Delaware Statutory Trusts and Their Use As Replacement Property in Like Kind Exchanges

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1. **Overview of Delaware Statutory Trust.** Revenue Ruling 2004-86 expanded the scope of replacement property to include interests in a Delaware Statutory Trust (DST) which itself owns real property.[2] Although finding application in myriad financial transactions and individual portfolios because of its attractive asset protection[3] and passive investment features[4], the DST has flourished as replacement property in like kind exchanges because of

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2 In approving exchange treatment, Revenue Ruling 2004-86 concluded: "Accordingly, the exchange of real property . . . for an interest in a DST through a qualified intermediary is 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 replacement property] is of like kind to Blackacre, and provided the other requirements of Section 1031 are satisfied, the exchange of real property for an interest in the DST . . .will qualify for nonrecognition of gain or loss under Section 1031."

3 The Delaware Act expressly provides that "[n]o creditor of the beneficial owner shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the statutory trust." 12 Del.C. §3805(b).

4 Investors seeking passive investment to diversify a portfolio into real estate may find the DST appealing. The DST also lends itself to estate planning, since the beneficial ownership interest can be divided into separate trusts among multiple beneficiaries, or bequeathed in fractions. As with other assets, a beneficial interest in a DST will receive a basis step-up when the owner passes.

its unique tax attributes.[5] Analyzing interrelated federal tax law concepts, the Ruling concluded that ownership in a (properly structured) DST owning real property[6] is, for federal income tax purposes, identical to owning the property outright. Since DST ownership interest is fractional, accredited[7] investors may diversify holdings among property classes, geographical locations, and investment strategies. Most syndicated offerings feature highly rated Class A "trophy" properties[8] with credit[9] tenants such as FedEx, Amazon or CVS.[10]

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5 If finding replacement property is difficult, or if the value of replacement is less than the relinquished property, a beneficial ownership interest in a DST can be used as insurance by identifying a DST in addition to other identified property. In a 1031 exchange, basis carries over to replacement property. By incurring debt in excess of that required to avoid boot gain, new depreciable basis can be created.

6 A Delaware Statutory Trust may be structured as a corporation, partnership or trust for federal income tax purposes.

7 An accredited investor is an individual with gross income exceeding $200,000 in each of the two most recent years, or joint income with a spouse or partner exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or a person with a net worth over $1 million, either individually or with a spouse, not including a primary residence.

8 DSTs are now being most actively marketed in geographic areas exhibiting the highest potential for growth. Those regions include (but are not limited to) the Carolinas, Georgia, Florida, Tennessee, Texas, Colorado, Utah, Nevada and Arizona.

9 A credit tenant is a tenant with exceptionally good credit, such that there exists a very high assurance of timely payment of principal and interest.

10 IRC §1031(a)(1) now applies only to qualifying exchanges of real property held for productive use in a trade or business, or for investment, and that is not held primarily for sale. Final Regulations provide three tests the satisfaction of any one of which will result in the determination the real property requirement under Section 1031 is satisfied:

(1) Is the asset treated as real property under state law?

(2) If an asset is not treated as real property under state law, is the asset specifically described in the final Regulations as an improvement to land or a structural component of an improvement to land?

(3) If an asset is not real property under state law and also is not specifically described in the final Regulations, is the asset treated as an improvement to land or a structural component of an improvement to land under the facts-and-circumstances test set forth in the Final Regulations?

DST syndications also offer varying amounts of debt which provide deductions that shelter income and increase the risk profile of the investment. New debt provided by a leveraged DST also provides new depreciable basis.[11] Since closing on a DST investment may take few as several business days, the DST may preserve an exchange where compliance with the 45-day replacement period under Section 1031 is problematic. Deferred exchanges involving DSTs are also now gaining currency as a stepping stone into a Real Estate Investment Trust (REIT)[12] under IRC §721.[13] The principal risk of a DST investment is an event of default which could entail a loss of all or part of the initial investment.

a. **Summary of DST Attributes.** The DST allows the investor to (i) obtain a fixed monthly passive income stream[14]; (ii) preserve capital in a medium to long-term

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Treas. Reg. §1.1031(a)-3.

Although defining what constitutes real property for purposes of Section 1031, the final regulations do not address the issue of whether relinquished and replacement property are of like kind.

11 However, a high degree of leveraged debt could decrease rental revenues and ultimately affect the ability of the DST to satisfy bank financing obligations.

12 Since REITS are personal property, they cannot serve as either relinquished or replacement property in a 1031 exchange. However, the DST can serve as a tax-deferred "bridge" to a REIT investment via IRC§721. Thus, DSTs in existence for 2 to 3 years (to satisfy the Section 1031 "held for" requirement) are being purchased by multi-billion dollar REITs through a 721/UPREIT exchange. After the exchange, the taxpayer receives operating partnership(OP) units of the REIT (rather than cash), which may qualify as a tax-deferred exchange under IRC §721. However, since the taxpayer receives a security, the eventual sale of the OP units will constitute a taxable disposition. This transaction enables an owner of property to use the DST as a means to invest in a REIT on a tax-deferred basis.

13 A sale by the DST of real property may be parlayed into an indefinite number of future 1031 exchanges provided real property is acquired in the subsequent exchange. In contrast, if the DST sales proceeds are exchanged under IRC § 721 for partnership interests, while the initial exchange will be nontaxable, any future sale of those interests will be taxable since partnership interests cannot be exchanged under IRC §1031. However, if the partnership interests were held at death, under current law the partner's estate would receive a step-up of the partner's outside basis.

14 If the property over-performs, the tenant's obligation is satisfied by payment of the fixed rent to the DST, unless the lease provides otherwise. Attempts to grant the DST a "take" in over-performance runs the risk of the lease not being deemed a "true lease," which would lead to unfavorable tax consequences. Although conditioning additional amounts on net revenue or

investment of five to ten (or sometimes more) years; (iii) defer capital gain recognition; (iv) obtain professional management,[15] (v) realize potential for capital appreciation and, if desired, (vi) reinvest proceeds in a subsequent 1031 deferred exchange or Section 721 nontaxable exchange. If the prospect of mortgage boot[16]

profit is anathema and will doom the lease for federal tax purposes, providing for higher monthly payments based on **gross revenue** of the master tenant is acceptable. Nevertheless, attempts to be creative in sharing gross revenues may result in the IRS scrutiny. The dichotomy whereby (i) the beneficial owners bear the entire risk of gain or loss on changes in property value when the property is sold at term end; and (ii) the tenant bears the entire risk of gain or loss with respect to rental revenues during the entire term of the DST illustrates the difference in the economic profiles of the master tenant and the beneficial owners. Where the tenant is not the sponsor's affiliate, it is unlikely that the tenant would agree to share revenues. However, if the tenant is the sponsor's affiliate and the property is being sublet, then the master lease might well provide for gross revenue sharing provisions. This duality may create tension between the beneficial owners and the sponsor. If rents are rising rapidly, but the property is not appreciating – an unlikely but possible scenario – the last thing the sponsor would want is to sell the property before the DST term ends. However, the beneficial owners might feel differently. In any such case, it is clear that under Delaware statutory law, the governing documents may expressly authorize the trustee to take any action the trustee deems appropriate, provided the action taken is fair and in good faith, a very low threshold to establish under Delaware statutory law.

15 The property manager acts pursuant to a property management agreement.

16 In a Section 1031exchange, boot refers to any non-like-kind property received in the exchange. Mortgage boot, a type of boot, occurs when debt on the replacement property is less than debt on the relinquished property. For example, if the mortgage on the relinquished property was $200,000, but the mortgage on the replacement property is only $100,000, the taxable boot would be $100,000. Since borrowing is a nontaxable event, various methods of finessing the issue of mortgage debt before a like-kind exchange exist. The objective is to equalize the debt on relinquished and replacement properties in order to vanquish mortgage boot. In some cases, mortgage boot can be avoided by paying down debt prior to the exchange. Thus, in the example, if the $200,000 debt was paid down to $100,000 before the exchange, then no mortgage boot would result. One important caveat exists: Whether new debt is incurred prior to the exchange, or the existing debt is paid down before the exchange, the transaction must be "old and cold," meaning it should occur well before the anticipated exchange. It should also possess a substantial business purpose. If not, the entire transaction could be challenged under the step transaction doctrine. Put simply, the IRS could argue that the transactions occurring close to the exchange should be ignored for tax purposes. **By selecting one or several bespoke DST investments with differing amounts of built-in debt, the taxpayer can avoid the issue of mortgage boot in a DST investment apparently without tax risk.**

looms, carefully selected leveraged debt may assist in debt balancing.[17] Return on the investment occurs when the property is sold at or before the end of the DST "hold" term. Although beneficial ownership interests in a DST may be sold by the owner during the term of the DST, substantial restrictions render the beneficial ownership interest rather illiquid.[18]

b. **Delaware Statutory Trust Defined.** A Delaware Statutory Trust is an unincorporated association recognized as an entity separate from its owners. The trust may sue or be sued, and property within the trust is subject to attachment or execution as if the trust were a corporation. Beneficial owners of a DST are entitled to the same limitation on personal liability extended to stockholders of a Delaware corporation. DST interests are freely transferable, but are not publicly traded on an established securities market.[19] Delaware Statutory Trust Act, 12 Del. C. 3801 et. seq. (1988). A DST may merge or consolidate with or into other entities such as a partnership.

c. **Trustees.** A DST must have (i) a Delaware trustee that maintains an office in Delaware for service of process; (ii) a "signatory trustee," often the sponsor, to manage the ministerial affairs of the DST, which include making mortgage payments and distributions to beneficial owners; and (iii) an independent trustee that protects the interests of the lender.[20] The signatory trustee holds legal title to trust assets and must adhere to the terms of the trust agreement. Although under the statute, the trust

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17 Investors whose relinquished property carries mortgage debt need to be replaced with new debt to avoid boot gain. PLR 9853028 stated that a new mortgage placed on the replacement property could be netted against an existing mortgage on the relinquished property. The taxpayer's immediate satisfaction of the new mortgage encumbering the replacement properties was inconsequential.

18 Although the transfer of interests held by beneficial owners is permitted, a number of qualifications limit the transferability of those interests. Transfer of interests may require (i) notice and consent of the bank; (ii) execution of confidentiality agreements by the prospective transferee; (iii) execution of other documents; and (iv) acceptance by the trustee. A beneficial owner may give or bequeath an interest without restriction, or sell the interest to another beneficial owner of the same DST. While sale to an outside investor is permitted, due to lack of an established market, the sale price may not reflect the value of the interest.

19 Under the Delaware Act, beneficial owners can contribute any form of property to a statutory trust in exchange for their beneficial interest. 12 Del.C. §3802(a).

20 A signatory trustee generally can only vote on a determination by the DST to file for bankruptcy.

may expand, restrict, or eliminate fiduciary duties owed to beneficial owners, the trust operates under an implied contractual covenant of good faith and fair dealing. Del.C. §3806(c). However, since rights of beneficiaries are invariably restricted in DSTs, a failure to satisfy the good faith requirement would require a failure to provide beneficiaries even their already restricted rights. In a sense, this outcome is consistent with the passive nature of the DST investment, and even its allure. Once the investment is made, beneficial owners sail along as passengers on the DST vessel, enjoying the income but not having any control over the destination of the trust. That is precisely why it is important to read and understand the private placement memorandum and governing documents.

d. **Sponsor.** The sponsor is an entity that organizes, funds and operates (itself or through an affiliate) the acquisition and management of property offered to accredited investors through a syndicated offering of DST interests in a special purpose entity (SPE)[21] owning real property. Typically, sponsors will specialize in a particular category of property. Although the sponsor will usually own the DST during the nascent offering period, the retention by the sponsor of any beneficial ownership past the offering period risks violating Rev. Rul. 2004-86, and could cause the DST to be taxed as a partnership. Despite this risk, some lenders may encourage or even require sponsors to retain ownership in a DST, or may require financing arrangements or guarantees that also risk violating Rev. Rul. 2004-86.[22] Sponsors may be able to secure financing at rates below that which would be available to an individual investor.

i. **SEC Oversight of Sponsor.** DSTs are regulated by the Securities and Exchange Commission. Compliance requires the expenditure of time and expense by the sponsor. SEC oversight helps ensure that the sponsor meet reporting and fiduciary obligations.

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21 A special purpose entity is a legal entity created to fulfill a narrow, specific purpose. SPEs are typically used to isolate a company from financial risk.

22 The sponsor retaining both an ownership interest in the DST as well as an interest as master tenant in a master lease agreement with could pose a conflict of interest. The conflict could arise because the interests of a beneficial owner and a master tenant might diverge in various situations. Having the sponsor retain a small equity interest in the DST may appease the lender, but otherwise accomplishes very little and creates unnecessary tax risk.

e. **Importance of Reputable Sponsor.**[23] The Delaware Act provides that the business affairs shall be managed "by or under the direction of the trustee." Del.C. §3806. Although Sections 3801(c) and §3806(a) of the Delaware Act expressly permit beneficial owners to participate in the management of the trust without being deemed trustees or otherwise losing the limited liability that attaches to the status of a beneficial owner, in practice sponsors typically retain all substantive powers in the DST.

f. **Uninsurable Risks and Nonrecourse Carve-Out Guarantees.** While the DST may self-insure, catastrophic risks such as those relating to floods, wars or terrorism may not be insurable. Property could later be found to contain toxic waste or hazardous substances. Under a nonrecourse carve-out, the sponsor would be liable under a "hazardous material indemnity agreement" that indemnifies the lender from any and all liability under all state and federal environmental or hazardous materials laws. However, beneficial owners are not direct borrowers under the loan and do not sign nonrecourse carve-outs. Therefore, a beneficial owner cannot be held personally liable for any claims made against the DST. This is a actually major advantage of the DST over the tenancy in common, where tenants in common may at times be held personally liable for debts relating to the property.

g. **Property Financing Must be Respected as Debt.** Beneficial owners could be deemed to have entered into a partnership if notes used by the sponsor to purchase the property are recharacterized as equity for federal income tax purposes. Whether an instrument intended to be debt will be respected for tax purposes depends on factors which include the following: (i) whether the notes have a fixed maturity date and fixed interest rate; (ii) whether the notes do not provide for contingent interest; (iii) whether the notes are consistent with the net economic return derived by the holder; (iv) whether the holder possesses a right enforce payment of principal and interest; (v) whether the holder's interests are senior to other creditors; (vi) whether the holder of the note has no involvement in the management of the properties; and (vii) whether the debtor is adequately capitalized.

23 The interest of a beneficial owner may not always align with that of the sponsor. If those interests diverge, the beneficial owner may disagree with a decision of the trustee, but have no available remedy. For example, a decision to sell the property is exclusively within the province of the sponsor, as would be a decision on whether to make a transfer distribution. With respect to fiduciary duties owed to beneficial owners, the statute provides that trustees are not liable to the trust or to trust beneficiaries for acts taken in good faith reliance on the provisions of the governing instrument and that the fiduciary obligations of a trustee may be varied by the trust instrument. 12 Del.C. §3806(d).

h. Investor Representations. Investors are generally *required to state* (if made through an offering) that (i) it has obtained legal advice; (ii) that it understands no advance ruling has been requested; (iii) that it understands the complexity of Section 1031 exchanges; (iv) that it understands that the IRS may disagree with the opinion of tax counsel[24] (for sponsor); (v) that it understands the existence of uncertainties in the tax treatment of real estate; and (vi) that it understands the risk of tenant default, interest rate changes, environmental issues that could affect property value, and other risks associated with owning real estate.[25]

i. Asset Management Agreement. The sponsor's affiliate will typically enter into an asset management agreement with the trustee. The asset manager may provide limited ministerial services to the DST. The asset manager is paid a negotiated percentage fee for its services. No agency relationship is intended to arise between the DST and the asset manager. In fact, it is imperative that the DST not be an agent of the sponsor for if it were, the DST would likely not be recognized as a separate entity for federal income tax purposes.

i. Property Management Agreement. The asset management agreement is not to be confused with the property management agreement, which is an entirely different animal. The DST will often enter into a triple net lease with a "master tenant" to operate and manage the real property. The master tenant is usually owned by the asset manager (above paragraph), an affiliate of the sponsor. The master tenant may engage a property manager to enter into subleases, and perform necessary property repairs. The sponsor will generally control both the master tenant and the property manager.

j. Broker-Dealers. Being securities, DST offerings may be marketed through licensed

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24 The opinion of tax counsel for sponsor might be made pursuant to an offering made through a Private Placement Memorandum (PPM) when required by securities law, or by a "term sheet" or other disclosure document when it is not. Whether or not disclosure occurs through a PPM or other legal document, federal securities law requires issuers to provide accurate information with respect to investment risks. Even when not strictly required, a PPM may be utilized since investors may expect it, and sponsors may consider deem it necessary to reduce risk.

25 The Delaware Act expressly provides that unless otherwise stated in the governing instrument, the business and affairs of the DST "shall be managed by or under the direction of the trustee." Del.C. at §3806.

broker-dealers, who perform due diligence, document preparation, sales, and securities compliance. Brokers are regulated by the Financial Industry Regulatory Authority (FINRA), a private corporation that regulates brokerage firms and exchange markets whose "mission" is to protect investors in the securities industry. Some brokers are affiliated with sponsors, a relationship requiring disclosure. A broker-dealer may hold the securities license for a group of registered representatives.

k. **Registered Investment Advisors.** RIAs serve in an advisory role and are compensated by fee rather than commission. Some RIAs specialize in the DST market. RIAs fall under the regulation of the SEC, a federal agency with greater regulatory authority than FINRA. The SEC has power to create and enforce securities laws.[26] Some broker-dealers are also Registered Investment Advisors.

l. **Comparison to Tenancies in Common.** A tenancy in common may have up to 35 owners, whereas a DST may have up to 499.[27] Whereas a separate loan must be made to each owner of a TIC interest, the DST has only a single borrower. DST investors are not required to provide financials and the credit report of an investor will be unaffected by the investment.[28] Only the sponsor requires financing. A DST investment is almost entirely passive. The same cannot be said of a TIC investment: The right of TIC owners to vote on issues may delay administering the property, and obstinate TIC owners may be an impediment to the functioning of the TIC. Beneficial owners of DSTs have no voting power and are entirely passive investors. The owner of a TIC interest must form a bankruptcy remote single-member LLC to hold the interest. The DST is itself a bankruptcy remote entity. While a beneficial owner of a DST enjoys personal liability protection from all claims made against the DST, a TIC owner does not enjoy the same protection: The TIC owner could in some instances have personal liability exposure for loans made to the TIC or for nonrecourse carveouts.

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26 The Supreme Court, in *SEC v. Jarkesy*, (22-859, 6/27/2024) recently ruled that the SEC must pursue civil penalties for securities fraud in federal court rather than through administrative proceedings.

27 DSTs may be owned by any number of persons, although ownership by more than 499 persons would cause the DST to constitute a security subject to federal securities laws.

28 Some sponsors require that an investor be accredited. The lender may require that a person owning 25 percent or more of a beneficial interest be underwritten.

i. **Limitations of DST Require Negotiating Rocky Terrain.** The substantial benefits accorded to DST investors are the fruits of DST limitations. While neither a TIC nor a DST may operate as a business, a TIC may borrow money, whereas a DST may not. The trustee is prohibited from taking any action that could vary the investment of beneficial owners. These prohibitions are termed the "seven deadly sins." For example, a major repair following a hurricane could pose an insurmountable problem for a DST if rent receipts and reserves were insufficient for the master tenant to mitigate property damages. Unless the insurer stepped up with alacrity, the DST might have no option but to terminate the trust and engage in a "transfer distribution" of trust assets to a new or existing LLC.[29] Traditionally, the DST has been most common when used with credit tenants entering into long term triple net leases involving Class "A" property not likely to require major repairs or renovation.

2. **Projected Annual Rate of Return.** Many DSTs[30] provide a projected annual cash-on-cash return (also referred to as "cash flow") of between 4 and 9 percent. The projected return is net of expenses, which include (i) management fees, (ii) debt service and (iii) property expenses. Cash flow is typically paid to investors on a monthly basis.[31] These expenses may shelter some or most DST income. Beneficial owners annually receive Form 1099 indicating their pro rata share of rental income and expenses. Projected cash flow is just that: There is no assurance that the property will provide the necessary rental income to meet projections; nor is there any assurance that the property will appreciate over the term of the DST. The DST possesses those risks inherent in real estate ownership[32] as well as risks specific to

29 Where a "master tenant" structure has been used, a sponsor might be able to infuse new money to effectuate repairs, but might hesitate since there would be no way to recoup the outlay.

30 Some specialized DSTs, termed "zero coupon" DSTs, in lieu of providing income to the investor, use any excess cash to pay down debt. The objective is to profit from property appreciation while deferring gain.

31 Distributions are typically made between the 5th and the 15th of the month following the month income is earned. Quarterly reports are provided which discuss the financial status of the property and factors impacting performance.

32 These include increased vacancies, economic recession, catastrophic weather events, environmental liabilities, and market fluctuations.

DSTs.[33] One risk arising with longer-term DSTs involves inflation. If the lease fails to keep up with the rate of inflation, it may become more difficult for the DST to meet the projected rate of return to investors. So too, if interest rates rise, the real estate market may weaken, also making it more difficult for the DST to provide the expected income and property appreciation.

a. **Effect of Debt.** DST offerings come with varying amounts of debt, ranging from no debt to highly leveraged properties. A high level of debt reduces cash flow and may put a strain on the ability of the DST to meet financing obligations. Yet the safety of an investment does not necessarily directly correlate with the amount of debt the property is carrying: Poorly performing properties can have low debt and well performing properties can have a high amount of debt.

b. **Effect of Income Tax in State Where DST is Located.** A beneficial owner's taxable income depends on income tax rate imposed by the state where the property is located. However placing an inordinate amount of importance on choosing a DST owning property only in a low tax state may not be advisable. First, income may be sheltered in whole or substantial part by deductions, especially with highly leveraged DSTs; and second, a highly investable property may be situated in an income tax state. Therefore, the presence of an income tax should be a factor, but not necessarily a disqualifying factor when choosing a DST.[34]

i. **Most DSTs Established in Favorable Tax Venues.** Still, many DSTs are created in the no-income tax jurisdictions of Florida, Texas, Nevada and Tennessee. Low property-tax states are also popular venues for DSTs: South Carolina (0.57% property tax; 0-6.5% income tax), Colorado (0.51% property tax; 4.4% income tax), Utah (0.62% property tax; 4.85% income tax) and Nevada (0.6% property tax; no income tax). Sunbelt states North Carolina (4.75% income tax), Arizona (2.5% income tax) and Georgia (1-5.57%

33 These include (i) risk of loss due to leverage; (ii) management lapses; (iii) interest rate changes; (iv) climate changes; (v) violation of the seven Ruling prohibitions; and (vi) illiquidity during the DST term.

34 "Don't let the tax tail wag the investment dog" is a well-known aphorism cautioning against over-reliance on tax issues when making investment decisions.

income tax) are also home to many DSTs.[35]

c. **Income Tax Liability of Beneficial Owner.** Each beneficial owner is required to report its own net income or loss from the DST. Certain expenses such as depreciation, will vary among beneficial owners. The Tax Cuts and Jobs Act of 2017 (TCJA) provides that "business interest" expense is not deductible to the extent such interest exceeds 30 percent of a taxpayer's "adjusted taxable income" as defined in Section 163(j). Business interest is defined as interest paid or accrued on indebtedness allocable to a trade or business for federal activities. Real estate activities are subject to the new rule.

d. **Sponsor's Acquisition of Property.** The DST is formed by the sponsor (or sometimes by its affiliate), a professional real estate company, who is the sole initial beneficiary. The sponsor will transfer equity-raised funds and financing obligations, if any, to the DST, which will then purchase the property. At closing, the bank will take a perfected security interest[36] in the property. Initially, the DST need not qualify as a separate entity for tax purposes, and need not comply with the prohibitions imposed on DSTs seeking qualification under Rev. Rul. 2004-86. At this point the DST is treated as a business entity which, since it is disregarded, has no separate filing requirements. The initial trust agreement details the transition from a business entity to its ultimate tax status as a "fixed investment trust" that complies with Rev. Rul. 2004-86.

i. **Conversion to a Fixed Investment Trust.** Conversion for tax purposes from a business entity to a fixed investment trust occurs by operation of law pursuant to provisions in the initial trust agreement. The conversion typically occurs when the sponsor has sold the first beneficial interest in the DST to an outside investor. All financing arrangements must be concluded at the time the entity becomes a fixed investment trust. Two class of trust are present in the conversion process: The sponsor relinquishes Class "A" beneficial

35 By comparison, New York has an average property tax rate of 1.4% and an income tax rate ranging from 4% to 10.3%. New York City imposes an additional income tax of between 3% and 3.876%.

36 A perfected security interest is a legally enforceable security interest in property that takes priority over other interests. It gives the lender or secured party the right to seize the collateral if the borrower defaults. A security interest is perfected by filing a financing statement, known as a UCC-1, with the secretary of state.

interests which the DST redeems for Class "B" beneficial interests. Investors purchase those Class B interests through funds escrowed with the Qualified Intermediary. Once all of the sponsor's interest in the DST has been sold, the syndication is closed. The DST is now required to comply with the requirement of Rev. Rul. 2004-86.

ii. **Asset Management Agreement.** Once a syndicated offering is concluded, the sponsor will have sold all beneficial ownership interests. At that point, the DST through its trustee may enter into an asset management agreement with the sponsor's affiliate. The role of the asset manager is to perform ministerial functions, such as ensuring that (i) rents are received; (ii) required property expenses are paid; (iii) proper reserves are maintained; (iv) required distributions to beneficial owners are made; and (v) a sale of the property be consummated if directed by the trustee. Actions taken pursuant to the asset management agreement must comply with the terms and restrictions imposed by Rev. Rul. 2004-86.

e. **Sponsor Should Not Retain Beneficial Ownership in DST.** Lenders may request – or at times even insist – that sponsors retain an interest in the DST past the offering. Retaining such an interest as an investor would not likely violate the seven "deadly sins," since a retention of an interest alone does not vary the interest of the beneficial owners. However, if the tenant is an affiliate of the sponsor (which might occur if a master trust is involved), the retention of an ownership interest could violate the single-class of interest rule applicable to fixed investment trusts. This could occur because the sponsor would have an ownership interest and also an interest as lessee. The result of a violation of the single-class of interest rule would cause the DST to be characterized under the regulations as a business entity, and thus taxed as a partnership.[37]

i. **Sponsor's Temporary Ownership During Offering Permissible.** Although there is no direct authority, it is generally assumed that the sponsor may retain ownership in the DST for the time necessary to sell the DST interests through

37 Rev. Rul. 2004-86 emphasized the abdication by the trustee of nearly all conceivable powers, retaining only the minimum powers necessary to operate the trust. Rev. Rul. 78-371 reached the opposite conclusion and classified the trust as a business entity. In that ruling, the trustee retained powers consistent with a profit motive. In Rev. Rul. 2004-86, since only a single class of trust interests existed, and the trustee had no power to vary the investment of beneficiaries by benefitting from fluctuations in the market, the DST was classified as a trust under the Regs. 301.7701-4(c)(1).

an offering, which should be a fixed period of time stated in the offering documents. This conclusion tracks the rule in Rev. Proc. 2002-22, applicable to the sale of interests in tenancies in common. Should construction continue beyond the date the beneficial ownership interest is acquired, the renovated property will still qualify for exchange treatment. However, the portion of construction costs expended after the acquisition of an interest by a purchaser will constitute taxable boot under Treas. Regs. §1.1031(k)-1(e)(4).

3. **Fees and Commissions.** Fees associated with DST ownership include (i) acquisition fees ("load"); (ii) management fees; and (iii) disposition fees. Up-front fees can range from between 10 to 18 percent of the equity invested. The debt-to-equity ratio for many DSTs ranges from 45 to 55 percent, although some DSTs have less or no debt, and some have considerably more.

a. **"Load."** Load is a term used to described the <u>total amount of capital</u> allocated toward fees and reserve accounts. <u>Load is "baked" into the investment cost basis</u>. The higher the load, the greater the income required in order to reach break-even on the investment. In some cases, unused reserves at term end are refunded to beneficial owners.

i. **Fees Included in Load.** These include sponsor acquisition fees, wholesaling fees, investment advisor fees, broker-dealer allowances, and other organizational expenses.

(1) **Sponsor Acquisition Fees.** Also referred to as a "<u>finder's fee</u>," this consists of payments to the sponsor for identifying, negotiating and financing the acquisition. The sponsor is also compensated for due diligence, and may receive an additional fee for obtaining financing for the acquisition. The fee also represents work involved in setting up the trust as a separate legal entity. The finder's fee may range from 2 to 4.5 percent of invested equity.[38]

38 According to one sponsor's brochure, DST sponsors may employ an acquisition team with real estate, legal, accounting, due diligence, and technical professionals. The 2 to 4.5 percent acquisition fee represents 1 to 2 percent of the total offering amount depending upon the amount of mortgage financing utilized by the DST. The DST may also reimburse due diligence and acquisitions costs of the sponsor. *"Understanding DST Fees and Expenses,"* June 16, 2022, by Inland Securities Corporation.

(2) **In-House Wholesaling Fees of Sponsor.** Sponsors often utilize an in-house selling team, known as wholesalers, who work with Registered Investment Advisors to ensure sponsors have the information and documents required to effectively market an offering. Wholesalers are typically responsible for a particular geographical area and are compensated by commission for sales in their region.

(3) **Registered Investment Advisor Fees.** Most syndicated offerings are accomplished through Registered Investment Advisors whose fees are also built into the offering. Being securities, DST offerings may also be marketed through broker-dealers, <u>who perform due diligence, document preparation, sales, and securities compliance</u>. Registered Investment Advisor fees may range from 5 to 9 percent of the load. Those fees are calculated by reference to rental income and the hold period of the invested properties, not the total price of the property.

(4) **Broker-Dealer Allowance.** Managing broker-dealers are often reimbursed for marketing expenses and due diligence efforts. This allowance can be in addition to managing broker-dealer fees, and is used to cover costs of obtaining third-party reports, marketing materials, or other items.

(5) **Offering and Organizational Expenses.** These include costs incurred establishing and maintaining the trust, effecting securities registration, producing marketing materials, covering printing costs, and satisfying other miscellaneous costs. Many of these expenses reimburse the sponsor.

ii. **Fees Not Included in Load.** These include asset management fees, property management fees and disposition fees.

(1) **Asset Management Fees.** Asset management fees typically range from 1 to 2 percent of the total equity invested. The fees include those amounts expended for (i) accounting and bookkeeping; (ii) investor relations and communications; (iii) overseeing the group in charge of managing the property; (iv) communicating with investors; (v) distributing regular performance reports to investors; and (vi) managing finances.

(2) **Property Management Fees.** The property manager typically maintains the structure and grounds of a property, collects rent, manages budgets, pays expenses, oversees tenant relations, secures new tenants as needed, and manages employees. The fee can range from 3 to 5 percent of gross monthly income, and is commensurate with the rate for that property type in a particular geographical area.

(3) **Disposition Fee.** The disposition fee when property is sold can range from 0 to 3.5 percent of the sale price of the property.

b. **Load-to-Equity Ratio.** A typical load to equity ratio is between 10 and 18 percent.[39] Although instructive, the metric may be deceptive, since factors causing it fluctuate may have little correlation with the expected revenue or profitability of the DST.

i. **Debt and Equity Variations May Skew Ratio.** Assume DST offering has $50M equity and $50M of mortgage debt. (A 50 percent loan-to-value is typical in DST offerings.) Sponsor charges a load of 19 percent. Consider the effect of keeping the load fee in dollars constant, but increasing the equity raised in the syndication to $100M: The load-to-equity ratio would be halved, to 9.5 percent. [i.e., load = $50M(.19) or $19M) ; $19M/$100M = 9.5%.)] While raising twice as much equity certainly makes the economic picture more compelling, it is not clear that the decrease from 19 to 9.5 percent is as significant as it might appear. Now consider the situation where raised equity were only $25M. Now the load to equity ratio would appear to increase to 76 percent. It seems logical to conclude that such dramatic variations in the load-to-equity ratio based on changes in raised equity underscore the somewhat arbitrary nature of the load-to-equity ratio. Put another way, it may be fair to ask whether raised equity should invariably be a bellwether of the soundness of a DST investment.

c. **Other Flawed Assumptions Concerning Load.** Other assumptions concerning load merit further examination. The first involves what is termed the "denominator" problem; the second involves the fact that one component of "load" is not a fee but rather an amount held in reserve that may be returned to investors.

i. **The Denominator Problem.** The flawed assumption that DST investments require astronomically more fees than real estate sales, may in part be

39 The "load" is exclusive of ongoing asset management fees throughout the term of the DST.

explained by the fact that real estate sales calculate expenses based on a percentage of the total value of the property, including debt. Expenses for DSTs are expressed as a load-to-equity ratio which entirely ignores debt. This skews the expression of acquisition fees for DSTs higher than for purchases of real estate because the overall value of DST property will often be more than the equity, sometimes much more.

ii. **The Reserve Assumption.** Finally, load includes reserves, which seem fundamentally different than other fees, but are included as part of the capital budget when acquiring property. Reserves are set aside in advance for specified or potential property repairs or improvements. They are created because DSTs cannot raise additional capital after the offering. Some sponsors will return unused reserves to investors at the conclusion of the DST term.

iii. **Increased Investable Capital With DST.** Assume investor owns a building on worth $1 million with an adjusted basis of $100,000. After tax, assume because of depreciation recapture, a straight sale leaves roughly $700,000 available for investment.[40] In a DST investment, the entire million may be reinvested. Fees and commissions are built into the cost of acquiring a beneficial ownership in a DST. Although the DST may be leveraged, the investor's risk of loss is limited to cash invested. Leverage does increase the volatility and risk of the investment.[41]

d. **Investor's Risk Limited to Initial Cash Investment.** An investor's risk is limited to the price paid for the beneficial ownership interest. This true regardless of the amount of nonrecourse debt incurred by the DST. A typical loan to value ratio in a leveraged DST is between 40 to 65 percent. Leveraged DSTs will skew gains or losses in either direction. Beneficial owners are not liable for any debts incurred by the DST, including nonrecourse "carveouts," or any other claims made against the DST.

40 Assuming tax imposed at following rates: capital gain, 20%, depreciation recapture, 25%, New York capital gain, 5.7%, Medicare tax, 3.8%.

41 As a means of acquiring leverage, the interest rates available for a large DST syndication will generally be lower than those rates available to an individual investor. For investors with a substantial amount of debt that needs to be replaced in an exchange, the lower rate of interest may appealing.

4. **Revenue Ruling 2004-86.** To qualify as replacement property, a DST must comply with the requirements imposed by Rev. Rul. 2004-86,[42] i.e., (i) that it is not an agent of either its owners or the sponsor; (ii) that it is not a disregarded entity; (iii) that it is a fixed investment trust and not a business entity; that it (iv) prohibits the trustee from exercising any of seven forbidden powers; (v) that it is deemed a property interest under the grantor trust rules; and (vi) that not achieve partnership status under common law rules; and (vi) that it not constructively violate the prohibition on the renegotiation of lease or financing agreements through loan guarantees.

   a. **DST Not An Agent of Owners or Sponsor.** Neither the DST nor the trustee is the agent of, or holds itself out as being the agent for the sponsor.[43] Nor does the DST hold itself out as agent for third parties. The DST should not be viewed as an agent of the beneficial owners, because unlike the trusts in *Commissioner v. Bollinger*[44] and Revenue Ruling 92-105, 1992-2 C.B. 204, the beneficial owners possess no right or

42 Unless the Ruling requirements are met, the entity – even if a trust for Delaware trust purposes – would no longer be a "fixed investment trust" for federal income tax purposes, but rather a business entity taxed as a partnership. Since partnership interests cannot be exchanged, the property would not qualify as replacement property. Moreover, if the IRS determined that the entity was a business entity for tax purposes within two years of the offering, particularly dire tax consequences could obtain: The IRS might seek to invalidate the initial exchange based on a violation of the "held for" requirement under Section 1031. If successful, a cascade of harms would ensue: The initial deferred exchange would be voided, resulting in immediate tax to the beneficial owners. Since the property would still be tied up in the trust, beneficial owners would be without the use of exchange proceeds to pay the tax liability. In order to renegotiate the DST lease or to take other ameliorative actions, a transfer distribution might be required. Otherwise, the property might need to be sold.

43 Purchasers of beneficial interests will have no right or power to contribute additional assets to the master trust, cause the master trust to negotiate or renegotiate mortgage loans or leases, or cause the master trust to re-invest the proceeds of a sale of its assets.

44 In *Bollinger*, the IRS disallowed a partnership's losses on the ground that they were attributable to the corporate owner of the property. The Supreme Court held that the partnerships were owners for federal tax purposes, since an agency relationship existed between the corporation and the partnership. The Court agreed with the Commissioner that evidence of an agency relationship is required, but the evidence need not be proof of an arm's length dealing between the principal and agent, and payment of an agency fee. Rather, adequate proof is "assured" where the agency relationship is "set forth in a written agreement at the time the asset is acquired, the corporation functions as agent. . . and is held out as agent in all dealings with parties." 485 U.S. 340, 61 AFTR2d 88-793 (1988).

power to direct the actions of the DST, the trustee, or the tenant, in connection with the management or operation of the DST or the real property.[45] Since the DST is not an agent of these entities, this lends support to its existence as a separate entity for federal income tax purposes.

b. **DST Not a Disregarded Entity.** A DST is an unincorporated association recognized as an entity[46] separate from its owners that may sue or be sued, whose property is subject to attachment or execution as if the trust were a corporation. Beneficial owners are entitled to the same limitation on personal liability extended to stockholders of a Delaware corporation. 12 Del. C. 3801 *et. seq*. (1988). Accordingly, the Ruling concludes that the DST is a separate legal entity for federal income tax purposes.

c. **DST A Fixed Investment Trust and Not a Business Entity.** Reg. § 301.7701-4(a) defines a "trust" as an arrangement created by will or inter vivos declaration pursuant to which trustees take title to property to protect and conserve it for beneficiaries. Nevertheless, entities designated as trusts under state law to carry on a profit will be classified as partnerships or corporations for federal income tax purposes. Since the

45 In Rev. Rul. 92-105, an Illinois land trust was disregarded, thus permitting a trust beneficiary to engage in a Section 1031 exchange. The beneficiary had retained the obligation to pay taxes and liabilities relating to the property. The beneficial owner in Rev. Rul. 2004-86 had no such obligations and no personal liability. Finally, whereas the Illinois land trust beneficiary retained the right to manage and control trust property, beneficial owners of a DST have no right to manage trust property. The paucity of powers exercisable by the beneficial owner caused the trust in Rev. Rul. 2004-86 to be recognized as a separate legal entity. As general rule, courts have been lenient in not finding an agency where the taxpayer engaged an accommodator to facilitate an exchange. See *Mercantile Exchange Company of Baltimore, Board of Tax Appeals* (1935); *Coupe v. Comr*., 52 T.C. 394 (1969), acq., 1970-2 C.B. xix. N.

46 Traditionally, trusts have been viewed as a right, enforceable in equity, to the beneficial enjoyment of property held by another. Thus, the dissent in *Venture, L.P. v. Blasimgame*, 947 G3d 925 (6th Cir. 2020) concluded that "[a] trust isn't an entity at all." Nevertheless, the current school of thought views trusts in a different light, and accords them status as a separate legal entity akin to a corporation or partnership. Delaware apparently takes that view in elevating the Delaware trust to the status of a separate legal entity. Federal tax law does not go quite so far: It recognizes DSTs that comply with Rev. Rul. 2004-86 as not being "disregarded" for purposes of determining that the trust should be taxed as a trust, rather than as a corporation or partnership. Yet for purposes of imposing tax on the trust the grantor trust rules have other designs: It proceeds to disregard the DST for purposes of determining the tax liability of beneficial owners.

DST is not disregarded, determination is required as to whether the entity is a fixed investment trust or a business entity. To be classified as a fixed investment trust (i) the DST must not be a business or commercial trust created by the beneficiaries simply as a device to carry on a profit, and the trustee must possess no powers that indicate an intent to carry on a business; (ii) the trustees' activities must be limited to the collection and distribution of income, but also may entail ministerial activities necessary to maintain and operate the DST under local law; (iii) the trustee must distribute all available cash (less reserves) quarterly to each beneficial owner in proportion to that owner's respective interest in the DST; (iv) the trustee may not exchange real estate or purchase assets other than short term Treasury obligations; and (vi) the trustee must have no power to vary the investment of the certificate holders and may not take advantage of variations in the market to improve the investment. Rev. Rul. 2004-86 concludes that since those requirements are met, the DST is a fixed investment trust for federal income tax purposes, and is not subject to reclassification as a business entity under Regs. § 301.7701-4(c)(1).[47] *See Com'r v. North American Bond Trust*, 122 F.2d at 546, (1941).

d. DST Prohibited From Granting Trustee Any of Seven Forbidden Powers. Ruling 2004-86 warns that the *mere existence* of any prohibited power, *i.e.*, "the Seven Deadly Sins" in any offering document will result in the DST being classified as a business entity and therefore be taxed as a partnership for federal income tax purposes. Note that the Ruling only requires that the trustee *be vested with the proscribed powers* for disqualification to result: *The trustee need not exercise the power.*[48] If the DST does meet the unfortunate fate of being classified as a business entity, the interest will be treated as a partnership, and qualification as replacement property in an 1031 exchange will be precluded.[49] The "Seven Deadly Sins" moniker, perhaps overly colorful when ascribed to a trust, has nevertheless been appropriated from biblical origin by tax lawyers to describe the fateful consequences emanating

47 See *Com'r v. North American Bond Trust,* 122 F.2d at 545 at 546. (CA-2, 1941), *cert. den*. 314 U.S. 701 (1941).

48 Id.

49 If one of the "sins" occurred after two years, the IRS could probably not void the initial exchange. However, it could still make life miserable for the DST and its beneficiaries, since the DST would no longer qualify as a fixed investment trust.

from a violation of restrictions intended to protect beneficial owners[50]:

i. **No Future Capital Contributions.** Once an offering is closed, the trust cannot accept additional contributions from new or current members. This rule protect the interest of beneficial owners, since new borrowing could dilute their ownership percentages, and cause the DST to be taxed as a partnership.

ii. **No Renegotiation of Loan and No New Borrowing.** The DST may not renegotiate existing loans or secure new loans. The rationale is that since beneficial owners do not have voting rights, the rule protects them from changes that could alter the risk of their investment. There is one exception: New borrowing or renegotiation of existing loans is allowed if the current tenant declares bankruptcy or is insolvent, or if the loan is currently in default or is at risk of being defaulted.

iii. **No Lease Negotiation or New Leases.** This rule is intended to encourage trustees to secure longer-term leases, resulting in less risk for beneficial owners. DSTs with short-term leases, such as apartments or storage, are often structured with a master lease to mitigate this risk. A master lease involves the DST leasing the property to a "master tenant" (discussed infra), who may enter into new subleases with underlying sub-tenants. As is the case with loans, the DST may be allowed to renegotiate leases if the current tenant is bankrupt or insolvent or is facing bankruptcy or insolvency.

iv. **No Reinvestment of Sales Proceeds.** Once the property owned by the DST is sold, the DST terminates, and the sales proceeds must be distributed to beneficial owners in proportion to their ownership interests (after sponsor recoups whatever is owed to it).

v. **No Significant Modifications[51] Unless Otherwise Required by Law.**

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50 The prohibitions exist to protect the interests of the beneficial owners, and specifically to prevent the varying of their interests, which could cause the entity to lose its status as a fixed investment trust.

51 Rev. Rul. 2004-86 fails to clarify the meaning of "significant modifications." Some have suggested that guidance be drawn from the REIT "prohibited transaction" rules, which apply a 30 percent value test. IRC §857(b)(6)(C)(iii). Most are of the view that ordinary repairs and maintenance will not violate the prohibition. The phrase "unless otherwise required by

Capital improvements are only permitted when required to maintain the property and its value. Thus, capital improvements can be made only for (a) normal repair and maintenance of the property, (b) minor non-structural capital improvements; and (c) repairs or improvements required by law. Structural improvements made during the offering period that comprise part of the contract between the tenant and the DST would not violate the Ruling, but might constitute taxable boot.[52]

vi. **No Investing of Cash Held Between Distribution Dates.** Any cash held between distribution dates or for reserves must be invested in short-term government debt or certificates of deposit, or bank CDs.[53] The DST cannot benefit from market fluctuations by reinvesting cash flow. This would cause the trust not to be a "fixed investment trust" and would lead to its being taxed as a partnership.

vii. **Earnings and Proceeds Must Be Distributed.** Except for a reasonable amount that may be held as reserves, all earnings and proceeds must distributed at least quarterly in proportion to each beneficial owner's proportionate interest.

e. **Additional Prohibitions (not one of the seven "sins").** It is insufficient that the DST not be reclassified as a business for federal income tax purposes as a result of its violating any of the seven enumerated prohibitions: The DST must also not

law" seems sufficiently ambiguous as to possibly constitute a formidable exception to the general rule.

52 What qualifies as a permissible repair or capital improvement is left unaddressed in the Ruling. A reasonable interpretation of the scant guidance seems prudent. So too, a letter signed by an expert as to whether the repair was minor or structural might also be helpful. It seems unlikely given the vagueness of the Ruling that disputes arelikely to arise where it is unclear whether a structural modification is "minor" or "required by law." On the other hand, some renovations or modifications would be difficult to characterize as "minor" or "otherwise required by law." Thus, the renovation of an entire floor damaged by a hurricane which affected only a portion of the floor would seem to violate the Ruling, unless the renovation of only the affected portion could not feasibly be done.

53 The investment by the DST of cash in activities for profit would vary the interest of interest of beneficial owners, and would cause the trust to be taxed as a partnership. Provided there is no power to vary the investment of beneficial owners, the existence of two classes of ownership interests would not per se violate the single class rule if the existence of two classes facilitated the investment of trust assets.

achieve partnership status under common law principles.[54] Therefore, neither the sponsor nor its affiliate may, through loan guarantees, constructively violate the prohibition on the renegotiation of lease or financing agreements.[55] Violation of this prohibition would cause the entity to be taxed as a partnership. Many states' LLC acts provide that members cannot demand a distribution of property. Unless the applicable state LLC statute treats members as co-owners of LLC property, the election out of partnership tax treatment under IRC § 761 would not be available.[56] If the DST owns the property, although New York partnership law treats partners as co-owners for "partnership" purposes, in the case of an LLC the result is different: New York LLC law does not treat members as co-owners. Therefore, if the LLC takes title to the property in a transfer distribution, an election under Section 761 would be unavailable.

f. **DST Deemed a Property Interest Under Grantor Trust Rules.** Under the grantor trust rules,[57] A grantor is any person "to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust," or a person who acquires an interest in a trust from a grantor of the trust if the interest acquired is a fixed investment trust. Regs. 671-2(e) (1), (e). Section 677(a) treats the grantor

54 Beneficial owners could be treated as partners for tax purposes if there is unequal sharing, or if other factors consistent with partnership status are present. Case law considers the following factors in determining the existence of a partnership for tax purposes: (1) unequal sharing of profits, (2) unequal sharing of losses, (3) ownership of partnership assets, (4) joint management and control, (5) joint liability to creditors, (6) intention of the parties, (7) compensation, (8) contribution of capital, and (9) loans to the organization (see generally, 43 NY Jur, Partnership, §§ 30-40).

55 Most sponsors use master leases in situations that involve subleasing and long-term financing that facilitates a sale of the property several years before term-end if a lucrative offer materializes at a time when most benefits of the DST have already been availed of.

56 Reg. 1.761-2(a)(2)(i). New York law does consider partners to be co-owners of partnership property, and therefore have an equal right to possess partnership property for partnership purposes. However, the New York LLC statute does not provide that members are co-owners of LLC property. Property owned by the LLC is the property of the LLC, not of the members. The owners of an LLC are "members" rather than shareholders or partners. See *Sealy v. Clifton*, LLC, 890 NYS 2d 598, 2009 NY App. Div. LEXIS (N.Y. App.Div. 2009).

57 Code Sections 671 through 678.

as owner[58] 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. Section 671 provides that a grantor who is treated as owner includes those items of income and credits of the trust attributable to that portion of income. A person who is treated as the owner of an undivided fractional interest of a trust (under 671) is considered for federal income tax purposes, to own trust assets attributable to that undivided fractional interest.

i. **Summary.** The beneficial owner (i) is a grantor since it acquires an interest in a fixed investment trust from the sponsor, who created the fixed investment trust; (ii) is treated as owner of a portion of the trust; (iii) as owner, includes income and deductions of the trust attributable to that portion; and (iv) as owner of an undivided fractional interest, is considered for tax purposes to own trust assets attributable to that portion.

g. **Trust Recitations.** The DST agreement typically provides that (i) the DST terminates after a fixed period of time, e.g., 10 years, or upon the sale of the property, if earlier; (ii) interests in the DST are of a single class[59] representing undivided fractional interests in the trust; (iii) the trustee is unrelated to bank; (iv) the trustee may establish a reasonable reserve; (v) all available cash less reserves will be distributed quarterly pro rata to beneficial owners; (vi) cash held in reserve will be invested in short-term treasuries; (vii) the trustee's activities are limited to the collection and distribution of income, but also may entail ministerial activities necessary to maintain and operate the DST; and (viii) the trustee has not entered into a written agreement with DST as its agent, and has not held itself out as its agent to third parties; nor will beneficial owners enter into an agency[60] agreement with the

58 Although for federal income tax purposes, the beneficial owner of a DST interest is treated as owner of a trust property, the Delaware statute itself does not go quite that far: Although the Act provides that a beneficial owner has an "undivided interest in the trust property," the statute adds that "[t]he beneficial interest is personal property and a beneficial owner has no interest in specific trust property." 12 Del.C. §3805(c).

59 A trust with multiple classes of ownership interests is permissible only if multiple classes of ownership interests are "incidental" to the primary purpose of the trust having no power to vary the investment of the certificate holders. Reg. §301.7701-4(c)(1).

60 Rev. Rul.2004-86 provides that the trust and bank are unrelated.

DST.

i. **Agency.** Neither the DST nor the trustee may be the agent of the sponsor or the beneficial owners[61]; and neither the DST nor the trustee may hold themselves out as their agent to third parties. In addition, beneficial owners may not enter into an agency agreement with either the DST or the trustee. Therefore, neither the DST nor the trustee may be viewed as an agent of the beneficial owners.

ii. **Relationships.** The sponsor and bank must be unrelated; and the trustee must be unrelated to the bank or the tenant of the property.

h. **Conclusion of Rev. Rul. 2004-86.** The Ruling concludes that beneficial owners become grantors upon receipt of their interests from the DST and are treated as owning a fractional interest in the trust assets. For purposes of Section 1031, beneficial owners are deemed to own real property in proportion to their ownership interest in the trust. <u>In contrast, under Delaware statutory law, the beneficial interest constitutes personal property</u>. That Delaware treats the interest as personal property rather than a real property interest is advantageous to beneficial owners.[62]

5. **Problem of Lack of Additional Capital to Effectuate Repairs.** One of the "seven deadly sins" prohibits investors from contributing additional money or property to the DST. This prohibition poses an issue if cash is required for costly repairs. Cash can sometimes be

61 Although the trustee may be an affiliate of the sponsor, an agency relationship does not automatically exist between a parent and its subsidiary; they are generally considered separate legal entities. The parent is not automatically liable for the acts of the subsidiary unless there is significant control.

62 A creditor might be deterred from commencing litigation in another state out of concern that a victory might by pyrrhic: Assume New York court renders judgment in favor of New York creditor. The most the New York court could do would be to issue a "charging order" against the DST interest. The effect of the order might be to create phantom income to the New York creditor, since as owner of the DST interest, the creditor would be required to report its proportionate share of DST income as reported on the Form 1099. Yet without a distribution, the creditor would be forced to pay that tax on that "phantom" income. While New York could choose not to give full faith and credit to the Delaware statute, it could not force a Delaware court to order a distribution be made to the New York creditor. Generally speaking, the Full Faith and Credit clause is "exacting" with respect to final judgments of courts but "is less demanding with respect to choice of laws." *Baker v. General Motors Corp.*, 522 U.S. 222, 232 (1998), quoted in *Franchise Tax Bd. of Cal. v. Hyatt*, 538 U.S. 488, 494 (2003).

derived from other sources, such as (i) reserves, (ii) offering proceeds, (iii) initial loan proceeds, or (iv) cash flow. Sometimes, the sponsor might contribute cash to the master tenant.[63] Each potential source of cash is not without its own limitations and drawbacks.

a. **Funding Repair With Reserves.** An existential problem arises with maintaining a reserve sufficient to address the scope of a repair calling for substantial cash, since a "reserve" should presumably not constitute a "war chest" intended to address a calamity. Maintaining a reserve sufficient to fund a costly repair or remedying a structural issue seems to run counter to the tenets of Rev. Rul. 2004-86 which envisions a trust leading a rather austere existence. Therefore, maintaining large reserves would appear to run counter to the spirit of the Ruling. A large reserve would also be a nonproductive asset.

b. **Funding Repair With Cash Flow.** The removal of cash flow might result in beneficial owners having phantom income. The prospect of receiving phantom income is not likely to endear the sponsor to beneficial owners.

i. **Phantom Income.** A beneficial owner is deemed a grantor of the DST. In computing income tax liability, the beneficial owner is required to take into account its proportionate share of all items of income, gain, loss, deduction and credit attributable to the DST. That income may constitute "phantom" if cash retained for reserves causes distributions made by the DST to be insufficient to cover the tax liability of the beneficial owner. In that case, cash from other sources would be required to pay tax on income reported on Form 1099.

c. **Funding Reserves With Loan Proceeds.** Funding repairs with loan proceeds will not constitute boot, but will increase the amount of debt encumbering the property, possibly making it more difficult for the DST to meet its mortgage obligations. Cash could also negatively affect the status of the lease as a "true lease" since it would reduce the capital to loan ratio. Funding reserves with loan proceeds which may never be needed or may not be needed for a period of time causes the unused proceeds to needlessly incur interest.

d. **Funding Reserves With Offering Proceeds.** Funding reserves with offering proceeds will increase the "load" investors are already burdened with, and increase

63 The sponsor's contribution of cash directly to the DST would clearly violate the seven prohibitions.

the quantum of revenue required to reach the break-even point in the investment. Funds derived from offering proceeds would not constitute qualified replacement property and would be taxable boot under Section 1031.

e. **Funding by Sponsor.** The sponsor may decide to contribute capital to the master tenant where the latter is its affiliate. While contributing or lending money to the master tenant is not likely not problematic under Rev. Rul. 2004-86, it might be problematic for the sponsor, who would at best have made an unsecured loan. The sponsor might not be able to recoup the funds even if revenues of the master tenant increase, due to the fact that the master lease may not be renegotiated. Nevertheless, the sponsor might be motivated to contribute cash to avoid a default by the DST which would be detrimental to its own economic interest in the affiliate, and could also harm the sponsor's reputation within the industry.

f. **Result if No Funding.** Under Rev. Rul. 2004-86, new capital contributions to the DST by beneficial owners are a grave "sin." Therefore, should lack of cash cause the master tenant to be unable to make needed repairs, it would likely default under the master lease. This could have a cascading effect, causing the DST default on its own mortgage obligations to bank. A transfer distribution to a new or existing LLC might then be the only viable option to avoid defaulting or immediately selling the property. A transfer distribution would enable the manager of the LLC take actions unavailable to the trustee: The LLC could renegotiate existing bank loans and take other steps to protect the property. If the property could not be saved from default and foreclosure, the LLC manager (formerly the DST trustee) would be forced to sell the property.

   i. **Transfer Distribution Appears Not to Violate Rev. Rul. 2004-86.** It might be argued that a transfer distribution results in a constructive of the proscription in Rev. Rul. 2004-86 barring a sale and then the acquisition of new property. This, because a transfer – like a sale – is a "disposition," in which the DST simply vanishes and becomes a new entity. However, this view presents a stilted application of the Ruling and actually runs counter to its objective, which is to protect the interest of beneficial owners. The Ruling is at best silent on the issue. In any event, the IRS does not appear troubled by its use.

6. **Concept of Master Tenant and Master Lease.** A long-term lease triple net[64] lease by DST to a credit tenant would require only a single lease. However, if the property is one that requires subletting, the seven prohibitions present an insurmountable barrier to accomplish this – unless a new intermediary not bound by the seven prohibitions is installed to sublet. Although the intermediary may enter into subleases, the seven prohibitions still exert some force on the new intermediary. New nomenclature is required to define this arrangement: The DST is said to enter into a "master lease" with the new intermediary, termed the "master tenant." Almost always, the master tenant will be an affiliate of the sponsor. The length of the master lease will mirror the term of the DST. The master lease could provide for additional rent based on gross revenues, but not profit. The master lease may not be renegotiated.

   a. **Illustration.** A master tenant would be required if the DST owned a residential complex. The sponsor's affiliate could be the master tenant. The sponsor's affiliate is called the master tenant **because** it is the intention of the sponsor that it serve as an intermediary for the purpose of subletting. The master tenant would be responsible for managing and operating the property, and could enter into management agreements with the sponsor. The difference between the master lease and the lease that would be found in the case of a single unrelated tenant is that the master lease could contain provisions that would not be found in the lease to a single tenant. The lease would still be fixed-rate and non-negotiable, with permissible increases based upon cost-of-living increases or other ascertainable metrics, but it could also contain provisions to share gross revenues. By installing its affiliate as master tenant, the sponsor is also taking on much more risk. A sponsor might not be willing to take on the additional risk, even if it could profit by subletting.

   b. **Master Tenant Unrelated to Sponsor.** If a residential complex is being leased by the DST to an unrelated party, the lease would likely be a triple net. The unrelated tenant would still be referred to as a master tenant, and the lease between it and the DST a master lease. However, the dynamics of the arrangement would change

64 A triple net lease (NNN) is a commercial lease agreement that requires the tenant to pay all expenses associated with a property, in addition to rent and utilities. These expenses include real estate taxes, building insurance, maintenance, and additional rent. Triple net leases are often signed for a minimum of ten years, and may contain built-in rent increases. A double net lease is a rental agreement whereby the tenant agrees to cover the costs of two of the three primary property expenses: taxes, utilities, or insurance premiums. Also known as a net-net (NN) leases, they are fairly common among commercial tenants.

drastically. The master tenant, unrelated to the DST, would most likely not structure the master lease in a revenue-sharing manner, although it probably could. In the event the property needed costly new repairs because of storm damage, the sponsor would be far less likely to infuse its own cash, since it has no economic stake in the tenant. Nevertheless, it does have a stake in the DST not defaulting. The sponsor might view the risk of DST default not sufficient enough to warrant subsidizing an unrelated tenant's lease. If the unrelated tenant were faced with insolvency or declared bankruptcy, then the DST could renegotiate the lease or enter into a new lease with another master tenant. .

c. **Limitations Imposed on Master Tenant and Sponsor.** As noted, the master tenant may sublease the property and enter into new subleases. Yet the master tenant can by no means ignore the prohibitions in Rev. Rul. 2004-86. Some actions taken by the master tenant could well result in a serious violation of Ruling prohibitions and jeopardize the arrangement for federal tax purposes. For example, it is doubtful the master tenant may make more than minor nonstructural repairs to the property in order to accommodate a new potential lessee. Sponsors have attempted to overcome this problem by allowing a subtenant to make alternations, but requiring that the space be restored to its original state when the subtenant vacates. It is unclear whether this would violate the Ruling. The problem illustrates the general unsuitability of some retail properties for DST syndications. At the same time it also demonstrates the premium sponsors place on new or fairly new properties not likely to require substantial repairs or modifications. The problem with retail DSTs would be acute with a mall, but a Best Buy or Costo might be an ideal candidate for an offering, since it would not involve subletting and would therefore not require an intermediary master tenant.

d. **Significance of Master Tenant's Fixed Obligations.** Although the master tenant may sublease property owned by the DST, its obligation to the DST remains fixed. This creates a situation where the master tenant is (in a sense) the master of its own fate – if the master tenant earns an amount through lease payments to sub-tenants in excess of its lease obligation to the DST, it may profit. Conversely, the master tenant will bear the risk of loss if its rental revenues fall short of the sum needed to satisfy its obligations under the master lease. It is perhaps for this reason banks may prefer that sponsors retain an equity interest in the DST. However, this can be problematic, since the sponsor will then be wearing "two hats," one as a beneficial owner, and the other as a tenant. These dual roles present a trifecta of tax and nontax issues, namely (i) a conflict of interest; (ii) a violation of requirement that the trust be a fixed investment trust; and (iii) the risk (albeit a low one) that any future contribution by the sponsor to the affiliate will be deemed to constructively violate the rule forbidding new contributions by beneficial owners to the DST.

i. **Importance of Creditworthy Tenant in DST-Tenant Lease.** Since any lease the DST enters into – be it to an unrelated master tenant, or to an unrelated entity in a straight single-lease situation, it is important that the tenant be creditworthy. The fortunes of the DST rise and fall on the ability of the lessee to satisfy lease obligations to the DST. While not all DST lessees possess the highest credit rating, an increase in risk should be commensurate with the potential for profit.

e. **Interests of Sponsor and Beneficial Owners May Diverge.** DST terms generally range from five to ten years. Gross revenues from master tenant subleases may outperform initial projections. If the master lease contains no provision granting the DST added remuneration for higher than anticipated revenues, the master tenant alone will benefit if revenues exceed expectations. Should a conflict arise between sponsor and beneficial owners with respect to whether the property should be sold before the DST term ends, beneficial owners should be aware the Delaware statute provides clearly provides that (i) trustees will not be liable to the trust or beneficiaries for acts taken in good faith reliance on the provisions of the governing instrument and (2) the fiduciary obligations and liabilities of a trustee may be varied by the governing instrument of the trust. 12 Del. C. §3806(c). In general, beneficiaries are granted few if any substantive rights under the governing trust agreement. Accordingly, if the sponsor determines that a sale is necessary, the trustee would be under an obligation sell regardless of the view of beneficial owners, provided the action was taken in "good faith." The point is that the trustee is under no obligation to take that action which would be most favorable to the beneficial owners. The trust agreement will be highly restrictive in rights accorded to beneficial owners. Circumscribing the rights of beneficial owners may also be required for the trust to be a separate taxable entity, since for reasons discussed earlier, partnership tax status might arise. In any event, Delaware Courts of Chancery have found that the terms "fair" and "good faith" means was the trustee's action were consistent with the (restrictive) terms of the trust indenture.

f. **Guarantees by Sponsor.** It is clear that the sponsor may not guarantee the DST mortgage obligation to the bank. This would be tantamount to a new contribution of capital to the DST which is strictly prohibited. Conversely, pursuant to nonrecourse carveouts, sponsors may properly guarantee liabilities arising from malfeasance by managers or master tenants which threaten the solvency of the DST on the theory that the DST might recover liabilities from the malfeasant. It has been suggested that a DST faced with a defaulting tenant could execute a guarantee of the tenant's rent obligation to the DST. The DST could then assign the guarantee to the bank. It is thought that since the guarantee does not involve direct payment to the DST, it might be viable. However, some would view this as risky. The IRS could challenge the transaction under the step transaction doctrine, the substance over form doctrine, or the economic substance doctrine. Even the uninspiring comfort level of "more likely than not" might not be warranted for such a transaction.

g. **Creation of Master Tenant Must Have Economic Substance.** A transaction entered into for profit must have economic substance.[65] The common law economic substance doctrine was codified in 2010 by IRC § 7701(o). The doctrine permits courts to disallow tax benefits that are inconsistent with Congressional intent, even if the taxpayer complies with statutory and regulatory requirements. The determination of whether the economic substance doctrine applies is made "in the same manner as if [the] subsection had never been enacted." IRC §7701(o)(5)(C). If the only purpose of the master lease were to enable the DST to avoid the prohibition against re-leasing, the transaction might lack economic substance. If the transaction were deemed to lack economic substance, the IRS could assert that the single class of interest rule was violated, resulting in the DST no longer being a "fixed investment trust." Rev. Rul. 2004-86 would then be inapplicable. Under §7701(o), a transaction entered into for profit will have economic substance only if

i. the transaction changes in a meaningful way (apart from federal income tax consequences) the taxpayer's economic position; and

ii. the taxpayer has a substantial purpose (other than tax) for entering into the transaction.

h. **Both "Prongs" of Doctrine Must Have Economic Substance.** In Notice 2010-62, the IRS stated it would continue to rely on relevant case law under the common law in applying the two-prong conjunctive test in §7701(o); but will challenge taxpayers

65 To resolve a split in the Circuits, the economic substance doctrine was codified in the *Health Care and Education Reconciliation Act of 2010,* Pub. L. No. 111-152, §1409, by adding new §7701(o) to the Code. The doctrine is the convergence of statutory interpretation and common law into a rule of law which provides that even if a taxpayer meets all Code requirements and all relevant common law doctrines, the taxpayer will not prevail unless the taxpayer can satisfy the subjective and objective standards applied by the courts. The determination of whether the economic substance doctrine applies to a transaction is made "in the same manner as if [the] subsection had never been enacted." IRC §7701(o)(5)(C).

who seek to rely on earlier case law for the proposition that a transaction will be treated as having economic substance because it satisfies either prong of the two-prong test. The IRS takes the position that both "prongs" of the doctrine must be met. Fortunately, the IRS has not frequently employed the economic substance doctrine, reserving its use for the most egregious cases. In any event, the master tenant should not have as its principle purpose the avoidance of the Ruling prohibitions. Treasury guidance helpfully adds that the purpose of the doctrine is not to find longstanding transactions lacking in economic substance. A master tenant that assumes real risks would tend to imbue the transaction with economic substance. On the other hand, a master lease that operated more or less as a flow-through of rents from the master tenant to the DST could violate the economic substance doctrine, since it could be argued that its principal purpose was simply to avoid the prohibitions imposed on the DST.

i. **Exceptions to Application of Economic Substance Doctrine.** The Joint Committee of Taxation Report which accompanied legislation codifying the economic substance doctrine states:

> The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Thus, two exceptions to the application of the doctrine appear to apply: First, whether the benefits claimed are consistent with a Congressional purpose or plan; and second, whether the transaction has been respected under longstanding judicial and administrative practice.

New York University 70th Institution on Federal Taxation, "Economic Substance," New York, NY October 23-28, 2011; San Francisco, CA November 13-18.

i. **Reasonable Cause Exception Inapplicable.** IRC§ 7701(o)(1)(B) imposes strict liability penalty under §6662 for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance. The penalty is 20 percent (increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return). <u>The reasonable</u>

cause and good faith exceptions under §6664(c)(1) are inapplicable to any portion of an underpayment attributable to a transaction lacking economic substance. No exceptions to the penalty are available. Thus, outside opinions or in-house analysis would not protect a taxpayer from the imposition of a penalty if it was determined that the transaction lacked economic substance or failed to meet the requirements of any similar rule of law. If a transaction is a "reportable transaction," the adequate disclosure requirement will be met only if the taxpayer files a Form 8886 (Reportable Transaction), and not merely Form 8275 (Disclosure Statement).

j. **Adequate Capitalization of Master Tenant.** The sponsor typically capitalizes its master tenant-affiliate with an unsecured promissory note. The entity – whether or not it is the sponsor – contributing the promissory note should have sufficient net worth to satisfy the note if drawn upon. The lender may also require that the note be guaranteed by a person with sufficient net worth, since the obligation of the DST to the bank is dependent on the master tenant fulfilling its obligations to the DST under the master lease.[66] As noted, an economic stake of the master tenant through its potential profitability via subleases is vital to the master lease having economic substance.

k. **Tiered Structure For Multiple Large Tenants.** The DST may own multiple properties, each serving as collateral for a separate bank loan. In the event the lessee of one of the properties defaults on a least payment to the DST, that single default could cause the DST to become unable to meet its own financing obligations to the bank. By using a tiered structure involving two layers of trusts, the default of one tenant on a rent obligation would be confined to that distressed property. Separate sub-trusts under the DST would be created for each property. Each sub-trust would own one property, and a separate lease would be created for each. A separate bank loan would also exist for each property. Each sub-trust would be wholly-owned by the DST and would be an extension of it. The DST could make a transfer distribution

66 The term of the master lease will coincide with the term of the DST, which may be a decade. For this entire period, the sponsor, through its affiliate, will be responsible for payments under the master lease. Even though the sponsor may profit from its subleases, if fortunes turn against it, the sponsor could be in the position of having to subsidize the master lease or cause the DST to default. Many sponsors will be unwilling to assume this risk. Lenders are now requiring greater participation through provisions in governing documents, and greater security for their loans. For example, lenders may require pre-approval for a transfer distribution; or may require collateralization of the DST's mortgage obligations, which may result in unacceptable tax risks.

to an LLC with respect to the property held by the sub-trust. The DST would continue to service its obligations to the bank through rent payments from non-defaulting tenants. The IRS has not approved this structure, but does not appear to object to it.

7. DST Participation in Master Tenant Revenues (But Not Profit) Permissible.

a. **Fixed Rent Lease Structure.** A fixed master lease must provide for rent equal to debt service plus a market rate of return. The lease may also contain an escalator clause. However, the terms of the lease are fixed throughout the term of the DST. The lease may not be renegotiated and the property may not be leased to another tenant if the first tenant vacates, subject to one exception: The lease may be renegotiated and the property may be leased to a new tenant if the tenant becomes insolvent or bankrupt. The master tenant has incentive to maximize net operating income above its fixed rent obligations under the master lease, since it will benefit from increased rental income. Given its own economic interest, the sponsor may have some incentive to cover short term operating deficits to satisfy the obligations of its affiliate lessee under the master lease, since a default by the affiliate-lessee would likely cause the DST to default as well. Therefore, sponsors may decide to self reserve their affiliate from net operating income for unanticipated repairs and uninsured losses in amounts beyond bank requirements, particularly if the lease is triple or double-net, which in most cases it would be.

b. **Participating Rent Lease Structure.** In a participating rent structure, the master tenant pays a fixed amount and an additional amount based on a percentage of gross revenue. There can be no sharing of net income or profit; this could result in partnership status. Reg. 1.856-4(b)(3) explicitly provides that the share of gross revenue cannot be an attempt to share net income. Multiple rent adjustments could also be construed as an attempt to share net income. Master leases that determine rent based on cash flow will not constitute a true lease for income tax purposes. Adjustments in participation based on operating expenses or costs should be avoided.[67] However, the master lease may contain "milestone" provisions that enable beneficial owners to participate in pre-defined revenue thresholds.

c. **Milestone Bonuses as Incentive to Maintain Profitability.** Escalating revenue-sharing provisions appear acceptable where based on the attainment of certain

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67 See PLR 2022205001; a conditional disposition fee should be based on a fixed dollar amount and not on a return of capital or a minimum return to investors.

revenue goals. This would reward the master tenant for exceeding revenue expectations, and reward beneficial owners as well. To the extent the master lease does not reward the DST for exceeding revenue goals, only the master tenant will stand to gain. Therefore, if no revenue milestones benefitting the DST are present in the master lease, then all beneficial owners can hope to receive will be the projected percentage yield. That amount is principally the difference between two constants: fixed rental payments under the master lease, and expenses, the lion's share of which are mortgage obligations and reserve contributions. On the other hand, if the master lease does contain milestone revenue sharing provisions, then beneficial owners will receive a higher rate of return during periods of the master tenant's high gross revenue. These scenarios reflect the effects of differing ways of structuring milestone payments:

i. No Milestone Bonus to DST and Property Appreciates
ii. No Milestone Bonus to DST and Property Depreciates
iii. Milestone Bonus Early to DST and Property Appreciates Early
iv. Milestone Bonus Late to DST and Property Appreciates Late
v. Revenue Shortfall Early and Property Depreciates Early

d. Four Scenarios Analyzed.

i. No Milestone Bonus to DST and Property Appreciates. Beneficial owners will receive their projected annual income percentage and benefit at term end from property appreciation when the property is sold.

ii. No Milestone Bonus and Property Depreciates. Beneficial owners will receive their projected income during the term, but will be disadvantaged by the property depreciation at term end when the property is sold.

iii. Milestone Bonus Early and Property Appreciates Early. Beneficial owners will profit from higher revenues due to bonus payments which will increase their yield during that period of increased gross revenues earned by the master tenant. Beneficial owners will also profit from property appreciation when the property is sold by the trust at term end.

iv. Milestone Bonus Early and Property Appreciates Late. Beneficial owners would receive early benefit from increased monthly payments, and increased profit on property appreciation when the property is sold.

v. Revenue Shortfall Early and Property Depreciates Early. Sponsor might make up shortfall with own contribution to master tenant, but would not be required to do so. A transfer distribution or sale might be necessitated by sponsor to avoid a default. If a transfer distribution were required, beneficial owners would be precluded from engaging in a subsequent 1031 deferred exchange. If the transfer distribution occurred within two years of the offering, beneficial owners could lose exchange treatment on the initial exchange. Whether tax-deferred status on the initial exchange would be lost depends on whether the IRS were to examine the transaction and disallow the exchange ab initio. In that unfortunate case, beneficial owners would receive a notice demanding payment of the original deferred capital gains tax (plus interest and penalties) or appear in Tax Court. Entreaties to the sponsor with respect to whether or not to sell the property and end the DST would likely be refractory. The determination the sponsor, provided it was made in good faith, would be entirely within its prerogative under the terms of the trust agreement which typically restricts the rights of beneficial owners. The taxpayer would be required to use other funds to pay the tax on the initial sale proceeds. One single silver lining would be that the transfer distribution to the LLC would at least be nontaxable under IRC §721.

vi. **Conclusion.** Whether or not the master lease grants the DST a right to bonus payments if revenue exceeds a threshold amount requires the prospective investor to gain a clear understanding of master lease terms. For some investors, choosing an investment that puts a premium on reliability of meeting projected income yields may be paramount. For other investors willing to assume more risk, DSTs offering higher projected yields or more lucrative revenue bonuses may be attractive investments.

e. **Potential Conflicts.** The sponsor's affiliate could conceivably benefit from increased rental revenues even when the property is not appreciating or could actually be depreciating. In this situation, a conflict could develop between the sponsor and beneficial owners, who might want the property to be sold. The sponsor, often the signatory trustee, does owe fiduciary obligations to the beneficial owners, but those obligations are likely to be quite restricted. Under Delaware law, the obligation to beneficial owners may be limited to an obligation to act in good faith, which in litigated cases in the Delaware Courts of Chancery has proved to be an exceedingly low bar.[68] The independent trustee, whose fealty is to the bank, would likely oppose an early termination of the bank loan to the DST.

i. **Beneficial Owners Without Recourse.** The master trust typically provides that beneficial owners have no right to any control the trust, and have no right to participate in the management of the trust. Therefore, provided sponsor actions are taken in "good faith" beneficial owners are generally without recourse to contest a decision made by the sponsor. Nevertheless, most large sponsors are highly reputable. It is not in the sponsor's interest to take actions that benefit only its affiliate and not the beneficial owners. This is true even if it could legitimately take those actions under the terms of the trust. It should also be noted that in order for the DST to be taxed as a fixed investment trust rather than a partnership, the beneficial owners could not be the agent of the DST. If beneficial owners were given sufficient powers to direct the trustee, then the DST might be viewed as an agent of the trust. This could cause the trust not to be viewed as a separate entity, resulting in the property no longer qualifying as replacement property. Moreover, giving the beneficial owners control could cause the trust to contain two classes of interest, and cause it to be taxed as a partnership.

8. **Transfer Distribution.** The DST will typically provide for conversion to a new or existing LLC if restrictions imposed by Rev. Rul. 2004-86 prevent the DST from addressing situations requiring actions prohibited in the Ruling. Accordingly, governing documents may provide that if the trustee (i) determines that the property in the trust is in jeopardy of being lost or the value thereof is being substantially impaired, and (ii) because of the limits on the powers of the trustee to respond, (iii) the trustee may terminate the trust, and (iv) at the

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One of the hallmarks of the Delaware Statutory Trust Act is to allow parties freedom of contract in drafting trust provisions, and in defining the rights and obligations of beneficial owners, sponsors, and trustees. Fiduciary obligations owed to beneficial owners may be expanded, restricted or eliminated in the trust agreement, provided that the trust must adhere to the implied obligation of good faith and fair dealing. The Delaware Court of Chancery has been reluctant to apply the covenant of good faith and fair dealing for conduct not explicitly prohibited by the plain language of the contract. In *Whitestone REIT Operating Partnership v. Pillarstone Capital REIT*, (Del. Ct. of Chancery, 2016), Vice Chancellor Lori W. Will stated that while the implied obligation of good faith and fair dealing exists in every contract, the implied covenant provides a "limited and extraordinary legal remedy" that must be used sparingly.

discretion of the trustee, convert the trust to a new limited liability company.[69] The LLC will remain liable on bank loans, and beneficial ownership interests will be converted to membership interests in the LLC. The new LLC could exercise powers the DST could not, including the power to renegotiate existing debt, obtain new financing, and enter into new leases.[70]

a. **LLC Interest Cannot be Exchanged.** Since partnership interests cannot be exchanged, no deferred exchange under Section 1031 is possible following the conversion to an LLC when the property is ultimately sold. However, the transfer distribution itself would be nontaxable[71] under IRC §721. The members' rights and obligations would carry over to the new LLC. Since a Delaware LLC may be created by a mere election, the former trustee, now the LLC manager, could expeditiously address pressing issues.[72] The income tax liability of the members would be determined under partnership, rather than grantor trust, tax principles.

b. **Transfer Distribution Within 2 Years of Syndication.** A transfer distribution occurring within two years of the exchange could violate the qualified use ("held for")[73] requirement of Section 1031. This could void the initial deferred exchange.

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69 The sponsor will become the manager of the new LLC.

70 The conversion might require bank pre-approval. The denial of approval could trigger a default and an acceleration of the loan.

71 IRC § 721(a) generally provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property in exchange for an interest in the partnership.

72 Delaware law permits the conversion by a simple election which does not constitute a transfer under Delaware law. The "Springing LLC" will contain the same SPE and bankruptcy remote provisions as the DST (for the Lender's benefit), but it will not contain the prohibitions against the raising of additional funds, the creation of new financing, or renegotiation of the terms of existing financing or the entering into new leases. In addition, it will provide that the trustee will become the manager of the LLC.

73 Section 1031(a)(1) provides that

NO GAIN OR LOSS SHALL BE RECOGNIZED ON THE EXCHANGE OF PROPERTY **HELD FOR** PRODUCTIVE USE IN A TRADE OR BUSINESS OR FOR INVESTMENT IF SUCH PROPERTY IS EXCHANGED SOLELY FOR PROPERTY OF LIKE KIND WHICH IS TO BE HELD EITHER FOR PRODUCTIVE USE IN A TRADE OR BUSINESS OR FOR INVESTMENT. (EMPHASIS ADDED).

A transfer distribution occurring more than two years after the completion of the offering would not void the initial exchange, but would preclude a subsequent deferred exchange under Section 1031. A transfer distribution within 2 years of the date the last beneficial interest is sold during the offering period would bring the wolf to the door: Not only could the initial deferred exchange be voided, but the former beneficial owner (now LLC member) could incur immediate tax on the initial sale of the property. To make matters worse, the investment of the LLC member would remain tied up in the DST until the term of the DST ended, or the sponsor sold the property, if sooner. The two-year "holding period" is not statutory or regulatory; rather, it is the result of PLR 8429039. The risk diminishes after 2 years.[74] It should be noted that since the beneficial owner embarking on a DST investment intends to hold the investment for the entire term, the investor could argue that even if the transfer distribution occurred within two years, the "held for" requirement was met. The IRS could reply that if the risk of a transfer distribution were sufficiently high, the held for requirement was constructively violated. Even though the taxpayer's argument seems meritorious, Tax Court is the last place the former beneficial owners – now members – would want to be, even if President Lincoln's proverbial angels "dancing on the head of a pin" would attest to the taxpayer's solemn intent.[75]

Therefore, an exchange of property acquired not for productive use, but rather for the purpose of engaging in a like kind exchange, would likely violate IRC §1031(a)(1); Rev. Rul. 84-121. Even so, the Tax Court in *Mason Est. v. Com'r,* T.C. Memo 1988-273 held that exchanges by former partners of property received from their recently terminated partnerships did qualify for exchange treatment. The phrase "held for" means the property must be in the possession of the taxpayer for a definite period of time. Exactly how long has been the subject of considerable debate. PLR 8429039 stated that property held for two years satisfies the statute. Some have suggested that, at a minimum, the property should be held for a period comprising at least part of two separate taxable years. However, it should be taxpayer's intent that is actually determinative. Therefore, an exchange of property held for productive use in a trade or business should qualify even if it were held for less than two years provided the taxpayer's intent when acquiring the property was to hold the property indefinitely.

74 Private Letter Rulings can only be relied upon by the person or entity requesting the ruling. In practice, PLRs are often relied upon by practitioners and taxpayers in the absence of more authoritative guidance.

75 President Lincoln, in his first inaugural address in 1861, appealing to the "better angels of our nature," urged people remember and preserve what made the Union great. The first reference to angels dancing on a needle's point occurs in an expository work by an English priest, William Sclater (1575–1626). In his *An Exposition with Notes upon the First Epistle to the Thessalonians* (1619), Sclater claimed that scholastic philosophers occupied themselves with such pointless questions as whether angels "did occupie a place; and so,

i. **Additional State and Local Tax.** While a transfer distribution would occasion no federal income upon conversion to the LLC under Section 721 which permits tax-free contributions to partnerships, the distribution could result in state or local income, transfer, sales, use or other tax.

c. **"Exit Ramp" For LLC or Partnership Interests?** Partnership and LLC interests (except "look-thru" single-member LLC interests which can be exchanged) cannot be exchanged under Section 1031. One method to avoid this problem is through a "drop and swap" in which (i) the partnership or LLC is dissolved; (ii) the property is distributed to the former partners who are now tenants-in-common and, after a sufficient period of time (i.e., the transaction is "old and cold") ; (iii) the individual owners deed the property to the buyer. Some of the former partners exchange their interest into replacement property (the swap), while others cash out. partner(s) or member(s) engage in a 1031 exchange. The DST has become more common than the "drop and swap" for the purpose of qualifying partnership or LLC interests for future exchanges. <u>If under state law, the partnership or LLC is converted to a DST, then the DST will itself will qualify as relinquished property in a 1031 exchange</u>. This method is simple and avoids deeds transfers, but it may be subject to the substance-over-form doctrine under *Court Holding v. Com'r*.[76]

9. **Rent Received by DST Must Reflect a "True Lease."** Rev. Proc. October 18, 2024 provides guidelines for advance ruling purposes in determining whether lease provisions will be respected for tax purposes. Noncompliance could result in the lease being recharacterized as a sale followed by a "leaseback." In that situation, the DST would be treated as selling the property to the master tenant, followed by the DST "leasing back" the property from the master tenant. Since the DST would own the property, no exchange could occur. The guidelines of Rev. Proc. 2001-28:

a. **Purchase and Sale Rights.** The tenant may not have a contractual right to purchase the property below its fair market value. However, the right of first offer or the right of first refusal would not violate this requirement.

b. **No Investment by Lessee.** Ordinary maintenance and repairs performed by the tenant do not constitute improvements and do not violate this requirement.

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whether many might be in one place at one time; and how many might sit on a Needles point; and six hundred such like needlesse points."

76 324 U.S. 331 (1945)

c. **No Lessee Loans or Guarantees.** The tenant may not lend the DST any of the funds necessary to purchase the property, or guarantee any indebtedness created in connection with the acquisition of the property by the DST. No entity other than the DST may be viewed as the borrower of the mortgage loan.

d. **Profit Requirement.** The DST must expect to receive a profit from the transaction, exclusive of the value of tax deductions or other tax attributes arising from the transaction. The absence of cash flow to beneficial owners during the lease term could arguably present an issue under the Guidelines. The risk is heightened by the fact that the Rev. Rul. 2004-86 requires that cash flow (except for "necessary reserves") be distributed to beneficial owners. Nevertheless, a leading tax leasing treatise notes that

> [n]umerous cases have recognized that the use of all of the rents to service debt on the lease property is not, in and of itself, much more than a neutral commercial reality.[77]

e. **Minimum Unconditional At Risk Investment.** The minimum investment when the property is first placed in service must be equal to at least 20 percent of the cost of the property. However, a number of litigated cases, as well as several Technical Advice Memoranda involving real estate, deemed equity ownership of less than 20 percent acceptable. Rev. Proc. 2001-28 provides that the minimum equity investment must continue throughout the entire lease term and must be present at the end of the lease term. It is unclear whether inflation may be taken into account when calculating the residual interest at the end of the lease term. (Rev. Proc. 2001-28 stated inflation may not be considered; *Thomas Estate v. Com'r*, 84 T.C. 412 (1985) allowed inflation to be considered in approving a residual value projection.)

10. **Risk of Partnership Classification.** Adherence to the prohibitions in Rev. Rul. 2004-86 are probative of the entity not being a partnership for tax purposes. Deviations from the Ruling, such as unusual financing arrangements, structural modifications, and in some cases capital contributions to the master tenant, could pose a risk that the entity would lose its status as a fixed investment trust, and be taxed as partnership. Therefore, caution should be exercised whenever transactions that might suggest the existence of a partnership for tax purposes

77 Toby Cozart 544-1st Tax Management Portfolio; Equipment Leasing: Substance and Form," page 128. In fact, zero-coupon DSTs provide that all rental income will be used to reduce debt.

exist. The Supreme Court has cited factors which indicate the existence of a partnership; they are listed in the footnote below.[78]

11. Replacement Properties Suitable For DST. Where the DST involves a single creditworthy tenant and property not likely to require improvements, risks to the DST are low. Consequently, the DST represents low risk when commercial property is triple-net-leased to a credit tenant executing a long term lease.[79] Similarly, new or recently renovated commercial, industrial, some retail, or residential property not requiring capital improvements or major structural changes or repairs[80] may also be ideal candidates for a DST. Where no sublease is required, such as where the DST owns a distribution center, the DST may itself lease the property to the commercial tenant, usually through a triple net lease. If the DST owns a residential complex, or if subletting is required, the DST will need to enter into a master lease with an affiliate of the sponsor who will be responsible for renting and managing the property.[81] If the DST will own multiple properties, a "tiered" structure may

78 Those factors include (1) the contributions made by both parties to the venture; (2) the parties' control over capital and income and the right of each party to make withdrawals; (3) whether each party shared a mutual proprietary interest in the net profits and had an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; and (4) whether the parties exercised mutual control and assumed mutual responsibilities of the venture. *Com'r. v. Culbertson*, 333 U.S. 733 (1949).

79 The DST will typically enter into a long-term triple net lease with the tenant. If subleasing is required, the master tenant will enter into a property management agreement who may, among other things, lease the residential and commercial units to subtenants, and repair the property. The sponsor will typically control the master tenant (when it is an affiliate of the sponsor), and the property manager.

80 Many syndicated offerings today consist of property in the southeastern states of Florida, Georgia, the Carolinas, and Tennessee, and western states including Texas, Arizona, Nevada and Colorado. Other properties now attracting attention include student housing, some hospitality categories, residential complexes, affordable housing sites, self-storage facilities, medical/commercial offices, industrial warehouse/fulfillment or single-tenant retail. Multifamily properties and commercial properties involving a single large creditworthy tenant have a proven DST track record. Some properties today not considered ideal for a DST include hotels, oil and gas properties, and senior care facilities.

81 If the DST owns more than one property, rather than structuring a separate lease for each property, the DST may form separate hierarchical "property trusts." Each such subtrust would to hold a single property, and each would enter into a separate lease with the master trust. Creating subtrusts prevents the possible default involving a single property from adversely affecting leases of other performing properties. For example, DST might own three

be used to address the possible default of only one master tenant. Each type of property has unique features when considering its viability for DST purposes.

a. **Office Buildings.** An office building leased to a single creditworthy tenant generally involves low amount of risk. If the property will require subleases to multiple subtenants, use of a master lease with an intermediary master tenant lessens issues arising because of the prohibitions imposed by Rev. Rul. 2004-86. One potential problem associated with a lease to a single tenant concerns the tenant's default. If the default was not due to the tenant's insolvency or bankruptcy, the DST would be required to sell the property and terminate the DST since no new tenant could be substituted. Even if the lease were to terminate because the tenant defaulted after becoming insolvent, the DST might not have sufficient reserves (or time) to make necessary repairs or improvements, in which case the DST would be in the same position – it would have to sell the property and terminate the DST. The problem with an early termination is that beneficial owners may have needed the last five years of a ten year DST to overcome the handicap of the load, and begin to see appreciable profits. In either of the above two cases, it might make sense for the sponsor to consider making a transfer distribution. Since a transfer distribution involves its own costs, it might not be attractive unless a significant portion of the DST term remained and even then it might not be feasible.

b. **Industrial Properties.** Industrial properties are generally subject to shorter lease terms than commercial properties, which makes them less desirable for a DST investment. A master tenant would be required to re-lease the property once or several times during the term of the DST. If a subsequent subtenant required substantial modifications (e.g., a food processing center to an auto parts manufacturer), a violation of the Ruling prohibitions could occur. It is unclear to what extent some of the prohibitions imposed by the Ruling apply to a master tenant. One proposed solution to the problem of modifications for a new subtenant would be to allow the subtenant to make necessary modifications, but require the property to be restored to its original state when the sublease ends. Putting aside the concern

Walgreens. One becomes financially unstable and requires either a sale of the property or a transfer distribution. Rather than being required to sell all three, or convert all three to LLCs, the two subtrusts not experiencing difficulties would continue unaffected; only the property experiencing difficulties would be required to make a transfer distribution. Although each subtrust would nominally require separate financing, the individual financing could be part of the overall financing provided by the bank. There would be three separate notes and financing agreements.

that the provision might be difficult to enforce, the reasoning behind this solution seems somewhat questionable. Allowing modifications and then requiring them to be undone appears to come perilously close to an admission that the DST has permitted modifications that Rev. Rul. 2004-86 forbids. In the end, it might be preferable to either assume the tax risk and allow the modifications, or not to assume the risk, and not enter into such a sublease.

c. **Multi-Family Residential Complex.** A master lease would be required to negotiate new leases with tenants who are typically on short-term leases. If repairs or non-structural improvements required amounts in excess of reserves, the sponsor might contribute cash to its affiliate, the master tenant. If so, the sponsor would benefit from the avoidance of a default by the DST on its bank mortgage. A default by the DST might also lessen the attractiveness of the sponsor's future offerings. On the other hand, the contribution would be in the nature of an unsecured loan. The sponsor might have difficulty recouping the cash outlay, in part because the terms of the master lease could not be renegotiated. It is not inconceivable that the master tenant might be unrelated. If that were the case, it seems unlikely that the sponsor would contribute new funds to the master tenant. Although the sponsor of course wishes to avoid a default by the DST, it would have no economic stake in the unrelated master tenant. Although the sponsor may profit from its associate being the master tenant, having its fortunes linked to that of its affiliate also poses a long-term risk. Aside from its decision whether to infuse new money into the affiliate, a default by the affiliate might trigger a guarantee required by the bank. For these reasons, a sponsor would be circumspect before entering into any situation involving its affiliate being master tenant, and exercise caution before committing its affiliate to a long-term obligation whose term is identical to that of the DST.

d. **Other Suitable Properties.** Delaware Statutory Trust offering syndications have been made for senior housing, student housing, storage facilities and hospitality.

e. **Zero Coupon DST.** A zero coupon DST invests in triple net leased properties to a credit tenant in which all cash flow is remitted to the lender to reduce the property's debt. Typically, the investor will not receive distributions or income from the DST. The structure may be useful for some investors since debt reduction may result in a higher return when the property is sold. One risk with a zero coupon DST is that as the debt decreased, the mortgage interest deduction decreases, resulting in higher taxable income. Since all income is being used to pay down debt, phantom income could result. The IRS could also make the argument that this structure does not adhere with the requirements of a true lease. However, that argument seems unconvincing since the zero coupon lease does appear to have economic substance.

12. Hypothetical Illustrations.

a. **Hypothetical 1. Commercial Lease to Unrelated Credit Tenant.** This hypothetical resembles the facts described in Rev. Rul. 2004-86. The property consists of a FedEx facility or an Amazon Distribution Center. The DST purchases the property using nonrecourse[82] financing collateralized by the property. DST then enters into a ten year triple net lease with FedEx. Neither DST nor the sponsor is related to, or the agent of, FedEx. An offering of beneficial ownership interests in the DST is made to prospective investors. Since the lease is triple net, FedEx will be responsible for all taxes, insurance, repairs and maintenance. FedEx could sublet the property without violating Rev. Rul. 2004-86, but the lease bars subletting.

i. **Note.** Although the property may have been constructed or improved pursuant to FedEx specifications, those renovations must have been completed within a reasonably short fixed period of time after the offering. The ten-year lease term mirrors the term of the DST. Since FedEx is a credit tenant, the risk of default is low. The master trust provides that the DST will terminate upon the earlier of a sale of the property, at which time each beneficial owner will receive a proportionate share of the trust (or LLC) assets. The master trust provides for a transfer distribution if necessary to avoid a default or premature sale.

ii. **Problem With Direct Lease to Tenant.** Where a single, creditworthy tenant enters into a lease involving a single structure, the DST may enter into a triple net lease directly with the tenant, as in above hypothetical above involving FedEx. However, if FedEx were to default in a situation where it was neither insolvent nor bankrupt, the DST would be in danger of defaulting on its own financing obligations. The lease with FedEx could not be renegotiated and the DST could not enter into a new lease with another tenant. If sponsor believed the risk of FedEx defaulting were sufficiently high, sponsor might consider interposing an affiliate between the DST and FedEx. By doing so, were FedEx to default, regardless of the reason, affiliate could renegotiate the lease or find another tenant. However, unless the sponsor expects the master lease

82 Nonrecourse financing is usually in place with the lender at the time of the offering, giving some assurance to the investor who must identify the property within 45 days. Closing on a DST property is rapid and can usually be accomplished several days after the investor submits executed documents to the broker or agent.

to be profitable, it might be reluctant to install its affiliate as master tenant. Furthermore, in circumstances where the master tenant has scant possibility of earning a profit or incurring a loss, the IRS could argue that the arrangement violates the substance-over-form[83], business purpose, or economic substance doctrine.

b. **Hypothetical 2. Single Tenant Structure With Master Lease to Affiliate.** Assume the same facts as in hypothetical 1, except that the tenant is Delta and the property is an airport hangar at JFK. Delta prefers a shorter lease. DST enters into a fifteen year lease with affiliate of sponsor. Affiliate then extends a five year sub-lease to Delta, with two five-year renewal options. Rev. Rul. 2004-86 only prohibits renegotiation of the master lease between DST and the master tenant, and does not bar the master tenant from entering into a new lease with another airline if Delta chooses not to exercise its option. Accordingly, if after five years Delta does not exercise its renewal option (or after ten years if Delta exercises the first but not the second option) then affiliate could find another tenant, or if not, sell the property and terminate the DST, or possibly effect a transfer distribution to an LLC. One thing is certain: Sponsor's affiliate remains liable to the DST for the entire fifteen year term of the loan. If Delta were to default and sponsor's affiliate could not find another subtenant, sponsor could possibly contribute funds directly to the affiliate without violating Rev. Rul. 2004-86. However, the loan would be unsecured and the sponsor would have difficulty recouping the funds. Yet a default by the sponsor might harm its reputation. [Note: This hypothetical is for illustrative purposes only. It is intended to the concept that a bank would likely not be eager to underwrite a DST offering involving an airport hangar and a sponsor would be unlikely to make such an offering. Yet a DST involving land is feasible in some cases.]

c. **Hypothetical 3. Multi-Tenant Structure With Master Lease to Affiliate.** Sponsor owns an apartment complex in Miami Beach it wishes to syndicate for an offering. After the syndication, sponsor retains no equity interest in the DST. It is not possible for the DST to enter into numerous leases with apartment tenants for many reasons: First, the apartment leases would be far shorter than the DST "hold" term. Second, it is entirely possible that further contributions in excess of the DST reserve

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83 The Supreme Court articulated the substance-over-form doctrine in *Gregory v. Helvering*, 293 U.S. 465 (1935), where it found that the separate steps of a reorganization complied with the terms of the Internal Revenue Code, but found the that "what actually occurred" was "an operation having no business or corporate purpose – a mere device which put on the form of a corporate organization as a device for concealing its real character."

might be required to perform necessary ordinary repairs and maintenance; reserves and cash flow held by the DST might be insufficient. Consequently, the DST enters into a long-term triple net master lease with Collins Avenue Fountain, LLC[84], an affiliate of sponsor. Collins Avenue enters into two-year subleases with two hundred new subtenants. Being new, the apartments not likely to need major renovation or repair during the term of the DST. It is also unlikely that they would incur damage by a storm or flood. Rent under the DST-master tenant lease is fixed and may not be renegotiated, except in the case of the master tenant's bankruptcy or insolvency. However, the master tenant is free to renegotiate its leases with existing tenants, or offer leases to new tenants when existing leases end. The obligation of the master tenant to the DST under the master lease is not dependent on the ability of the master tenant to sublet the apartments, nor is it dependent on the master tenant collecting sufficient rental income from the apartments it does rent to fulfill its lease obligations to the DST under the master lease. In the event repairs are necessary to any of the apartments, sponsor could likely contribute cash to the master tenant if the master tenant's own reserves were insufficient without violating the Ruling prohibitions. However, the contribution would still be subject to the limitation imposed by the Ruling that the repair be made to return the apartment to its original condition, and not constitute an improvement. Since the sponsor retains no interest in the DST, the contribution presumably would not vary the interest of the beneficial owners. Therefore, the Ruling prohibition barring new equity contributions to the DST would not be violated.

13. **Personal Property Component.** Under the 2020 Regulations in exchanges involving a qualified intermediary, personal property deemed "incidental" is disregarded in determining whether a taxpayer's rights are expressly limited, as required by Treas. Reg. § 1.1031(k)-1(g)(6). Personal property is "incidental" to real property acquired in an exchange if its value does not exceed 15 percent of the fair market value of the replacement property. If the value exceeds fifteen percent, the property may not be identified for exchange. If the personal property does not exceed 15 percent, then the entire fair market value of the property, including the personal property, may be included for identification purposes. However, even if the property is included for identification purposes, the personal property is still not "like kind" property, and must be treated as boot. The incidental property rule is found in Prop. Regs. Sec. 1.1031(k)-1(g)(7)(iii), which references commercial transactions. The preamble states:

84

Under the lease, master tenant. is required to pay all taxes, insurance, maintenance, ordinary repairs, and utilities, and other charges imposed by federal, state, and local authorities.

> Personal property is incidental to real property acquired in an exchange if, in standard commercial transactions, the personal property is typically transferred together with the real property, and the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property.

14. Issues Involving the Lender. Ideally, risks involving the bank and mortgage financing should be disclosed in the PPM. However, the prospective beneficial owner should make an independent inquiry to determine that the loan structure is acceptable and does not impose unnecessary risk, or impair the ability of the DST to meet challenging situations.

a. **Lender Actions That Could Affect DST Qualification.** Some master lease provisions required by lenders could result in the DST not qualifying as a fixed investment trust. This would cause the DST to be taxed as a partnership and result in its being unsuitable as replacement property. Loan documents should not contain provisions that (i) allow the master tenant and sponsor to be co-borrowers; that (ii) allow the lender to obtain more funds from the master tenant than is owed under the master lease; that (iii) allow "remedies" against the master tenant where the master tenant has not defaulted; or that (iv) allow the sponsor to be a lender or to guarantee the loan, (except for nonrecourse carveouts).[85]

b. **Objectionable Lender Powers Not Disqualifying DST.** The loan should not give the lender the right (i) to require pre-approval for a transfer distribution, or (ii) to compel a transfer distribution, or (iii) to dictate language in the trust documents with respect to when a transfer distribution is permitted, or (iv) to impose unreasonable restrictions on a sale. Granting the lender the power to compel a transfer distribution may cause beneficial owners to lose their right to complete an exchange in situations where the DST might remedy the situation without taking drastic action. Requiring pre-approval could hinder the sponsor's ability to take immediate action to avoid a default.

c. **DST Form Attractive to Lenders.** Lenders benefit from the relative simplicity of lending requirements involving DST financing: Thus, (a) transaction costs are

[85] A nonrecourse carveout is an exception to nonrecourse liability. Such a carveout might exist for environmental liabilities or other unknown risks at the time the loan is extended. A "springing recourse liability" causes a nonrecourse liability to become a recourse liability upon the occurrence of an event.

reduced since only the DST, sponsor and related entities (i.e., master tenant, guarantor of master tenant, and affiliates) need to be underwritten; (b) the lender need only have contact with the DST trustee, and related persons and entities; (c) the bankruptcy of a beneficial owner will not affect property owned by the DST or any loans made to the DST; and (d) the lender need not be concerned with the transfer of beneficial interests.

d. **Lender Risks.** A lender must acknowledge that the DST cannot actively operate and manage the property and that the loan will not be refinanced at the end of the loan term since the property must be sold.

e. **Lender Concerns.**

i. **Risk of DST Default.** Where a master lease is involved, the bank may require the master tenant to become co-obligor on the loan to the DST. However, the master tenant can not incur this risk-sharing obligation without causing the relationship to be taxed as a partnership. One solution posing less tax risk might be to provide lenders with pledges or giving lenders preference through subordination agreements. Any such ameliorative measures would reduce rather than eliminate tax risk.

ii. **Guarantees.** Any new contribution made by a beneficiary would vary the interest held by beneficial owners. Therefore, beneficial owners cannot guarantee loans made to the DST without causing the entity to lose its tax status as a fixed investment trust and be taxed as a partnership. A guarantee by a sponsor or master tenant with respect to the bank loan would risk partnership classification for the same reason applicable to a guarantee made by beneficiaries: It would be in the nature of an additional contribution made to the DST which is forbidden since it would indirectly vary the interests of beneficial owners. However, some believe it may be possible to structure an indirect guarantee involving the master tenant's obligation under the master lease.

(1) **Indirect Guarantee.** May the sponsor indirectly guarantee the rent obligations of the master tenant to the DST under the master lease? The DST might assign that guarantee to the bank. The guarantee would be triggered only if the master tenant failed to fulfill its monthly lease obligation to the DST. Since no cash passes through the DST, the prohibition against new cash contributions to the DST would not be violated. The guarantee does appear to be somewhat vulnerable to challenge under the substance-over-form or step transaction doctrine. Although the risk of partnership taxation may be reduced, the risk may not be worth the benefit, since if successfully challenged, the result could be a complete failure of the DST to achieve its intended tax benefits.[86]

(2) **Sponsor's Retention of Beneficial Ownership Interest.** The retention by the sponsor of any beneficial ownership of the DST past the offering period risks violating Revenue Ruling 2004-86, which could result in the DST being taxed as a partnership. The risk reaches its zenith where the sponsor or its affiliate is a master tenant with an economic stake, since it could be argued that the sponsor's interest as beneficial owner and as owner of the affiliate-master tenant creates two classes of trust interests, thereby violating the rules governing fixed investment trusts, which may have only a single class of interest.

(3) **Elimination of Conflict May Cause Arrangement to Lack Economic Substance.** The risk of conflict may be reduced or eliminated if the master lease limits the ability of the master tenant to earn a profit from its own subleases. Yet if the master tenant becomes a vehicle that for the most part simply transfers rental income earned by the master tenant to the DST, then the arrangement might become vulnerable to challenge under the economic substance doctrine, i.e., does transaction changes in a meaningful way (apart from tax consequences) the taxpayer's economic position; and the taxpayer has a substantial purpose (other than tax) for entering into the transaction.

15. **Federal and NYS Tax Risks.** Some tax risks relate to propriety of certain standard DST provisions merely appearing in the trust indenture. Rev. Rul. 2004-86 prohibits language in the trust granting the trustee certain powers, such as the power to effect a transfer distribution. Other tax risks involve disputes over whether actions taken violate the Ruling. For example, whether a repair impermissibly improved the property. When the IRS issues a deficiency notice, it enjoys a presumption of correctness which the taxpayer may rebut by

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86 When contemplating imaginative arrangements, it may be tempting to factor in the risk of audit. Howard M. Zaritsky, J.D., LL.M., a nationally-recognized expert in federal taxation, noted at an annual Heckerling Institute conference in Orlando, that clients often ask "how will the IRS find out," to which he invariably responds, "they find out."

proving that the deficiency determination was issued arbitrarily or erroneously.[87] New York also establishes a presumption of correctness to a "properly issued notice of deficiency, with the burden resting on the taxpayer to rebut this presumption."[88]

a. **Sponsor Representations Important But Not Sufficient.** In compliance with FINRA recommendations, the sponsor, after conducting its own due diligence, should be prepared to represent in its offering that (i) the DST "should" be treated as a fixed investment trust described in Treasury Regulation Section 301.7701-4(c) and classified as a "trust" under Treasury Regulation Section 301.7701-4(a); (ii) the purchasers should be treated as "grantors" of the DST under the grantor trust rules of the Code; (iii) as "grantors," the purchasers should be treated as owning an aliquot portion of the trust; (iv) the acquisition of a beneficial ownership interest by purchaser should be treated as an acquisition of an undivided fractional interest in the properties for purposes of IRC Sec. 1031; (v) a beneficial ownership interest should not be treated as a "security" for purposes of Section 1031; and (vi) leases entered into by the DST should constitute bona fide leases and not debt financings for federal income tax purposes.

b. **Substantial Compliance With Rev. Rul. 2004-86 Sufficient?** Some minor deviations from Rev. Rul. 2004-86 seem acceptable. They include (i) the assumption that a sponsor may retain interests in the DST during the offering period; (ii) the assumption that a tiered structure of a master trust and sub-trusts is viable under Rev. Rul. 2004-86; (iii) the assumption that a transfer distribution does not violate one of Ruling prohibitions; and (iv) the assumption that certain aspects of the master trust structure do not violate the Ruling.

c. **Revocation of Rev. Rul. 85-13.** The 2024 Green Book proposes that Rev. Rul. 85-13 be legislatively repealed. Without Rev. Rul. 85-13 the beneficial owner would be a mere beneficiary of a trust rather than a pro rata owner of DST property for federal tax purposes. This would render the trust interest ineligible as replacement property under Section 1031. If Rev. Rul. 85-13 were revoked, the revocation could conceivably be made retroactive by Congress. The Supreme Court has held that

87 See *Bull v. U.S.*, 295 U.S. 247 (1935); *Walker v. Com'r.*, 757 F.2d 36 (3d Cir. 1985).

88 See *Matter of Tavolacci v. State Tax Commn*., 431 NYS2d 174 (A.D.3d 1980)

retroactive tax legislation is not per se unconstitutional.[89] Both Democrats and Republicans have long expressed concern that Section 1031 constitutes an unwarranted tax expenditure. However, the legislative unanimity that would be required to revoke Section 1031 now seems quite unlikely. While there is currently no statutory limit on the amount that may be deferred, President Biden had been in favor of limiting the deferral amount to $500,000 per year, or $1 million in the case of joint returns.

d. Transfer Distribution Appears to Pose Acceptable Tax Risk. Although there is no certainty in the manner in which the IRS views transfer distributions, the conversion to an LLC does not appear to entail tax avoidance. In fact, the conversion to an LLC negates the possibility of a subsequent like kind exchange. This "risk" may paradoxically be a somewhat positive factor giving tax headwinds to transfer distributions. Still, the IRS might view the transfer distribution as a constructive violation of Rev. Rul. 2004-86, which prohibits the DST from selling and acquiring new property. Under the Delaware statute, conversion to an LLC can be made by a mere election. This would make it more difficult for the IRS to argue that a transfer distribution would be a constructive "sale."

e. New York Generally Follows Federal Tax Law. New York tax law in generally conforms to federal tax law as embodied in the Internal Revenue Code. In some cases New York tax law "decouples" from provisions in the Code.[90] It is not unusual for New York to examine transactions which the IRS does not, and vice versa. Should

89 Although the Supreme Court has narrowly construed retroactive tax laws, such laws are not bills of attainder barred by the Constitution. As early as the 1930s, the Supreme Court has found retroactive tax laws constitutional and subject to a standard that depends upon whether "retroactive application is so harsh and oppressive as to transgress the constitutional limitation." *Welch v. Henry*, 305 U.S. 134, 147 (1938).

90 For example, PLR 201310002 blessed a tax planning and asset protection strategy that fuses elements of grantor trusts, asset protection and trust taxation in a manner that accomplishes salient tax and asset protection objectives. In these "Delaware Incomplete Non-Grantor Trusts," or "Nevada Incomplete Non-Grantor Trusts" the grantor forms a nongrantor trust in a state with no income tax that also recognizes the ability of a grantor to establish a self-settled spendthrift trust. The grantor, who resides in an income tax jurisdiction, will have avoided state income tax. New York became aware of ING trust abuse relatively soon after those trusts were marketed, and shut them down in 2014 by "decoupling" the state's tax law with the Internal Revenue Code with respect to the classification of this type of trust. This PLR also illustrates the tension between the IRS and wealthy states imposing an income tax, as both vie for tax revenue.

the IRS make changes to the federal return, the taxpayer is required to report that change to the Department of Taxation within 90 days. A failure to report the change will result in the tolling of the statute of limitations on collection, and New York may assess the tax at any time.[91] The obligation to report the change is not mutual: There is no requirement that the taxpayer advise the IRS of a state change in tax liability. This conclusion emanates directly from the Supremacy Clause: Federal tax law does not look to state tax law. New York and especially California have shown an interest in like kind exchanges, and may audit like kind exchanges in situations where the IRS does not. States not imposing an income tax would have little reason to audit a return reporting a like kind exchange.

f. **Passive Activity Limitations.** Beneficial investors will not be actively participating in rental real estate activities, and therefore income and deductions from DST activities will be passive. Passive activity income and deductions are confined to a separate 'basket" of income for federal income tax purposes, and may offset other items in that basket, but may not offset other income and deductions which are not passive. Under IRC § 469, passive activities include (i) trade or business activities in which the taxpayer does not materially participate and (ii) rental activities.

g. **Importance of Tax Opinion.** Investors contemplating the acquisition of beneficial ownership interests in a DST should consider obtaining a formal tax opinion, and not rely exclusively on the opinion of counsel for the sponsor, or the private placement memorandum. FINRA advises that investors obtain a "should" assurance[92] before proceeding with a tenancy in common investment. Given its comparative complexity,

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91 New York Tax Law §§ 659, 683(c)(1)(C).

92 A transaction that "will" result in the desired tax treatment is one that has a 90 percent or higher chance of success. Such as transaction would not, according to the IRS, require an opinion letter issued by the IRS. A transaction that "should" result in the desired tax treatment is understood to mean at least a 60 percent chance of prevailing if audited. A transaction whose success is "more likely than not" indicates a greater than 50 percent chance of prevailing. A transaction with a 33 percent chance of success is said to have a "reasonable basis." For a transaction to be "not frivolous," it must have at least a 10 to 20 percent chance of success. Treas. Reg. § 1.664-4(c)(1)(ii) provides that a tax opinion cannot be relied upon if based on unreasonable facts or assumptions. Moreover, if the transaction violates the economic substance doctrine, reliance on a professional opinion will not serve to mitigate penalties.

the same level of comfort seems appropriate for a DST investment.[93] Although a reputable Sponsor will disclose relevant information, differences in structures, leases, and loan agreements vary widely. Unusual financing terms which could affect beneficial owners also require examination. Although the rights of beneficial owners are typically circumscribed in the master trust, many terms in the offering will affect beneficial owners; and some of those terms may directly affect the suitability of the investment for a particular investor.

15. Conclusion. For the reasons discussed, the Delaware Statutory Trust may be an attractive option for some investors when considering replacement property in a like kind exchange.

93 Under the section "Suitability and Due Diligence" in connection with private placements of tenants-in-common, the Financial Industry Regulatory Authority (FINRA) concludes: "Given the importance of that tax treatment, a member should obtain a "clean" legal opinion that a TIC "should" or""wil"" qualify for exchange under Section 1031. If a sponsor failed to obtain a legal opinion, or only obtained a "more likely than not" opinion, that would be a material fact. . ." The need for a "should" legal opinion is no less important when considering a DST investment than it is for a tenancy-in-common investment.