# Properly Structured DSTs – More Than the "Seven Deadly Sins"

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice.

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July 20th of this year marks the 20th anniversary of the issuance of Revenue Ruling 2004-86[1] (the "*Revenue Ruling*"), whereby the IRS provided guidance regarding structuring a Delaware statutory trust ("*DST*") such that beneficial interests therein may be eligible for treatment as "replacement property" for Section 1031 like-kind exchanges.[2] Although the Revenue Ruling and its structure were born in the shadows of the prevailing "tenancy-in-common" structure set forth in Revenue Procedure 2002-22[3] when first issued, the Revenue Ruling has enjoyed increasing attention following the 2008 "great recession" and in recent years has attracted an impressive list of real estate operators and sponsors that recognize its unique power – allowing tax-advantaged syndicated real estate offerings that can attract Section 1031 investors of all ticket sizes. Your authors believe that for so long as Section 1031 generally remains a viable option for investors seeking tax-deferred real estate exchanges, the syndicated DST structure will remain a cornerstone of the securitized real estate offering industry.

Despite this, readers and taxpayers alike should approach the Revenue Ruling and related offerings with tempered caution, as the Revenue Ruling appears deceptively straightforward at first blush. After all, it is only a few pages on standard printed paper and can easily be read in a single sitting without resorting to treatises and other secondary materials to understand. However, taxpayers should not be lulled into a false sense of understanding or security based solely on a facial reading of the Revenue Ruling. Hidden between the lines are decades of case law, regulatory history, and statutory intent. Although public commentary on the Revenue Ruling focuses almost entirely on the so-called "seven deadly sins" laid out in the Revenue Ruling, unsuspecting sponsors and investors (and yes, even some tax lawyers) can fall prey to latent traps not apparent on the face of the Revenue Ruling.[4] Notably, the Revenue Ruling essentially stands for the premise that a properly structured DST can be treated as an "investment trust" for U.S. federal income tax purposes under Treas. Reg. Section 301.7701-4(c) and related case law (collectively, the "*Investment Trust Rules*"). It is often overlooked that it is this characterization as an investment trust that makes a DST eligible for Section 1031 treatment. Indeed, the Revenue Ruling simply gets one's foot in the door. However, any offering or suite of offering documents that purports to comply with the Revenue Ruling but includes only a copy-pasted laundry list of prohibitions against the seven deadly sins but which does not include an analysis of the underlying transactions, relationships, documents, agreements and arrangements in the context of the full Investment Trust Rules may have blind spots and fall short of the rigorous requirements of such rules. This is an unfortunate market development that your authors have observed.

In light of the proliferation of purported Revenue Ruling-compliant offerings, Peter Matejcak and Russell Lawson of Baker & McKenzie LLP author this column to give you a brief and plain-English crash course in the history and requirements of DSTs, and lay out several common issues that you, either as a sponsor or an investor, should be able to answer immediately if the DST offering in question is properly structured.

## BACKGROUND

In decades past, a taxpayer seeking to engage in a tax-deferred like-kind exchange under Section 1031 was subject to a host of requirements that resulted in complex transactional forms. The taxpayer would sell real estate (*i.e.*, relinquished property) and need to identify other real estate (*i.e.*, replacement property) within a 45-day period and close within a 180-day period, each running as of the date of the disposition of the relinquished property. Each property needed to be of "like-kind" (a term of art under the Section 1031 rules with attendant regulations and analysis), and together with the interplay of mortgage and taxable "boot" considerations, taxpayers often found the process more complicated than anticipated.

Over time, tax law practitioners, consistent with guidance from the IRS, devised real estate structures to bring the benefits of a Section 1031 like-kind exchange to a broader market.[5] One such structure was the "tenancy-in-common" or "TIC" structure that prevailed prior to the issuance of the Revenue Ruling, whereby a sponsor could carefully structure an offering such that investors would be considered as owning an undivided fractional interest in the real property that was the subject of the offering. As a result, investors could claim that their investment in the TIC structure qualified as an investment in qualifying replacement property for purposes of Section 1031 and obtain tax deferral. Tax-advantaged TIC structures, however, are subject to various requirements as provided in Revenue Procedure 2002-22, including that each investor must directly own (or indirectly, through an entity disregarded for tax purposes) an interest in the property,[6] a limit on the number of investors (*i.e.*, 35), restrictions on property management, and the requirement that any decision related to the sale, leasing, financing, or management of the property be unanimous among the investors. In the fallout of the 2008 "great recession," the TIC limitations meant that investors found themselves in structures where a single dissenting vote

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could veto plans to mitigate a crisis, causing investors to become acutely aware of the pitfalls of these limitations. Such limitations and the difficulties of liaising with co-owners seeking unanimous consent also caused TICs to fall out of favor with commercial real estate lenders.

Enter the Revenue Ruling. In the ruling, an individual, A, negotiated an interest-bearing loan with a bank and used the loan proceeds to acquire a property, Blackacre, which was the sole collateral of the loan. A then leased Blackacre to a tenant, Z, pursuant to a "net" lease whereby Z was responsible for all property-level expenses (including taxes, insurance, maintenance, etc.) and paid a fixed amount of rent to A. Neither A nor Z could alter the amount of the fixed rental payment, except to the extent of certain pre-wired rental adjustments that were fixed and in place as of the inception date of the lease, or alter the terms of the lease unless Z was bankrupt or insolvent. Thus, in effect, A organized the acquisition of Blackacre and then master leased Blackacre to Z in a wholly pre-determined structure, such that A did not have to manage the property and received a pre-determined rental income stream that did not depend on the profitability or vacancy of Blackacre. Immediately thereafter, A formed a DST under Delaware state law and contributed A's entire interest in Blackacre to the DST in exchange for ownership interests in the DST. A then conveyed its DST ownership interests to unrelated parties, B and C, in exchange for their own respective real estate properties. Importantly, as of the time of conveyance, the DST's trust agreement contained restrictions and other requirements (some of which form the seven deadly sins noted above) that practically required the DST act as a single-purpose entity with respect to Blackacre, and limited the DST to acting as a form of investment trust that did not allow owners of the DST to alter the form of the DST's investment in Blackacre. Looking to these facts and drawing on applicable tax law relating to investment trusts and Section 1031 exchanges, the IRS concluded that B and C could each be treated as acquiring an undivided fractional interest in Blackacre, allowing B and C to treat their acquisition of DST interests as the acquisition of real estate replacement property for purposes of Section 1031.

Although restrictive, the Revenue Ruling provided a structure that differed from TIC offerings in several regards, three of which are paramount: (1) control over the property could be delegated to a trustee or trust manager separate from the owners of the DST without the need for unanimous consent on major decisions, including for purposes of property management and disposition; (2) a single legal entity could be formed to serve as the "borrower" for finance law purposes (yet remain disregarded for income tax purposes); and (3) the number of potential DST owners was not limited by tax law.[7] With centralized control that could be retained by a sponsor (without the sponsor needing to be an investor itself) and the ability to cater to a large number of investors, the modern DST offering marketplace was born.

## EVOLUTION TO THE PRESENT

After reading the (truncated) description above, readers may be surprised to know that additional IRS guidance regarding tax-advantaged DST offerings is practically nonexistent. Beyond Revenue Procedure 2020-34,[8] which temporarily loosened some of the IRS-imposed restrictions on DST offerings during the Covid pandemic, your authors are aware of no material guidance beyond the Revenue Ruling itself. As a result, the tenor of the DST marketplace has evolved organically.

In recent years, smaller-scale sponsors seeking to expand their product portfolio have joined the fray, recognizing that their existing real estate arrangements and expertise can be leveraged to offer investors a wider range of attractive investment opportunities. In addition, large-scale real estate operators, including certain SEC registered, non-traded REITs, have come to view DST offerings as a way to further access the alternative investments market and attract capital from a previously untapped pool of investors, *i.e.*, those trying to engage in like-kind exchanges.[9] As a result, the types and variety of offerings have changed. For example, complex offerings involving properties on land subject to long-term ground leases are becoming more common, as are offerings involving mixed portfolios of debt-free and leveraged properties, and increased competition in the marketplace is driving sponsors to consider alternative property portfolios to attract investors.

With increased sponsor and investor attention, the demand for competent legal counsel to service these transactions has naturally increased. However, and as noted above, the misleading simplicity of the Revenue Ruling draws attention to the baseline "must haves" of structuring a Section 1031-compliant DST offering in a manner that does not inform taxpayers or even counsel of the practical implications of these restrictions, or of other areas of tax law that could apply to negate the intended tax structuring. An offering or a tax opinion authored by tax counsel that has not analyzed latent considerations deriving from the Investment Trust Rules is dangerously incomplete. Considering that there are generally no cure provisions for Section 1031, an adverse determination by the IRS could jeopardize <u>all investors'</u> Section 1031 exchanges, which would likely evoke catastrophic consequences and liability obligations for sponsors.

Your authors have devised the following non-exhaustive list of "hot topics" that investors, sponsors, and tax counsel should keep in mind when designing and/or vetting a DST structure, coupled with limited commentary to start conversations. To the extent that these considerations are not addressed (if applicable) or cannot be readily addressed, the DST offering in question may be deficient.

### Prohibition on Powers of the DST

Per the Revenue Ruling, it is not enough that the DST simply avoid taking any action that violates the seven deadly sins. Instead, the DST (and its trustees and manager) should not even have the power to undertake any such actions. From a practical perspective, a DST's operative document should expressly prohibit any such actions or powers.

### One Class of Interests

Under the Investment Trust Rules, a DST should only have a single class of ownership interests, representing undivided beneficial interests in the assets of the trust. If a DST facially has more than one class of interests, it should be confirmed that the existence of multiple classes of ownership interests is merely incidental to the facilitation of direct investment in the assets of the trust in order to stay within the bounds of the Investment Trust Rules. For example, it is typical for sponsors to utilize

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a sponsor-specific "different in name only" class to represent its initial ownership of the DST that is redeemed out as the DST is syndicated to external investors. One of the key considerations that should not be missed is analyzing whether any other contractual arrangements within the structure could create a *deemed* second class of DST interests – a strong understanding of judicial tax doctrines and the complexities of DST structures is critical to avoiding this pitfall.

### DST Ownership of Property

Because it is imperative that a taxpayer seeking to effectuate a Section 1031 like-kind exchange be treated as acquiring an interest in real property, a DST's ownership of real property should be structured to avoid interposing a regarded taxable entity between the beneficial owners and the DST's underlying real property. The simplest way is for a DST to own real property directly. However, if a DST must hold property through an entity (for example, if a sponsor is syndicating multiple properties and desires to segregate the properties in individual entities beneath a syndicated "parent" DST) a DST may hold properties through subsidiary DSTs that themselves are structured within the bounds of the Revenue Ruling and the Investment Trust Rules, thereby creating a tiering of investment trusts between the taxpayer and the underlying property. A DST should not own real property via a common single member LLC holding company. While common in practice outside of the DST space, because the Revenue Ruling allows beneficial owners to essentially ignore the DST and "look through" to its underlying assets for purposes of Section 1031, multiple taxable persons will thus be considered as owning interests in an LLC, causing the LLC to spring into existence as a partnership for tax purposes, which would ruin tax deferral under Section 1031.[10]

### Aggregating Exit Should Not Be Foregone Conclusion

Some offerings may contemplate a potential tax-deferred aggregation transaction as an exit strategy for investors, such as a so-called "UPREIT" transactions whereby investors will contribute property (*e.g.*, their DST interests) to the operating partnership of a REIT in exchange for equity interests therein in a tax-deferred transaction under Section 721. No such transaction should be hardwired, guaranteed or otherwise arranged such that its occurrence is a foregone conclusion, otherwise certain judicial doctrines (*e.g.*, step transaction, substance over form, etc.) could apply to collapse these transactions (for example, by recharacterizing the initial investment a partnership in substance notwithstanding the initial appearance as a DST) and negate qualification under Section 1031, thereby vitiating all Section 1031 tax deferral for investors. Due to the intent-based aspects of Section 1031, such an analysis would be based on facts and circumstances to be sure, however, your authors have at times observed a cavalier approach by a limited few when it comes to marketing an investment in a DST as a mere transitory and perfunctory annoyance before slotting investors into a promised UPREIT transaction.

### State and Local Transfer Tax Beyond Asset Acquisition

Certain state and local tax authorities may levy a controlling interest or similar transfer tax in connection with the DST's syndication of beneficial interests to investors. This can often come as a surprise to sponsors who may have only budgeted for one level of transfer tax on the DST's acquisition of real property, particularly if they are not hit with any such tax until their syndication is well under way or even complete. Because contributing additional capital to a DST is one of the seven deadly sins, sponsors should carefully vet any potential state or local tax implications and build in offering proceeds and mechanics to timely pay any such tax when due.

### Use of "Springing LLCs"

As a safety valve, most properly-designed trust agreements generally allow the trust manager to convert or "kickout" the DST into a "springing LLC" in a tax-deferred Section 721 transaction if necessary to address critical issues that arise during the course of property ownership and take ameliorative action that could not be undertaken if the entity remained a DST that is compliant with the DST rules and the Investment Trust Rules. This should be a last resort (as the conversion from a Section 1031-qualifying DST interest into a non-qualifying partnership interest has negative implications for a possible future Section 1031 exchange), and thus DSTs should limit lenders' ability to influence this decision if there is not an event of default. In the event a DST becomes a springing LLC, any potential re-conversion to a DST and the attendant facts and circumstances should be carefully analyzed under judicial doctrine (*e.g.*, step transaction, substance over form, etc.) to determine whether there is a risk that the "kickout" and any subsequent transaction may be grouped together such that desired tax benefits are denied.

### Analysis of Master Leases and Property-level Leases

A master lease structure, if used, helps to comply with the Revenue Ruling but does not necessarily automatically solve all related issues. For example, if the sponsor or counsel has not run an analysis to confirm that the master lease transaction has sufficient economic substance or complies with the "true lease" factors set forth in Revenue Procedure 2001-28,[11] a master lease could instead be characterized as a "deemed partnership" or agency relationship between the DST and the master tenant.[12] Further, even if a master lease is present, sponsors should review property-level subleases to ensure that the master tenant is not subject to a separate "deemed partnership" risk, or that property-level subtenants cannot undertake actions in violation of the Revenue Ruling and/or Investment Trust Rules in a manner that can be attributed upstream to the DST or beneficial owners (*e.g.*, discounted call options; encumbering their leasehold interests in a manner that poses an alienation or economic risk to DST investors; materially and structurally modifying the property in violation of the Revenue Ruling).

### Financing-related Concerns

DST-level financing presents a plethora of potential traps for the unwary. Financing terms, if applicable, must be compliant with Section 1031, the Revenue Ruling and the Investment Trust Rules in substance, not only in name.[13] A DST is simply one kind of state-law entity and alone does not confer any tax advantages or benefits absent detailed tax structuring. For example, financing terms that merely nominally acknowledge the DST as an entity but without any further operative provisions to follow the rules and regulations provide no benefit and, absent thoughtful tailoring, are unlikely to be compliant. A high level "hit list" of what to look for follows.

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- As set forth in the Revenue Ruling specifically, financing arrangements related to the property must be fixed "for the entire life of [the DST]," and the trust manager cannot have the power to "renegotiate or refinance the obligation used to purchase [the property.]"[14]
- If applicable, a "master tenant" entity should not be a party to the loan agreements or sign a joinder. Loan documents should be solely between the lender and the DST, and should not contain any provisions that cause the master tenant to be a *de facto* co-borrower indirectly or via joinder or side agreement in a manner that could create a "deemed partnership" issue for U.S. federal income tax purposes, as explained above. Likewise, if an event of default under the loan documents can be triggered directly by the master tenant and runs directly between the master tenant and the lender, this may be a negative factor when analyzing the separateness of the DST and the master tenant.
- A limited nonrecourse carve-out guaranty for a loan may be allowed so long as the nonrecourse items are generally within the guarantor's control. These would include, for example, failure to pay taxes or insurance, but only if there is sufficient revenue to do so.
- Syndication- and exit-related transfers should be included as permitted transfers and/or pre-approved. This includes that the offering and related syndication (*i.e.*, private placement) to investors is pre-approved, DST investors can make subsequent transfers (*e.g.*, transfers relating to their estate planning, etc.), there is flexibility to pursue internal restructuring upstream from the DST, and any potential aggregation transactions after a sufficient aging period for purposes of the "held for" requirement[15] (such as exit transactions via a tax-deferred Section 721 "UPREIT" transaction, as explained above).
- The lender cash management function, including "lockbox" and deposit account control agreement-like agreements, should be structured to reflect and respect the existence and separateness of a master lease and master tenant from the DST.
- The trust manager, not the lender, should control whether there is a "transfer distribution" or "kickout" to a springing LLC. The triggers for any such execution should be set forth in the trust agreement.
- If the loan has a variable interest rate, an interest rate hedge could be acceptable but must be hardwired from the outset. Because the loan generally cannot be modified during the life of the deal (absent an insolvency or bankrupt exception under the Revenue Ruling) in order to remain compliant with the DST rules, any interest rate hedge also cannot be created or modified during the life of the DST.
- If a sponsor affiliated lender is making a loan to a DST or its investors directly, it should be structured to be certain that the financing does not violate the prohibition on "Lessee Group loans" set forth in Revenue Procedure 2001-28.
- With respect to bridge loans, the depositor entity or sponsor should not offer as collateral to the bridge lender any asset or income of another party (*e.g.*, a security interest in the property; class 1 beneficial interests owned by investors or income inuring thereto). Having the beneficial owners put up their assets as collateral creates a deemed partnership issue, with similar negative tax consequences as noted above. Granting an upstream bridge lender control over the trust manager as collateral for an upstream bridge financing can also be viewed as tantamount to giving such bridge lender control over the DST and its asset(s) as the trust manager generally controls the ability to dispose of a DST's asset(s).

## CONCLUSION

As can be seen by the above, the perceived straightforwardness and simplicity of the Revenue Ruling can be a trap for the uninitiated, and investors, sponsors, and even counsel should take heed of the various inadvertent mistakes, oversights and omissions that can be made in structuring a DST offering. Although taxpayers should exercise caution when approaching any DST offering, these potential pitfalls have not stopped the Revenue Ruling from maturing into a staple of the syndicated Section 1031 like-kind exchange market as of its 20th birthday.

## End Notes

[1] 2004-2 C.B. 191. For additional general commentary on tax-advantaged DST offerings, *see* Peter R. Matejcak and Daniel F. Cullen, *The ABCs of DSTs Revised – Rev. Rul. 2004-86 at Ten Years*, J. Real Estate Tax'n, Q2 (2015); Matejcak, Lipton, Steinhause and Cullen, *The Do's and Don'ts of DSTs (Part I)*, J. Passthrough Entities (Jan./Feb. 2018); Matejcak, Lipton, Steinhause and Cullen, *The Do's and Don'ts of DSTs (Part II)*, J. Passthrough Entities (May/June 2018).

[2] More accurately, the underlying corpus of the DST would constitute the replacement property, with holders of beneficial interests in a properly-structured DST being treated for U.S. federal income tax purposes as owning an undivided fractional interest in the DST's underlying assets (*i.e.*, real property).

[3] 2001-1 C.B. 1156. For additional commentary on TIC-related considerations in the context of the DST space, *see* Lipton, Harrison, and Golub, *The Intersection of Delaware Statutory Trusts and Tenancies-in-Common*, J. Real Estate Tax'n, Q1 (2005).

[4] The "seven deadly sins" moniker refers to a list of seven requirements that must be met in order for a DST to be characterized as an investment trust per the Revenue Ruling. Specifically, a Revenue Ruling-compliant DST may not do, or even grant the authority to the DST or the manager of the DST, to do the following as of the date that the DST seeks to be compliant with the Revenue Ruling: (1) dispose of the DST's property and acquire new property; (2) renegotiate any lease with respect to which the DST is a party; (3) enter into any new leases except in the case of an existing tenant's bankruptcy or insolvency; (4) renegotiate or refinance the obligation used to purchase the DST's property; (5) receive capital contributions from investors; (6) invest cash received to profit from market fluctuations; and (7) make more than minor, nonstructural modifications except as required by law. The "seven deadly sins" terminology was coined by Richard Lipton of Baker & McKenzie LLP.

[5] The focus of this column is syndicated, securitized DST real estate offerings, in particular because the Financial Industry Regulatory Authority, Inc. requires private placements of tax-structured DSTs be accompanied by a "should" level tax opinion issued by tax counsel. However, it should be noted that DSTs can be and are utilized in non-syndicated private transactions as well.

[6] This requires a direct deed in the real property because the TIC itself is *not* an entity but, rather, simply a description of the relationship among the co-owners.

[7] Nonetheless, ownership limitations are often imposed as a result of other substantive areas of law and/or business requirements, *e.g.*, securities law or lender preference (if and to the extent applicable); however, the number of permitted owners in a DST structure is significantly greater than in a traditional TIC structure.


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[8] 2020-26 I.R.B. 990. Revenue Procedure 2020-34 provided that certain actions that would ordinarily constitute one of the "seven deadly sins" would be excused in light of the Covid pandemic. Specifically, for a limited time, DSTs would be allowed to modify loan documents to secure a loan forbearance, modify an existing lease to defer or waive rental payments, and accept capital contributions from owners, in each case as a result of economic hardship and difficulties resulting from the Covid pandemic. Baker & McKenzie and DLA Piper led the industry effort resulting in the IRS granting this temporary relief.

[9] Notably, equity interests in corporations and partnerships are securities and therefore not eligible for tax deferral under Section 1031. Thus, unless an investor was willing and able to contribute their to-be relinquished property to an entity in a tax-deferred Section 351 or Section 721 transaction, *e.g.*, the former to a REIT or the latter to the operating partnership of a REIT (which in either case assumes that such entity even wants to acquire what the taxpayer is relinquishing, among other things), investors were not able to unilaterally dispose of their relinquished property and funnel resulting funds into such operations in a tax-deferred manner.

[10] Investing in a partnership (deemed or otherwise) instead of a properly-structured DST would generally negate Section 1031 benefits as equity in a partnership is not eligible for tax deferral under Section 1031 (where as beneficial interests in a properly structured DST are blessed by the Revenue Ruling as interests in an investment trust and, therefore, interests in the underlying assets). *See* Treas. Reg. § 1.1031(a)-1(a)(1); *see also* Treas. Reg. § 1.1031(a)-3(a)(5)(i).

[11] 2001-1 C.B. 1156. Although Revenue Procedure 2001-28 specifically addresses leveraged equipment leases, it nonetheless serves as a useful framework to determine that a purported leasing arrangement is a "true lease" and not a financing arrangement. The application of these rules in the real estate lease setting is well-established in the tax bar.

[12] Under U.S. federal income tax law, a partnership can exist for tax purposes even if no partnership entity exists for state law purposes or the parties state that no partnership is intended. This is a facts-and-circumstances analysis that looks to several factors and thus requires a holistic analysis of all facts and circumstances to determine the risk of a potential recharacterization for federal income tax purposes.

[13] The financing-related concerns and analysis herein are complicated and often overlooked because they are not necessarily facially present within the four corners of the Revenue Ruling, and require additional understanding of the Investment Trust Rules and application thereof to a DST structure's financing documents and arrangements.

[14] 2004-2 C.B. 191.

[15] *See* Treas. Reg. § 1.1031(a)-1(a)(1) ("Under section 1031(a)(1), no gain or loss is recognized if property *held for* productive use in a trade or business or for investment is exchanged solely for property of a like kind to be *held either for* productive use in a trade or business *or for* investment") (emphasis added).

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