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Like-Kind Exchanges and Involuntary Conversions (Related Articles)

THE INTERSECTION OF DELAWARE STATUTORY TRUSTS AND TENANCIES-IN-COMMON

The rules for Delaware statutory trusts are separate and apart from the rules for tenancies-in-common.

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Terry Cuff is a well-known expert in the area of like-kind exchanges, and he has graced tax professionals with numerous articles on the subject.[1] Thus, it is unusual to read one of his articles and conclude that it is wrong. However, Terry's recent article in these pages (hereafter referred to as "the prior article"),[2] requires a response. In the authors' view, Terry glossed over the distinctions between a Delaware statutory trust (DST) and a tenancy-in-common (TIC) arrangement by indicating that the rules concerning the latter are also relevant to the former.

As described in more detail below, the rules concerning DSTs and TICs arise under separate provisions of the regulations. Moreover, they have little in common except that an interest in either may constitute an interest in property for purposes of Section 1031. In this regard, the IRS had to issue two separate authorities to provide guidance on how and when an interest in a DST and a TIC can be used as like-kind property in an exchange under Section 1031. The first guidance issued was Rev. Proc. 2002-22[3] ("the TIC Rev. Proc."), which sets out the guidelines under which the IRS will consider issuing private rulings that a TIC constitutes a direct interest in real property, and not an interest in a business entity under Reg. 1.7701-3.

The second guidance was Rev. Rul. 2004-86[4] ("the DST Ruling"), which addressed whether a trust will be treated as a trust under Reg. 1.7701-4 or will be classified as a business entity under Reg. 1.7701-3. If an entity is classified as a trust, and the trust also satisfies the requirements of a grantor trust under Section 671, interests in that trust will be treated as interests in the property owned by the trust for purposes of applying Section 1031. In contrast, if the trust is treated as a business entity, interests in the trust will be treated as interests in a partnership or corporation (under Reg. 1.7701-3), which will not constitute valid replacement property under Sections 1031(a)(2)(D) and (E).

The TIC Rev. Proc. and the DST Ruling provide guidance on when interests in a TIC and a DST can be interests in real property, and not interests in an entity. However, the DST Ruling (which was released after the TIC Rev. Proc.) does not indicate that the requirements of both must be satisfied when an interest in a DST is

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acquired. It is silent on this point. Nevertheless, the prior article concluded that anytime a DST is used in a like-kind exchange under Section 1031, the requirements of both the TIC Rev. Proc. and the DST Ruling must be satisfied.

While it is unfortunate that the IRS did not specifically address the interaction of the TIC Rev. Proc. and the DST Ruling in the DST Ruling (or elsewhere), the authors believe the proper analysis to be that the requirements enumerated in the TIC Rev. Proc. are irrelevant to a DST analysis. In fact, the authors believe that if the requirements established in the TIC Rev. Proc. are applied to a DST, the DST will, by its terms, fail to satisfy the requirements of the DST Ruling.

A TIC lacks a legal entity for jointly owning property, so the relationship of the co-owners is governed by a contract. The TIC Rev. Proc. and its various requirements make it clear that in a TIC, the IRS is concerned with the relationship of the co-owners amongst themselves and amongst the sponsors. It is testing whether a joint venture or contractual relationship resembles a partnership, not just by the quantum of all activities undertaken with respect to the real estate, but in looking at how the parties interact with each other with respect to the finances and operation of the real estate. Under the TIC Rev. Proc., a substantial quantum of activities involved with rental real estate are permitted (leasing, financing, managing, repairs, improvements, etc.) so long as "non-customary services" are not rendered. There are, in fact, what one generally would refer to as normal ongoing rental operations being carried on. However, the rental operations are not the focus of the TIC Rev. Proc. It focuses on how the parties make decisions, split profits and allocate debt, and the like.

The Service's view of testing under the DST Ruling is very different. It will permit a look-through of a DST for Section 1031 purposes only if the trust qualifies as a "fixed investment trust." The analysis assumes an entity involvement, but fits it in a very narrow characterization traditionally reserved for single pools of securitized debt or stock. The rules under Reg. 1.7701-4 look to the quantum and scope of the activities in determining whether the DST is a traditional trust or a trust being used as what would otherwise be thought of as a "business trust." It is for this reason that the trustees' powers with respect to the real estate are greatly limited far below what would be necessary to carry on the type of a rental business that was permitted for TICs by both the TIC Rev. Proc. and Rev. Rul. 75-374.[5] The concept is that the DST, to be a fixed investment trust, must be extremely passive and cannot undertake very normal rental activities, such as releasing the properties and refinancing debt.

THE RULES CONCERNING DSTS AND TICS ARISE UNDER SEPARATE PROVISIONS OF THE REGULATIONS.

Contrary to Terry's assumptions, these powers do not migrate over to the beneficiaries of the DST—they just do not exist at all. A classic trust requires that the trustees have the power to "protect and preserve" the property. The beneficiaries do not have any say in the operations or control of the trust's investment operations. Their role is simply to receive the distributions in accordance with the trust terms. Thus, the beneficiaries can have no say whatsoever in the operation and control of the DST. (This is what in fact makes it such an excellent vehicle from the lender's point of view, because a bankruptcy of a beneficiary will not affect the trust or its assets.)

As the discussion below will show, the complete inconsistencies of the TIC Rev. Proc. and the DST Ruling can be reconciled only by concluding that they are mutually exclusive in their application. That is, the IRS views them as totally separate analytical regimes. The rules concerning a TIC do not apply to a DST, and vice versa.

TICs

Under the TIC Rev. Proc., the IRS generally will issue a ruling that a TIC arrangement will be treated as the direct ownership of an interest in real estate, and not as an interest in a business entity taxable as a partnership, if numerous criteria have been satisfied. Direct ownership in real estate (as a TIC) would constitute an interest in property that qualifies for a like-kind exchange under Section 1031,

[1] He is also a friend of Richard Lipton's and consented to the publication of this article.

[2] Cuff, "Exchanges, Parking Transactions and Delaware Statutory Trust—Some New Developments under Section 1031," 32 Real Estate Tax'n 4 (Fourth Quarter 2004).

[3] 2002-1 CB 733.

[4] 2004-33 IRB 191.

[5] 1975-2 CB 261.

whereas an ownership interest in a business entity could never be subject to a like-kind exchange.

Although a complete listing of all of the requirements of the TIC Rev. Proc. is beyond the scope of this article,[6] its key requirements include the following:

- A TIC may be created with respect to only one property.
- Each co-owner must directly (or through a single-member LLC) hold title to the property.
- The number of co-owners is limited to 35.
- The co-ownership may not file a partnership return, conduct business under a common name, or hold itself out as any other form of business entity.
- The co-owners must unanimously approve any agreement involving the sale, lease, financing, or management of the property; all other agreements require only majority approval.
- A manager cannot be hired for a period in excess of one year, and the co-owners cannot grant a global power of attorney.
- Each co-owner must have the right to transfer, partition, or encumber its interest without the approval of any other co-owner.
- If the property is sold, any debt encumbering the property must be repaid and the net proceeds distributed to the co-owners pro rata.
- The co-owners can make advances, other than pro rata advances or contributions, only for a limited period of time. The co-owners can make unlimited pro rata contributions with respect to the property.
- A co-owner may have an option to acquire an interest of other co-owners (a call option), but a co-owner may not acquire an option to sell its interest to the sponsor, a lessee, or another co-owner (a put option).
- The co-owners' activities are limited to those customarily performed in connection with the maintenance and repaid of real estate.
- Management and brokerage agreements are permissible, with limitations.
- A lease cannot be entered into with a co-owner.

A TIC LACKS A LEGAL ENTITY FOR JOINTLY OWNING PROPERTY.

The TIC Rev. Proc. was an outgrowth of prior cases and rulings. In Rev. Rul. 75-374, the IRS ruled that a co-ownership of real property did not give rise to a partnership when the co-owners performed only customary services related to the rental of property (e.g., providing heat and water and removing garbage) and did not engage in other business activities. While this level of services is not extensive, it is consistent with the activities that are undertaken by owners of property. There also were a number of cases in which the courts found that a co-ownership either did (or did not) rise to the level of a partnership.

Another important authority underlying the TIC Rev. Proc. was Reg. 1.7701-3—the "check the box" or "business entity" regulations. These regulations determine whether an unincorporated organization will be treated as a business entity. If a business entity is found to exist, it must be treated as either a partnership or a corporation. Any domestic business entity with two or more owners that is not described in Reg. 1.7701-3 is, under the default rule in the regulations, treated as a partnership. Thus, every unincorporated organization that is found to be a business entity will be treated as a partnership for tax purposes unless it elects to be treated as a corporation.

The TIC Rev. Proc. was needed to address the difficult question of whether the co-ownership of property constituted a partnership for tax purposes, or whether TICs could be treated as owning a direct interest in real estate. If the former treatment applied, the interest of each co-owner would be viewed as a partnership interest that was not eligible for like-kind exchange treatment under Section 1031(a)(2)(D). If the tenants in common were treated as owning direct interests in real estate, however, the ownership interests could be sold or acquired in a like-kind exchange.

It must be emphasized that the guidelines set out in the TIC Rev. Proc. apply only when a co-ownership that does not involve the formation of a legal entity would be treated for tax purposes as not resulting in a business

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[6] For a thorough discussion of the TIC Rev. Proc., see Lipton, "New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges," 96 J Tax'n 303 (May 2002).

entity.[7] If the TIC arrangement constitutes a business entity, it is a partnership under the default rules in Reg. 1.7701-3. If the TIC arrangement does not give rise to a business entity, each of the TICs is permitted to treat the arrangement as direct ownership of an interest in real property (instead of as an interest in a partnership). Thus, the crux of the TIC Rev. Proc. is a determination whether or not Reg. 1.7701-3 applies to a particular co-ownership agreement.

DSTs

The most important distinction in analyzing the tax treatments of a DST and TIC is that the latter involves a determination of whether the relationships and activities constitute a partnership for tax purposes, whereas in the DST Ruling, the existence of an entity was assumed but the entity had to classified. Specifically, the DST Ruling addressed whether a trust would be treated as a trust under Reg. 1.7701-4 or would be classified as a business entity under Reg. 1.7701-3. If a trust is classified as a trust, and also satisfies the requirements of Section 671, interests in the trust will be treated as interests in the property for purposes of applying Section 1031. In contrast, if the trust is treated as a business entity, interests in the trust will be treated as interests in a partnership or corporation (under Reg. 1.7701-3) that will not constitute valid exchange property under Sections 1031(a)(2)(D) and (E).

Again, a full discussion of the DST Ruling is beyond the scope of this article.[8] The DST Ruling, however, imposed several requirements if a trust is to be treated as satisfying the requirements of Reg. 1.7701-4. The most important of these requirements is that the beneficiaries cannot be involved in the operation or management of the trust and that the trustee can not have any of the powers that have come to be known as the "seven deadly sins":[9]

1. The trustee cannot dispose of the trust's property and then acquire new property (although the trustee can sell the trust's assets and dissolve the trust).
2. The trustee cannot enter into new leases.
3. The trustee cannot renegotiate a lease with an existing tenant.
4. The trustee cannot enter new debt encumbering the trust's assets.
5. The trustee cannot renegotiate any existing debt.
6. The trustee cannot invest cash received to profit from market fluctuations (all cash must be invested in short-term Treasuries that will be distributed at the end of each calendar quarter).
7. The trustee may not make more than minor, non-structural modifications to the trust's property not required by law.

As a practical matter, these restrictions mean that a DST can be engaged only in the passive holding of rental real estate. It cannot engage in the types of activities that a valid TIC structure can engage in under the guidance established in Rev. Rul. 75-374. Certainly the trustee cannot lease, improve, re-finance, or otherwise "operate" the real property in any context other than the mere receipt of rental payments. That is why it has been assumed that DSTs will work best with property that is subject to a long-term, triple-net lease, or property that requires little or no action by its owner, such as a master lease or a ground lease. Any property that requires either active management or foreseeable capital contributions from its owner likely will be inappropriate for a DST. These restrictions are all consistent with the fact that a DST *is* a legal entity, but it is not treated for tax purposes as a "business entity," because the DST will be considered an investment trust since it will be involved only in the passive holding of real estate.

IF THE TIC ARRANGEMENT CONSTITUTES A BUSINESS ENTITY, IT IS A PARTNERSHIP.

The prior article

The prior article contains a number of specific statements and analyses concerning how the rules in the TIC Rev. Proc. will be applied in determining the tax treatment of a DST. Fundamentally, by assuming that both sets of

[7] Despite the somewhat arduous ruling guidelines provided in the TIC Rev. Proc., numerous transactions have been sold in the marketplace, relying on a favorable tax opinion rather than a private letter ruling. Most of these deals do not strictly comply with all of the requirements of the TIC Rev. Proc.'s requirements. Significantly, only one private letter ruling has been issued under the TIC Rev. Proc. See Ltr. Rul. 200327003.

[8] For a thorough discussion of the DST Ruling, see Lipton, Golub, and Cullen, "Delaware Statutory Trusts and 1031: A Marriage Made In Heaven or Just a Pipe Dream," 101 J Tax'n 140 (September 2004).

[9] These restrictions may be relaxed somewhat in the case of the tenant's bankruptcy or insolvency.

rules apply with respect to a DST, the prior article collapsed the two types of ownership into one, referring to "tenancies-in-common in which a Delaware statutory trust owned the real property."[10] Such a simple statement is wrong because a DST does *not* involve a TIC.[11] A DST is one means by which multiple persons can collectively own an interest in real estate; a TIC is another. Other means by which multiple individuals could collectively own an interest in real estate include a partnership or a corporation, neither of which would be taxed the same as a DST or a TIC.

IN THE DST RULING, THE EXISTENCE OF AN ENTITY WAS ASSUMED BUT THE ENTITY HAD TO CLASSIFIED.

The prior article goes on to address the interaction of the TIC Rev. Proc. and the DST Ruling. It states:

> Curiously, [the DST Ruling] seems completely oblivious to the existence of ruling standards for tenancies-in-common that are incorporated in [the TIC Rev. Proc.]. It is almost as if there is a left side and right side of the IRS that do not communicate with one another. The [DST Ruling] is not well coordinated with the [TIC Rev. Proc.].

In fact, the DST Ruling was not—and should not have been—coordinated with the TIC Rev. Proc. because they addressed totally different situations. The rules for determining whether an unincorporated organization will be treated as a business entity versus a co-ownership as a TIC are completely different than the rules for determining whether a legal entity—a trust—will be classified as a trust or a business entity. Put simply, the TIC Rev. Proc. considered situations in which there was no legal entity and the issue was whether a business entity should be imputed, whereas the DST Ruling considered situations in which there clearly is a legal entity and the question is the classification of that legal entity as a trust versus a business entity.

After discussing specific aspects of the DST Ruling, the prior article then addresses, for several pages, all of the open questions that arise in structuring a DST that also meets or attempts to meet the requirements of the TIC Rev. Proc.—which requirements are, of course, totally inapplicable. The suspect statements in the prior article include the following:

1. "A [DST] holding real property technically cannot can qualify to apply for a private letter ruling under [the TIC Rev. Proc], but that apparently does not preclude applying for a ruling that the arrangement is a tenancy-in-common for tax purposes." This statement cannot be correct, because a DST by definition involves a legal entity holding title to the property, which cannot be present in a TIC. A TIC avoids classification as a business entity under Reg. 1.7701-3 and also does not constitute a trust under Reg. 1.7701-4, whereas a DST *is* a trust under Reg. 1.7701-4. Thus, a DST would never qualify for a private ruling under the TIC Rev. Proc.
2. "Advisors nevertheless should be cautious if the number of holders of beneficial interest of the [DST] exceeds 35." The 35-owner limitation is relevant for purposes of receiving a ruling under the TIC Rev. Proc., although there is no direct substantive legal basis for this limitation. It certainly has no impact whatsoever on a DST. The IRS was concerned in the TIC Rev. Proc. about whether a co-ownership arrangement was so large that there "must" be some type of business entity present in a situation where one was not legally formed. In a DST, in contrast, there is by definition a legal entity, so the ownership limitation is unnecessary.
3. "[The DST Ruling] does not discuss how decisions should be made among owners of the trust interests and whether decisions must be made by majority decision or by unanimous decision." This statement in the prior article misses the fundamental point that the owners of the beneficial interests in a trust make *no* decisions. All decisions concerning a trust and the property owned by the trust are made by the trustee; the beneficiaries have no decision-making power. In contrast, in a tenancy-in-common arrangement, the consent of each tenant is required for every sale, lease, and re-financing, except perhaps for immaterial decisions. The two methods of ownership are as different as night and day in this respect—a TIC provides maximum decision-making authority to each of

[10] Cuff, *supra* note 2 at 6.

[11] Likewise, the prior article stated that the DST Ruling addressed situations in which a TIC could be structured with the underlying real estate owned by a DST. Cuff, *supra* note 2 at 6. In fact, the DST Ruling addresses situations in which there is no TIC.

the co-owners to avoid partnership status, whereas a DST provides none at all to the beneficiaries, to support trust status.

4. "The approval of sale of the property is not addressed in the [DST Ruling], although the [DST Ruling] is clear that the trustee cannot have this authority." This sentence contains two misstatements. First, it is clear that the beneficiaries have *no* right of approval with respect to a sale of the property, because only the trustee can cause actions by a trust. Second, it also is clear that the trustee of a DST can *sell* the trust's property—the DST Ruling only prohibits the trustee from selling the property *and* re-investing the proceeds of the sale. Nothing in the DST Ruling prohibits the trustee from selling the property owned by the trust and distributing the proceeds of the sale to the beneficiaries.[12]
5. "It is not clear by what vote the holders of beneficial interests must approve a lease or the creation or modification of a blanket lien under the [DST Ruling]. Advisors are likely to default to the [TIC] Rev. Proc. standard." Again, the DST Ruling is clear—no approval whatsoever is required or permitted from the holders of beneficial interests in the trust. The "unanimous approval" standard that applies to TICs is wholly inapposite in the case of a DST.
6. "It is not clear from the [DST Ruling] whether decisions by the owners of beneficial interest in the trust require majority vote or unanimous vote. Advisors are likely to default to the standard of the [TIC] Rev. Proc." See discussion above—the owners of beneficial interest in a DST have no vote at all, and the TIC Rev. Proc.'s rules for TIC arrangements do not apply to a DST.
7. "[A]dvisors likely will default again to the standards of" the TIC Rev. Proc. with respect to the rights of the co-owners "to transfer, partition, and encumber the co-owner's undivided interest in the property without the agreement or approval of any person." The TIC Rev. Proc. requires that each co-owner of property as a TIC be entitled freely to transfer or encumber its interest, because limitations on the rights of ownership are more consistent with a business entity than co-ownership of property. In contrast, because there is an entity in the case of a DST, there is no reason why the rules in the TIC Rev. Proc. need be applied to the beneficial interests in a DST. Thus, the beneficiaries of the DST could impose whatever limitations they determine to be appropriate on the transfer rights of their co-beneficiaries without regard to the requirements in the TIC Rev. Proc. Moreover, there is no reason to restrict transfers by the beneficiaries of a DST as they cannot take any actions that will hurt the other beneficiaries.
8. "[A]dvisors will endeavor to comply with the more restrictive standards of either the [TIC Rev. Proc. or the DST Ruling] on questions of management or brokerage agreements, disbursing revenue, obtaining or modifying insurance, negotiating lease modifications, negotiating indebtedness modifications, and manager and brokerage fees." Again, the TIC Rev. Proc. will play no role. The trustee of the DST can enter into a long-term management agreement for a manager of the property, provided that the management agreement does not involve a sharing of net income or loss (which could result in a deemed partnership between the DST and the manager). Moreover, the trustee of the DST is not permitted to have the power to engage in any of the seven deadly sins—let alone actually do so—including lease modifications and negotiating indebtedness. Put simply, the rules for DST and TICs are completely different, so that the "more restrictive standard" approach is not correct.
9. "Advisors presumably will seek to satisfy the standards of the [TIC] Rev. Proc." with respect to leases, percentage rent, the lenders, payments to sponsors, etc. In this case, the analysis in the prior article might be wrong, but the conclusion is likely correct. Advisors of a DST

AS A PRACTICAL MATTER, A DST CAN BE ENGAGED ONLY IN THE PASSIVE HOLDING OF RENTAL REAL ESTATE.

[12] If the trust owns real estate, each of the beneficiaries would be treated as having disposed of its portion of that real estate.

will want to make sure that the DST is not deemed to be engaged in a partnership with either the lessee of the property or any sponsor. So the requirements of the TIC Rev. Proc., which basically restricts TICs from entering into arm's-length arrangements with lessees and sponsors (and property managers), will likely be employed by a prudent trustee as well. In most cases, of course, a DST will involve a long-term net lease of property (or a property that is subject to a long-term master lease), so the types of issues that frequently arise in a TIC environment simply will not come up in the context of a DST.

10. "[I]t would be inadvisable for [a DST] to undertake business under a common name." Why? A DST *is* an entity, whereas a TIC is not. Thus, because it is an entity, a DST can operate under a common name. It simply must be passive in the way in which the property is operated.

There are many other places in the prior article where a comparison is made between the rules for DSTs on the one hand and TICs on the other, and the suggestion is made that the "more restrictive" of the two rules should be applied. Presumably Terry was concerned that a revenue agent will not understand the distinction between a DST and a TIC. But the distinction between DSTs and TICs is not like one of apples and oranges, which are different but are both fruit. A DST and a TIC are more like a steak and broccoli. They both are ways to hold property for multiple owners (i.e., in this analogy, they both are food), and they both create a means to qualify for a like-kind exchange (they could be viewed as part of the same menu), but that is where the similarity ends. The rules for one simply do not apply to the other.

Conclusion

It is a rare day when Terry Cuff makes a mistake. Unfortunately, his analysis in the prior article appears to have gotten off on the wrong foot, and the fundamental theoretical flaw—that the rules for TICs are applicable to DSTs—infects much of the analysis in the prior article. In fact, the rules for DSTs are separate and apart from the rules for TICs, and practitioners need to consider the different types of ownership structures that are available in order to determine which rules apply. A DST can be used by multiple persons as a legal entity to own title to real property (which is something that many lenders like), but the activities of the DST are extremely limited. In contrast, a TIC arrangement can be used by multiple persons to own property without a legal entity, but the restrictions in the TIC Rev. Proc. and the case law concerning TIC arrangements would be applicable. Either method can be used to allow multiple persons to own interests in the same real estate in a manner that would not invalidate a like-kind exchange of real estate. ■