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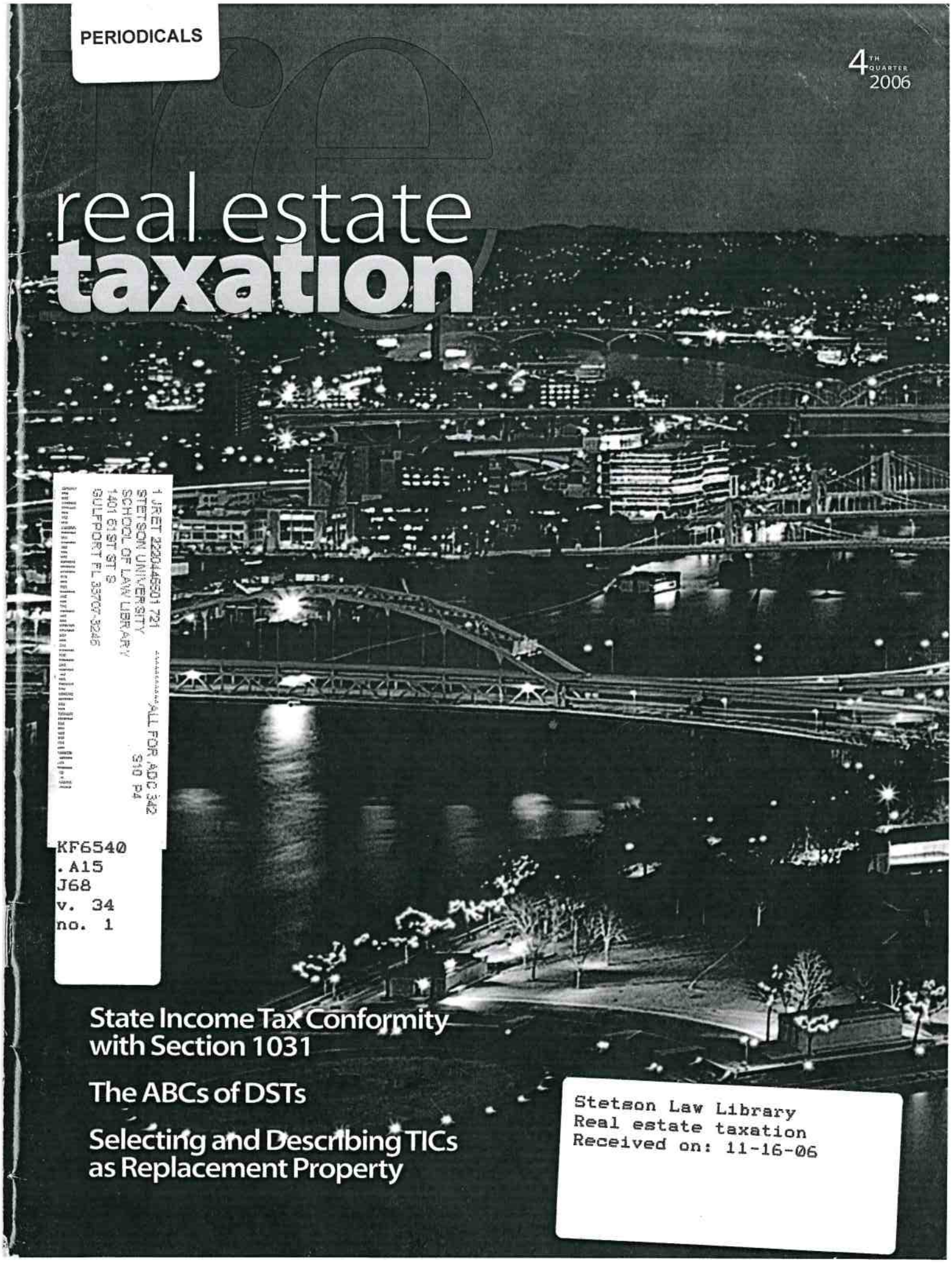

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The ABCs of DSTs

Selecting and Describing TICs as Replacement Property

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THE ABCs OF DSTs

Using fixed investment trusts in Section 1031 real estate transactions

DANIEL F. CULLEN

On 7/20/04, the IRS issued Rev. Rul. 2004-86,[1] which addressed whether a Delaware Statutory Trust (DST) will be treated as a trust[2] or a business entity[3] for federal income tax purposes. The Ruling held that if an entity is classified as a fixed investment trust, and the trust also satisfies the requirements of a grantor trust under Section 671, interests in that trust will be treated as interests in the real property owned by the trust for purposes of applying the like-kind exchange rules under Section 1031. Accordingly, taxpayers disposing of real estate in an otherwise-qualifying like-kind exchange can acquire an interest in such a DST as qualifying replacement property. In contrast, if the trust is treated as a business entity, interests in the trust will be treated as interests in a partnership,[4] which will not constitute valid replacement property under Section 1031.[5]

Most tax advisors view Rev. Rul. 2004-86 as restrictive,[6] yet helpful, guidance for an emerging market—i.e., the sale of credit-tenant, or certain master lease, real estate as replacement property for Section 1031 like-kind exchanges.[7]

Prior to the recent emergence of tenancy-in-common and DST offerings, a taxpayer who sold real estate (relinquished property) would have to search for other real estate (replacement property) that cost about the same as the proceeds from the sale of the relinquished property. It often was not possible to find the appropriate replacement property at the right cost in a timely manner (i.e., within the 45 days provided by Section 1031(a)(3) for identifying replacement property), notwithstanding that there were several reputable companies engaged in marketing replacement properties for like-kind exchanges. The purchase of a properly-structured DST interest (or DST trust certificate) as replacement property makes economic sense in some cases[8] because the size of the DST interest can be tailored to the taxpayer's needs, assuming the taxpayer has concluded that an investment in a particular triple-net, credit-tenant property is a preferred investment in contrast to the type and quality of properties the taxpayer could acquire on his or her own.

Classifying investment trusts

A brief overview of how other investment trusts historically have been classified for federal income tax purposes is helpful in understanding the classification and use of DSTs in Section 1031 transactions.[9] Investment trusts were often used, for the most part, as vehicles for investing in securities and similar instruments. Accordingly, most of the body of law governing the taxation of investment trusts does not factually contemplate real estate transactions. One must carefully review the case law in this area, keeping in mind the similarities and differences between a trust's investment in real estate and those in securities.

Common trust funds. Prior versions of the Code defined a "common trust fund" for federal income tax purposes as a fund maintained by a financial institution exclusively for the collective investment and reinvestment of moneys contributed to the fund by the financial institution in its capacity as a trustee in "con-

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formity with the prevailing rules and regulations of the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks."[10] At that time, the Code simply provided that such trusts would not be treated as corporations for federal income tax purposes. Congress apparently enacted this provision in response to *Brooklyn Trust Co.*[11] In *Brooklyn Trust,* the Second Circuit classified a common trust fund as an association taxable as a corporation. Congress, being aware of *Brooklyn Trust,* effectively reversed it.[12] Even thought the investors in *Brooklyn Trust* were not related in any manner, apart from being investors in the bank's common trust fund,[13] the Second Circuit concluded that the investors were associated and that their organization actively conducted a business. This result was reached in spite of the fact that the investors did not interact with the common trust fund as a group (instead acting individually through their separate participating trusts).[14] Clearly, in a Section 1031 transaction, a similar conclusion by a court would be fatal to the investor's like-kind exchange.

Management and fixed investment trusts. Historically, the IRS treated a trust as a "management trust" if the trustee had substantial unfettered discretion to buy and sell securities held by the trust. The IRS viewed such a trust as engaging in an active business on behalf of the investors and, thus, taxable as a corporation for federal income tax purposes.[15] Similarly, if the trustee's discretion to vary the corpus of the trust was restricted, the IRS looked to various other powers of the trustee to determine whether the trust should be taxed as a corporation for federal income tax purposes.

Until 1945, the Regulations provided that "an 'investment trust' (whether of the fixed or the management type)" was an association taxable as a corporation.[16] In 1945, however, the regulations were modified[17] in response to *North American Bond Trust*[18] and its companion case, *Chase National Bank of the City of New York.*[19] Both of these cases involved fixed investment trusts in which investors purchased interests in units of specified securities and received dividend and interest income earned by the underlying securities. In *Chase,* each unit had to be identical. In *North American,* the trust agreement provided that the various units could be composed of different securities. Furthermore, all income produced by all the securities in all the units was commingled and then distributed in proportion to the amount of each investor's investment. The Second Circuit held that the investment trust in *Chase* was not carrying on a business but that the investment trust in *North American* was, because of the latter's power to take advantage of market fluctuations.[20] Both

[1] 2004-33 IRB 191. For a detailed discussion of this ruling, see Lipton, Golub, and Cullen, "Delaware Statutory Trusts and 1031: A Marriage Made In Heaven or Just a Pipe Dream?" 101 J. Tax'n 140 (September 2004).

[2] Reg. 1.7701-4.

[3] Reg. 1.7701-3.

[4] *Id.*

[5] See Section 1031(a)(2)(D).

[6] See Lipton, Golub, and Cullen, *supra* note 1.

[7] This article does not address tenancy-in-common (TIC) structures. For a detailed discussion of TIC structures, see Lipton and Cullen, "Tenancy-in-Common Interests: A valuable addition to the financial planner's toolkit," 6 J. of Prac. Est. Planning 21 (Oct/Nov 2004). It should be emphasized that there is no relationship between the requirements that apply to a DST structure and the requirements that apply to a TIC structure. Each involves multiple ownership of property for purposes of a like-kind exchange, but there the relationship stops. A DST is an entity that seeks to be disregarded for tax purposes (because it is classified as a trust), whereas a TIC involves a non-entity owned by multiple persons (tenants in common) who are seeking to avoid partnership classification. It is easy to think that a DST must satisfy the requirements of Rev. Proc. 2002-22, 2002-1 CB 733, and that Rev. Rul. 2004-86 somehow applies to a TIC arrangement, but that simply is not accurate. See Lipton, Harrison, and Golub, "The Intersection of Delaware Statutory Trusts and Tenancies-in-Common," 32 Real Estate Tax'n 76 (1st Quarter, 2005).

[8] As always, taxpayers should evaluate the tax deferral benefit derived under Section 1031 in contrast to the tax depreciation benefit provided from a step-up in tax basis in an after-tax deal.

[9] For a detailed discussion of fixed investment trusts, see Peaslee, "Investment Trusts in the Age of Financial Derivatives," 49 Tax Law Rev. 419 (1994).

[10] See Ltr. Rul. 7606030600A.

[11] 80 F.2d 865, 17 AFTR 133 (CA-2, 1936), *cert. den.*, 298 U.S. 659 (1936).

[12] S. Rep't. No. 2156, 74th Cong., 2d Sess. 20 (1936).

[13] The dissenting judges on the Board of Tax Appeals did not agree that the investors were organized in any way whatsoever. See Brooklyn Trust, 31 BTA 1070, at 1081.

[14] See Brooklyn Trust, *supra* note 11; see also Ltr. Rul. 7606030600A.

[15] Ltr. Rul. 7606030600A.

[16] Former Regs. 103, section 29-3797-2, and 111, section 19.3797-2.

[17] TD 5468.

[18] 122 F.2d 545, 27 AFTR 892 (CA-2, 1941), *cert. den.*, 314 U.S. 701 (1942).

[19] 122 F.2d 540, 27 AFTR 887 (CA-2, 1941).

[20] For cases similar to Chase, see Buckley, 128 F.2d 124, 29 AFTR 473 (CA-9, 1942), Pennsylvania Company, Etc., 146 F.2d 392, 33 AFTR 391 (CA-3, 1944), and Commerce Trust Company, PH TCM ¶ 44372, 3 CCH TCM 1217 (1944). For cases similar to North American Bond Trust, see City National Bank & Trust Co., 142 F.2d 771, 32 AFTR 737 (CA-10, 1944), Hamilton Depositors Corp., 111 F.2d 385, 24 AFTR 934 (CA-10, 1940), Pennsylvania Company for Insurances, Etc., 138 F.2d 869, 31 AFTR 853 (CA-3, 1943), *cert. den.*, 321 U.S. 788 (1944), and Continental Bank & Trust Co. of New York, 19 F. Supp. 15, 19 AFTR 663 (DC N.Y., 1937).

Chase and *North American* make clear that the mere power to vary investments is sufficient, even if it is never exercised by the trustee.[21]

Today, the "trust classification regulations"[22] provide special rules for determining whether entities organized as investment trusts have an objective to carry on business and divide the gains from such business activities. Most management trusts are presumed to have this objective. Fixed investment trusts are presumed to have this objective if the trustee has the power to vary the investment held by the trust on behalf of the beneficial-interest certificate holders. Under the trust classification regulations, an investment trust is classified as a trust only if (1) there is no power to vary the investment of certificate holders and (2) the trust either has only one class of ownership interests or, if it has multiple classes, it "is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose."[23] These rules constrain the ability to use investment trusts in creative ways by raising the risk that, under the trust classification regulations, a trust will be classified as a partnership.[24]

The "power-to-vary" test, as outlined in the case law and memorialized in the trust classification regulations, is the hallmark of determining the classification of an investment trust and acts as the benchmark for determining the permitted activities of a fixed investment trust and its trustee. As discussed in greater detail below, fixed investment trusts are limited, in almost all respects, to fixed investment activities that have no management discretion.

Rev. Rul. 2004-86

Rev. Rul. 2004-86, the most recent guidance concerning investment trusts, addressed the use of a DST as a vehicle to facilitate the fractional ownership of replacement property by taxpayers completing a like-kind exchange.[25]

The structure permitted under Rev. Rul. 2004-68. Rev. Rul. 2004-86 considered a 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 Lauryn for ten years.[26] Under the terms of the lease, Lauryn was required to pay all taxes, assessments, fees, and 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. Lauryn was free to sublease Blackacre as she saw fit.

The rent paid by Lauryn to John was a fixed amount that could be adjusted by a formula described in the lease agreement. This formula was based on a fixed rate or an objective index (such as an escalator clause based on the Consumer Price Index); however, adjustments to the rate or index were not within the control of any of the parties to the lease. The rent paid by Lauryn was not contingent on her ability to lease the property or on her gross sales or net profits derived from Blackacre.[27]

On the same date that John acquired Blackacre and leased it to Lauryn, he also formed a DST to which he contributed fee title to Blackacre after entering into the loan with the bank and the lease with Lauryn. The DST assumed

[21] See also American Participations Trust, 14 TC 1457 (1950), Royalty Participation Trust, 20 TC 466 (1953), *acq.*, 1953-2 CB 6, and Abraham, 406 F.2d 1259, 23 AFTR 2d 69-657 (CA-6, 1969), overruling Gibbs-Preyer Trust No. 1, 117 F.2d 619, 26 AFTR 453 (CA-6, 1941).

[22] Reg. 301.7701-4(c).

[23] *Id.* The Service interprets this "incidental" exception in the trust classification regulations very narrowly.

[24] In the past, this risk was more substantial as there was a risk that corporate tax applied. Under current law, however, the classification debate has a different focus. Under the trust classification regulations, "almost any investment trust failing to qualify as a trust can be structured to qualify as a partnership rather than as an association. Consequently, in many cases, the critical issue in evaluating an investment trust is not whether the trust itself should be taxed, but instead whether it is more appropriate to tax investors under the grantor trust rules or under subchapter K." See Peaslee, *supra* note 9.

[25] Based on unpublished statements provided by the IRS in connection with Rev. Proc. 2002-22, it seemed unlikely that the IRS would permit taxpayers to own replacement property through a legal entity such as a DST. However, the IRS (appropriately) opened such a door by issuing Rev. Rul. 2004-86.

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

[27] Although the lease from John to Lauryn 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.

TAXPAYERS DISPOSING OF REAL ESTATE IN AN OTHERWISE-QUALIFYING LIKE-KIND EXCHANGE CAN ACQUIRE INTERESTS IN CERTAIN DSTS AS QUALIFYING REPLACEMENT PROPERTY.

John's rights and obligations under the loan from the bank as well as under the lease with Lauryn. The loan was nonrecourse; thus, neither the DST 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 for the DST provided that interests in the DST were freely transferable, although the interests were not publicly traded on an established securities market. The DST 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 DST. The agreement further provided that interests in the DST would be of a single class, representing undivided beneficial interests in the assets of the DST (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 DST's funds. All available cash, less reserves, had to be distributed quarterly to each beneficial owner in proportion to their respective interests in the DST. The trustee also had to invest cash received from Blackacre between each quarterly distribution. 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/or 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 DST (i.e., Blackacre).

The trust agreement further 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 DST from the beneficiaries. The trustee also could not renegotiate either the terms of the debt used to acquire Blackacre or the lease with Lauryn, or enter into leases with tenants other than Lauryn except in the case of Lauryn's bankruptcy or insolvency.

In addition, the trustee was restricted from modifying the property held by the DST—in short, the trustee was permitted to make only minor, non-structural modifications to Blackacre (unless otherwise required by law).[28] The agreement further provided that the trustee could engage in ministerial activities to the extent required to maintain and operate the DST 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 DST) was his agent.

Immediately after John formed the DST, he conveyed his entire interest in the DST to Michael and Riley in exchange for interests in Whiteacre and Greenacre, respectively. Michael and Riley were not related to the lender or Lauryn (the lessee of Blackacre), and neither the trustee nor the DST was an agent of Michael or Riley. Michael and Riley desired to treat the interests in the DST that they acquired as replacement property in a like-kind exchange for their relinquished properties, Whiteacre and Greenacre, respectively.[29]

Classification of the DST—business entity or trust? The fundamental corporate law concept that underlies Rev. Rul. 2004-86 is that a DST is an entity 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. However, in light of the purpose of, and

[28] It is somewhat unclear how broadly the phrase "unless otherwise required by law" should be interpreted. Read broadly, this may provide significant latitude, depending on the facts of a particular case.

[29] It is appropriate to presume that John would 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.

the powers and privileges afforded to, a DST and the beneficial owners thereof, the IRS concluded in Rev. Rul. 2004-86 that the DST was an entity that could not be classified as a "disregarded entity" under the check-the-box regulations for federal income tax purposes.[30] Thus, it was necessary to classify the DST for tax purposes as either a business entity or a trust.

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 (Michael and Riley). The IRS noted its assumption that neither the trust nor the trustee was an agent of John, Michael, or Riley, 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*,[31] 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.[32] In that Ruling, an Illinois land trust effectively was 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 Lauryn.

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," while 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.

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 be either 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.

Under the facts of 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 Lauryn 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.

In addition, 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

INVESTMENT TRUSTS WERE OFTEN USED, FOR THE MOST PART, AS VEHICLES FOR INVESTING IN SECURITIES AND SIMILAR INSTRUMENTS.

[30] Reg. 301.7701-3.
[31] 485 U.S. 340, 61 AFTR2d 88-793 (1988).
[32] 1992-2 CB 204.

renegotiate the terms of the debt used to acquire Blackacre and could not renegotiate the lease with Lauryn or enter into leases with tenants other than Lauryn 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 that in Rev. Rul. 78-371.[33] The trust in that Ruling 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 interests 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 the trust classification regulations.[34]

THE RULES CONSTRAIN THE ABILITY TO USE INVESTMENT TRUSTS IN CREATIVE WAYS BY RAISING THE RISK THAT, UNDER THE TRUST CLASSIFICATION REGULATIONS, A TRUST WILL BE CLASSIFIED AS A PARTNERSHIP.

Using DSTs in Section 1031 real estate transactions

The next question considered in Rev. Rul. 2004-86 was whether the purchase of interests in the trust by Michael and Riley 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.

Disregarding the trust for federal income tax purposes. 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 if trust income is (or, in the discretion of the grantor, a non-adverse party, or both, may be) distributed or held or accumulated for future distribution to the grantor or the grantor's spouse without the approval or consent of any adverse party. 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.

In Rev. Rul. 2004-86, the IRS determined that Michael and Riley 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 Michael and Riley 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. Thus, all income, deductions, and credits attributable to that portion are includable by Michael and Riley 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, Michael and Riley each are considered to own an undivided fractional 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 Michael and Riley 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 Michael and Riley (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

[33] 1978-2 CB 344.

[34] Reg. 301.7701-4(c)(1).

outcome to the parties would have been the same even if John had transferred interests in Blackacre to Michael and Riley, who then immediately contributed their interests in Blackacre to the trust.

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.

Moreover, Section 671 does not explicitly state that the taxpayer holds property held by a grantor trust; rather, 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 an interest in a grantor trust as replacement property 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 seven deadly sins. The use of a grantor trust in a Section 1031 transaction, however, requires that the ownership interest that is acquired be an interest in a trust (within the meaning of the trust classification regulations) 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 trust 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:

- Dispose of Blackacre and acquire new property.
- Renegotiate the lease with Lauryn.
- Enter into leases with tenants other than Lauryn (except in the case of Lauryn's bankruptcy or insolvency).
- Renegotiate or refinance the obligation used to purchase Blackacre.
- Receive capital contributions from the investors.
- Invest cash received to profit from market fluctuations.
- 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 rather than as a grantor trust. 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.[35]

The limitation on the powers of the trustee 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 been granted 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.

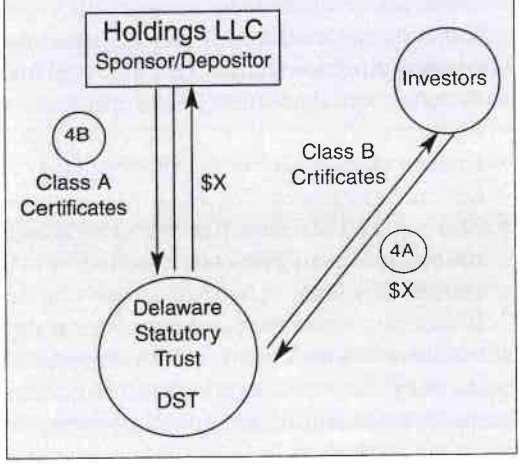
In addition to ensuring the DST is not classified as a business entity under the trust classification regulations, it also is necessary to avoid classification of a syndicated DST arrangement as a partnership. The owners of beneficial interests in a DST could be treated as partners if there were unequal sharing, for example, or if the DST sponsor were somehow subject to their obligations. Thus, for example, if the lender with respect to a DST transaction wanted to impose recourse liability on the sponsor as a result of loan agreement violations by the owners of beneficial interests, the question would arise whether there was improper risk shifting that could give rise to a partnership.

Even though DSTs have been approved by the IRS, the limitations provided in Rev. Rul.

FIXED INVESTMENT TRUSTS ARE LIMITED, IN ALMOST ALL RESPECTS, TO FIXED INVESTMENT ACTIVITIES THAT HAVE NO MANAGEMENT DISCRETION.

[35] Reg. 1.761-2(a)(2)(i).

EXHIBIT 1. Basic DST Acquisition Structure.



2004-86—particularly the seven deadly sins—make it difficult to use a DST in many situations. On the one hand, because a DST is a separate legal entity that holds fee title to the property, it is "efficient" from a lending perspective (as compared to a TIC arrangement in which there are multiple owners of interests in the property).[36] On the other hand, as a practical matter, the beneficiaries of a DST are not permitted to contribute any funds to the DST to address the routine financial needs that arise in connection with the ownership and operation of rental properties. As a result, the DST is most useful for holding real estate investments where additional capital is not needed (e.g., a triple net lease to a credit tenant[37] such as a Wal-Mart store), or an investment in land that is leased to a user (e.g., a long-term ground lease) or an investment in certain master lease structures involving stabilized real estate assets.

Structuring issues—acquisition, sale, and addressing unexpected events

Several issues must be addressed in structuring a Section 1031 transaction using a DST.

Acquiring the property. In many cases, a sponsor of a DST transaction will need to acquire the property prior to selling DST interests to investors.[38] In such a case, the initial beneficiary of the DST is the sponsor (or its affiliate) who transfers all equity funds to the DST and arranges any financing needed to acquire the property (see steps one and two (circled) in Exhibit 1, above).[39] This initial DST is created pursuant to an agreement (the "initial trust agreement") that lacks any of the restrictions required under Rev. Rul. 2004-86 in order to qualify as a grantor/fixed investment trust for federal income tax purposes. Under the initial trust agreement, the sponsor has complete control over the property and may address any matters relating to the property as the sole beneficiary of the DST. As a result, the DST is initially viewed as a "business entity" that has only one owner—the sponsor or its affiliate. Accordingly, the sponsor is able to treat the DST as a disregarded entity for federal income tax purposes, so that no separate returns will be filed for the DST. As a disregarded entity, the DST's assets are treated as owned directly by the sponsor (or its affiliate).

In some cases, the initial trustee of the DST will be a Delaware financial institution or other qualified party. The initial trust agreement expressly authorizes the trustee to enter into a management agreement (discussed below) with an affiliate of the sponsor as well as (1) the conversion of the DST to a fixed investment trust (also discussed below), and (2) the sale of beneficial interests in the DST by the sponsor. The trustee usually receives an annual fee that is either a flat amount or a percentage of the gross rent from the property.

After initial funding (Exhibit 1, steps 1 and 2), the DST then acquires the property from the seller (Exhibit 1, steps 3A and 3B). At the closing of the property acquisition the lender takes a perfected security interest in the property to secure its loan to the DST (Exhibit 1, step 3E). Some DST transactions have been structured in which the property (or properties) is made subject to a long-term master lease (to the sponsor or its affiliate) (Exhibit 1, steps 3C and 3D). In many cases, the use of a master lease is not necessary in a DST structure—accordingly, many DST structures do not involve a master lease component (i.e., the DST will lease the property directly to the under-

[36] See note 7, *supra*. For a detailed discussion of TIC structures, see Lipton and Cullen, *supra*, note 7.

[37] A "credit tenant" is a tenant that has issued "investment grade" debt instruments that have been rated by one of the major rating agencies.

[38] In some cases, a sponsor may have the ability to structure the deal as a simultaneous closing (i.e., investor funds and loan proceeds are available at the time a sponsor acquires a property). For exemplary purposes, this article assumes a simultaneous closing is not possible.

[39] In lieu of the trust, the sponsor could form a single-member limited liability company (SMLLC) to acquire the property. This SMLLC could then be converted into a Trust at the time beneficial interests are sold, as discussed below.

lying tenant who occupies the property). The use of a master lease component in a DST structure may not be appropriate in some cases because if capital needs arise with respect to the property, there is no way to obtain the needed funds without terminating the DST via a kick-out transaction (discussed below). Depending on the property at issue, and the facts and circumstances of the transaction, this may create additional tension on the tax requirements of a DST transaction. Moreover, if the sponsor wants to make the capital investment needed for the property, it could probably do so in its capacity as a master lessee, but because the master lease cannot be altered under the DST agreement it is difficult, if not impossible in many cases, for the sponsor to get back its additional investment. These practical considerations have resulted in many sponsors concluding that a DST is best suited for ground leases or property subject to a long term, triple-net lease to a credit tenant, in which case the need for additional funds is not anticipated. With this in mind, in some cases the use of a master lease component in a DST structure might be appropriate for certain stabilized assets.

When the property is acquired, the DST (through its trustee) often will enter into an asset management agreement with an affiliate of the sponsor serving as the asset manager. Under the asset management agreement, the DST often will retain the manager to act as the DST's agent in limited respects. Specifically, the manager will be authorized to (1) receive rent from the tenant, (2) make all payments that are required to be made by the DST with respect to the property, (3) hold reserves that are required with respect to the property, (4) use the balance of the cash from the property to make distributions to the beneficiaries of the DST (i.e., the investors),[40] (5) receive notices from the lender with respect to any financing encumbering the property, and (6) serve as the sales agent for the trustee at such times as the trustee is authorized or required to attempt to market or sell the property. The asset manager is paid an arm's-length fee for its service (e.g., 2% of gross rent per annum) and is also paid a sale commission at a market rate (e.g., 4%) when the property is sold.

Sale of the beneficial interests in the DST. Many DST transactions use a "conversion feature" within the operative trust agreement that allows the DST to convert from a disregarded entity to a fixed investment trust for federal income tax purposes. Specifically, this conversion feature provides that, when the sponsor is ready to sell the DST interests to investors, the initial trust agreement will, via its own operative terms, convert to a fixed investment trust by the springing applicability of the restrictions provided under Rev. Rul. 2004-86 and the applicable case law governing fixed investment trusts. In most cases, this conversion becomes effective upon receipt of written notice by the trustee from the sponsor that the initial trust agreement is to be converted. Upon conversion, the DST agreement must contain all of the restrictions that are required in Rev. Rul. 2004-86 (i.e., the seven deadly sins discussed above). In addition, upon conversion, the DST agreement must further provide that no additional contributions may be made to the trust by the beneficiaries thereof.

This conversion feature provides the sponsor greater flexibility during the property acquisition process prior to sale. Because the DST is treated as a disregarded business entity for federal income tax purposes prior to conversion, it is not subject to the restrictions that apply to a fixed investment trust (i.e., the seven deadly sins), which may be important during the acquisition and pre-investor period. Upon conversion, the DST (by operation of the conversion feature provided by the terms of the trust agreement) should be treated as a fixed investment trust for federal income tax purposes—and, therefore, if structured properly, should be treated as qualified Section 1031 replacement property for investors engaging in a like-kind exchange.

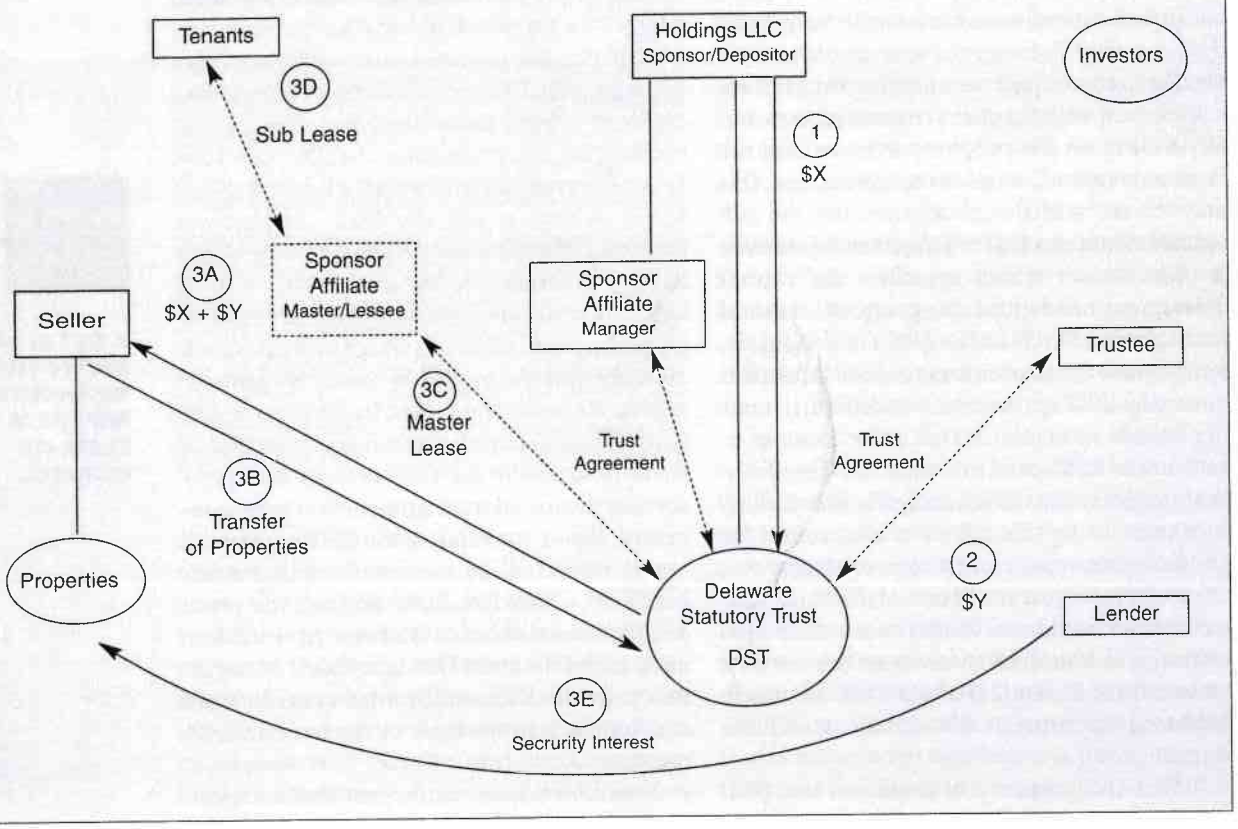
The sale process for a DST transaction often involves the use of two classes of DST interests (see Exhibit 2 on page 30).[41] At the start of the sale process, the sponsor/depositor owns all of the "Class A" certificates (or beneficial interests) in the DST. The investors/beneficial owners contribute cash in exchange for "Class B" certificates (usually by instructing their qualified intermediary involved in the like-kind exchange to contribute such funds). The DST then uses such funds to repurchase the

A DST IS AN ENTITY THAT IS RECOGNIZED AS SEPARATE FROM ITS OWNERS.

[40] To comply with Rev. Rul. 2004-86, the asset manager will be required to invest all of its cash on hand in 90-day Treasury bills and to distribute at least quarterly all funds not held in reserves.

[41] The use of two classes of trust interest is not needed in a simultaneous property acquisition.

EXHIBIT 2. DST Sale to Investors.



Class A beneficial interests held by the sponsor/depositor, and thereby reduces the sponsor's ownership interest in the DST—i.e., the sponsor often has a redemption right associated with its Class A certificates (Exhibit 2, steps 4A and 4B).

The trust classification regulations generally prohibit the use of two classes of interests in an investment trust, unless such use is merely incidental to a trust's investment purpose. The trust classification regulations contain two examples that illustrate the type of different ownership rights that would be merely incidental to a trust's investment purpose. The first example illustrates a circumstance whereby the existence of two classes of ownership interests in a trust is incidental to the trust's purpose of facilitating direct investment in a portfolio of residential mortgages.[42] In that situation, the originator of the mortgage portfolio transferred the mortgages to a bank under a trust agreement, retained the class D beneficial ownership interest in the trust, and sold to investors the class C beneficial ownership interests in the trust. The two classes were identical except that, in the event of a default on the underlying mortgages, the payment rights of the class D interests were subordinate to the rights of the class C certificate holders. The example observes that the interests of the beneficial holders in the aggregate, however, is substantially equivalent to an undivided ownership interest in the mortgage pool, coupled with a limited recourse guarantee running from the originator to the class C beneficial holders. Thus, the difference in rights between the class D and class C beneficial ownership interests is present simply to facilitate the investment by the class C beneficial owners in the trust's assets.

Likewise, the second example illustrates a circumstance in which multiple classes of ownership interests in a trust merely facilitate direct investment in the assets held by the trust.[43] In that example, investors purchased trust certificates evidencing the right to receive a particular payment with respect to a specific

[42] See Reg. 301.7701-4(c)(2), Example 2.

[43] See Reg. 301.7701-4(c)(2), Example 4.

bond that was included in a bond portfolio held by the trust. Because the purchase of stripped interests in bonds and coupons are treated as separate bonds for federal income tax purposes, the example states that the multiple classes simply provided each certificate holder with a direct interest in what would be treated as a separate bond. Because the certificate holders acquired an interest in the trust's assets that was similar to what the certificate holder could acquire by direct investment, the multiple classes of ownership interest will not prevent the trust arrangement from being treated as a trust rather than a business entity for federal income tax purposes.

Consistent with the facts in the examples discussed above, the redemption right of the sponsor/depositor also should be treated as existing simply to facilitate the investor's investment in the Class B beneficial interests in the DST. The redemption right simply replaces a portion of the sponsor's pro rata ownership interest in the DST and its underlying assets with that of the investor. This same result could be accomplished by either the sponsor/depositor selling to an investor a portion of its Class A beneficial interest or the sponsor/depositor selling the investor a direct interest in the property followed by the investor's contribution of same to the DST. Under either scenario, the result is the same.

Kick-out events. Even in situations in which it is not expected that any additional funding will be needed by the DST, bad events can arise. To address these situations, most properly structured DSTs contain a "kick-out" provision providing that if the assets of the DST are imperiled due to unexpected circumstances, the trustee(s) of the DST are authorized to contribute the assets to a partnership or LLC (often referred to as the "kick-out LLC") and then distribute interests in the kick-out LLC to the beneficiaries in liquidation of the trust.[44] This approach appears to be consistent with both the letter and spirit of Rev. Rul. 2004-86, and it is also consistent with prior rulings from the IRS in which a trust was permitted to contribute its assets to a corporation and then distribute the corporate stock in liquidation. That said, there are no authorities expressly permitting this provision in a DST agreement, although it has become quite common. This use of a kick-out provision provides a prudent method to address unexpected circumstances—failure to use such a feature is tantamount to allowing the "tax-tail" to wag the dog.

THE GRANTOR TRUST ASPECT OF REV. RUL. 2004-86 IS QUITE HELPFUL TO TAXPAYERS.

Conclusion

As a practical matter, a Section 1031 DST structure can be used only for the passive holding of rental real estate.[45] It cannot engage in the types of activities that other real estate entities can engage in under the tax laws (e.g., the activities allowed to tenants in common under the guidance established in Rev. Rul. 75-374[46]). A DST trustee certainly cannot lease, improve, re-finance, or otherwise "operate" the real property in any context other than the mere receipt of rental payments. That is why it has been assumed by many sponsors that DSTs will work best with property that is subject to a long-term, triple-net lease, or property that requires little or no action by its owner, such as a master lease of stabilized assets or a ground lease. Any property that requires either active management or foreseeable capital contributions from its owner likely will be inappropriate for a DST. ■

[44] Alternatively, some DSTs will provide that the trustees have the right to convert the DST into an LLC under state law, which should have the same tax result, although a mere conversion might be viewed more skeptically by the IRS.

[45] In some cases, a DST may also be used to hold certain oil and gas interests. See, e.g. Ltr. Rul. 8047016.

[46] 1975-2 CB 261.