They specifically disallow the trustee to engage in certain activities that are critical to most income-producing real estate, such as:

Negotiating loans or leases is not allowed.

No new equity investments can be accepted, even from existing beneficiaries, once the offering is closed, and

Investors are truly passive — they actually can't have a say in how the property is operated,

The trustee can only perform normal repair and maintenance or minor non-structural capital improvements, and

The property of the trust must be held for investment purposes only and not for active conduct of a business, which is why DSTs are popular for triple net property ownership.

CHARACTERISTICS OF A DELAWARE STATUTORY TRUST

PARTICIPANTS

- Sponsor (Depositor & Signatory Trustee)
- Beneficiaries
- Master Lessee
- Springing LLC (with its own Manager and Members to be used as a contingency in case the property is failing due to a DST limitation)

DECISIONS / OPERATIONS

- Asset manager or property manager makes day-to-day decisions
- Trustee makes major decisions; Beneficiaries cannot participate

ORGANIZATIONAL DOCUMENTS

- Certificate of Trust
- Trust Agreement
- Property Management Agreement
- Master Lease Agreement
- Springing LLC Operating Agreement

TAXATION

- Earnings pass through to each beneficiary

BENEFITS

- Limited Liablity: Same as for a Delaware LLC
- Individual co-owners may 1031 Exchange in or out of a DST

To learn more, do a Google search for the "seven deadly sins" of DSTs and you'll see the complete list of prohibited activities. These restrictions make it difficult — and potentially risky — to use a DST to purchase a property that requires frequent leasing, may need periodic cash infusions, and/or occasional refinancing, like an apartment complex or other multi-tenant building, other than a triple net leased property with long-term leases already in place.

To combat these limitations, lawyers create a complicated and expensive structure that involves the following:

The depositor (you) gets a property under contract and assigns the contract to a DST. The depositor keeps a portion of the DST interests for itself and sells the rest to beneficiaries. Each beneficiary acquires an undivided fractional interest in the trust.

Each DST has a signatory trustee (manager) and a Delaware trustee.

The depositor and signatory trustee are both 100% owned by the sponsor of the deal (you).

The DST holds title on its own or through a wholly owned subsidiary entity.

DST beneficiaries have the same limitation on personal liability as do shareholders in a Delaware corporation. Because of this, they can take title to their beneficial interests individually and are treated as if they own undivided interests in the underlying real estate for federal tax purposes.

The DST will typically have a master lease agreement with a third-party lessee so that the master lessee can negotiate leases, since the DST can't do this on its own. The sponsor or an affiliate can be the lessee; however, the master lessee cannot refinance the property. If it does, the DST will convert to an LLC — which could trigger taxation of the 1031 exchange investors/beneficiaries. Yikes!

The structure may include a Springing LLC with a pre-written operating agreement that the trustee can invoke and convert the DST to an LLC if the property is in danger of being lost due to DST limitations. This would allow additional funds to be raised or to attract better financing or negotiate new leases.

All of this is great for lawyers because there are lots of legal documents to create, but it will drive up the legal costs and time needed to get the deal done. You will have to find a lender willing to loan to a DST, which won't be your run-of-the-mill commercial lender.

Taxation. One major benefit of a DST, however, is that, if the rules above are followed, the beneficial interests qualify for 1031 exchange. Unlike TICs, which are limited to 35 investors to be eligible for a 1031 exchange, there is no restriction on the number of beneficiaries in a DST, making a DST a better choice for larger deals where millions of dollars are being raised and the 35-investor limit would not be feasible.

About the Author

Kim Lisa Taylor, Esq.

Kim Lisa Taylor is the founder of Syndication Attorneys, PLLC, a corporate securities legal practice.

She is a nationally recognized corporate securities attorney, author and public speaker and is licensed in California and Florida. She has been the responsible attorney for more than 300 real estate securities offerings as of July 2019.

Kim's nationwide practice is focused on helping clients structure their companies and legally raise money from private investors under federal and state securities laws.

She holds the Certified Capital Raising Specialist designation from the Investment Certification Institute.