DELAWARE STATUTORY TRUSTS AND 1031: A MARRIAGE MADE IN HEAVEN OR JUST A PIPE DREAM?

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The IRS and practitioners alike continue to think "outside the box" in terms of using newer forms of entities as a means of accomplishing time-honored transactions. A new Revenue Ruling approves the use of a Delaware statutory trust in a Section 1031 exchange, but so circumscribes the powers of the trustee as to severely limit the practical utility of this idea. Nonetheless, the Service's reasoning with respect to grantor-type trusts may far outlast the other aspects of this pronouncement.

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Issues that had been of concern to practitioners planning Section 1031 exchanges included the following:

1. When will a trust be considered a grantor trust (and thus disregarded) rather than a business entity for federal tax purposes?

2. Is an interest in a grantor trust the same as an interest in the property owned by the trust, and thus eligible for like-kind exchange treatment?

3. Can an interest in a grantor trust be exchanged for an interest held as a tenant in common (TIC) without recognition of gain, given the requirement that the TIC own the property "directly"?

In late July, the IRS issued Rev. Rul. 2004-86, 2004-33 IRB 191, concerning the tax treatment of a Delaware statutory trust (DST) for purposes of Section 1031 like-kind exchanges. The Ruling provides answers to some of these questions, as will be discussed in more detail below. Many tax practitioners had hoped that, in situations in which there were multiple owners of a single piece of real estate, DSTs could be used to hold title to the property instead of requiring direct ownership by TICs. Those practitioners are likely to be disappointed by Rev. Rul. 2004-86, which as a practical matter will restrict the use of DSTs in Section 1031 exchanges.

Rev. Rul. 2004-86 may best be viewed as setting forth the very limited situations in which a DST can be structured to be treated as a trust for tax purposes and not as a business entity (taxable as a corporation or a partnership). These circumstances are very narrow and, in most instances, will be practical when debt-financed property is involved only for leased property where the lessee is responsible for capital improvements.

Nevertheless, Rev. Rul. 2004-86 provides very useful guidance concerning grantor trusts and Section 1031 exchanges. Prior to this Ruling, there was an open question whether an interest in a grantor trust would be treated as an interest in the property held by the trust for purposes of Section 1031. The IRS has answered this question in the affirmative, which will facilitate the use of grantor trusts in Section 1031 exchanges.

ENTITIES AND THE EXCHANGE RULES

Under Section 1031(a)(1), no gain or loss is recognized if property used in a trade or business or held for investment is exchanged for other property of like-kind that will be used in a trade or business or held for investment. Section 1031(a)(2) provides that Section 1031(a) does not apply to any exchange of stocks, bonds, or notes, other securities or evidences of indebtedness or interest, interests in a partnership, or certificates of trust or beneficial interests. A partnership that has in effect a valid election under Section 761 to

be excluded from the application of Subchapter K, however, is treated as an interest in each of the assets of the partnership and not as an interest in a partnership.

Section 1031 does not expressly address DSTs. Delaware law provides that a DST is an unincorporated association recognized as an entity separate from its owners. It is created by executing a governing instrument and filing an executed certificate of trust. Creditors of the beneficial owners of a DST may not assert claims directly against the property in the DST. A DST may sue or be sued in its own name, and property held in a DST is subject to attachment or execution as if the trust were a corporation. Beneficial owners of a DST are entitled to the same limitation on personal liability stemming from actions of the DST that is extended to stockholders of Delaware corporations. A DST may merge or consolidate with or into one or more statutory entities or other business entities.

Despite its narrow holding on DSTs, Rev. Rul. 2004-86 provides very useful guidance concerning grantor trusts and Section 1031 exchanges.

In determining the tax classification of a DST, Section 761 and the Section 7701 Regulations must be taken into account. Section 761(a) provides that "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate. The statute provides that, under Regulations, the Service, at the election of all the members, may exclude an unincorporated organization from the application of Subchapter K.

To be eligible for such exclusion, the income of the members of the organization must be able to be adequately determined without the computation of partnership taxable income. Furthermore, the organization can be availed of only (1) for investment purposes and not for the active conduct of a business, (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities. Under Reg. 1.761-2(a)(2), in order for the participants in the joint purchase, retention, sale, or exchange of investment property to elect out of Subchapter K, the participants must own the subject property as co-owners.

CLASSIFICATION ISSUES

Under Reg. 301.7701-1(a)(1), whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law. Generally, when participants in a venture form a state law entity and avail themselves of the benefits of that entity for a valid business purpose, such as investment or profits, and not for tax-avoidance purposes, the entity will be recognized for federal income tax purposes.[1]

Assuming that a DST would be recognized as an entity for federal income tax purposes under the foregoing test, it is necessary to classify the DST under the Regulations. Reg. 301.7701-2(a) defines "business entity" as any entity recognized for federal income tax purposes (including an entity with a single owner that may be disregarded) that is not properly classified as a trust under Reg. 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more owners is classified for federal income tax purposes as either a corporation or a partnership, whereas a business entity with only one owner is either classified as a corporation or disregarded. Under Reg. 301.7701-3(b)(1), unless the entity elects otherwise, a domestic business entity that is not classified as a corporation will be classified as a partnership if it has two or more owners or will be disregarded if it has a single owner.

Under Reg. 301.7701-4(a), a "trust" is an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting and conserving it for the beneficiaries. Usually the beneficiaries of a trust do no more than accept the benefits thereof and are not voluntary planners or creators of the trust arrangement.[2] Reg. 301.7701-4(b) provides that there are other arrangements known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for federal income tax purposes because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business that normally would have been carried on through business organizations that are classified as corporations or partnerships.

Under Reg. 301.7701-4(c)(1), an "investment trust" will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power to vary the investment of the certificate holders. A power to vary the investment of the certificate holders exists where there is a managerial power under the trust instrument that enables a trust to take advantage of variations in the market

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[1] See Moline Properties, Inc., 319 U.S. 436, 30 AFTR 1291 (1943); Zmuda, 731 F.2d 1417, 53 AFTR2d 84-1269 (CA-9, 1984); Boca Investerings Partnership, 314 F.3d 625, 91 AFTR2d 2003-444 (CA-D.C., 2003); Saba Partnership, 273 F.3d 1135, 88 AFTR2d 2001-7318 (CA-D.C., 2001); ASA Investerings Partnership, 201 F.3d 505, 85 AFTR2d 2000-675 (CA-D.C., 2000); Markosian, 73 TC 1235 (1980).

[2] The beneficiaries of a trust may be the persons who create it, and it will be recognized as a trust if it was created for the purpose of protecting and conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them.

to improve the investment of the investors.[3]

'Trusts'

Several Rulings and cases have dealt with the issue of whether an entity that is labeled a "trust" will be recognized as such.

Rev. Rul. 57-112, 1957-1 CB 494, involved an investment trust that consisted solely of "nonworking interests" such as oil and gas royalties, oil payments, and similar participations in hydrocarbons. The Ruling addressed the proposed inclusion in the trust corpus of certain mineral fee interests that represented fee simple title to minerals in place which were to "be leased by the trustees if and when the opportunity presents itself." The IRS ruled as follows:

"Where 'mineral fee interests' are included in the trust corpus and under the trust agreement the trustees do not have authority to exploit the mineral by developing and operating the property but may only, with approval in writing of a particular contract by all the owners of beneficial interest, lease to an operating company for such purpose, and the income from such interest will constitute royalty, the inclusion of the 'mineral fee interests' in the trust corpus will not, in itself, result in the trust being treated as an association taxable as a corporation."

Ltr. Rul. 7807031 evaluated the "power to vary the investment" issue with respect to a trust containing mineral interests. The trust permitted the trustees to lease any part of the mineral interests. The trust, however, prevented the trustees from acquiring other interests or actively exploiting the mineral interests. The Service ruled that the trust was an investment trust with no power to vary the investment because (1) the trust could not acquire other interests and (2) the trust could not actively exploit the interests. The IRS did not consider whether the trustee's power to lease the interests would result in a power to vary the investment of the trust.[4]

In Ltr. Rul. 200021002, an investment trust held all of the shares of a holding company for the benefit of the beneficial owners. Under the trust agreement, the trustee had the power to engage in "the sale, lease or exchange all or substantially all of the property or assets" of the holding company, subject to the consent of the beneficial owners. After examining other trust powers, the Service found that those powers, including the power to lease the trust property, did not amount to a power to vary the investment.

Under Delaware law, a DST is an unincorporated association recognized as an entity separate from its owners.

Rev. Rul. 75-192, 1975-1 CB 384, involved a provision in the trust agreement that required the trustee to invest cash on hand between the quarterly distribution dates in either short-term obligations of (or guaranteed by) the U.S., or any agency or instrumentality thereof, and in certificates of deposit of banks or trust companies having a minimum stated surplus and capital. The trustee was permitted to invest only in obligations maturing prior to the next distribution date and was required to hold such obligations until maturity. The IRS concluded that, because the restrictions on the types of permitted investments limited the trustee to a fixed return similar to that earned on a bank account and eliminated any opportunity to profit from market fluctuations, the power to invest in the specified kinds of short-term investments was not a power to vary the trust's investment.

In Rev. Rul. 78-371, 1978-2 CB 344, the IRS concluded that a trust was taxable as a corporation because the trustees had the power to purchase and sell contiguous or adjacent real estate, accept or retain contributions of contiguous or adjacent real estate, raze or erect any building or structure, make any improvements to the land contributed to the trust, borrow money, and mortgage or lease the property. In contrast, in Rev. Rul. 79-77, 1979-1 CB 448, a trust that was formed by three parties to hold a single parcel of real estate was classified as a trust for federal income tax purposes because the trustee had only limited powers that were not evidence of an intent to carry on a profit-making business.

Rev. Rul. 92-105, 1992-2 CB 204, considered whether a transfer of a taxpayer's interest in an Illinois land trust qualified for nonrecognition of gain under Section 1031(a). A single taxpayer had created the Illinois land trust and named a domestic corporation as trustee. The taxpayer transferred legal and equitable title to real property to the trust subject to the provisions of an accompanying land trust agreement. Under the agreement, the taxpayer retained exclusive control of the management, operation, rental, and sale of the real property, together with an exclusive right to the earnings and proceeds from the real property. Under the agreement, the taxpayer was required to file all tax returns, pay all taxes, and satisfy any other liabilities with respect to the real property.

The Service concluded in Rev. Rul. 92-105 that, because the trustee's only responsibility was to hold and transfer title to the property at the direction of the taxpayer, there was no trust within the meaning of Reg. 301.7701-4(a). Moreover, there were no other arrangements between the taxpayer and the trustee (or between the taxpayer and any other person) that would cause the overall arrangement to be classified as a partnership or any other type of entity.

In *Chase National Bank*, 122 F.2d 540, 27 AFTR 887 (CA-2, 1941), the court addressed the issue of whether a trust should be taxed as an association or recognized as a true trust. In that case, the depositor purchased shares of the common stock of several corporations and made up "units" consisting of a number of shares of the common stock of each corporation. The units were deposited in trust with the trustee. The trustee issued trust certificates that in the aggregate entitled the certificate holders to 10,000 undivided one ten-thousandth interests in a unit.

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[3] North American Bond Trust, 122 F.2d 545, 27 AFTR 892 (CA-2, 1941).

[4] See also Ltr. Rul. 8104202.

The trustee was vested with all of the rights of ownership of the shares except that the depositor controlled the voting rights of the shares and the trust instrument governed and restricted the disposal of the shares. Under the terms of the trust instrument, whatever went into the trust was held until some disposition of it was made consistent with the terms of the trust instrument. Further, distributions of currently available funds were required. No purchases were to be made by the trustee by way of reinvestment of funds or otherwise.

The Second Circuit found that the trust instrument "prevented the trusts from being, or becoming, more than what are sometimes called strict investment trusts." The court concluded that the trust required "that the trust property was to be held for investment and not to be used as capital in the transaction of business for profit like a corporation organized for such a purpose. This distinction is what makes the difference tax-wise."

In another opinion released on the same day as *Chase National Bank,* the Second Circuit reached a different result. In *North American Bond Trust,* 122 F.2d 545, 27 AFTR 892 (CA-2, 1941), *cert. den.,* the court recognized that it was dealing with a trust similar to that in *Chase National Bank.* Nevertheless, the terms of the trust instrument in *North American Bond Trust* were slightly different in that the trust instrument granted the depositor the "power in effect to change the investment of certificate holders at his discretion." In making up new units, the depositor was not confined to the same bonds he had selected for the previous units. Further, the bonds of all units constituted a single pool in which each certificate holder shared according to his proportion of all the certificates issued. In other words, the money from new investors could be used to purchase new bond issues that would in turn reduce the existing certificate holders' interests in the old bond issues.

Whether an organization is an entity separate from its owners for federal tax purposes does not depend on whether it is recognized as an entity under local law.

The court held the trust was taxable as an association because there existed a power to vary the investment of the existing investors. The depositor could take advantage of market variations in a manner that could improve the investment of the original investors through dilution of the original investment.

THE TRUST AND THE LEASE

Rev. Rul. 2004-86 considered the situation in which an individual (John) borrowed money from an unrelated bank and signed a ten-year, interest-bearing, nonrecourse note. John used the loan proceeds to purchase rental real property, Blackacre, which was the sole collateral for the loan from the bank.

Immediately thereafter, John "net" leased the property to Mary for ten years.[5] Under the terms of the lease, Mary was required to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, she was required to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. Mary was free to sublease Blackacre to anyone she chose.

The rent paid by Mary to John was a fixed amount that could be adjusted by a formula described in the lease agreement that was based on a fixed rate or an objective index, such as an escalator clause based on the Consumer Price Index, but adjustments to the rate or index were not within the control of any of the parties to the lease. The rent paid by Mary was not contingent on her ability to lease the property or on her gross sales or net profits derived from Blackacre.[6]

On the same date that John acquired Blackacre and leased it to Mary, John also formed a DST ("the trust") to which he contributed fee title to Blackacre after entering into the loan with the bank and the lease with Mary. The trust assumed John's rights and obligations under the loan from the bank as well as under the lease with Mary. In accordance with the nonrecourse nature of the note, neither the trust nor any of its beneficial owners were personally liable to the bank for the loan, which continued to be secured by Blackacre.

The trust agreement provided that interests in the trust were freely transferable, although the interests were not publicly traded on an established securities market. The trust was to terminate on the earlier of ten years from the date of its creation or the disposition of Blackacre, but would not terminate on the bankruptcy, death, or incapacity of any owner, or the transfer of any right, title, or interest of the beneficial owners, of the trust. The agreement further provided that interests in the trust would be of a single class, representing undivided beneficial interests in the assets of the trust (i.e., Blackacre).

Rev. Rul. 2004-86 does not indicate whether the trustee was an individual or an institution, although it expressly states that the trustee was not related to the bank or the lessee of the property. Under the trust agreement, the trustee was authorized to establish a reasonable reserve for expenses incurred in connection with holding Blackacre that might be payable out of the trust's funds. All available cash less reserves had to be distributed quarterly to each beneficial owner in proportion to their respective interests in the trust. The trustee also was required to invest cash received from Blackacre between each quarterly distribution.

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[5] The Ruling does not indicate whether John is related to Mary, but given that the IRS stated that Mary is not related to persons described in the Ruling other than John, it can be assumed that she may be related to him.

[6] Although the lease from John to Mary is described in the Ruling as a "net" lease, it is not clear whether the lessor or the lessee would be required to make capital improvements or major repairs to the property. Thus, the lease might be "double net," in which the lessor remains liable for certain capital improvements and repairs (such as repairs to the roof), instead of a "triple net" lease in which the lessee is responsible for the property in all events.

All cash held in reserve had to be invested in short-term obligations of (or guaranteed by) the U.S., or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee was permitted to invest only in obligations maturing prior to the next distribution date, and was required to hold such obligations until maturity. In addition to the right to a quarterly distribution of cash, each beneficial owner had the right to an in-kind distribution of its proportionate share of the property of the trust.

The agreement provided that the trustee's activities were limited to the collection and distribution of income. The trustee could not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) for the trust from the beneficiaries. The trustee also could not renegotiate either the terms of the debt used to acquire Blackacre or the lease with Mary, or enter into leases with tenants other than Mary except in the case of Mary's bankruptcy or insolvency.

An investment trust with a single class of owners having undivided beneficial interests in the assets will be a trust for tax purposes if there is no power to vary investments.

In addition, the trustee was permitted to make only minor, non-structural modifications to Blackacre, unless otherwise required by law. The agreement further provided that the trustee could engage in ministerial activities to the extent required to maintain and operate the trust under local law. Finally, the trustee did not enter into a written agreement with John, or indicate to third parties, that the Trustee (or the Trust) was his agent.

Immediately after John formed the trust, he conveyed his entire interest in the trust to Dick and Jane in exchange for interests in Whiteacre and Greenacre, respectively. Dick and Jane were not related to the lending bank or to Mary (the lessee of Blackacre), and neither the trustee nor the trust was an agent of Dick or Jane. John did not claim that his exchange qualified as a like-kind exchange under Section 1031 (which would be difficult for him to do because he did not acquire Blackacre for investment or for use in a trade or business). Dick and Jane, however, desire to treat the interests in the trust that they acquire as replacement property in a like-kind exchange for their relinquished properties, Whiteacre and Greenacre, respectively.

CLASSIFICATION OF THE DST—BUSINESS ENTITY OR TRUST?

The fundamental concept that underlies Rev. Rul. 2004-86 is that a DST is an entity for federal income tax purposes that is recognized as separate from its owners. Creditors of the beneficial owners of the DST may not assert claims directly against the property held by the DST. A DST may sue or be sued, and the property of a DST is subject to attachment and execution as if it were a corporation. The beneficial owners of a DST are entitled to the same limitation on personal liability stemming from actions of a DST that is extended to shareholders of a Delaware corporation. A DST may merge or consolidate with or into one or more statutory entities or other entities, such as a partnership, and a DST can be formed for investment purposes.

Based on the purpose of, and the powers and privileges afforded to, a DST and the beneficial owners thereof, the IRS concluded in Rev. Rul. 2004-86 that the trust was an entity that could not be disregarded for federal income tax purposes. Thus, it was necessary to classify the trust for tax purposes as either a business entity or a trust.

Agency. The first question addressed in the Ruling, which if decided in the affirmative might have obviated further discussion, was whether the trust should be viewed as an agent of John or its subsequent beneficial owners (Dick and Jane). The IRS noted that it was assumed that neither the trust nor the trustee was an agent of John, Dick, or Jane, and that neither the trust nor the trustee held themselves out as their agent to third parties. Furthermore, the beneficiaries of the trust did not enter into an agency agreement with either the trust or the trustee. Thus, pursuant to the Supreme Court's decision in *Bollinger*, 485 U.S. 340, 61 AFTR2d 88-793 (1988), neither the trust nor the trustee could be viewed as an agent of the beneficial owners of the trust.

The Service then concluded that this situation also had to be distinguished from Rev. Rul. 92-105. In that Ruling, as discussed above, an Illinois land trust was effectively disregarded in determining whether its beneficiary could transfer an interest therein as part of a Section 1031 exchange. The IRS noted that the beneficiary in Rev. Rul. 92-105 retained the direct obligation to pay liabilities and taxes relating to the property, whereas in Rev. Rul. 2004-86 the trust assumed John's obligations under the loan from the bank and the lease with Mary.

Furthermore, the DST provided the beneficial owners of the trust with the same limitation on personal liability extended to shareholders of a Delaware corporation, whereas there is no limitation on the liability of a beneficiary of an Illinois land trust. Moreover, the beneficiary of an Illinois land trust retains the right to manage and control the property of the trust, whereas in Rev. Rul. 2004-86 the beneficiaries had no right to control or manage the trust's property. Thus, the Illinois land trust was disregarded because it could not rise to the level of an "entity," whereas the trust in Rev. Rul. 2004-86 had to be classified as an entity because it had sufficient powers to constitute a separate entity for tax purposes.

Classification. Having concluded that the trust was not the agent of its beneficiaries, and that it could not be disregarded in the manner that the Illinois land trust in Rev. Rul. 92-105 was disregarded, the IRS turned to the classification of the trust for tax purposes.

Because a DST is an entity separate from its owner, the DST must either be

a trust or a business entity for federal tax purposes. To determine whether the trust in Rev. Rul. 2004-86 was taxable as a trust or a business entity, it was necessary to determine whether there was a power under the trust agreement to vary the investment of the holders of the beneficial interests in the trust.

In the situation in the Ruling, on the date of (but immediately prior to) the transfer of Blackacre to the trust, John also (1) entered into a ten-year nonrecourse loan with the bank secured by Blackacre and (2) leased Blackacre to Mary for ten years. All of John's rights and obligations under the loan and the lease were assumed by the trust. Because the duration of the trust was the same as the duration of the loan and the lease that were assumed by the trust at the time of its formation, the financing and leasing arrangements related to the trust and its assets (Blackacre) were fixed for the entire life of the trust.

Furthermore, the trustee was permitted to invest only in short-term obligations that matured prior to the next distribution date, and was required to hold these obligations until maturity. Because the trust agreement provided that (1) any cash from Blackacre, and any cash earned on short-term obligations held by the trust between distribution dates, had to be distributed quarterly, (2) no cash could be contributed to the trust by the beneficiaries, (3) the trust could not borrow money, and (4) the disposition of Blackacre would result in the termination of the trust, there was no possibility of the reinvestment of money under the agreement.

In analyzing the tax classification of the trust, the IRS emphasized that the trustee's activities were limited to the collection and distribution of income. The trustee could not exchange Blackacre for other property, purchase assets other than short-term investments or accept any additional contributions of assets (including money) for the trust. The trustee could not renegotiate the terms of the debt used to acquire Blackacre and could not renegotiate the lease with Mary or enter into leases with tenants other than Mary except in the event of her bankruptcy or insolvency. In addition, the trustee could make only minor non-structural modifications to its property except to the extent required by law.

The limited power of the trustee was, in the Service's view, the key to distinguishing this situation from Rev. Rul. 78-371. As discussed above, in that Ruling the trust was classified as a business entity because the trustee had powers unrelated to the conservation of the trust's assets. In Rev. Rul. 2004-86, however, the trustee had none of the powers that would indicate an intent to carry on a profit-making business. Because all of the interests in the trust were of a single class representing undivided beneficial interest in the assets of the trust, and because the trustee had no power to vary the investment of the beneficiaries of the trust so as to benefit from fluctuations in the market, the trust was classified as a trust under Reg. 301.7701-4(c)(1).

USING TRUST INTERESTS IN A LIKE-KIND EXCHANGE

The next question considered in the Ruling was whether the purchase of interests in the trust by Dick and Jane would be treated as an acquisition of interests in the real property, Blackacre, owned by the trust (in exchange for their interests in Whiteacre and Greenacre that were conveyed to John). The IRS indicated that this analysis was to be made under the grantor trust provisions.

Section 671 provides that, where the grantor or another person is treated as the owner of any portion of a trust, the taxable income and credits of the grantor or the other person will include those items of income, deduction, and credit of the trust that are attributable to that portion of the trust to the extent that the items would be taken into account in computing taxable income or credits against the tax of an individual.

Under Reg. 1.671-2(e)(1), a grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust. Reg. 1.671-2(e)(3) provides that "grantor" includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in an investment trust. Under Section 677(a), the grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is (or, in the discretion of the grantor or a non-adverse party, or both, may be) distributed or held or accumulated for future distribution to the grantor or the grantor's spouse. A person that is treated as the owner of an undivided fractional interest of a trust (under Section 671) is considered, for federal income tax purposes, to own the trust assets attributable to that undivided fractional interest.

Unlike the Illinois land trust in a 1992 Ruling, the DST in Rev. Rul. 2004-86 had sufficient powers to constitute a separate entity for federal tax purposes.

In Rev. Rul. 2004-86, IRS determined that Dick and Jane should be treated as grantors of the trust under Reg. 1.671-2(e)(3) when they acquired their interests in the trust from John, who had formed the trust. Because Dick and Jane have the right to distributions of all the income of the trust attributable to their undivided fractional interests, they are treated under Section 677 as the owners of an aliquot portion of the trust, and all income, deductions, and credits attributable to that portion are includable by Dick and Jane in computing their taxable incomes. Because the owner of an undivided fractional interest of a trust is considered to own the trust assets attributable to that interest for federal income tax purposes, Dick and Jane are each considered to own an undivided factional interest in Blackacre for federal income tax purposes.

Based on this reasoning, the IRS then concluded that the exchange of real property (Whiteacre and Greenacre) by Dick and Jane for an interest in the trust was the exchange of real property for an interest in Blackacre, and not the exchange of real property

for a certificate of trust or beneficial interest under Section 1031(a)(2)(E). Because the properties exchanged were of like-kind, and assuming that the other requirements of Section 1031 were met by Dick and Jane (e.g., they held Whiteacre and Greenacre for investment or for use in a trade or business, and they timely identified and acquired interests in the trust as replacement property), the exchange of real property for an interest in the trust qualified for nonrecognition of gain or loss under Section 1031. Moreover, because the trust was a grantor trust under Section 671, the outcome to the parties would have been the same even if John had transferred interests in Blackacre to Dick and Jane, who then immediately contributed their interests in Blackacre to the trust.

Impact. The grantor trust aspect of Rev. Rul. 2004-86 is quite helpful to taxpayers. For years, many practitioners had been hesitant, for purposes of completing a Section 1031 exchange, to treat an interest in a grantor trust the same as an interest in the property owned by the trust. The limited guidance concerning what constituted a "certificate of trust or beneficial interest" under Section 1031(a)(2)(E) led to fear that the IRS could assert that an interest in a grantor trust was not the same as an interest in the underlying assets of the trust.

In analyzing the tax classification of the trust, the IRS emphasized that the trustee's activities were limited to the collection and distribution of income.

Moreover, Section 671 does not explicitly state that the taxpayer holds property held by a grantor trust—it just treats the grantor as the owner of assets of the trust for purposes of computing the grantor's taxable income. Accordingly, some practitioners were concerned that the acquisition of replacement property through a grantor trust might not satisfy the "held for" requirement in Section 1031(a)(1).

Rev. Rul. 2004-86 puts these fears to rest by expressly stating that the interest of a grantor in a grantor trust will be treated the same as the ownership of the underlying property held by the trust. As a result, taxpayers can acquire property by obtaining an interest in a grantor trust or, in the alternative, they may transfer property to a grantor trust immediately after its acquisition without any fear that the IRS will assert that Section 1031(a)(2)(E) applies.

The use of a grantor trust in such situations, however, requires that the ownership interest that is acquired is in a trust (within the meaning of Reg. 301.7701-4(c)) and not in a business entity. The IRS expressly warned in Rev. Rul. 2004-86 that it would have reached a completely different conclusion if the trustee had been given additional powers under the agreement. Specifically, the trust would have been classified as a business entity (under Reg. 301.7701-3) if the trustee had been given the power to do one or more of the following:

1. Dispose of Blackacre and acquire new property.
2. Renegotiate the lease with Mary.
3. Enter into leases with tenants other than Mary (except in the case of Mary's bankruptcy or insolvency).
4. Renegotiate the obligation used to purchase Blackacre.
5. Refinance the obligation used to purchase Blackacre.
6. Invest cash received to profit from market fluctuations.
7. Make more than minor nonstructural modifications to Blackacre that were not required by law.

If the trustee had the power to commit any one of these "seven deadly sins," or if the trustee could vary the investments of the trust (for example, by obtaining additional property or money from the beneficiaries), the trust would have been classified as a business entity. Furthermore, because the assets of the trust would not be owned by the beneficiaries as co-owners under state law, the trust would not be able to elect out of Subchapter K under Section 761.[7]

The limitation on the *powers* of a trustee of a trust is a very important aspect of Rev. Rul. 2004-86. It is not sufficient that the trustee never commits one of the "seven deadly sins" that would cause classification of the trust as a business entity—the trustee must lack the power to undertake those actions. This aspect of Rev. Rul. 2004-86 is consistent with the case law in which a trust is classified in accordance with the powers that the trustee has under the trust agreement and without regard to what actions, if any, the trustee has performed other than to conserve and protect the property of the trust.

APPLICATION TO TICs

Rev. Rul. 2004-86 resulted primarily from a request filed with the IRS for guidance concerning whether an ownership interest in a DST could qualify as like-kind exchange property for tenants in common.

As discussed in prior articles concerning TIC programs,[8] a tenancy-in-common market has arisen that allows owners of real estate to acquire replacement property when they sell their relinquished property that has been held for investment or used in a trade or business. In most of these TIC offerings, a "sponsor" will acquire real estate using bank financing and then sell TIC interests in the property to taxpayers who need replacement property in connection with a Section 1031 exchange. Usually, the sponsor or its affiliate will either master lease the entire property from the TICs or, in the alternative, manage the property on their behalf. Rev. Proc. 2002-22 sets forth the Service's ruling guidelines for determining whether a TIC interest with respect to real estate constitutes an interest in a partnership or an interest in the underlying real estate.

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7 Reg. 1.761-2(a)(2)(i).

8 Lipton, "The 'State of the Art' in Like-Kind Exchanges, Revisited," 98 JTAX 334 (June 2003); Lipton, "New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges," 96 JTAX 303 (May 2002); Golub and Nochowitz, "Tenancy in Common Interests and Current Developments Under Rev. Proc. 2002-22," J. Passthrough Entities, March-April 2004.

The real estate market has responded favorably to Rev. Proc. 2002-22. Although most sponsors of TIC programs are unable to satisfy all of the requirements in Rev. Proc. 2002-22 because of lender-imposed restrictions, most sponsors have been able to sell TIC interests to taxpayers who need replacement property in transactions that satisfy Rev. Proc. 2002-22 in most material respects. Moreover, tax counsel who are involved in these transactions generally have been able to reach a "should" level of comfort concerning TIC offerings, provided that care is taken to make certain that the relationship between and among the co-owners and the sponsor should not be viewed as a partnership by the IRS.

One of the practical problems raised by Rev. Proc. 2002-22 is that the IRS will not grant a ruling thereunder unless the co-tenants *directly* own interests in the underlying real estate. This requirement is somewhat complicated by the fact that lenders require that the owner of a TIC interest be a bankruptcy-remote entity. The latter problem has been solved by having each taxpayer who desires to acquire a TIC interest form a single-member LLC (SMLLC) to hold its interest, i.e., if there are ten co-tenants in a single piece of real estate, they will own their TIC interests through ten separate SMLLCs. Because an SMLLC will be disregarded under Reg. 301.7701-3 (a business entity that is not a corporation and that has one owner is automatically disregarded), ownership of the SMLLC is treated as direct ownership of the property by the taxpayer.

Although most lenders will accept that each TIC interest must be acquired through a separate SMLLC, what most lenders would really prefer is that title to the property be held by a single person that is bankruptcy-remote. As a result, the lender would not have to deal with multiple owners of the property, would not have to run the risk that any one of a number of TIC owners could file for bankruptcy, and the lender would not receive conflicting requests from different borrowers. Furthermore, it would greatly reduce borrowing costs if a loan had to be made to only one borrower (e.g., a DST) rather than have multiple borrowers directly assume a portion of the loan initially made to the sponsor. So lenders (as well as TIC sponsors, who desired to reduce the cost of borrowing money and their own ongoing exposure) had hoped that the IRS would permit a DST to be used to hold title to property for purposes of a TIC offering of interests in real estate.

Is the DST the answer? It is too early to know for certain, but it is likely that the TIC sponsors (and lenders) who were hoping that a DST could be used for a TIC offering will be disappointed by Rev. Rul. 2004-86. The limitations imposed in the Ruling—including particularly the fact that the trustee cannot have the power to commit any of the "seven deadly sins" and the beneficiaries cannot make additional contributions to the trust—are likely to make this form of ownership impractical in many situations.

For example, every lender wants to make certain that it can avoid a bankruptcy filing by renegotiating a loan if necessary, but if title to property were held by a DST as outlined in Rev. Rul. 2004-86, the trustee would be prohibited from even discussing the terms of the loan with the lender. Likewise, in most situations a lender would want the owner of property to have the right to renegotiate a lease with a tenant (in good times or in bad), but this power also could not be given to the trustee of a DST. Most important, Rev. Rul. 2004-86 prohibits anything other than non-structural modifications to the property held by a DST, which would make it very difficult to accommodate the needs of tenants or to cope with casualties or condemnations.

The casualty issue is an important one that is not addressed in Rev. Rul. 2004-86.[9] The Ruling could be read to require that on the occurrence of a casualty to the property, the trustee of a DST could merely restore (but could not improve in any manner, except as required by law) the property. As a practical matter, however, whenever a casualty occurs the lender will have to approve the manner in which the damaged property is repaired. If the lender wants the DST to do anything other than simply return the property to its pre-casualty condition, the trustee of the DST would lack the power to make such changes.[10]

The Ruling expressly states that the interest of a grantor in a grantor trust will be treated the same as the ownership of the underlying property held by the trust.

Although the casualty issue is a difficult theoretical one, the most important practical issue involves tenant improvements. It is common for a tenant of rental real estate to require that the landlord make or authorize improvements to the property. Rev. Rul. 2004-86 prohibits the trustee from having the power to make anything other than minor non-structural modifications to the property held by the trust, and it prohibits the beneficiaries from making contributions to the trust. As a result, if a tenant or sub-tenant (new or old) requires improvements, they could be funded only out of reserves and could not be structural modifications to the property. This likely means that only net leased property could readily be held by a DST eligible for taxation as a trust. The lessee would have to be responsible for all improvements to the property, and the DST could not be involved unless it used reserves to pay for the improvements (although the trust could approve any changes to the property made by the lessee).

What is the likely effect of applying this requirement to TIC programs? Some TIC sponsors use a master lease format in which the co-owners lease

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9 The Ruling also does not deal with condemnations, but those are much rarer events than casualties and the DST could respond to a condemnation simply by distributing the proceeds thereof to the beneficiaries.

10 Indeed, the Ruling could be read even as prohibiting the trustee from making capital repairs to the damaged property, although such a reading seems contrary to the requirement that a trust "conserve" property for the beneficiaries.

Practice Notes

The Delaware business trust that is the subject of Rev. Rul. 2004-86 would have been classified as a business entity (under Reg. 301.7701-3) if the trustee had been given the power to do any of the following:

1. Dispose of the contributed property and acquire new property.
2. Renegotiate the lease with the tenant.
3. Enter into leases with tenants other than the original tenant (except in the case of that tenant's bankruptcy or insolvency).
4. Renegotiate the obligation used to purchase the property.
5. Refinance the obligation used to purchase the property.
6. Invest cash received to profit from market fluctuations.
7. Make more than minor non-structural modifications to the property that were not required by law.

If the trustee has the power to commit any one of these "seven deadly sins," or if the trustee could vary the investments of the trust (for example, by obtaining additional property or money from the beneficiaries), the trust will be classified as a business entity. It is not sufficient that the trustee never commits one of the "seven deadly sins" that would cause classification of the trust as a business entity—the trustee must lack the power to undertake those actions.

their property on a net basis to the sponsor, who then sublets the property to third parties. At first blush, this type of transaction appears to be amenable to the use of a DST as a title-holding entity.[11] Nevertheless, the master lessee (which is an affiliate of the sponsor) usually will not be heavily capitalized and will not have the wherewithal to make capital or major tenant improvements to the leased property. If the property needs improvements, and if the property were held directly by the TICs, the TICs could directly pay for the needed improvements. If title were held by a DST, however, it is clear that the DST could not make structural changes (or "major" non-structural changes) to the property, and it appears that the TICs could not even advance money to the sponsor/lessee in order to allow the sponsor, as lessee of the property, to make capital or major tenant improvements. Indeed, any improvements are likely to have to be funded from reserves or from the sponsor's own pocket. There even would be a risk that, because the trustee of the DST is required to "conserve" the property, any improvements might be rejected by the owner of legal title of the property (the trustee of the DST) because a tenant of property normally cannot do indirectly what the direct owner of the property is prohibited from doing.

Other practical problems in using a DST for a TIC program may surface over time. It seems likely, however, that (with one exception discussed below) lawyers will be unwilling to issue favorable tax opinions for any TIC program conducted through a DST unless the scope of the actions that can be undertaken by the trustee (and the lessee to whom the property owned by the DST is leased) is clarified through future guidance or litigation. Based on the plain language of Rev. Rul. 2004-86, it is doubtful that the DST will quickly become the favored vehicle for structuring TIC ownership of leveraged replacement property for like-kind exchanges.

The triple net exception. The one situation in which DSTs are likely to replace direct ownership by TICs involves triple net leased property where the trust and the lease are co-terminous (or the lease outlives the trust) and the lessee is responsible for *all* costs related to the property. In that event, assuming that a lender likes the credit profile of the lessee, a DST will be more advantageous due to several factors:

- There will be only one borrower.
- One trust can be made bankruptcy-remote more easily than multiple SMLLCs.
- Transaction costs are lower for one borrower than multiple borrowers.

IRS expressly warned in Rev. Rul. 2004-86 that it would have reached a different conclusion if the trustee had been given additional powers under the agreement.

Moreover, because this scenario is squarely described in Rev. Rul. 2004-86, tax counsel can easily furnish a favorable opinion, provided that the trustee lacks the power to commit any of the seven deadly sins.[12]

CONCLUSION

At the bottom line, Rev. Rul. 2004-86 most likely will be viewed as important for two reasons. First, the Ruling highlights the limited role that DSTs can play in property ownership if tax treatment as a trust is desired—in this regard, the Ruling likely will make it very difficult to use DSTs in TIC programs. Second, the Ruling provides favorable guidance concerning the treatment of grantor trusts for purposes of Section 1031, and it is this aspect of the Ruling that is most likely to be long remembered. ■

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[11] Indeed, the master lease format is likely the only TIC structure that potentially would be feasible for a TIC offering. If the TICs desire to use a property manager, the property manager normally would need to have the authority to lease the property. Because the DST would lack this power (as lessor), the property manager also would have to have no power to enter into leases on behalf of the DST. As a practical matter, this limitation on the power to lease property would be completely incompatible with the reason that a property manager is retained in the first place.

[12] Some master leases to sponsors also may manage to meet the requirements of the new Ruling, although the master lessee will need to find a way to raise the funds needed for tenant improvements and to address situations in which a tenant defaults on its obligations.