THE PROMISE (AND PERILS) OF USING DELAWARE STATUTORY TRUSTS IN REAL ESTATE OFFERINGS

BY RICHARD M. LIPTON, MICHAEL T. DONOVAN, AND MICHELLE A. KASSAB

DSTs are enjoying increasing popularity as vehicles for syndicated offerings of undivided interests in real estate, in part because of changes in the lending environment. DSTs are useful in appropriate circumstances but are subject to different rules than apply to tenant-in-common offerings. Different issues may apply with respect to using DSTs for different property classes, and special considerations arise with respect to financing DST offerings.

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Delaware Statutory Trusts (DSTs) are rapidly becoming the preferred vehicle for sponsors of syndicated offerings of undivided fractional interests (UFIs) in real estate. Such offerings generally come in two flavors:

1. Offerings of undivided tenant-in-common (TIC) interests based on Rev. Proc. 2002-22, 2002-1 CB 733 ("TIC offerings").
2. Offerings of beneficial interests in DSTs based on Rev. Rul. 2004-86, 2004-2 CB 191 ("DST offerings").[1]

DST offerings and TIC offerings are subject to very different requirements and restrictions.

Syndicated offerings of UFIs are marketed principally to taxpayers looking to complete a like-kind exchange of real estate under Section 1031. Because beneficial interests in trusts and partnership interests cannot be used as replacement property in a like-kind exchange, a DST must be classified as an investment trust and as a grantor trust for tax purposes if it is to be used in such transactions.[2] In Rev. Rul. 2004-86, the IRS ruled that the acquisition of the beneficial interests in the trust described in the Ruling would be treated as the acquisition of an undivided interest in the real property held by the trust and qualified as good replacement property under Section 1031.

Rev. Rul. 2004-86 places significant limitations on the powers that a DST may have with respect to the property. In general, the trustee cannot have the power to:

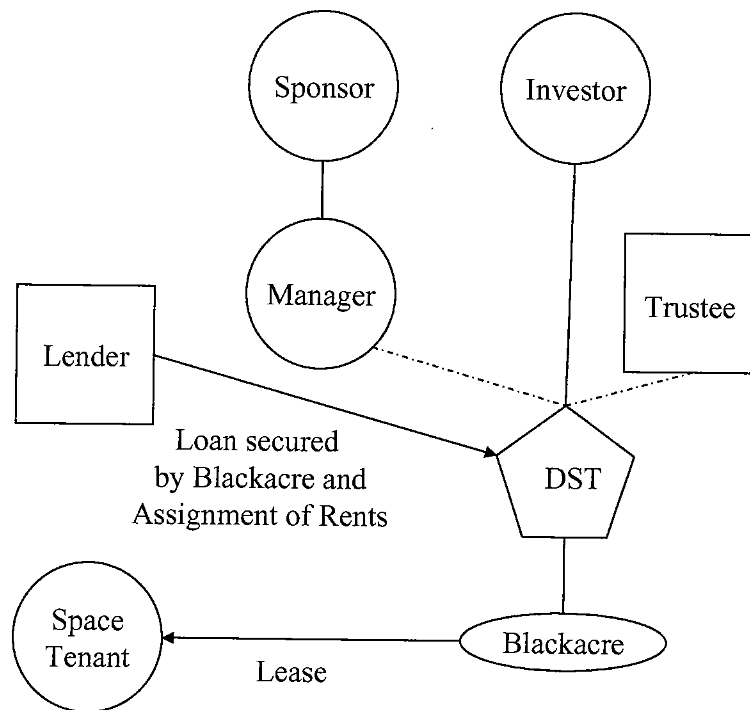
- Dispose of the property and acquire new property.
- Renegotiate existing leases.
- Enter into new leases.
- Renegotiate the terms of debt used to acquire the property.
- Refinance the debt used to acquire the property.
- Invest cash received from the property to profit from market fluctuations.
- Make more than minor non-structural modifications to the property that were not required by law.

These restrictions are commonly referred to as the "seven deadly sins."

While several sellers of UFIs ("sponsors") have focused on DSTs for years, DSTs generally have been less frequently used than TIC offerings. This view may be undergoing a sea change. The recent turmoil in the credit markets has restricted, at least temporarily, the availability of financing for a variety of transactions, including both DST offerings and TIC offerings. There are indications that, at least for the present, it may be relatively easier to obtain financing for DST offerings than for TIC offerings.

DSTs always have been an attractive platform in the case of property leased to a single, credit-worthy tenant pur-

■ **EXHIBIT 1**
Basic DST Structure



suant to a long-term, triple-net lease. There are a limited number of such properties available, however. Sponsors and investors currently are reexamining the use of DSTs for offerings of a wider variety of property types, including commercial, industrial, retail, and residential properties.

Some of the opportunities and risks associated with DST offerings in the current environment are highlighted below, beginning with a summary of Rev. Rul. 2004-86 and a review of the rules applicable to DST offerings. This is followed by a look at the more important risks and challenges associated with DST offerings, along with some of the techniques developed to deal with them.

Rev. Rul. 2004-86 generally imposes more substantial restrictions on the use of property held by a DST than Rev. Proc. 2002-22 imposes on the use of property held by TICs. Not all properties that are suitable for use in TIC offerings are suitable for DST offerings (and vice versa). Sponsors and investors must carefully consider a number of risks in connection with DST offerings including the need to re-lease the property, the need for additional capital, the need to make substantial improvements to the property, the limitations on the ability of the sponsor to recover capital used for such purposes, and the risk that unexpected events could trigger a "kickout" of the property to a partnership. As discussed below, a master lease may be used to manage some of these risks.

Risks and challenges also may be specific to DST offerings of particular property types and classes. The risks associated with DST offerings can vary substantially depending on the nature of the property involved. Not surprisingly, therefore, some types of property are more appropriate for DST offerings than others.

Finally, there are issues that relate to financing of DST offerings. Limitations on recourse liability and permissible guarantees in DST offerings differ from the limitations in TIC offerings. If a DST offering fails to comply with the relevant limitations, investors may be treated as acquiring an interest in a partnership rather than an interest in the real property owned by the DST for purposes of Section 1031.

DSTs GENERALLY

Prior to Rev. Rul. 2004-86, there was significant doubt as to whether the IRS would allow taxpayers to acquire replacement property in a like-kind exchange under Section 1031 through a legal entity such as a DST. Sections 1031(a)(1)(D) and (E) gen-

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1 Practitioners generally have concluded that TIC offerings do not need to comply with the Service's pronouncement in all respects. Tax opinions issued in connection with TIC transactions therefore generally are based on consideration of all existing law rather than on strict compliance with Rev. Proc. 2002-22, 2002-1 CB 733.

2 Sections 1031(a)(1)(D) and (E).

erally provide that interests in a partnership and certificates of trust or beneficial interests in a trust do not qualify as good replacement property for purposes of a Section 1031 exchange.

Because syndicated offerings of undivided interests in real estate are marketed primarily, although not exclusively, to investors seeking to complete a Section 1031 exchange, concern over the use of DST offerings in Section 1031 exchanges was a significant issue for the industry. The conclusion reached in Rev. Rul. 2004-86 that DSTs could be used for such purposes was extremely valuable to the real estate industry. (A typical DST structure is shown in Exhibit 1.)

Facts of the 2004 Ruling

In Rev. Rul. 2004-86, an individual (Todd) borrowed money from an unrelated bank and signed a ten-year, interest-bearing, nonrecourse note. Todd used the loan proceeds to purchase rental real property (Blackacre), which was the sole collateral for the loan from the bank. Immediately thereafter, Todd "net" leased the property to Jay for ten years. Under the terms of the lease, Jay was required to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, he was required to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. Jay was free to sublease Blackacre to anyone he chose. The rent payable under the lease was a fixed amount that could be adjusted by a formula described in the lease agreement. The formula was based on a fixed rate or an objective index, such as an escalator clause based on the Consumer Price Index, but adjustments to the rate or index were not within the control of any of the parties to the lease. The rent paid by Jay was not contingent on his ability to lease the property or on his gross sales or net profits derived from Blackacre.

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

A master lease structure allows leases to be renegotiated and new leases for the property to be entered into without violating the seven deadly sins.

The DST agreement provided that interests in the trust 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 trust would be of a single class, representing undivided beneficial interests in the assets of the DST (i.e., Blackacre).

Rev. Rul. 2004-86 expressly stated 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 the owner's respective interests in the DST. 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.

The trustee was required 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, 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.

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

In addition, the trustee was permitted to make only minor nonstructural modifications to Blackacre, unless otherwise required by law. The agreement further provided that the trustee could engage in ministerial activities to the extent required to maintain and operate the DST under local law. Finally, the trustee did not enter into a written agreement with Todd indicating, and did not indicate to third parties, that the trustee (or the trust) was Todd's agent.

Immediately after Todd formed the DST, he conveyed his entire interest in the trust to Deanna and Jane in exchange for interests in Whiteacre and Greenacre, respectively. Deanna and Jane were not related to the lending bank or to Jay (the lessee of Blackacre), and neither the trustee nor the trust was an agent of Deanna or Jane. Deanna and Jane desired to treat the interests in the trust that they acquired as replacement property in a Section 1031 exchange for their relinquished prop-

erties, Whiteacre and Greenacre, respectively.

DST Classification Under the Ruling

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

Based on the purpose of, and the powers and privileges afforded to, a DST and the beneficial owners thereof, the IRS concluded that the DST was an entity separate from its owners for federal income tax purposes. Thus, it was necessary to classify the DST for tax purposes as either a business entity or a trust.

The first question raised in the Ruling was whether the DST should be viewed as an agent of Todd or its subsequent beneficial owners (Deanna and Jane). The IRS noted that it was assumed that neither the DST nor the trustee was an agent of Todd, Deanna, or Jane, and that neither the DST nor the trustee held themselves out as their agent to third parties. Furthermore, the beneficiaries of the DST did not enter into an agency agreement with either the DST or the trustee. As a result, neither the DST nor the trustee could be viewed as an agent of the beneficial owners of the DST.

The Service then distinguished Rev. Rul. 92-105, 1992-2 CB 204, in which it had concluded that an Illinois land trust was effectively disregarded in determining whether its beneficiary could transfer an interest in the trust as part of a Section 1031 exchange. The IRS emphasized that the beneficiary in Rev. Rul. 92-105 retained the direct obligation to pay liabilities and taxes relating to the property, whereas the DST in Rev. Rul. 2004-86 assumed Todd's obligations under the loan from the bank and the lease with Jay.

No authorities expressly permit a kickout provision in a DST, although it has become quite common.

The IRS also emphasized that the DST provided the beneficial owners of the DST with the same limitation on personal liability extended to shareholders of a Delaware corporation, whereas there was no limitation on the liability of the beneficiary of the Illinois land trust. Moreover, the beneficiary of the Illinois land trust retained 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 DST's property. Thus, the Illinois land trust was disregarded because it could not rise to the level of an "entity," whereas the DST 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 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 DST 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 DST 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 DST agreement to vary the investment of the holders of the beneficial interests in the DST.

Reg. 301.7701-4(a), distinguishing trusts from business entities, states that "trust" refers to an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting and conserving it for the beneficiaries. Usually, the beneficiaries of a trust do no more than accept the benefits of the trust and are not voluntary planners or creators of the trust arrangement. The Regulations recognize, however, that if the beneficiaries of a trust are the persons who created it, the trust still will be recognized as a trust if it was created for the purpose of protecting and conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them.

Thus, generally speaking, an arrangement will be treated as a trust for federal tax purposes if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit. By contrast, entities organized as trusts under state law to carry on profit-making business activities rather than to protect or conserve property for the beneficiaries are classified as partnerships or corporations, rather than as trusts, for federal income tax purposes.[3]

In general, a trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust only if there is no power to vary the investment of the certificate holders. A trust with multiple classes of ownership interests, in which there is no power under the trust agreement to vary the investment of the certificate holders, will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of

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[3] Reg. 301.7701-4(b).

ownership interests is "incidental" to that purpose.[4]

In Rev. Rul. 2004-86, on the date of (but immediately prior to) the transfer of Blackacre to the DST, Todd also (1) entered into a ten-year nonrecourse loan with the bank secured by Blackacre and (2) leased Blackacre to Jay for ten years. All of Todd's rights and obligations under the loan and the lease were assumed by the DST. Because the duration of the DST was the same as the duration of the loan and the lease that were assumed by the DST at the time of its formation, the financing and leasing arrangements related to the DST and its assets (Blackacre) were fixed for the entire life of the DST.

Owning property through a DST presents challenges if the nature or condition of a property suggests that additional capital may be required in the future.

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

In analyzing the tax classification of the DST, 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 DST. The trustee could not renegotiate the terms of the debt used to acquire Blackacre and could not renegotiate the lease with Jay or enter into leases with tenants other than Jay except in the event of his bankruptcy or insolvency. In addition, the trustee could make only minor non-structural modifications to its property except to the extent required by law.

The limited power of the trustee was, in the Service's view, the key to distinguishing this situation from Rev. Rul. 78-371, 1978-2 CB 344. In that Ruling, a trust was classified as a business entity because the trustee had powers unrelated to the conservation of the trust's assets. In Rev. Rul. 2004-86, however, the trustee had none of the powers that would indicate an intent to carry on a profit-making business. Because all of the interests in the DST were of a single class representing undivided beneficial interests in the assets of the DST, and because the trustee had no power to vary the investment of the beneficiaries of the DST so as to benefit from fluctuations in the market, the DST was classified as a trust for federal tax purposes.

Using DST Interests in a Like-Kind Exchange

Having concluded that the DST in Rev. Rul. 2004-86 should be classified as a trust for federal tax purposes, the IRS next considered whether the purchase of interests in the DST by Deanna and Jane would be treated as an acquisition of interests in the real property (Blackacre) owned by the DST (in exchange for their interests in Whiteacre and Greenacre that were conveyed to Todd). The IRS indicated that this analysis was to be made under the grantor trust provisions.

Under Section 671, if the grantor or another person is treated as the owner of any portion of a trust, the grantor or other person must include the income, deductions, and credits attributable to that portion of the trust in computing taxable income. For this purpose, a grantor includes any person to the extent such person either creates a trust or makes a direct or indirect gratuitous transfer of property to a trust. A grantor also 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.[5]

A grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is (or, in the discretion of the grantor or a non-adverse party, or both, may be) distributed or held or accumulated for future distribution to the grantor or the grantor's spouse.[6] A person that is treated as the owner of an undivided fractional interest of a grantor trust 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 Deanna and Jane should be treated as grantors of the DST when they acquired their interests in the DST from Todd, who had formed the DST. Because Deanna and Jane have the right to distributions of all the income of the DST attributable to their undivided fractional interests, they were treated as the owners of an aliquot portion of the DST, and all income, deductions, and credits attributable to that portion would be includable by Deanna and Jane in computing their taxable incomes. Because the owner of an undivided fractional interest of a trust is considered to own the trust assets attributable to that interest for federal income tax purposes, Deanna and Jane were thus each 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 Deanna and Jane for an interest in the DST was the exchange of real property for an interest in Blackacre, and not the exchange of real property for a certificate of trust

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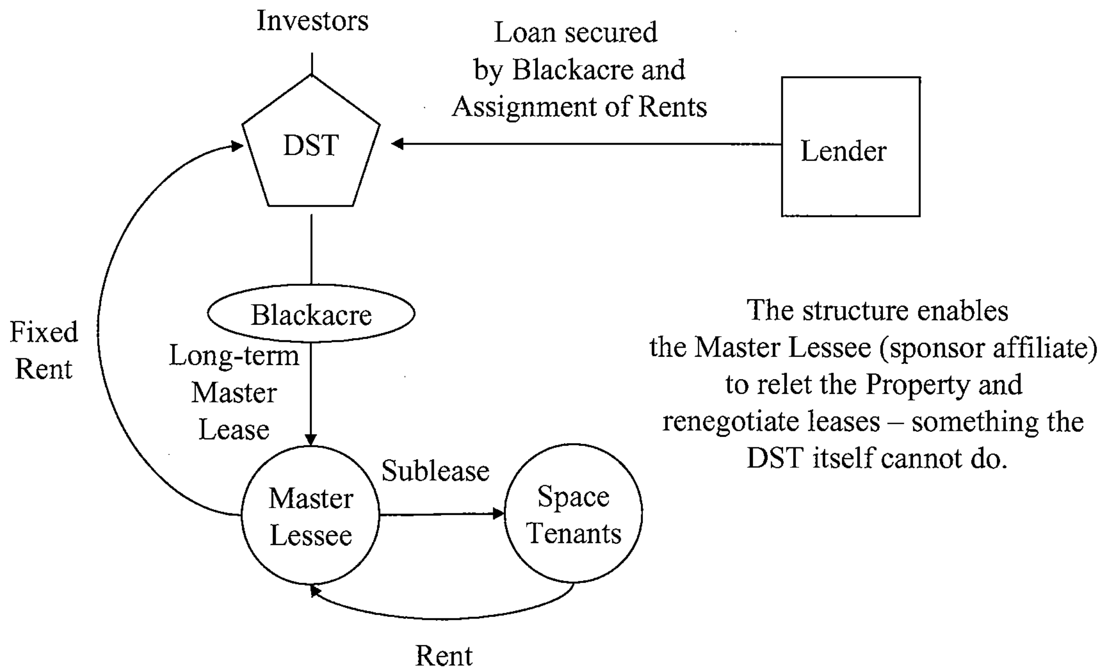
[4] Reg. 301.7701-4(c)(1).
[5] Reg. 1.671-2(e)(3).
[6] Section 677(a).

■ **EXHIBIT 2**
Master Lease Structure



or beneficial interest under Section 1031(a)(2)(E).

In the course of issuing its ruling, the IRS warned that it would have reached a completely different conclusion if the trustee had been given additional powers under the agreement. Specifically, the DST would have been classified as a business entity (and therefore as a partnership) if the trustee had been given the power to do one or more of the following:

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

These limitations on the powers of a trustee of a trust are a very important aspect of Rev. Rul. 2004-86. It is not sufficient that the trustee never commits one of these "seven deadly sins" that would result in the classification of the DST as a business entity—the trustee must lack the power to undertake those actions.

Rev. Rul. 2004-86 also imposes additional restrictions on DSTs. Beneficiaries of a DST can have neither the right nor the obligation to contribute additional capital to the DST. In addition, the DST must avoid classification as a partnership under common law principles. For example, the owners of beneficial interests in a DST still could be treated as partners in a partnership if there were unequal sharing of losses between them. As will be discussed in more detail below, liability of the sponsor or its affiliates for loans secured by properties held by a DST can raise similar concerns under case law distinguishing partnerships from other arrangements.[7]

DEALING WITH LIMITATIONS ON DSTs

The strict limitations imposed by the "seven deadly sins" and other aspects of Rev. Rul. 2004-86 present several significant challenges in DST offerings. Sponsors and their tax advisors have developed techniques for

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[7] Although not cited in Rev. Rul. 2004-86, the analysis appears to be based in part on Rev. Rul. 80-150, 1980-1 CB 316, in which the IRS ruled that a trust established for the purpose of liquidating and distributing the assets of a corporation (1) qualified as a liquidating trust under Reg. 301.7701-4(d) and (2) that the shareholders of the corporation were treated as the owners of the trust and were taxable on the income of the trust under the grantor trust rules. The trust at issue in Rev. Rul. 80-150 had many of the same restrictions the IRS relied on in reaching a favorable conclusion in Rev. Rul. 2004-86. The trust instrument specified that the trust was formed solely for the purpose of holding (and liquidating) the assets and had no objective to continue or engage in the conduct of a trade or business. The terms of the trust provided that the trust would terminate after a fixed number of years or on a sale of the property. The investment powers of the trustee were limited to demand and time deposits in federally insured banks and savings institutions, and short-term certificates of deposit. Under the terms of the trust instrument the trustee was required to distribute at least semi-annually to known shareholders any proceeds from the sale of assets and income from investments.

addressing these challenges, some of which are briefly discussed below.

Use of Master Lease

A DST generally cannot renegotiate an existing lease or enter into a new lease except in the event of the bankruptcy or insolvency of an existing lessee. This limitation may not present significant issues if the property is subject to a long-term triple net lease with a credit-worthy tenant. In such circumstances, it is not uncommon for the DST to lease the property to the tenant directly and to use a property manager.

If property is subject to a short-term lease, or if other features of the property make it likely that the property may need to be re-leased during the period the property is to be held by the DST, it is common for the DST to use a long-term master lease to an affiliate of the sponsor. (A typical master lease structure is shown in Exhibit 2.) Rev. Rul. 2004-86 explicitly allows the lessee of property owned by a DST to sublease the property and does not limit the ability of the lessee to renegotiate subleases or enter into new subleases. A master lease structure, therefore, allows leases to be renegotiated and new leases for the property to be entered into without violating the seven deadly sins.

As is true with master lease structures used in connection with TIC offerings, the benefits and risks associated with subleasing the property fall to a substantial degree on the master tenant since the amount of rent the master tenant must pay to the DST is fixed. The risk assumed by the master tenant in connection with a DST offering, however, is somewhat greater because (1) the DST lacks the power to agree to renegotiate the terms of the master lease, and (2) at least under the facts of Rev. Rul. 2004-86, the rent paid by the master tenant is limited to a fixed amount, can be adjusted only by a formula based on a fixed rate or objective index not within the control of any of the parties, and cannot provide for payments based on net or gross rents.

Kickouts

Unexpected events can occur that may imperil the property unless actions are taken that a DST lacks the power to do. To address these situations, most DSTs contain a "kickout" provision—if the assets of the DST are imperiled due to unexpected circumstances, the trustees of the DST are authorized to contribute the assets to a partnership or LLC (often referred to as the "kickout LLC") and then distribute assets in the kickout LLC to the beneficiaries in liquidation of the DST.

This approach appears to be consistent with both the letter and spirit of Rev. Rul. 2004-86, and is 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. No authorities expressly permit this provision in a DST, although it has become quite common. Nevertheless, the use of kickout LLCs involves several considerations.

DST offerings typically include an opinion of tax counsel stating that (1) the DST is treated as an investment trust for tax purposes, (2) the investors are treated as the "grantors" of the trust, and (3) as "grantors," the investors should be treated as owning an undivided fractional interest in the property owned by the DST for federal income tax purposes. In order to render an opinion, tax counsel generally relies on a representation from the sponsor that the possibility of a kickout event occurring is unlikely or remote. If the nature or condition of the property is such that a kickout is likely, the conclusion that the DST should be treated as a trust rather than a partnership may be subject to challenge under substance over form or similar principles. Accordingly, where the nature of the property, existing leases, or the financing on the property is such that either the sponsor is unable or unwilling to give this representation, or it is unreasonable for tax counsel to rely on the representation, tax counsel may be unable to render the required opinion.

Imposing a restoration obligation on the tenant appears to be a reasonable approach to dealing with the limitation on structural improvements to the property.

In addition, it is generally anticipated that some DST investors may wish to structure the subsequent disposition of their interests in the DST as a Section 1031 exchange. Unlike interests in the DST, interests in the kickout LLC will not be treated as interests in real property for purposes of a like-kind Section 1031 exchange. As a result, if a kickout occurs, it is unlikely that the DST investors would be able to defer the recognition of gain on the subsequent disposition of their investment under Section 1031.[8]

Finally, it should be kept in mind that a transfer to a kickout LLC may involve additional costs. Under current law, no gain or loss should be recognized on the transfer of the property to the partnership or LLC under Section 721. Because the DST is a grantor trust, the beneficial owners of the DST would be treated as owning the interests in the kickout LLC directly and the distribution of the interests in the kickout LLC would be disregarded for federal income tax purposes. Nevertheless, state and local taxes, including state and local transfer and recording taxes, may be incurred as a result of these transfers.

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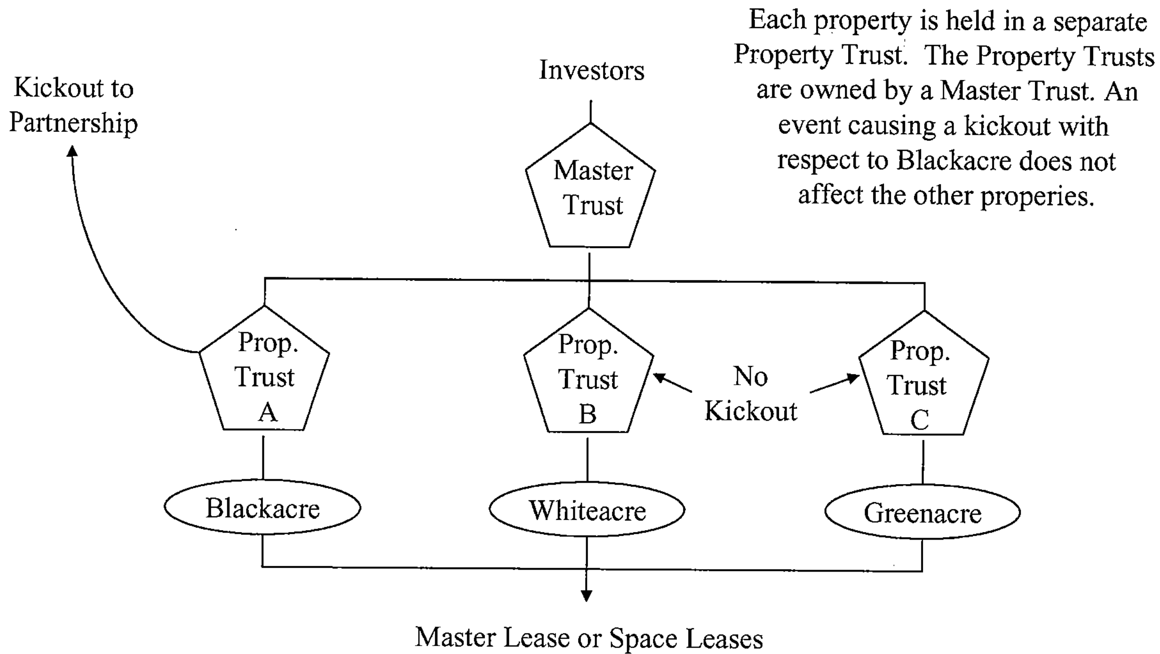
[8] It may be possible to structure the disposition as a Section 1031 exchange following a kickout. A variety of techniques are arguably available for avoiding the restriction on like-kind exchanges of partnership interests under Section 1031(a)(2)(D). See Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2006" 104 JTAX 138 (March 2006).

It has sometimes been suggested that this problem could be avoided by having the property kick out to a tenancy-in-common rather than a kickout LLC. Several issues arise, however, with respect to such a transaction. For example, the fact that section 6.02 of Rev. Proc. 2002-22 limits the number of tenants-in-common to 35 or fewer means that DSTs with more than 35 beneficial owners could not avail themselves of this strategy.

■ **EXHIBIT 3**
Double Stack Structure



Double Stacks

One of the problems with a kickout is that it effectively terminates the DST. If a DST owns multiple properties (which is one of the advantages of the DST) and only one of the properties encounters difficulties that make a kickout necessary, how can the DST take the actions with respect to the one property without either tainting the entire structure or requiring a kickout of all of the properties?

This problem has been solved through the "double stack,"[9] in which there are two layers of DSTs—investors own interests in a master trust, which in turn owns a series of property trusts, each of which holds one of the properties (see Exhibit 3). By using this structure, the investors are treated as owning an undivided interest in all of the properties. If a problem arises with one of the properties, the DST can simply kick out the troubled property while retaining all of the good properties. With this structure, the distribution of some but not all of the properties of a DST appears to be permissible as long as the distribution is pro rata.

Additional Capital

A significant disadvantage of a DST is that the beneficiaries cannot have the right or obligation to contribute additional capital. As a result, owning property through a DST presents challenges if the nature or condition of a property suggests that additional capital may be required in the future. Rev. Rul. 2004-86 permits a DST to establish reserves out of offering proceeds, loan proceeds, or cash flow from the property, and such reserves may provide a source for additional capital for the property. Funding reserves out of offering proceeds or loan proceeds, however, may not be an attractive option if it is uncertain whether the capital will ever be needed or if the capital will not be needed for several years.[10] In addition, the amount of reserves needed may be difficult to estimate.

Obtaining funds out of cash flow may be a more attractive option, but may present other problems. Beneficial owners will recognize phantom income since they will be allocated their pro rata portion of net profits but will not receive a distribution of cash. Some practitioners are of the view that another way to address this issue may be through a pre-agreed line of credit obtained when the DST is formed; because the liability asso-

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[9] The description of this technique as a "double stack" was first used by Arnold Harrison, Esq., of Jenner & Block in Chicago.

[10] To the extent needed, reserves should be funded whenever possible out of loan proceeds rather than out of offering proceeds. Reserves funded out of offering proceeds generally would not be viewed as having been invested in qualifying replacement property or as used to pay qualifying expenses. Accordingly, an investor would recognize gain to the extent exchange proceeds are used to fund the reserves. While loan proceeds used to fund reserves also are not viewed as having being reinvested in replacement property, as long as the investor fully reinvests the exchange proceeds and acquires replacement property with a value at least equal to the value of the relinquished property, excess loan proceeds can be used to fund reserves without triggering the recognition of gain.

ciated with the line of credit exists at the time the DST is formed, it can be argued that drawing on the line is a permissible power for a DST. The authors do not express a definitive view as to the use of this technique.

Certainly, the DST cannot obtain additional funds by new borrowings of money, although the restriction in Rev. Rul. 2004-86 only prohibits loans that are secured by the property; arguably, a DST could borrow money on an unsecured basis.[11] Nevertheless, it seems likely that even an unsecured loan undertaken by a DST could be viewed as changing the nature of the assets and liabilities of the DST, which is the linchpin for its classification as a fixed investment trust.

If the sponsor is willing to advance the funds, it should be able to lend or contribute money to the master tenant of the property (but not to the DST itself). The sponsor will have no way to recover this capital investment, however. The terms of the master lease, including the amount of rent to be paid by the master tenant to the DST, generally cannot be renegotiated except in the case of the bankruptcy or insolvency of the master tenant. Many sponsors have been unwilling to assume this economic risk. Finally, as will be discussed in more detail in the next section, even if the sponsor or master tenant is willing to provide the funds, an issue still exists as to whether it can make improvements other than minor non-structural improvements.

Permissible Improvements

A DST has only the right to make *minor non-structural improvements* to the property, unless otherwise required by law. (Clearly, repairs can be made to maintain the property in its condition at the time of contribution). Rev. Rul. 2004-86 provides little guidance on the scope of this limitation. One interpretation would be that the DST (1) is not permitted to make structural modifications, even if they are minor, and (2) is not permitted to make more than minor non-structural modifications.

The scope of the exception for modifications "otherwise required by law" also is unclear. At one extreme, it is possible to argue that any improvement that improves health and safety is covered by the exception and, as a result, only purely cosmetic modifications fall outside of the exception. At the other extreme, the exception could be interpreted to extend only to modifications necessary to avoid violating minimum health and safety standards.

Finally, it is unclear what constitutes a "structural" as opposed to a "non-structural" modification under Rev. Rul. 2004-86. The Ruling provides no guidance on this point. While alterations to the foundation, perimeter, load-bearing walls and roof structure of a building would appear to constitute structural modifications, it is unclear whether the following examples, which illustrate the complex factual issues resulting from the lack of a clear definition, would constitute structural modifications:

- Creation of a platform for new office space at an industrial warehouse facility.
- Constructing an additional bay door at an industrial facility.
- Adding skylights to a roof to provide for additional light in a building.
- Construction of a new bathroom in a building, including the addition of new plumbing.
- Moving a bathroom at a building, including installing new plumbing or moving existing plumbing.
- Addition of a sign at a retail property.
- Construction of a kiosk at a retail property or a guardhouse and gate at a residential property.

In the absence of a formal definition, the determination of whether a modification is structural or non-structural should be given its ordinary meaning. For practical purposes, this means that sponsors and tax counsel should be able to rely on the opinion of an engineer as to whether a proposed modification is structural or non-structural as long as the engineer's opinion is not unreasonable on its face.

The sponsor, who generally will be in the chain of title, also should be able to execute a guarantee of environmental liabilities.

Repairs or improvements constructed in conjunction with the acquisition of property by the DST should not cause the DST to be recharacterized as a partnership. Arguably, even structural improvements can be made at this point. It generally will be better to complete these improvements prior to transferring the property to the DST, since improvements completed prior to the time the property is transferred to the DST clearly do not vary the interests of the investors and therefore can have no impact on the classification of the DST as an investment trust.

If, however, there is a binding commitment for the DST to construct limited improvements after the property is transferred to the DST, arguably such improvements should not affect the classification of the DST as an investment trust because the improvements do not vary the investment of the beneficiaries in the property. Instead, the beneficiaries should be viewed as acquiring an interest in the property as improved, provided that such improvements do not rise to the level of a trade or business.

As a result, although there is no explicit authority on point, the construction of limited improvements that do not change the nature of a rental property should not cause the DST to be classified as a partnership rather than as a DST. Such after-acquired improvements, however, would not be good replacement property in a Section 1031 exchange.

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[11] Some advisors believe that a DST can borrow funds to repair property, even if the loan is secured by the property; the law on this point is not completely clear, although the authors are somewhat skeptical.

Increases in the value of the property resulting from such improvements may be treated as boot and cause the investors to recognize gain.[12]

An additional issue is the extent to which the tenant may make changes or improvements to the property without causing a kick-out.[13] Rev. Rul. 2004-86 states only that the DST itself is prohibited from making improvements other than minor non-structural improvements to the property; it is silent with respect to the ability of a lessee to make more substantial improvements. It seems questionable whether the DST can grant a tenant a power to deal with the property that the DST itself lacks. The basis for this concern is that if the trustee cannot make substantial improvements to the property because its powers are limited to protecting and conserving the property, it arguably should not be able to grant another the right to make such improvements.

A reasonable argument can be made to the contrary. The trustee also lacks the power to renegotiate a lease or enter into a new lease, but Rev. Rul. 2004-86 explicitly recognizes that the lessee may sublease the property and therefore can renegotiate and re-lease the property. The Ruling thus recognizes that a master tenant may be granted a right to take actions that the DST cannot. Moreover, the lease will be entered into prior to the transfer of the property to the DST. Accordingly, there is no necessary correspondence between the powers of the DST and the powers of the master lessee.

Whatever merit such arguments may have, many practitioners are not comfortable with the view that the tenant may make more than minor non-structural improvements. If the tenant has powers a DST is prohibited from possessing, there is significant risk that the DST could be viewed as having the power to vary its assets, which is impermissible in a fixed interest trust.[14]

One potential solution is to give the tenant the power to make structural modifications to the property, but require the tenant to restore the property to its original condition at the end of the lease term. The power to make structural improvements should not be viewed as a power to vary the interest of the beneficial owners of the DST in the property if the tenant is required to restore the property to its original condition at the end of the lease term, although there do not appear to be any authorities endorsing this position. One practical consideration is whether the tenant is willing to assume the financial obligations in connection with such a restoration obligation. Nevertheless, the addition of a restoration obligation appears to be a reasonable approach to dealing with the limitation on structural improvements to the property.

USING DSTs FOR DIFFERENT PROPERTY TYPES

The limitations discussed above make DSTs more suitable for offerings of certain types of property and less suitable for others. The ideal property for a DST is a commercial property, leased to a single creditworthy tenant pursuant to a long-term triple-net lease, or an investment in land that is leased to an end-user under a long-term ground lease. Nevertheless, prior DST offerings have included other property types. Because it may be easier to obtain financing for a DST offering than a TIC offering in the current lending environment, there is increasing interest in the use of DSTs for offerings of other property types. Some of the issues related to DST offerings of other types of properties are discussed below.

Commercial property. Some DSTs have been used to hold a typical commercial property with multiple tenants. The commercial property is made subject to a long-term master lease (to the sponsor or its affiliate), and then contributed to a DST.

One issue with respect to such transactions is that if any capital needs arise with respect to the property, there is no way to obtain the needed funds without terminating the DST. Thus, if one of the tenants should vacate the property, capital to make tenant improvements or other changes necessary to re-lease the property may not be available.

A DST must be classified as an investment trust and as a grantor trust for tax purposes if it is to be used in 1031 transactions.

As discussed above, the beneficiaries of the DST cannot contribute additional capital. The master tenant can provide the funds, but many sponsors have been unwilling to assume this economic risk. While tenant improvements with respect to such properties generally should be limited to minor non-structural improvements, the need to make structural improvements may cause issues in some situations. In that event, it may be desirable to have the improvements constructed by the space tenant combined with a restoration obligation.

Industrial properties. Industrial properties also pose challenges for DSTs. In general, lease terms for industrial properties are shorter than the projected holding period for commercial properties. As a result, there is a substantial likelihood that such properties may have to be re-leased during the investment period. In general, therefore, the property will have to be leased pursuant to a long-term master lease and the master tenant will have responsibility for re-leasing the property.

A new lease of industrial property may require substantial tenant improvements and reconfiguration of the space to accommodate new tenants. Some of the complexities involved in the analysis of whether

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[12] See Reg. 1.1031(k)-1(e).

[13] Possible distinctions between the actions that a DST may take and the actions a tenant may take make it important to distinguish between whether a lease is a net lease, a net-net lease, or a triple net lease.

[14] It can be argued that the same concerns do not apply where the master tenant is unrelated to the sponsor.

modifications to industrial properties constitute structural improvements already have been discussed above. Is the construction of a platform for new office space or the construction of a new bay door structural? What if bathrooms need to be moved or added or skylights need to be added to the roof to provide additional light because the space is being reconfigured for use by additional tenants? Whether such modifications are minor and non-structural, and the need for additional capital to make such modifications, are likely to be significant issues that will have to be carefully considered in connection with industrial properties.

Retail properties. Retail properties often are leased pursuant to a large number of short-term leases. Some properties pose a higher risk of tenant default. Retail properties frequently have complex relationships among tenants, including lease termination rights or provisions for abatement of rent if anchor tenants move out or "go dark."

Retail properties offered through a DST will need to be subjected to a long-term master lease and the master tenant may be required to assume significant risk. Substantial tenant improvements may be required in connection with the re-lease of vacant space, including structural improvements that could cause a kick-out. Accordingly, as a property class, retail properties pose some of the highest risks for offerings structured as DSTs.

Apartment buildings. Holding multi-family housing such as apartment buildings through a DST also may pose challenges for DST offerings, although the challenges are likely more manageable than for most other types of real estate. Since apartment leases are typically executed with terms much shorter than those of commercial property (typically one year or less), a long-term master lease would be required to ensure new tenant leases could be negotiated and executed.

If an apartment complex requires subsequent repairs and improvements, the sponsor can fund these improvements through the master tenant, but will be able to recover its investment only to the extent that the improvements result in a net increase in the rental income generated by the property. If more than minor non-structural improvements (apart from those required for health and safety) are required, the property may have to be "kicked out," as the DST will lack the authority to make the necessary improvements or to authorize the master tenant to do so.

Because of the number of lessees in apartment complexes, a restoration obligation may not be a realistic method of addressing the limitations on structural improvements. Accordingly, while apartment buildings can be suitable properties for DST offerings, the sponsor must take care in selecting properties that do not have major structural issues and that are likely to remain competitive in their respective markets without the need for substantial upgrades.

FINANCING ISSUES

DST offerings traditionally have been more attractive to lenders than TIC offerings because loans to DSTs are made to a single borrower, while TIC offerings involve up to 35 borrowers. It is easier to enforce a loan against a single borrower, to foreclose on a single borrower, and to ensure that a single borrower is bankruptcy remote. A DST is not affected by the bankruptcy of one of its beneficiaries, which can be a problem in a TIC offering. Moreover, beneficiaries of a DST possess little or no decision-making authority with respect to the property. By contrast, a significant number of decisions with respect to property held by TICs require unanimous consent.[15] As a result, the bankruptcy of a beneficiary of a DST is less likely to affect the operation of the property than the bankruptcy of a TIC or its owner.

Recently, there have been indications that lenders may be willing to fund DST offerings more readily than TIC offerings. Whether this will in fact be the case remains to be seen. As a result, however, sponsors who have traditionally structured their offerings as TICs are viewing DSTs with renewed interest.

Whatever relative advantages DSTs may have over TICs in the eyes of lenders, in the current environment lenders are increasingly looking to the sponsor for additional assurances that liabilities will be paid. The rules applicable to DSTs impose important limitations on the ability of the sponsor or owners of beneficial interests in a DST to provide such assurances. Some of these limitations are discussed below.

Loan guarantees by DST beneficiaries. Under Delaware law, beneficiaries are not liable for the obligations of the DST. As discussed above, Rev. Rul. 2004-86 specified that beneficiaries cannot have an obligation to contribute additional capital to the DST. This limitation appears to be justified. An obligation of the beneficiaries to contribute additional capital provides the DST with the power to vary the investment of the beneficiaries. The existence of such a power would cause the DST to be recharacterized as a partnership. A loan guarantee essentially obligates beneficiaries to contribute additional capital to the DST. Accordingly, beneficiaries cannot guarantee the obligations of the DST. The prohibition on beneficiary guarantees is absolute and includes guarantees of nonrecourse carve-outs and springing liabilities.[16]

This prohibition is an important distinction from TIC offerings. In TIC offerings, investors generally have been required to guarantee nonrecourse carve-outs and springing liabilities resulting from their own bad acts and the acts of the special purpose, bankruptcy-remote LLCs through which the investors

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[15] Rev. Proc. 2002-22, section 6.05.

[16] A nonrecourse carve-out is a provision imposing recourse liability for losses resulting from certain actions. A springing liability or springing recourse liability is a triggering event that converts all or part of a nonrecourse loan into a recourse loan.