Acquisition, Disposition & Structuring Techniques Corner

The Do's and Don'ts of DSTs (Part II)

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Introduction

This column is the second in a series intended to provide a high-level refresher on the "do's and don'ts of DSTs" and serves as a useful resource for practitioners seeking to properly structure Delaware statutory trusts ("DSTs") in an increasingly competitive, crowded and diversifying marketplace. The first column in this series ("Part I")[1] pointed out the real estate syndication industry's optimism following the initial preservation of Code Sec. 1031 like-kind exchanges for real property in the Republican tax reform plan, and anticipated increased activity resulting in greater diversification for investors, a deeper and more innovative knowledge base and increased pressure on established sponsors and new entrants alike to distinguish themselves and stay "cutting edge." With the President signing the tax reform legislation known as the Tax Cuts and Jobs Act ("TCJA")[2] into law on December 22, 2017, and officially saving real estate Code Sec. 1031 like-kind exchanges, that prediction has come to fruition with industry diversification and activity kicking into another, higher gear. All the more reason for market participants to refresh themselves on the do's and don'ts of DSTs, recall the lessons of the last industry peak in 2006,[3] and proceed with caution.

DSTs Background

Subsequent to the 2006 peak, DSTs surpassed tenancy in common as the industry favored like-kind exchange driven structure. In Rev. Rul. 2004-86 (the "Ruling"),[4] the IRS provided guidance for the use of a DST as a vehicle to facilitate the fractional ownership of replacement property by taxpayers completing like-kind exchanges. In a nutshell, if an entity is classified as an investment trust,[5] 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.[6] 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[7] and not an investment trust, the trust interests will be treated as interests in a partnership and, therefore, will not constitute valid replacement or relinquished property pursuant to Code Sec. 1031. With this latter treatment resulting in catastrophic failure for an intended like-kind exchange, it is crucial that a DST be properly structured and executed within not only the framework of the Ruling (including the so-called "seven deadly sins") but also the relevant case law and judicially created doctrines.

Do's and Don'ts of DSTs (continued)

Financing of Property

As discussed in Part I of this series, a DST that intends to be classified as a fixed investment trust and be compliant with the Ruling should refrain from operating in a manner that exceeds the prohibitions set forth in the Ruling or otherwise varies the investment of the beneficial owners. Limiting the powers and authority of the various parties to do so is a key element. However, DSTs must also practice what they preach and actually conduct their business in a manner that is consistent with and confined by such limitations, particularly once a DST constitutes an investment trust for federal income tax purposes. This includes handling the timing and arranging of the DST's financing consistent with the Ruling and any limitations imposed by the trust agreement.

All the more reason for market participants to refresh themselves on the do's and don'ts of DSTs, recall the lessons of the last industry peak in 2006, and proceed with caution.

As with the leasing and operational considerations as set forth in Part 1 of this series, a Ruling-compliant DST should be locked into the terms of its financing and should close on such financing prior to such time that the DST becomes an investment trust. Again, this is because of the prohibition on renegotiating existing financing or refinancing or entering into any new financing (subject to the limited tenant bankruptcy/insolvency exception in the Ruling).

One could argue that a financing which technically closes subsequent to the acquisition of property or properties and the admission of beneficial owners to the DST (*i.e.*, subsequent to such time the DST becomes an investment trust) although inconsistent with the Ruling could notwithstanding qualify as an investment trust as long as the terms of the financing and the actual exercise of the power and authority to enter into the financing are effectively executed and "locked in" at the time of the acquisition closing and admission of beneficial owners. Although one could attempt to structure such a later closing on a financing in a way that purports to comply with the investment trust authority outside of the Ruling, such efforts should be carefully considered in light of judicially created doctrine that the IRS would likely apply in any challenge of such structuring. For example, any such delay in closing a financing that lacks a meaningful business purpose other than to reduce taxes will face significant hurdles under the economic substance and business purpose doctrines. In addition, although taxpayers are generally free to structure their business transactions as they please, even if motivated by tax avoidance considerations, the incidence of taxation in connection with any such delayed closing will depend upon the substance, rather than the form, of the closing transaction, and structuring involving mere formalities designed to make a transaction appear to be other than what it is will face significant risk of collapse under the substance-over-form and step transaction doctrines.

Further, practitioners should be aware that such seemingly innocuous structuring at the DST level in order to satisfy the Ruling while delaying the financing should also be viewed through the lens of tax avoidance at the beneficial owner level for purposes of these judicial doctrines. In particular (and compliance with the Ruling aside), the timing of the closing of a DST's financing is also important to beneficial owners seeking to determine whether or not a DST's debt financing constitutes "boot" in connection with their acquisition of the DST's beneficial interests as part of their own Code Sec. 1031 like-kind exchanges. A DST structuring a financing closing after such time that it constitutes a fixed investment trust should make certain that such structuring is not inconsistent with the Code Sec. 1031 rules relating to incurring debt before or concurrent with an exchanger's closing. It appears that there is an inherent conflict between the DST complying with the Ruling (*i.e.*, ensuring that the financing is closed effective as of the acquisition of the

property or properties and admission of beneficial owners) and beneficial owners complying with the requirements of Code Sec. 1031 and the regulations thereunder (*i.e.*, the requirement that no refinancing or new financing be viewed as locked in or effective as of the closing of an exchanger's transaction).

In addition to simply closing the loan, even terms that are variable in nature, such as floating interest, prepayment penalties or hedges should be agreed to (and executed, as applicable) at closing (such as determining and establishing the formula or mechanism for calculating a variable item at a specified point in time). As a result of the restrictions in the Ruling, DST financing can be complicated, particularly when a master lease is being utilized. It is very important to structure the financing so that the DST is the only entity that could be viewed as a borrower under the loan and the DST is not deemed to have entered into a loss-sharing arrangement with either the master tenant (if applicable) or the sponsor. The following rules should be followed with respect to DST financings:

- No other party, including the master tenant, should be a co-borrower on the loan or execute a joinder agreement to the loan.
- No other party should pledge any collateral for payment of the loan obligations.
- The loan should not be recourse to any party other than the DST, including the sponsor (although the sponsor or its affiliates may execute standard "bad boy" carve-out guaranties).
- It is typical in master lease transactions for the master tenant to pledge certain assets as security for its obligation under the master lease (a pledge that is then made part of the DST's collateral to the lender). However, this pledge should be limited to the master tenant's obligations under the master lease.
- The master tenant should not be responsible for the DST's obligations and the DST should not be responsible for the master tenant's obligations (including nonrecourse carve-outs caused by the master tenant).
- The lender cannot create a structure where property cash flow is used to pay items through a waterfall in the loan documents. The DST's funds must be used for DST obligations and the master tenant's funds must be used for master tenant obligations.
- The lender should not have unlimited control regarding a decision to spring the DST to the springing LLC (discussed further below).
- The loan should not include any provisions that could require the sponsor to make future actual or deemed capital contributions to the DST.

Other Structuring Considerations

Classes of Interests

A Ruling-compliant DST should not offer multiple classes of ownership interests. However, a trust with multiple classes of ownership interests that otherwise meets the description of an investment trust also will be classified as a "trust" for federal income tax purposes if the existence of multiple classes of ownership interests is incidental to the purpose of facilitating the direct investment in the trust's assets.[8] Many DSTs nominally have two classes of interests; however, they avoid violating this restriction because the only purpose of the two separate classes is to facilitate tracking a DST sponsor's initial contribution of capital to form a DST against the outside investor money coming in (which is used to redeem such capital contributed by the DST sponsor on a proportionate basis) and because the trust agreement will provide that the two different classes are actually identical in terms of economics and participation. As an example, many DST sponsors' trust agreements create "Class 1" and "Class 2" interests with identical economic and participation rights, and provide that a sponsor-related entity will initially own 100% of the Class 2 interests and the sponsor will syndicate Class 1 interests to outside investors. For each dollar of Class 1 interests sold, a proportionate amount of the Class 2 interests are redeemed in exchange for the proceeds of the Class 1 syndication. In essence, the two classes of interests are there only to separately identify and track the sponsor-related and outside investor interests (and in a 100% fully-syndicated deal 100% of the Class 2 interests would be redeemed out, leaving just the Class 1 interests remaining anyway). In such a structure, the existence of Class 2 interests should be viewed as incidental to bringing in the outside investors' investment in the DST's underlying property *via* purchases of Class 1 interests.

Additional Contributions of Assets

It should also be noted that a Ruling-compliant DST should not accept additional contributions of assets, including money; however, sales of beneficial interests in a DST over time do not necessarily violate this prohibition to the extent that the total amount of the equity raise is fixed at the outset and such staggered sales only serve to replace the forming sponsor-related entity with the initial outside capital (again, facilitating the direct investment in the DST's assets).

Investment Trust Toggle

Business realities may dictate that a DST may need to undertake certain actions that would otherwise be prohibited

under the Ruling. The trust agreement can be drafted in a way that provides for certain flexibility both in connection with initial formation and ongoing operation of a DST. In the formation stage, particularly where a DST utilizes a separate "direct investment facilitation" class of interests, as described above, a trust agreement can be drafted to include an "investment trust toggle" pursuant to which the DST operates as a simple disregarded entity for federal income tax purposes prior to such time that an outside investor is brought in, and it is only when the DST closes the first sale of a beneficial interest to the first outside investor and ceases to be owned solely by the single initial (generally sponsor-affiliated) beneficial owner that the Ruling-compliant investment trust provisions become operative. In other words, the DST can operate more like any other business trust or business entity (and will not be subject to the various restrictions imposed by the Ruling) until the trust agreement toggles and makes the investment trust-related provisions operative. It is key to note that the toggle must be triggered once the DST is no longer a wholly owned disregarded entity, and from that point forward the DST will be subject to the Ruling-related requirements that are the subject of this column. For example, this toggle is commonly effective at midnight on the day prior to closing the first outside investor's acquisition of a beneficial interest in the DST, which should occur no sooner than the DST's closing of its property acquisition(s) and financing(s). Timing is of the essence with such a feature, as the outside investors need the beneficial interests in the DST to qualify as replacement property in connection with their own inbound like-kind exchanges from day one and, subject to very limited exceptions, the DST must be "locked in" and closed in terms of property acquisitions, leases and financings concurrent with or prior to the investor's acquisition of a qualifying DST interest as replacement property in connection with their like-kind exchange. Thus, a typical structure includes a bridge loan to the depositor followed by a contribution of the funds by the depositor to the DST.

Springing LLCs

In the event a DST must undertake prohibited actions after such time that a DST becomes an investment trust (such as renegotiating or entering into new leases, or renegotiating, refinancing or entering into new financing, in the absence of any of the exceptions provided for in the Ruling), a trust agreement should also provide for a "kickout" mechanism whereby a DST's property is effectively moved to a "springing LLC," generally either by contribution of the property by the DST in exchange for LLC ownership interests in a Code Sec. 721 tax-deferred transaction (followed by a distribution of such LLC ownership interests by the DST to the DST's own beneficial owners) or *via* a conversion of the DST into a Delaware LLC pursuant to state law. In either case, when the dust settles, the property has been transferred to a new Delaware LLC on a tax-deferred basis with the original DST beneficial owners now left holding proportionate ownership interests in the resulting LLC. The LLC's operating agreement will usually attempt to mirror the governance of the DST, with the key exception being that the LLC (which will be a business entity taxable as a partnership) will not be subject to the restrictions imposed by the Ruling. This operational flexibility comes at the cost of the original DST investors' continued tax deferral *via* like-kind exchange, as once they receive the LLC ownership interests on a tax-deferred basis they are left holding securities which are not eligible relinquished property in future like-kind exchanges. Due to the lack of a bright-line timeframe in the "held for" rules in Code Sec. 1031, some DSTs that have converted to LLC status under such a mechanism seek to address their issues and then immediately re-convert to DST on a tax-deferred basis, claiming that the resulting new DST interests are immediately eligible for use in a like-kind exchange. Most practitioners will caution that a certain amount of "aging" should be factored into the investors' holding of the new DST interests if they plan to utilize same as relinquished property in a like-kind exchange.[9] Further, the pre-wired ability to "spring" to take an action in violation of the Ruling followed by a "spring back" could be viewed as a violation of the investment trust rules.

Tiered DSTs

Finally, DST sponsors are increasingly getting creative in assembling portfolios of multiple assets. A multi-asset DST may consider implementing a "tiered DST" structure to syndicate beneficial interests in a parent DST which in turn owns individual subsidiary DSTs which each own a separate property. Practitioners should apply the foregoing guidance to each tier, ensuring that the parent DST and each subsidiary DST are governed by separate trust agreements that comply with the requirements of the Ruling. In other words, proper structuring would result in an investment trust-qualifying parent DST in turn owning a number of separate investment trust-qualifying subsidiary DSTs. It should also be noted that the tiered structure should be limited to a series of Ruling-compliant DSTs, as a DST cannot own an LLC or other entity and still afford the beneficial owners with the ability to treat their beneficial

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2017.[21] Since enactment on December 22, 2017, the IRS has released Notice 2018-8, which provides a deferral of the withholding requirement for dispositions of publicly traded interests in publicly-traded partnerships (as defined in Code Sec. 7704) ("PTPs").[22] This deferral does not apply to other partnerships and does not even apply to non-publicly traded interests in PTPs. The Notice provides that the deferral will last only until the IRS issues guidance on how brokers are to implement the withholding.

Conclusion

As this column has made clear, there is little that is clear about the new limitations on excess business losses or on how the taxation and withholding system will work for foreign-held partnership interests. One can only hope that the IRS and Treasury will act with all haste to begin to answer the questions raised, so that taxpayers can comply with, and plan for, these new provisions of the Code.

ENDNOTES

1 Code Sec. 461(l)(3)(A). These dollar-based limitations are increased each year after 2018 for inflation by a cost of living adjustment. Code Sec. 461(l)(3)(B). The new law also contains an additional loss limitation rule on excess farm losses that eliminates a non-corporate taxpayer's ability to deduct excess farm losses in excess of $500,000 for married individuals filing jointly or $250,000 for single individuals, which thus allows a higher amount of farm losses than was previously allowed under Code Sec. 461(j).

2 It is unclear whether wages and salary are to be considered business income or nonbusiness income for this purposes. *See, e.g.*, Reg. §1.172-3(a)(3)(i).

3 Code Sec. 461(l)(4).

4 Code Sec. 461(l)(6). Note that the statute does not specify whether at-risk or basis limitation rules apply before or after the new limitation. Your authors presume that they, like the passive activity loss limitation, would apply first and only to losses that survive those limitations are tested for purposes of Code Sec. 461(l)(6), but this is unclear.

5 Code Sec. 469(b).

6 Code Sec. 469(g).

7 Under new Code Sec. 168(k), taxpayers are allowed to expense 100 percent of "qualified assets" placed in service after September 27, 2017, and before December 31, 2022, and then ratably at a phased down rate over the succeeding five years. Qualified assets are defined as both new and used property. Because full expensing is allowed for tax years 2018–2022, presumably, the application of Code Sec. 461(l) will become increasingly important.

8 Presumably, to the extent a business loss does not exceed the threshold amounts, but exceeds a taxpayer's income, such excess also becomes part of the taxpayer's net operating loss carryover.

9 Code Sec. 172(c).

10 Code Sec. 172(b)(1)(A).

11 Code Sec. 172(a)(2).

12 Note, for taxpayers that are 2017/2018 fiscal year filers, the effective date may be important as an NOL arising in the 2017/2018 tax year may not be carried back two years since it arose in a taxable year after 2017.

13 It is currently unclear how new Code Sec. 172 applies at the state level for those states that incorporate Code Sec. 172 in the calculation of state-level taxable income.

14 Code Sec. 199A(c)(2).

15 Code Sec. 469(g).

16 Rev. Rul. 91-32, 1991-1 CB 107.

17 *Grecian Magnesite Mining*, 149 TC 3, Dec. 60,968 (July 13, 2017).

18 Code Secs. 864(c)(8)(B)(i)(I) and 864(c)(8)(B)(ii)(I).

19 Code Sec. 702(a)(1), (2) and (3).

20 Note that Code Sec. 1446(f) only refers to disposition. Since, as noted above, Code Sec. 864(c)(8) applies to any sale, exchange or disposition, it might be possible to argue that, if there is a sale or exchange and not some other kind of disposition, no withholding is required. However, section 13501(c)(2) of P.L. 115-97 provides that the portion of that law enacting Code Sec. 1446(f) applies to "sales, exchanges and disposition" after December 31, 2017.

21 Section 13501(c) of P.L. 115-97.

22 Notice 2018-8, 2018-7 IRB 352 (Jan. 2, 2018).

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interests as undivided fractional interests in the DST's underlying real property. Tiered DSTs are complex. It may be easier if there is no lender's cross default to just "paper clip" two DSTs in the sales process.

Conclusion

The Ruling and the oft-simplified recitations of the seven deadly sins provide the basic framework for classification of a DST as an investment trust. However, business realities and an ever-evolving marketplace require a thoughtful approach to the broader intent and context of such framework (and any ambiguity on the face thereof). The "do's and don'ts" presented in this series aim to provide practitioners with a deeper practical knowledge of certain DST structuring and operational considerations in the context of the basic framework. The authors hope that this will prove to be useful guidance to an industry seeking to build a more sustainably successful environment than its last peak. With the preservation of real estate Code Sec. 1031 like-kind exchanges now formalized through the TCJA, existing DST sponsors seem to be doubling down and new entrants—whether former tenant-in-common sponsors waiting for the right moment or new sponsors altogether—are diving in head first every week. Sustained and widespread success will require that market participants apply the highest standards in designing and operating their DST structures, and remember to diligently follow both the guidance set forth in the Ruling as well as the applicable judicial doctrine.

ENDNOTES

1 *See* Matejcak, Lipton, Steinhause and Cullen, *The Do's and Don'ts of DSTS (Part I)*, J. PASSTHROUGH ENTITIES (Jan./Feb. 2018).

2 An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution

on the budget for fiscal year 2018, P.L. 115-97 (Dec. 22, 2017).

3 Part I of this series provides information regarding the real estate syndication industry's prior peak in 2006.

4 Rev. Rul. 2004-86, 2004-2 CB 191. The Ruling is still the primary guidance concerning the use of DSTs in connection with like-kind exchanges. A deep dive into the Ruling and the DST structure in general is beyond the scope of this column; however, this brief background on the Ruling is presented in order to provide some context for the "do's and don'ts" that follow. A brief Internet search on the topic will reveal that the Ruling is perhaps best known for its list of requirements and prohibitions, colloquially referred to as the "seven deadly sins" of DSTs. Indeed, a reader familiar with these requirements and prohibitions will note that the "do's and don'ts" that follow are presented in order to equip the reader with an understanding of how to ensure compliance with the Ruling.

5 *See* Reg. §301.7701-4(c) regarding investment trusts.

6 It should be noted that, the federal income tax treatment of a properly structured DST notwithstanding, the beneficial interests in a DST are otherwise treated as securities and, therefore, will be subject to the requirements of securities law.

7 *See* Reg. §§301.7701-2, -3 and -4(b) regarding business entities.

8 Reg. §301.7701-4(c)(1).

9 Despite the increasing industry interest in such transactions, the authors would be hard pressed to issue a "should" level tax opinion regarding such a transaction regardless of the holding period.

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the status of a grandfathered grantor trust could change and that nongrantor trusts could later be treated as grantor trusts with respect to a foreign person. Simply put, Congress could have added language to specifically limit the Statutory Exception or implement the Regulatory Rule, but failed to do so.

Instead of attacking the IRS's rulemaking, the trust's grantor in LTR 201807001 sought reformation of the trust. The trust in LTR 201807001 permitted discretionary distributions to beneficiaries outside the permitted scope of Code Sec. 672(f) as the statute now reads and as retroactively applied by Treasury by regulation. In pursuing reformation and accepting the retroactive rulemaking of Treasury, the Trustee took advantage of authority provided in the trust agreement which allowed an independent trustee "to reform by a writing made and filed with the records of such Trust ... any of the provisions of the Trust Agreement ... to the end and purpose that burdensome tax consequences may, consistent with the purposes of such Trust ... be eliminated or minimized."[6]

Using this decanting power, the grantor filed an action to reform the trust to comply with the terms of Code Sec. 672(f)(2)(A)(ii). Crucially, not only the grantor but also the attorney testified to the intention that the trust be a foreign grantor, grantor trust. This evidence, coupled with the court's recognition that there had been a retroactive change in tax rules governing the determination of foreign grantor, grantor trust status, allowed the court to conclude that the trust as initially written reflected mistakes of both fact and law.

The IRS found the court's determination met the *Bosch*[7] standard that the reformation involve *bona fide* issues and be consistent with the law that would be applied by the highest court of the jurisdiction. While the IRS accepted the reformation as achieving the desired tax results *nunc pro tunc*, taxpayers should not necessarily see it as a too ready path to taxpayer success. In issuing its ruling, the IRS highlighted the "unique circumstances"[8] presented by the grantor. Clearly, the IRS has no desire that taxpayers use trust reformation as an end run around the retroactive application of tax law. Notwithstanding the warning, the use of trust reformation in appropriate circumstances as a way to achieve foreign grantor, grantor trust status is important at a time when foreign grantor, grantor trusts present new tax planning possibilities in ESBT and "S" corporation planning.

ENDNOTES

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1 LTR 201807001 released February 16, 2018.

2 Act Sec. 11343(a) of the Revenue Reconciliation Act of 1990 (P.L. 101-508). This original provision has been re-designated as Code Sec. 672(f)(5) and is effective for any trust created after November 5, 1990, or any portion of a trust created on or before such date which is attributable to amounts contributed to the trust after such date.

3 Enacted as part of the Act Sec. 1904(a)(1) of the Small Business Job Protection Act of 1996 (P.L. 104-188).

4 T.D. 8831, IRB 1999-34, 264.

5 Reg. §1.672(f)-3(e).

6 LTR 201807001 (Nov. 13, 2017).

7 *H.J. Bosch Est.*, SCt, 67-2 USTC ¶12,472, 387 US 456.

8 LTR 201807001 (Nov. 13, 2017).

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reduction in the U.S. tax collected as the result of adjustments to CFTEs for which no credit would have been allowed to the partner if the CFTEs had been correctly reported in the reviewed year.

If the amount of CFTEs is decreased on audit, the regulations treat the item as if the partners had reduced their U.S. tax by that amount and, therefore, increase the imputed underpayment by the amount of the CFTE reduction. Conversely, if the amount of CFTEs is increased on audit, the regulations treat the item as if the FTC limitation would prevent use of the increased credit and, therefore, do not reduce the imputed underpayment. The Preamble states that Treasury and the IRS recognize that