§ 9:17 Delaware statutory trusts

A Delaware statutory trust (DST) is a form of co-ownership of property for I.R.C. 1031 purposes. The DST has emerged as an alternative to a tenancy in common (TIC) for fractional ownership of real property. Rev. Proc. 2002-22, the private letter ruling guidance for TICs discussed in §§ 9:10 et seq., does not apply to a DST. Therefore, a DST can have over 35 investors, and up to a maximum of 2000 investors.[1] Unlike a TIC, the beneficial owners of a DST do not participate in any aspect of the management of the property and have no voting rights. Their only right is the distribution of income. The DST has a Delaware trustee but that trustee's rights and obligations are usually minimal. The management of the property is instead vested in a "signatory trustee" who is related to the sponsor. The signatory trustee must conserve and protect the trust estate.

Lenders prefer a DST rather than a TIC. A lender for the property makes one loan to the DST rather than separate loans to each of the beneficial owners, so borrowing costs are reduced. The lender does not need to deal with multiple owners, or the potential that a TIC owner could file for bankruptcy. The creditors of the beneficial owners of the DST cannot reach the DST's assets. The beneficial owners have no management or voting rights, and are not required to execute loan documents or "bad boy" carve outs. Further, transfers of DST interests are less costly and more efficient that TIC interests. Title to a beneficial interest in a DST can be transferred by a certificate of trust and without the recordation of a deed. Furthermore, separate LLCs for each investor are not needed to hold title with a DST.

A DST is a trust under Delaware law, created by executing a governing instrument and filing a certificate of trust.[2] It has a single class of ownership interests. A DST is also classified as a trust for federal tax purposes, provided it meets the requirements of a "fixed investment trust," discussed below.[3] If instead the trustee has the power to vary the investment of the interest holders, then the trust would be classified as either a partnership or a corporation.

While a DST is a trust for federal tax purposes, it is also considered a grantor trust under the grantor trust rules of I.R.C. §§ 671 and 677. Therefore, each interest holder is treated as owning an undivided fractional interest in the DST's property. Note that a DST, as a separate entity for federal tax purposes, differs from a revocable living trust, or an Illinois land trust, which are not separate taxpayers from their beneficiaries for federal tax purposes.[4] A DST also differs from a TIC, which is not an entity for federal tax purposes.

In Rev. Rul. 2004-86, the IRS approved interests in a DST as replacement property in an I.R.C. § 1031 exchange.[5] In the ruling, the DST held real property and multiple persons held beneficial interests in the DST. The ruling specifically provided that the DST interests were not publicly traded on an established securities market. The trustee's duties were limited to the collection and distribution of income to the beneficial owners. The beneficial interests in the DST represented interests in a grantor trust and the beneficial owners were considered to own undivided fractional interests in the real property for federal tax and I.R.C. § 1031 purposes.

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[1] 2012 JOBS Act.

[2] Del. Code Ann. Title 12 Chapter 38.

[3] Reg. 301.7701-4(c)(1); see Commissioner of Internal Revenue v. North American Bond Trust, 122 F.2d 545, 41-2 U.S. Tax Cas. (CCH) P 9644, 27 A.F.T.R. (P-H) P 892 (C.C.A. 2d Cir. 1941).

[4] See § 2:13 for a discussion of a land trust.

[5] Rev. Rul. 2004-86, 2004-33 I.R.B. 191 (July 20, 2004). See Appendix 9D.

Importantly, in Rev. Rul. 2004-86, the trustee of the DST also could not have certain powers, commonly known as the "seven deadly sins" so that the DST would meet the requirements of a fixed investment trust. The DST could not: (1) dispose of the trust's assets and then acquire new assets (but the trustee could sell the trust's assets and dissolve the trust); (2) purchase assets other than short term investment assets; (3) accept additional contributions of assets by new or existing beneficiaries once the offering was closed; (4) renegotiate the terms of the debt used to acquire the property or refinance the debt, except where a property tenant is bankrupt or insolvent; (5) renegotiate the lease with the tenant of the property, or enter into new leases, except in the case of bankruptcy or insolvency of the tenant; (6) fail to distribute all cash, other than normal reserves, on a current basis; and (7) make anything other than minor non-structural modifications to the property, unless otherwise required by law. If the trustee had any of these additional powers, then the ruling provided that the DST would be a business entity classified as a partnership or corporation and therefore the beneficial interests would not be valid replacement property in an exchange.

Due to the restrictions of the seven deadly sins, DSTs are best suited for properties subject to a long term, triple net lease to an investment grade tenant. Other types of real property that require more management, such as multifamily properties, will require a master lease to another party who will perform the management activities necessary for the property. For example, a multifamily residential property will require the releasing of the units. The master tenant in a syndicated DST is typically the sponsor or an affiliate. This raises the issue of whether the master tenant's activities will be attributed to the DST, which would result in the DST being deemed to commit a deadly sin. In addition, the master lease cannot be a deemed partnership or financing arrangement between the DST and the master tenant. Thus, rent must be fixed and cannot depend on the net income from the property. In addition, the master tenant should not have a residual interest in the property. The rent paid under the master lease will generally be equal to the amount of debt service plus a rate of return. Thus, the master tenant will be entitled to any net rent for the subleases. See § 9:11 for a further discussion of master leases as a method of insulating the co-owners from activities.

A DST could also be used for a non-syndicated co-ownership of property. For example, two taxpayers intending to acquire replacement property may find that the lender will not lend to them in a TIC structure. Therefore, they use a DST as the legal owner, and they are the beneficial owners of the DST. They still must navigate around the seven deadly sins, which will likely require a master lease for a property that requires any management. The beneficial owners will also want to own the master tenant to retain the profit and loss from the property. They will also want to act as the signatory trustee to control the relationship with the master tenant. These roles, however, create significant tax issues if the master tenant is not a sufficiently separate party from the beneficial owners. They run the risk of deemed agency and thus committing deadly sins. They also risk deemed partnership status if the DST and the master tenant are found to be sharing profits and losses.

Many DSTs provide that if the trustee must commit any of the seven deadly sins, such as refinancing the debt, then the DST automatically converts to an LLC with pre-arranged terms. The DST would then be a partnership for federal tax purposes and the interest holders could not exchange out of their LLC interests.

§ 9:18 Corporation liquidation, formation, or reorganization prior to or after exchange

Prior to the Tax Reform Act of 1986, it was possible for a corporation under I.R.C.