A Passive 1031 Exchange Solution?

Taking a Closer Look at Delaware Statutory Trusts

Strictly defined, a **Delaware Statutory Trust (DST)** is a pass-through legal entity investing in income-producing commercial real estate properties like office buildings, apartment complexes, warehouses, and other brick-and-mortar establishments.

Unlike direct real estate investments, DSTs combine capital from multiple individuals into a single trust, where each member (often referred to as a “beneficiary”) holds a fractional interest in the trust's underlying holdings. Whether a DST holds title to a single property or multiple properties simultaneously, its beneficiaries can enjoy years of passive monthly income without having to shoulder the burden of physical property management. Instead, logistical tasks like rent collection, structural repairs, and pest control fall under the purview of a sponsor-affiliated trustee.

We spoke with Westmount President **Mike Amash** to learn more about the potential advantages DSTs bring investors:

How do Delaware Statutory Trusts fit in with Westmount's broader investment philosophy?

Delaware Statutory Trusts help sophisticated clients defer taxes and manage their financial lives with passive exposure to real estate. These investors tend to be wealthier, and they have more complex needs than simply buying and selling stocks and bonds. Many live in California–specifically in Los Angeles, where they already directly own substantial amounts of real estate, where migrating some of those holdings to a passive exposure through DSTs can potentially round out their portfolios.

What key advantages do DSTs bring to the table?

There are many. For example, DSTs shield investors from judicial liability in the wake of litigation. In other words, investors can't be sued over legal disputes, which are instead absorbed by the trust itself. Another chief advantage of DSTs is the favorable tax treatment they bring. Thanks to a 2004 IRS ruling, ownership interests in DSTs qualify for use on a 1031 exchange, which lets individuals selling off real estate assets defer their capital gains tax via swaps for like-kind properties. This gives investors the agency to manage their tax obligations and can ultimately benefit their long-term bottom lines.

Why is Westmount taking a closer look at DSTs? Why now?

The popularity of DSTs ebbs and flows along with the real estate cycle, and one reason for the recent increase in demand is tied to the spike in real estate as a whole, where property values have generally appreciated. This is coupled with the fact that it's become increasingly challenging to be a landlord in California. People are tired of the headaches of property management, and they're ready to get out. But this is easier said than done because the majority of our clients have a very low cost basis on their properties, where cap rates are at their lowest levels in years.

Not Just for Delawareans...

Delaware Statutory Trusts are so named because trustees must file a Certificate of Trust with the Delaware Division of Corporations, as per the Delaware Statutory Trust Act of 1998.

However, neither the underlying investment properties nor the investors themselves must necessarily reside in the state.

Consequently, investors are free to cherry-pick DSTs based on regional supply and demand trends across the country, thus boosting their chances for profitability.

About Westmount

Founded in 1990, Westmount is one of L.A.'s oldest independent investment firms.

We provide an institutional approach to portfolio construction, eschewing commissions and proprietary products to eliminate potential conflicts of interest.

Clients often come to Westmount for objective advice about their investments, or for guidance about major wealth events and other complex financial situations.

Let's Start a Conversation

To learn more about our firm, people, and capabilities, visit www.westmount.com, call us at 310-556-2502, or email info@westmount.com to speak with an advisor today.

So, it's a perfect storm, where prices are up, cash flow is down, and it's more difficult than ever to be a landlord. And that's where the 1031 exchange becomes an essential driver in letting investors sell off properties and reinvest in DSTs, where they can potentially save on taxes, collect passive income, and diversify outside of California, where yields may be higher.

Is there an ideal allocation model investors should strive for when taking the DST plunge? And should they diversify across multiple DSTs?

As I mentioned earlier, many clients initially come to us with a majority of their net worth directly tied up in real estate. From a sizing standpoint, we'd recommend reducing those holdings to 10%-30% of their portfolio, which is still a meaningful amount, but some people are reluctant to pare down their holdings because of the taxes. Others come to the table with 20% of their net worth tied up in real estate, but it's locked into a single property. In either scenario, DSTs can be the solution, respectively, by deferring taxes and by converting a single holding into a portfolio of holdings with DSTs that own multiple properties.

What's a typical DST minimum investment?

It ranges, depending on the DST, but the minimum investments associated with the DSTs Westmount primarily deals with are typically $500,000.

How do you curate relationships with third-party DST sponsors?

It requires a tremendous amount of research. In our experience, this space is dominated by low-quality retail offerings pitched by sell-through brokers who get commissions if they place them, even though the quality isn't necessarily good on the underlying investments themselves.

Fortunately, we're not a broker-dealer; we're a registered investment advisor with a fiduciary obligation to source responsible institutional-quality products. We're constantly vetting potential strategic partners.

How should investors plan to eventually exit their DST investments?

There are two potential exit strategies. The traditional—and most common—one occurs when the property is sold. There's typically a 10-year debt schedule, which means that the property will be sold prior to the debt maturity, often around year seven. At that point, investors can decide to do another exchange or pay taxes on the sale. Some DSTs have an option that lets investors mitigate capital gains by converting profits to shares in real estate investment trusts (REITs), which are professionally managed diversified real estate portfolios. Those assets can remain there indefinitely if the DST does what's called a "721 exchange," which isn't as common as 1031 exchanges, but is still a compelling alternative because it becomes a permanent solution.

Finally, how does Westmount differ from other firms operating in the DST space?

It comes down to our private alternative investment platform as a whole, which we've built up to facilitate direct investments across real estate, debt, and private equity. DSTs are one small piece of what we do in the private investment space.

For more information, call us at 310-556-2502 to speak with an advisor, or email info@westmount.com.

This document was prepared by Westmount Asset Management, LLC ("Westmount"). Westmount is registered as an investment advisor with the U.S. Securities and Exchange Commission. The information contained in this document was prepared using sources that Westmount believes are reliable, but Westmount does not guarantee its accuracy. The information reflects subjective judgments, assumptions and Westmount's opinion on the date made and may change without notice. Westmount undertakes no obligation to update this information. It is for information purposes only and should not be used or construed as investment, legal or tax advice, nor as an offer to sell or a solicitation of an offer to buy any security. No part of this report may be copied in any form, by any means, or redistributed, published, circulated or commercially exploited in any manner without Westmount's prior written consent.

All investments, including DSTs and other private placement offerings, have inherent risks. You should consider investing only if you can afford a loss of some or all of your principal. Potential risks relating to each offering are disclosed in a private placement memorandum (PPM) that must be read by the investor prior to making an investment decision.

This type of investment is not suitable for all investors. You should perform your own due diligence and consult your tax and legal professional regarding your situation before considering any investment. Past performance and/or forward-looking statements are never an assurance of future results.

If you have any comments or questions about this report, please contact us at info@westmount.com.