

REVENUE RULING 2004-86: DELAWARE STATUTORY TRUST

Background: When the Service issued Revenue Procedure 2002-22, which provides guidelines under which an advance ruling may be obtained by Sponsors of tenancy in common interests in property, some Sponsors were offering the interests for sale through a title holding Delaware Statutory Trust (“DST”). The Delaware Statutory Trust was used to mitigate bankruptcy concerns of lenders and because it was simpler for a lender to deal with the trustee of the trust.

One of the conditions of Rev. Proc. 2002-22 is that the co-owners hold title to the property as tenants in common, either directly or through a disregarded entity. It appeared that the use of a DST was a violation of the Rev. Proc. Additionally, and more importantly, it was unclear whether property held through a DST would violate the provisions of §1031(a)(2) which states that §1031(a) does not apply to any exchange of stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership or certificates of trust or beneficial interests in trusts.

Facts: Individual A secured financing from Bank to acquire Blackacre. The 10-year term loan was secured by Blackacre. Immediately following the acquisition, A enters into a 10-year net lease with B. Under the lease, B is required to pay all taxes, assessments, fees, insurance, maintenance, utilities and ordinary repairs related to Blackacre. B pays rent to A at a fixed rate with some escalators based on the CPI. On the same date, A forms a DST and transfers title to Blackacre to the Trust.

The Trust assumes A’s rights and obligations under the note and the lease. The Trust agreement provides that interests in the trust are freely transferable. The Trust is set to terminate on the earlier of 10 years from the date of its creation or the disposition of Blackacre. The interests in the Trust are of a single class – undivided beneficial interests in the assets of the Trust (i.e.: there are no preferred issues).

Additionally, the Trustee is authorized under the provisions of the Trust Agreement, to create a reasonable reserve for expenses, distribute all available cash quarterly, and invest cash received from the property. Each beneficial owner of the Trust has the right to a quarterly distribution of cash as well as an in-kind distribution of the beneficiary’s proportionate share of the trust property.

Almost immediately after the formation of the Trust, Taxpayers X and Y exchange their properties, Whiteacre and Greenacre, for all of A’s interest in the Trust through a Qualified Intermediary in a transaction designed to qualify for non-recognition of gain under IRC Section 1031. Taxpayer A did not engage in a like kind exchange.

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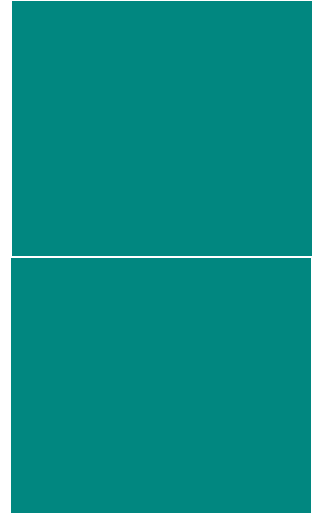
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The Ruling: Initially the Service examined how the Trust should be categorized for federal income tax purposes and determined that the Trust was a separate taxable entity. The Service also looked at the relationship between the Trust, the trustee and the beneficial owners to determine whether an agency relationship existed, and concluded that neither the Trust nor the trustee was acting as an agent of the Taxpayer. It was determined that the Trust should be categorized as an investment trust and not a business entity – based on the fact that the Trustee had no power to vary the investment of the beneficial owners to benefit from variations in the market. The limited powers granted the Trustee were the key factor in the Service concluding that the Trust was an investment trust and not a business entity. [If the Service had determined the Trust was a business entity, the transaction would not have fit within the parameters of Rev. Proc. 2002-22]

Finally, the Service concluded that X and Y were deemed to have acquired an undivided fractional interest in the trust (and therefore considered to own the underlying assets attributable to that interest i.e.: interest in Blackacre).

Application: The holding that a beneficiary of a grantor trust is considered the owner of the underlying assets is significant for §1031 purposes generally. The ruling, being “fact sensitive” is likely to be of limited use to Sponsors in the marketplace. Most notably, Rev. Proc. 2002-22 requires that property be held by the co-owners either directly or through disregarded entities. In a DST structure, the Trust is the legal titleholder of the property. This is an issue that will still need to be reconciled if a Sponsor is using the DST structure and is requesting a private ruling.



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