

# How Real Estate Funds Can Leverage Del. Statutory Trusts

By **Cameron Weil and Edward Hannon** (July 22, 2025)

According to recent reporting by financial news outlets,[1] approximately \$84 trillion in wealth will change hands by 2045 due to our aging population. As such, investors are seeking tax-efficient solutions for their portfolios, which has led to an increase in interest from real estate fund sponsors in capital-raising strategies related to Sections 1031 and 721 of the Internal Revenue Code.

In light of these developments, this article discusses how real estate funds can leverage the Delaware Statutory Trust, or DST, structure in conjunction with these sections to access new sources of capital.

Over the past decade, DST equity syndication has significantly grown in popularity, starting from nearly \$1 billion of equity syndicated in 2015, growing to nearly \$10 billion in 2022, and finally settling around \$5 billion in recent years. According to recent data, 2025 is currently on pace to increase 50% over 2024 and raise over \$7 billion.[2]

Given the immense growth and success in capital raising through the DST structure, real estate investment trusts have adopted DST programs and regularly use them as part of their capital-raising strategies. The DST/REIT paired program typically includes a conversion feature where the investors in the DST program have their beneficial interests in the DST ultimately converted into REIT shares or cash.

In many cases, use of a DST program allows the REIT an opportunity to expand and diversify its capital-raising strategies by offering an investment product for investors seeking replacement property to complete a like-kind exchange under Section 1031 of the code.

Over the past 24 months, traditional real estate fund sponsors have begun to adopt similar DST programs to diversify capital-raising strategies.

## The Benefit of a DST Program

The DST program is beneficial because it provides a path for potential investors seeking to complete a like-kind exchange under Section 1031 of the code to invest in institutional-quality fund-owned properties.

Under the tax rules that apply to like-kind exchanges, the acquisition of equity interests in a real estate fund would not qualify as replacement property for purposes of a like-kind exchange.

Because a traditional fund structure does not allow the fund to offer an investment product for investors seeking replacement property to complete a like-kind exchange, the DST program increases the ability to raise capital.

However, the DST program is tax-driven and requires the satisfaction of specific conditions,



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some of which are more restrictive than the tax rules that apply to funds.

As a result, sponsors contemplating the adoption of the DST program must understand the mechanics of the DST structure and the conditions that must be satisfied to qualify as replacement property to complete a like-kind exchange.

### **Part I: DST and Like-Kind Exchanges — Section 1031 of the Code**

Section 1031 of the code sets forth the rules that apply to like-kind exchanges. Under these tax rules, an owner of real property can exchange the real property for other real estate of what is referred to as "like kind" without recognition of the gain inherent in the relinquished real estate.

For purposes of the like-kind exchange rules, the tax law is very taxpayer-friendly when it comes to determining what kind of property is of like kind to real estate. Under Section 1031 of the code, almost all direct ownership interests in real estate are considered to be of like kind to each other.

Notwithstanding the broad application of the term "like kind," Section 1031 of the code specifically excludes certain types of assets.

For example, a membership interest in a multimember limited liability company, an interest as a partner in a limited partnership or fund, and a share of stock in a REIT are not considered like kind, notwithstanding that all of the assets held consist of real property.

As a result, the use of the traditional fund structure does not provide an opportunity to satisfy the like-kind requirement of Section 1031.

### ***Revenue Ruling 2004-86***

In 2004, the IRS released guidance that set forth the conditions under which beneficial interests in a DST can qualify as replacement property for purposes of the like-kind exchange rules.

Under this guidance, which is set forth in Revenue Ruling 2004-86, the real estate owned by the DST will be used to determine whether the like-kind requirement is satisfied, and the acquisition of the beneficial interest in the DST will be treated as the acquisition of an undivided fractional interest in the real estate for purposes of the replacement property requirements.

In order for the beneficial interest in the DST that owns real property to qualify as replacement property, the following conditions must be met:

- The DST cannot engage in the conduct of an active trade or business;
- The DST cannot raise additional capital;
- The DST cannot amend existing leases or enter into new leases unless there is a tenant bankruptcy or insolvency;
- The DST cannot modify any existing debt, refinance any debt, or obtain debt unless there is a tenant bankruptcy or insolvency;

- The DST is prohibited from making anything other than minor, nonstructural modifications to the real estate unless required by law;
- The DST must distribute its cash, other than amounts needed for reasonable reserves, pro rata among the beneficial interest holders; and
- Upon the sale of the real estate, the DST cannot reinvest the sales proceeds in new investments.

### ***Mitigating the Limitations of 2004-86***

Because of the limitations imposed by 2004-86, the DST will typically own property that is either leased to a single tenant under a triple-net lease or an affiliate of the sponsor acting as the master tenant under a master lease.

The master lease must be a true lease for tax purposes and must provide the master tenant entity with a reasonable expectation of realizing an economic profit. As a result, the master tenant cannot act merely as an agent of the DST or undertake actions that would cause it to be a partner of the DST for income tax purposes.

Since the DST cannot raise additional capital, the DST must create up-front reserves to account for mid-deal expenses to avoid having to fund these expenses from cash flow. Because the DST is also prohibited from making anything other than minor nonstructural modifications to the property, ongoing expenses are more predictable than a development or value-add transaction.

Lastly, longer-term debt (typically five to 10 years) is put in place, since the DST cannot modify property level loans.

One final mechanism that is used to mitigate structural limitations of 2004-86 is the so-called springing LLC, which involves converting the DST to an LLC structure in certain situations, which would qualify for tax-free treatment under Section 721 of the code.

Once the DST has converted to an LLC, it would no longer be subject to the limitations imposed by 2004-86, but also would no longer qualify as replacement property for purposes of the like-kind exchange rules.

### ***Governance of the DST and Mechanics***

Under the typical DST program, an affiliate of the sponsor is the controlling trustee, i.e., signatory trustee. Additionally, in the DST structure, a sponsor-affiliated entity typically called the depositor will be the initial beneficiary of the DST and initial owner of the DST interests. Once the interests in the DST have been syndicated to third-party investors, the depositor will hold any unsold interests in the DST.

In a fully syndicated offering, the depositor will hold zero ownership in the DST, with third-party investors owning 100%.

Under the DST structure, even though the depositor may not hold any interest in the DST, the sponsor and its affiliates are left with control of the DST through its ownership of the signatory trustee, and with control of the asset through its ownership of the master tenant.

Since interests in the DST are securities, the sponsor may not offer or sell securities unless the offering has been registered with the U.S. Securities and Exchange Commission or falls within an exemption from registration.

An exempt or private offering is used to describe the offer and sale of securities that is exempt from registration under the Securities Act. Sponsors typically seek to qualify the offering of DST interests as exempt under Rule 506(b) or 506(c) of Regulation D.

Additionally, the DST structure usually requires that sponsors close on the acquisition of property prior to syndication, which leads to a timing issue because the sponsor may not have its equity capital secured by the time of closing.

DST investors can only buy into a DST that is fully capitalized with its property and its senior financing.

Most DSTs are leveraged with senior financing around 50% to 75%, which leaves a gap in the equity required to close that is ultimately syndicated postclosing in the DST investor market. This leaves sponsors with two options: use more of their own equity, or find temporary bridge financing.

### ***Income and Fees in the DST Structure***

The sponsor will typically charge certain fees to the DST in connection with this structure, as follows:

- Acquisition fee, charged in connection with the acquisition of the property;
- Disposition fee, charged in connection with the sale of the property;
- Asset management fee, charged in connection with ongoing asset management; or
- Property management fee, charged if the sponsor also serves as property manager.

As noted above, the master lease must be structured as a so-called true lease for income tax purposes, which will require the master tenant to have the opportunity for an economic profit from the spread between the net rental income received by the master tenant from the property and the amount required to be paid by the master tenant to the DST in master lease rent.

### **Part II: Conversion of DST Interests to Fund Interests — Section 721 of the Code**

The mechanics for the conversion of the beneficial interest in the DST into limited partner interests in the fund will be set forth in the trust agreement governing the DST and in the limited partnership agreement for the fund.

Due to the rules surrounding 1031 exchanges, conversion of DST interests to fund interests cannot happen for a certain length of time — typically two years. In order to convert the DST interests to fund interests, the fund will offer to purchase 100% of the interests in the DST from third-party investors.

Typically, the price paid by the fund will be based on the fair market value of the beneficial interest at the time of conversion as determined by multiplying the fair market value of the underlying real estate by the percentage interest held by the converting investor, without

discount.

In general terms, the conversion of the beneficial interest in the DST into limited partner interests will qualify for tax-free treatment under Section 721 of the code.

### **Part III: Benefits**

#### ***Sponsor Benefits***

Under the like-kind exchange rules, an equity interest in a fund can never qualify as replacement property. By contrast, if properly structured, the beneficial interest in a DST can qualify as replacement property even if the beneficial interest is convertible into equity interests in the fund at a later date.

As a result, the use of a DST structure provides the fund sponsor with the ability to raise capital from investors that are in the middle of a like-kind exchange and looking for replacement property.

#### ***1031 Investor Benefits***

When structured correctly, the acquisition of the beneficial interest in the DST will be treated as the acquisition of an undivided fractional interest in the real estate for purposes of the replacement property requirements, allowing investors access to institutional quality assets and management.

Additionally, the use of a DST program by a fund sponsor provides a unique opportunity for an investor seeking to place like-kind exchange proceeds with the ability to obtain diversification if the investor converts its beneficial interests in the DST into limited partnership interests in a real estate fund.

### **Conclusion**

As the American population ages and retires, there will need to be more tax-advantaged ways to structure real estate transactions.

Given the recent increase in velocity of DST capital raising, an understanding of this useful investment tool is crucial for real estate funds and investment professionals.

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[1] <https://www.investmentnews.com/opinion/the-great-wealth-transfer-demands-a-wealth-management-revolution/260232>.

[2] See <https://altswire.com/mountain-dell-dst-fundraising-up-year-over-year-more-than-50/>.