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Editorial Staff

Managing Editor
Robert J. Murdich, J.D.
Thomson Reuters
121 River Street
10th Floor
Hoboken, NJ 07030
Phone:(201) 536-8192
E-mail: robert.murdich@thomson.com

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THE ABCs OF DSTs REVISITED—REV. RUL. 2004-86 AT TEN YEARS

PETER R. MATEJCAK AND DANIEL F. CULLEN

In the past decade, DSTs have become the preferred structure for tax-deferred exchanges of undivided fractional interests in real property.

July 2014 marked the tenth anniversary of the issuance of Rev. Rul. 2004-86 (the "Ruling"),[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 if such trust also satisfies the requirements of a grantor trust under Section 671, interests in that trust will be treated as interests in the *underlying real property owned by the trust* (as opposed to beneficial interests in the trust itself) for purposes of applying the like-kind exchange rules under Section 1031.[4] In the decade since the issuance of the Ruling, DSTs have become the preferred structure for tax-deferred exchanges of undivided fractional interests in real property, surpassing (but not eliminating) the once-popular tenancy-in-common (TIC) structure. This article provides a refresher on the Ruling and the basics of the DST structure in connection with a like-kind exchange of real property,[5] then goes on to provide an overview of how DST syndication has developed over the past ten years.

Before Rev. Rul. 2004-86

Prior to the use of TIC and DST structures in connection with Section 1031 like-kind exchanges, a taxpayer who sold real estate (i.e., relinquished property) would have to identify other real estate (i.e., replacement property) that cost roughly the same as the proceeds from the sale of the relinquished property. This was often not possible within the 45-day time frame required by Section 1031(a)(3). However, the purchase of a properly-structured TIC or DST interest as replacement property took some of the burden off of this process because the size of the TIC or DST interest can be tailored to the taxpayer's needs, and because of the widespread availability of syndicated investment opportunities.

Before the Ruling was issued, the TIC structure, under the guidance of Rev. Proc. 2002-22,[6] was the prevalent structuring alternative for taxpayers seeking to exchange out of a parcel of real property and into an undivided interest in real property in a Section 1031 exchange.

Rev. Proc. 2002-22 sets out the guidelines the IRS will follow when considering whether or not to issue a private letter ruling that a TIC constitutes an interest in real property, and not an interest in a business entity. Important requirements of Rev. Proc. 2002-22 include: (1) each co-owner must directly (or, more commonly, through a single-member LLC) hold title to the underlying property; (2) the number of co-owners is limited to 35;[7] (3) the TIC may

PETER R. MATEJCAK is an associate and DANIEL F. CULLEN is a partner in Bryan Cave LLP's Chicago office.

not file a partnership return, conduct business under a common name, or hold itself out as any other form of business entity; (4) the co-owners must unanimously approve any agreement involving the sale, lease, financing, or management of the property; (5) a manager cannot be hired for a period in excess of one year, and the co-owners cannot grant a global power of attorney; (6) each co-owner must have the right to transfer, partition, or encumber its interest without the approval of any other co-owner (subject to commercially reasonable lender restrictions); (7) if the property is sold, any debt encumbering the property must be repaid and the net proceeds distributed to the co-owners pro rata; (8) the co-owners can make unlimited pro rata contributions with respect to the property; (9) a co-owner may have a fair-market-value call option on interests of other co-owners, but cannot have a put option to the sponsor, lessee, or another co-owner; (10) the co-owners' activities are limited to those customarily performed in connection with the maintenance and repair of real estate; and (11) a lease cannot be entered into with a co-owner.[8]

Rev. Proc. 2002-22 focuses on whether or not a TIC structure constitutes a business entity. As discussed below, this is a key distinction from the DST structure, in which a separate legal entity is formed that owns the fee interest in the underlying real property.

Rev. Rul. 2004-86

The Ruling, still the primary guidance concerning investment trusts,[9] addresses the use of a DST as a vehicle to facilitate the fractional ownership of replacement property by taxpayers completing a Section 1031 like-kind exchange.

The structure permitted under Rev. Rul. 2004-86. The Ruling considered a situation in which an individual, A, borrowed money from an unrelated bank and signed a ten-year, interest-bearing, nonrecourse note. A used the loan proceeds to purchase rental real property, Blackacre, which was the sole collateral for the loan from the bank. Immediately thereafter, A "net" leased the property to a tenant, Z, for ten years.[10] Under the terms of the lease, Z was required to pay all taxes, assessments, fees, and other charges imposed on Blackacre by federal, state, and local authorities. In addition, Z was required to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. Z was free to sublease Blackacre as Z saw fit.

Rev. Proc. 2002-22 sets IRS guidelines on whether a TIC constitutes an interest in real property or interest in a business entity.

The rent paid by Z to A 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). Adjustments to the rate or index were not within the control of any of the parties to the lease, however. The rent paid by Z was not contingent on Z's ability to lease the property or on Z's gross sales or net profits derived from Blackacre.[11]

1 2004-33 IRB 191.

2 Reg. 1.7701-4.

3 Reg. 1.7701-3.

4 By effectively treating interests in a DST as interests in real property, the Ruling allows taxpayers disposing of real estate in an otherwise-qualifying like-kind exchange to acquire DST interests as qualifying replacement property, and vice versa. In contrast, if a trust is treated as a business entity and not a fixed investment trust, the trust interests will be treated as interests in a partnership and, therefore, will not constitute valid replacement property pursuant to Section 1031(a)(2)(D).

5 Much of the content of this article, indeed inspiration for the title, has come from a prior article, "The ABCs of DSTs" by Daniel F. Cullen, which appeared nearly ten years ago in this publication. See Cullen, "The ABCs of DSTs: Using Fixed Investment Trusts in Section 1031 Real Estate Transactions," 34 Real Estate Tax'n 21 (Fourth Quarter, 2006).

6 2002-1 CB 733.

7 This requirement of the revenue procedure appears to be based on the need for administrative convenience, as it is not supported or mandated by statute or case law. The requirement may be intended to address the unlikely scenario in which a nearly infinite number of tenants-in-common co-own the property and, thus, no co-owners have dominion or control over the property because the individual fractional interests are too small.

8 While a more detailed discussion of Rev. Proc. 2002-22 is beyond the scope of this article, see Lipton, Harrison, and Golub "The Intersection of Delaware Statutory Trusts and Tenancies-in-Common," 32 Real Estate Tax'n 76 (First Quarter, 2005) for more in-depth discussion of TICs and comparison of Rev. Proc. 2002-22 and the Ruling.

9 Little substantive case law has developed specific to the issues of utilizing the DST structure in the context of a Section 1031 like-kind exchange.

10 The Ruling does not indicate whether A is related to Z, but given that the IRS stated that Z is not related to persons described in the Ruling other than A, it can be assumed that Z may be related to A.

11 Although the lease from A to Z 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.

Rev. Proc. 2002-22 sets IRS guidelines on whether a TIC constitutes an interest in real property or interest in a business entity.

On the same date that A acquired Blackacre and leased it to Z, A also formed a DST to which A contributed fee title to Blackacre after entering into the loan with the bank and the lease with Z. The DST assumed A's rights and obligations under the loan from the bank as well as under the lease with Z. 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).

The Ruling 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 United States, 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 Z, or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency.[12]

In addition, the trustee was restricted from modifying the property held by the DST, and was permitted to make only minor, non-structural modifications to Blackacre (unless otherwise required by law).[13] 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 A, or indicate to third parties that the trustee (or the DST) was A's agent.

A, immediately after forming the DST, conveyed A's entire interest in the DST to B and C in exchange for interests in Whiteacre and Greenacre, respectively. B and C were not related to the lender or to Z (the lessee of Blackacre), and neither the trustee nor the DST was an agent of B or C. B and C desired to treat the interests in the DST that they acquired as re-

[12] While the term "insolvency" is not defined in the ruling, based on an analysis of the use of the term throughout the Code and in other non-tax areas of law, the authors are of the opinion that insolvency should be construed to mean "balance sheet insolvency" (i.e., the condition of an entity's having liabilities in excess of assets) as opposed to "cash flow insolvency" or some other formulation of insolvency.

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

[14] It is appropriate to presume that A would not claim that A's exchange qualified as a like-kind exchange under Section 1031, which would be difficult for A to do because A did not acquire Blackacre for investment or for use in a trade or business.

[15] For example: 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.

[16] Reg. 301.7701-3.

[17] 485 U.S. 340, 61 AFTR2d 88-793 (1988).

[18] 1992-2 CB 204.

placement property in a like-kind exchange for their relinquished properties, Whiteacre and Greenacre, respectively.[14]

Classification of the DST—Business entity or trust? The fundamental corporate law concept that underlies the Ruling is that a DST is an entity that is recognized as separate from its owners.[15] However, in light of the purpose of, and the powers and privileges afforded to, a DST and the beneficial owners thereof, the IRS concluded in the Ruling 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.[16] Thus, it was necessary to classify the DST as either a business entity or a trust for federal income tax purposes.

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 A or its subsequent beneficial owners, B and C. The IRS noted its assumption that neither the trust nor the trustee was an agent of A, B, or C, and that neither the trust nor the trustee held itself 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*,[17] neither the trust nor the trustee could be viewed as an agent of the beneficial owners of the trust.

The IRS then said that this situation also had to be distinguished from Rev. Rul. 92-105,[18] in which an Illinois land trust effectively was disregarded in determining whether its beneficiary could transfer an interest therein as part of a Section 1031 like-kind 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 the Ruling, the trust assumed A's obligations under the loan from the bank and the lease with Z.

Furthermore, the DST in the Ruling provided the beneficial owners 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 the beneficial owners of the DST in the Ruling 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 DST in the Ruling had to be classified as an entity because it had sufficient powers to constitute a separate entity for tax purposes.

Having concluded that the DST 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 U.S. federal income 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 deter-

mine whether the DST in the Ruling 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.

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.

Under the facts of the Ruling, on the date of (but immediately prior to) the transfer of Blackacre to the trust, A also (1) entered into a ten-year nonrecourse loan with the bank secured by Blackacre and (2) leased Blackacre to Z for ten years. All of A'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 (i.e., 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 renegotiate the terms of the debt used to acquire Blackacre and could not renegotiate the lease with Z or enter into leases with tenants other than Z except in the event of Z's 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 IRS's view, the key to distinguishing this situation from that in Rev. Rul. 78-371,[19] in which a trust was classified as a business entity because the trustee had powers unrelated to the conservation of the trust's assets. In the Ruling, 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 DST in the Ruling was classified as a trust under the trust classification regulations.[20]

Using DSTs in Section 1031 real estate transactions pursuant to the Ruling. The next question considered in the Ruling was whether the purchase of interests in the trust by B and C would be treated as an acquisition of interests in the underlying real property owned by the trust (i.e., Blackacre) in exchange for their interests in Whiteacre and Greenacre that were conveyed to A. In the Ruling, 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, if 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 the regulations, "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.[21] Further, the regulations provide 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.[22] Under Section 677(a), the grantor is treated as the owner of any portion of a trust if trust income is—or may be, in the discretion of the grantor, a non-adverse party, or both—distributed, 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 treated as the owner of an undivided fractional interest of a trust (under Section 671) is considered, for federal income tax pur-

poses, to own the trust assets attributable to that undivided fractional interest.

In the Ruling, the IRS determined that B and C should be treated as grantors of the trust under Reg. 1.671-2(e)(3) when they acquired their interests in the trust from A, who had formed the trust. Because B and C 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 B and C 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, B and C 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 B and C 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 B and C (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 A had transferred interests in Blackacre to B and C, who then immediately contributed their interests in Blackacre to the trust.

The grantor trust aspect of the Ruling is quite helpful to taxpayers. For years, many practitioners had been hesitant, for purposes of completing a Section 1031 like-kind 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). The Ruling put 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.

Rev. Proc. 2002-22 sets IRS guidelines on whether a TIC constitutes an interest in real property or interest in a business entity.

The 'seven deadly sins.' The use of a grantor trust in a Section 1031 like-kind exchange transaction requires that the acquired ownership interest is an interest in a trust (within the meaning of the trust classification regulations) and not in a business entity. In the Ruling, the IRS expressly warned 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 Z.
- Enter into leases with tenants other than Z (except in the case of Z's bankruptcy or insolvency).
- Renegotiate or refinance the obligation used to purchase Blackacre (except in the case of Z's bankruptcy or insolvency).
- Receive capital contributions from the investors.
- Invest cash received to profit from market fluctuations.
- Make more than minor nonstructural modifications to Blackacre, unless otherwise required by law.

If the trustee had the power to commit any one of these actions—often referred to in practice as the "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

[19] 1978-2 CB 344.
[20] See Reg. 301.7701-4(c)(1).
[21] Reg. 1.671-2(e)(1).
[22] Reg. 1.671-2(e)(3).

the beneficiaries as co-owners under state law, the trust would not be able to elect out of Subchapter K under Section 761.[23]

The limitation on the powers of the trustee is a very important aspect of the Ruling. It is not sufficient that the trustee never commits one of the "seven deadly sins"—*the trustee must lack the power to undertake those actions altogether.* This aspect of the Ruling is consistent with the case law and other IRS guidance 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.[24]

In addition to ensuring that 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[25] 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 (often including the sponsor's wholly-owned master tenant entity used in the structure) 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 deemed partnership. The courts have provided a plethora of factors that must be considered when considering whether or not a DST lease should be characterized as a deemed partnership and not a true lease, for example: (1) intent to enter into a true lease / not to enter into a financing arrangement, joint venture, or management arrangement with the tenant; (2) joint contribution of capital or services; (3) joint capital and ownership of capital and earnings; (4) sharing profits as co-proprietors; (5) sharing losses; (6) joint control over the business; (7) sharing in residual proceeds; and (8) acting as a partnership (e.g., filing tax returns, maintaining shared books, etc.).

Even though DSTs have been approved by the IRS in the context of a Section 1031 like-kind exchange, the limitations provided in the Ruling, particularly regarding 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 undivided fractional interests in the underlying property). 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[26] such as an established national "big box" store, a corporate headquarters, or some other "essential asset"-type property), if the investment is in land that is leased to a user (e.g., a long-term ground lease), or if the investment is in certain master lease structures involving stabilized real estate assets, including certain multi-family properties.

The limited power of the trustee was, in the IRS's view, the key to distinguishing the situation in the Ruling from that in Rev. Rul. 78-371.

Structuring issues

In light of the concepts set forth in the foregoing discussion of the Ruling, the following discussion provides an overview of several key stages and events in the life cycle of a DST structure utilized in connection with a Section 1031 like-kind exchange—acquisition of the property, syndication, and addressing unexpected events.

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.[27] In such a case, the initial beneficiary of the DST is the sponsor (or its affiliate), which transfers all equity funds to the DST and arranges any financing needed to acquire the property.[28] This initial DST is created pursuant to an agreement (the "initial trust agreement," often referred to as a "short-form trust agreement" in practice[29]) that lacks any of the restrictions required under the Ruling 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 (i.e., the sponsor or its affiliate, as the case may be). 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, as the case may be.

In some cases, the initial trustee of the DST will be a Delaware financial institution or other qualified party.[30] 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 (i.e., the syndication). 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 formation, the DST acquires the property from the seller. At the closing of the property acquisition, the lender takes a perfected security interest in the property to secure its loan to the DST.

Depending on the real estate asset class involved, some DST transactions have been structured such that the property (or properties) is made subject to a long-term master lease (to the sponsor or its affiliate). In cases involving triple net lease assets, 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 underlying 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.[31]

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 that participate in the syndication),[32] (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

The grantor trust aspect of the Ruling is quite helpful to taxpayers.

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

[24] See, e.g., *North American Bond Trust*, 122 F.2d 545 (CA-2, 1941), *cert. den.* 314 U.S. 701 (1941); *Pennsylvania Co. for Insurances on Lives and Granting Annuities*, 146 F.2d 392, 33 AFTR 391 (CA-3, 1944); see also Rev. Rul. 78-149, 1978-1 CB 448; Rev. Rul. 73-460, 1973-2 CB 425.

[25] For the purposes of this article, "sponsor" refers to entities, generally real estate investment companies of a subsidiary thereof, that organize, fund and operate (generally through various affiliates) the acquisition and management of properties that are offered to accredited investors through syndicated offerings of interests in a property-owning special-purpose entity.

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

[27] 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). This article assumes that a simultaneous closing is not possible.

[28] In lieu of the trust, the sponsor could form a single-member LLC to acquire the property. This single-member LLC could then be converted into a trust at the time beneficial interests are sold, as discussed below.

[29] Such initial or short-form trust agreements are almost always replaced by more robust amended and restated trust agreements, which address the various requirements of the Ruling, prior to or in conjunction with the initial closing of the sale of DST interests to outside investors.

[30] The role of initial trustee (often referred to as the "Delaware trustee") is often performed by the trust division of a Delaware chartered financial institution or one of the national registered agent companies.

[31] The master leased DST structure is most commonly used when the underlying property of the DST is a multifamily residential property. In this situation, the master lease is used out of necessity. Because entering into and/or renegotiating leases is one of the "seven deadly sins," the DST must interpose a master tenant entity (generally an affiliate of the sponsor) that can enter into resident-level leases.

[32] To comply with the Ruling, 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.

paid an arm's-length fee for its service (e.g., 2% of gross rent per annum) and may also receive compensation in connection with various other management transactions.[33]

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 the Ruling and the applicable case law governing fixed investment trusts. In most cases, under the language of the trust agreement this conversion becomes effective at such time that there is more than one beneficial owner of the DST (i.e., at such time that the sponsor has sold its first DST interest to an investor). Upon conversion, the trust agreement must contain all of the restrictions that are required in the Ruling, such as avoidance of the seven deadly sins. In addition, upon conversion, the DST agreement must further provide that no additional contributions may be made to the trust by the beneficiaries thereof.

The Ruling warned that the trust would have been classified as a business entity if the trustee had been given additional powers under the trust agreement.

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—again, 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 U.S. federal income tax purposes. Therefore, if structured properly, the DST should be treated as qualified replacement property for investors engaging in a Section 1031 like-kind exchange.

The syndication process for a DST transaction often involves the use of two classes of DST interests.[34] 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 contribute cash in exchange for "Class B" certificates. In the case of investors participating in connection with a Section 1031 like-kind exchange, they do so by instructing their qualified intermediary to contribute such exchange funds. The DST then uses such funds to repurchase and redeem the Class A beneficial interests held by the sponsor/depositor, and thereby reduces the sponsor's ownership interest in the DST. Thus, once a DST is 100% syndicated to outside investors, the sponsor/depositor is fully redeemed out and no longer retains ownership in the DST.

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.[35] Likewise, the second example illustrates a cir-

[33] For example, the asset manager may be paid a sale commission at a market rate (e.g., 4%) when the property is sold.

[34] The use if two classes of trust interests is often based on security law exemptions. The use of two classes of trust interests is not needed in a simultaneous property acquisition.

[35] See Reg. 301.7701-4(c)(2), Example 2. 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 two classes of beneficial ownership interests is present simply to facilitate the investment by the Class C beneficial owners in the trust's assets.

[36] See Reg. 301.7701-4(c)(2), Example 4. Investors purchased trust certificates evidencing the right to receive a particular payment with respect to a specific 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 U.S. federal income tax purposes.

[37] 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.

[38] Although the DST structure has undeniably become the preferred choice in the industry, that is not to say that the TIC structure is no longer a viable alternative. Indeed, certain sponsors continue to successfully syndicate real estate offerings using the TIC structure, albeit in reduced numbers as compared to the TIC's heyday.

cumstance in which multiple classes of ownership interests in a trust merely facilitate direct investment in the assets held by the trust.[36] Consistent with the facts in the examples, 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 economic 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. Although DST structures are set up on the expectation that no additional funding will be needed, DSTs can be structured such that there is some flexibility to respond to unintended events or poor performance. 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 "springing LLC") and then distribute interests in the springing LLC to the beneficiaries in liquidation of the trust.[37] This approach appears to be consistent with both the letter and spirit of the Ruling, and it is also consistent with prior rulings from the IRS in the context of corporation liquidations. The use of a kick-out provision provides a prudent way to address unexpected circumstances. Although a decade after the Ruling there are no authorities expressly permitting this provision in a DST agreement, it has become quite common in practice.

DSTs over the last ten years

Since the Ruling was issued, DSTs have largely supplanted TICs as the preferred structure for syndicated tax-deferred exchanges of undivided fractional interests in real property.[38]

DSTs vs. TICs. The differences between the DST and TIC structures has ultimately resulted in the rise of DSTs for a number of reasons.

The DST as a separate legal entity lowers finance and setup costs. A DST is a separate legal entity while a TIC structure consists of an agreement between multiple co-owners / co-borrowers. This is one of the most salient differences between the two structures, and a key driver of their divergent prominence. A single borrower, as opposed to up

to 35 separate borrowers, makes the DST structure more attractive to lenders, a preference that has translated into greater access to financing on more favorable terms, with a smaller expenditure of time and money, to the ultimate borrowers. The fact that the DST is a bankruptcy-remote entity also obviates the need for investor to go through the trouble and expense of establishing a single-member LLC for holding a TIC interest.

The limitations provided in the Ruling, particularly regarding the seven deadly sins, make it difficult to use a DST in many situations.

Investors' passive role in DSTs can help avoid operational stalemate. While major actions and decisions of a TIC will require the review and input of the various co-owners, the investors in a DST are passive, with no ability to vote or participate in the operation of the trust. By centralizing decision making with the trustee, the DST structure eliminates the potentially cumbersome aspect of the TIC structure—operating by unanimous consent. Further, it eliminates the ability of a holdout investor to create an operational stalemate.

More investors, lower buy-in. Unlike the 35-investor cap in Rev. Proc. 2002-22, the Ruling places no limitation on the number of investors that may participate in a DST structure.[39] This ability to bring more investors into deals allows sponsors to make offerings at lower starting minimum investments, opening the structure to a wider pool of investors. From an investor's perspective, lower minimums also allows for deployment of investment dollars among multiple deals, resulting in further diversification of an investor's real estate portfolio.

Continued challenges of the DST structure. Despite the many benefits of the DST structure and its rise to prominence over the past decade, the requirements of the Ruling and practical consideration can add some complexity and cost to the DST structure.

The seven deadly sins. Although DSTs can be structured to allow another affiliated entity to take certain actions (e.g., the tenant in a master lease structure) or to contain a safety valve in the event of unforeseen difficulties (e.g., kick-out to a springing LLC as a last resort), the DST structure ultimately is always bound by the requirements of the aforementioned seven deadly sins. While TIC structures labor under the unanimous consent requirement, they are not subject to the same strict operational limitations.

Learning curve. DSTs have picked up steam and garnered much industry attention in recent years. However the structure and the Delaware Statutory Trust Act[40] still remain new to many sponsors, investors, lenders, and practitioners. This can result in a steep and sometimes expensive learning curve. While the Ruling has been in place for over a decade now, the pool of DST offerings continues to grow with new sponsors leaving the familiar confines of TICs and straight fund offerings. When coupled with lenders that are only now working with DST borrowers for the first time, the learning curve can drive up the costs of setting up a DST structure. The result can be that anticipated costs savings versus the TIC structure (e.g., avoiding the need for single-member limited liability companies, streamlining the financing process) can be cancelled out.[41]

CMBS 2.0. Perhaps one of the most challenging areas for practitioners and sponsors is the concurrent rise of DSTs and the return of commercial mortgage-backed security (CMBS) lending, or CMBS 2.0.[42] While CMBS 2.0 has resulted in greater access to geographically diverse financing,[43] often on better terms, the consensus among practitioners is that deals involving

[39] While the IRS is silent on this point, from a practical perspective the securities laws impose limitations. Trust agreements generally contemplate that a DST will have no more than 1,999 investors.

[40] 12 Del. C. 3801, *et seq.*

[41] Many first-time DST sponsors can be caught off guard by the cost and effort of establishing an initial DST structure. In practice, it can take several offerings before a sponsor has developed and become comfortable with a structure and set of documents that makes sense for its objectives and institutional abilities.

[42] CMBS 2.0 is generally understood to refer to CMBS transactions that were originated in or after 2010. See Hopper and Hurd, "They're Back! CMBS Lending in 2013: Lender and Borrower Pointers; A Practitioner's Approach to Negotiating CMBS Loan Transactions for Both Lenders and Borrowers; What is Negotiable, Non-Negotiable, and Why," 47th Annual William W. Gibson, Jr., Mortgage Lending Institute, available at www.tklaw.com/files/Publication/23441f16-aae0-49bd-a8bc-db0cb8a302d3/Presentation/Publication Attachment/5535a847-a089-43a7-9cfd-ddc0f5b45794/Lender%20and%20Borrower%20Pointers%3B%20A%20Practitioner%27s%20Approach%20to%20Negotiating%20CMBS%20Loan%20T.pdf.

[43] For example, CMBS lending—often with a large-scale, nationwide institutional reach—may allow regional sponsors who rely on local or regional lender relationships to expand to other markets.

[44] Practitioners must carefully review financing documents. While some lenders seek to make the master tenant a co-borrower on the face of the loan agreement (e.g., by making the master tenant a signatory party to the loan agreement), others seek to make the master tenant a de facto co-borrower through other means, such as by joinder or by requiring the inclusion of the assets or income stream of the master tenant as collateral for the loan.

[45] The Financial Industry Regulatory Authority, Inc.

[46] The lender could potentially access the master tenant's assets or income from the property in the event of a default under the master lease.

CMBS lenders are more time-consuming and involve greater up-front costs because they generally involve review by and negotiation with more lender-side parties.

Practitioners have reported recurring trends in recent negotiations with lenders. In DST deals involving a master lease, lenders (particularly first-time DST lenders) are increasingly attempting to make the master tenant a co-borrower with the DST.[44] DST sponsors and practitioners cannot allow a DST and master tenant to be co-borrowers (whether on the face of the loan agreement or otherwise) because such an agreement and sharing of the risk of loss could allow the IRS to argue that the arrangement should be viewed as a partnership and, thus, preclude the DST interests from qualifying as replacement property in a Section 1031 like-kind exchange. While not free from doubt, this issue should be carefully considered, especially in light of the preference expressed by FINRA[45] for a "should"-level tax opinion in connection with Section 1031-related syndications.

Sponsors have developed several alternatives in an effort to make lenders comfortable while preventing the master tenant from becoming a co-borrower under the loan documents. For example, a properly drafted subordination agreement can be effective in providing comfort to a lender that its interest is senior, without creating the need for a direct security interest given by the master tenant. Alternatively, under a back-to-back pledge, the master tenant can first pledge its assets to the DST as security for its obligations under the master lease. The DST would then be able to pledge this pledge to the lender. The back-to-back pledge provides the lender with potential access to the master tenant's assets and income without direct privity of contract between the master tenant and the lender.[46]

Lenders also are increasingly seeking to exert a greater degree of influence on the terms and operation of DST master leases. For example, lenders are frequently seeking to add wholesale "lender's prior consent" qualifiers. In addition, lenders are requesting the ability to terminate the master lease. Each of these requests should be carefully reviewed in light of the tax structure.

Finally, due to the desire to preserve the collateral in the event of unforeseen difficulties, lenders are also seeking greater involvement and control over the kick-out process. Lenders are pushing to impose restrictions on kick-out provisions, such as requiring lender's consent or imposing the ability of the lender to force kick-out by conversion to the springing LLC (as opposed to allowing the DST to choose when to convert or even distribute the property to a separate springing LLC). Such involvement of the lender in the kick-out process interposes a layer of conflict and administrative burden that can actually end up hindering the DST's ability to be nimble and take necessary action to save the property. It also places the lender in a position it may not enjoy from a lender liability risk perspective.

Conclusion

In the ten years since the issuance of the Ruling, DSTs have become the preferred structure for syndicated tax-deferred exchanges of undivided fractional interests in real property. Due to the various requirements of the Ruling, many sponsors prefer to utilize the structure in connection with either property that is subject to a long-term, triple net lease, or with property that requires little or no action by its owner, such as a master lease of stabilized assets or a ground lease. Although implementation of a DST structure is not without its challenges, the use of the structure continues to gain momentum, and likely will continue to do so in the event of a continued rebound in the lending and real estate markets. ■