DELAWARE STATUTORY TRUSTS
and
LIKE KIND EXCHANGES

KEVIN THOMASON, PARTNER
ELLIOTT,THOMASON & GIBSON, LLP
and
CHRISTOPER A. CUNNINGHAM, PARTNER
ELLIOTT,THOMASON & GIBSON, LLP

Presented to the
Dallas Bar Association Real Estate Section
July 9, 2018

KEVIN THOMASON
ELLIOTT, THOMASON & GIBSON, LLP
511 N. AKARD, SUITE 301
DALLAS, TEXAS 75201
214.506.1121
kevin@etglawfirm.com

Kevin Thomason focuses on the representation of clients in tax matters. He provides advice and counseling on partnership, corporate, and real estate tax issues, with an emphasis on like kind exchanges including creative uses of tenant-in-common and Delaware Statutory Trust (DST) structures. He also advises on wealth preservation and estate planning matters and provides general counsel to businesses in multiple sectors. He is a Past Chair of the Section of Taxation of the State Bar of Texas, the Section of Taxation of the Dallas Bar Association and the Real Estate Committee of the Section of Taxation of the American Bar Association and is currently a member of all three of these organizations. He is the Chairman of the Board and Past President of the Texas Federal Tax Institute and is a Fellow of the American College of Tax Counsel. While Chair of the State Bar Tax Section, Kevin drafted legislation to ban tax strategy patents and had such legislation approved by both the Council of the Tax Section of the State Bar of Texas and the Board of Directors of the State Bar of Texas, a first. He worked diligently with the AICPA for many years to help enact a form of that legislation, which now effectively prohibits the patenting of tax strategies.

All you really need to know about Kevin is that he was the starting catcher on the 1972 State Champion Ardmore Tigers Baseball Team. It has all been downhill from there.

CHRISTOPER A. CUNNINGHAM
ELLIOTT, THOMASON & GIBSON, LLP
511 N. AKARD, SUITE 301
DALLAS, TEXAS 75201
214.506.1123
chris@etglawfirm.com

Christopher represents clients on a wide array of tax issues, with a particular concentration on like-kind exchanges and taxation of real estate investments. He has practiced in all areas of business tax law, from C-corporations to partnership taxation, from public and private M&A transactions to tax exempt entities. Prior to his legal career, Christopher was educated as a computer scientist and worked for a number of years as an engineer in the field of network security. He continues to apply the same engineering based, results-oriented approach to client problems, for which he has received specific praise from clients.

Outside of his law practice, Christopher enjoys astronomy and teaches at the Dallas branch of Schola Saint George, an international school of chivalric martial arts.

DELAWARE STATUTORY TRUSTS[1]

I. INTRODUCTION

Real estate investors that jointly own property often have a tax motivation to be treated as co-owners, and not as partners, of that property. That treatment is often obtained by creating, either at the outset of an investment or shortly before the disposition of an investment, a tenant-in-common (TIC) relationship between or among those investors. The motivation for such treatment is the desire to initiate or complete a "like kind exchange" under Section 1031 of the Internal Revenue Code of 1986, as amended. (All Section references herein are to sections of that Code.) The same treatment may be obtained in certain circumstances by the use of a Delaware Statutory Trust (DST). The article explores that planning opportunity

II. THE NEED FOR CO-OWNERSHIP TREATMENT

The applicable federal and state tax rules allow the tax deferral benefit of Section 1031 only when like kind properties are exchanged. Partnership interests do not qualify as property that is like kind to real estate, but TIC interests in real property do.

A. Partnership Interests are Not "Like Kind" to Real Estate

1. Section 1031(a) provides, as here pertinent, that "No gain or loss shall be recognized on the exchange of real property . . . for property of like kind . . ." Partnership interests are not considered "real property," even where the sole asset of the partnership is real property.
    a. While Section 1031(a) previously applied to "the exchange of property," Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017) (formerly the "Tax Cuts and Jobs Act") amended Section 1031(a)(1) to limit to only "exchanges of real property."
    b. Prior to Pub. L. No. 115-97, Section 1031(a)(2)(D) provided that the non-recognition benefit provided by Section 1031(a) "shall not apply to any exchange of . . . interests in a partnership." While Pub. L. No. 115-97 repealed Section 1031(a)(2)(D), the limitation of Section 1031(a)(1) to "real property" instead of just "property" effectively continued the prohibition on exchanges of partnership interests.
2. Thus, when a taxpayer needs to access the tax-deferral benefits of Section 1031, neither the asset being sold, not the asset being acquired, may constitute an "interest in a partnership" for tax purposes.

B. Disposition problem

1. A, B and C are each 1/3 partners in BA Partnership, a general partnership that owns Blackacre, an appreciated, unencumbered piece of raw land. C desires to sell its interest in BA Partnership to B, use the sales proceeds to acquire a tract of raw land, and defer his gain on that sale using Section 1031.
2. C cannot do so because the partnership interest in BA Partnership does not qualify as like kind property.

---

[1] A prior version of these materials was presented at the State Bar of Texas 39th Annual Advanced Real Estate Law Course, July 13-15, 2017.

3. If, however, A, B and C had jointly owned Blackacre as tenants-in-common (TICs), then the gain realized on C's sale of his undivided TIC interest in Blackacre would have qualified for tax deferral under Section 1031.

C. Acquisition Problem

1. X owns Whiteacre, an appreciated, unencumbered tract of raw land. X wants to sell Whiteacre and then combine those sales proceeds with funds provided by Y and Z to purchase Replacement Property, another unencumbered piece of raw land. They form a partnership, XYX Partnership, to acquire Replacement Property, with X contributing the proceeds from the sale of Whiteacre and Y and Z contributing cash.

2. X desires to defer her gain on the sale of Whiteacre under Section 1031 but cannot do so because she has acquired, not an interest real property which would qualify under Section 1031, but rather a partnership interest which does *not* qualify under Section 1031.

3. If, however, X, Y and Z were to acquire Replacement Property as TICs, then X's acquisition of a TIC interest in Replacement Property would have allowed her to defer the gain she realized on the sale of Whiteacre under Section 1031.

D. Labels Don't Matter

1. Simply calling a joint ownership relationship a "tenancy in common" doesn't mean that the relationship is treated as such under applicable tax law. The line between a co-ownership/TIC relationship and a partnership is a thin one, and the controlling federal case law relies heavily on the intention of the parties to determine the actual relationship. *Commissioner v Culbertson*, 337 U.S. 733 (1949).

III. THE TIC SOLUTION

The advent of syndicated real estate deals using a TIC structure led to the issuance of guidance from the IRS on how to structure a deal so as to be on the "right side" of the line between a partnership relationship and a TIC relationship.

A. The Rise of Syndicated TIC Deals; The Need for Guidance

1. In the mid-1990s, the demand by 1031 exchangors for TIC interests in quality, professionally managed commercial real properties became so high that some real estate syndicators starting offering, in private securities offerings, such TIC interests.

2. Those offerings, however, had to include a tax opinion giving a high level of comfort to potential investors that the TIC interests being offered would, if purchased, quality as TIC interests in real property (thus allowing the successful completion of that investor's like kind exchange), and conversely would NOT be classified as a partnership interests (which classification would be fatal to qualifying the transaction as a tax-deferred like kind exchange). There was at that time very little guidance available from the IRS on this issue, and several leading practitioners sought such guidance.

B. The Issuance of Rev. Proc. 2002-22

1. In response to this industry request, in early 2002 the IRS issued *Revenue Procedure 2002-22*, 2002-1 C.B. 733 (the "Rev. Proc.").

2. The issuance of the Rev. Proc. allowed the TIC syndication market to grow from less the $200 million of equity investments in 2002 to over $2 billion of such investments by 2007.

3. The weakness of the Rev. Proc., however, is that it did not provide a "safe harbor", that is, a list of requirements that, if met, would *guarantee* the needed tax treatment. Instead, it provided 15 conditions (the "15 Conditions"), all of which supposedly would need to be met in order to obtain a private letter ruling blessing the structure for tax purposes.

C. The Fifteen Conditions

1. Titling. The subject property must be titled as a tenancy-in-common.
2. Number of Co-Owners. There can be no more than 35 TIC owners.
3. No Treatment/Holding Out as Partners. The co-owners may not file a corporate or partnership tax returns or execute any agreement referring to themselves as partners or other members of a business entity or hold themselves out as partners or members of a business entity.
4. TIC Agreement Allowed. The co-owners may enter into a limited co-ownership agreement which contains, as its only limitation on transfer rights, a right of first offer (ROFO).
5. Unanimous Consent Required of Major Decisions. All TICs must unanimously agree to (i) the sale of the property, (ii) any lease or re-lease of the property, (iii) any negotiation or renegotiation of indebtedness secured by a blanket lien on the property, and (iv) the hiring of any manager or the negotiation of any management contract. **This set of conditions are considered absolutely mandatory.**
6. Alienation Restrictions. Other that the ROFO or lender-required restrictions, the TICs cannot agree to restrict transferability or partition of the property.
7. Pro Rata Sharing of Sales Proceeds. Net proceeds from the sale of the property, after repayment of debt, must be shared pro rata based on TIC ownership percentages. Thus, **no promoted interests can be created.**
8. Pro Rata Sharing of Profits and Losses. Profits and losses from the property must be shared pro rata based on TIC ownership percentages. Again, **no promoted interests can be created.**
9. Pro Rata Debt Sharing. Debt secured by a blanket lien on the property must be shared pro rata based on TIC ownership percentages.
10. Options. No put options are allowed, and call options must be at fair market value **at the time the option is exercised.**
11. No Business Activities. Basically, all the TIC owners are allowed to do is receive rents; no businesses can be run on the property the profits of which go to the TICs. For example, in a self-storage property the TICs could not receive profits from the sale of boxes and packing tape.
12. Management and Brokerage Agreements; Cash Management. Such agreements must be renewed annually, call for payment of fair market value fees and not allow the property manager to be compensated based on a share of net profits from the property (only a percentage of gross rentals). The manager can maintain a single account into which to deposit rents and from which to pay expenses, but the net amounts in such account must be distributed at least every three months.
13. Leasing Agreements. Rents paid to the TICs must be fair market value and cannot be based on net profits from the property (only a percentage of gross rentals, if a percentage rent is to be part of the rent computation).
14. Loan Agreements. The lender on the property cannot be related to the TICs, the sponsor, the manager or any lessee of the property.
15. Payments to Sponsor. Any acquisition fees paid to a sponsor of a TIC offering must be fair market value and cannot be based on the net profits from the property.

D. The Problem with the Rev. Proc.

1. The Rev. Proc. had several practical problems.
2. First, syndications occurred, generally, too quickly to allow time to obtain a private letter ruling from the IRS.
3. Several of the 15 Conditions seemed to be overly strict or unnecessary based on the case law extant at the time.
4. Therefore, the industry continued to rely on tax opinions issued by law firms to give potential investors the comfort they desired. Those opinions would regularly cite the 15 Conditions, discuss them, and point out why the tax opinion would and could still be favorable *even though* some of the conditions would not, or could not, be met.

IV. THE PRACTICAL PROBLEMS WITH TIC STRUCTURES

TIC structures accomplish the tax objectives of clients, but they come with a multitude of very difficult problems.

A. Lender Resistance

1. When a lender loans funds, usually purchase money funds, to a group of TICs, it is lending to multiple borrowers. Lenders generally do not like to do so, especially when the market mandates that those loans be nonrecourse. Moreover, many lenders are unfamiliar with the TIC structure.
2. The syndicated TIC market was dominated by CMBS lenders, who came up with their own set of terms to try to make the loans made to TIC groups sellable into mortgage pools.

B. Unwieldy/Disfunctional Management Structure

1. The unanimous consent requirements of the Rev. Proc. create many problems during the life of the property, and massive problems if the property became distressed. There are many horror stories about the inability of TIC investors (most of whom had never met their fellow TIC investors) to work together productively when there became a need to re-lease the property, refinance the loan, or sell the property, all of which actions require unanimous consent. That requirement also spawned an industry of "TIC trolls", companies that would acquire a TIC interest (usually in violation of the ROFO provisions of the TIC Agreement) and hold the other TICs hostage at critical times.
2. The requirement of unanimous consent to enter into new leases is particularly unworkable for multi-family or retail deals, which led to the creation of a master lease structure that caused its own set of problems.
3. Similarly, the prohibition on "business activities" also led to the use of master leases to shield the TICs from such activities. Many of the master tenants in such arrangements had little to no independent financial capability, so if operations failed there was nothing to ensure the continued payment of the master lease rent. Such arrangements often led properties which were cash flowing well enough avoid a monetary default to the lender to fall into default anyway because failure to pay the "guaranteed" rent under the master lease itself was defined as a default under an otherwise performing loan. At the extremes, this type of master lease structure led to the DBSI bankruptcy, where 240 properties, all master leased to the same master tenant, went into bankruptcy at the same time, notwithstanding the fact that over 90% of such properties could still meet their respective lender payment obligations.

C. Need for SPEs and Carveout Guarantees

1. The greatest fear of a lender to a TIC structure is a serial bankruptcy of all of the TIC owners of a property. Thus, lenders mandated that each TIC form a new disregarded "special purpose entity" (SPE) to own that investor's TIC interest, the thinking being that an entity is easier to control than a person. This requirement added significant up front and ongoing expense to the TIC structure.
2. Then, in order to avoid the feared "serial bankruptcy" problem (where one TIC after the other would stop a foreclosure on a defaulted loan by putting that TIC's SPE into bankruptcy), lenders started mandating that the "warm body" TICs execute carve-out guarantees providing that if a TIC did a "bad boy" act (put the SPE into bankruptcy, took other actions that would jeopardize the lender's collateral) that TIC could be held personally liable for (a) all the debt, (b) a pro rata share of the debt, or even (c) all of the debt due to a default by another TIC investor! At various times, different lenders have included all of these kinds of provisions in their carve-out guarantees, to the great expense and dismay of TIC investors.
3. Lenders and 1031 investors clamored for a structure that reached the same tax result, but without some of the very practical, and sometimes dangerous, provisions mandated by the Rev. Proc. for TIC-structured deals. Thus was born the Delaware Statutory Trust.

V. THE DELAWARE STATUTORY TRUST SOLUTION

An alternative to the TIC structure—the Delaware Statutory Trust—has been utilized to accomplish the same tax objectives, and the IRS has blessed it.

A. What Is a "Delaware Statutory Trust"?

1. A Delaware Statutory Trust is a separate legal entity created as a trust under the laws of Delaware in which each owner has a "beneficial interest" in the DST for federal income tax purposes and is treated as owning an undivided fractional interest in the property owned by the DST. It is a legal entity which must have one Delaware trustee (basically the substitute for a registered agent in Delaware; this trustee generally has no powers beyond ministerial) and one other trustee, known as the "Signatory Trustee", in which all the management powers are vested.
2. The holders of the beneficial interests (the "BIs") of the DST are effectively the owners of the property held by the DST. They are known as the "beneficial interest holders" (the "BI Holders").
3. The BI Holders are as protected from the liabilities of the DST as are shareholders of a corporation.
4. The Signatory Trustee is usually a newly-formed entity (LLC or corporation) which may be owned by any of the BI Holders and may have management terms as determined by such owners. Thus, if there is a desire for one owner or group of owners to have the management authority over the DST, then can do so no matter what percentage, if any, such persons have in the DST in their capacity as BI Holders.
5. Lenders love this structure because they have a single borrower under the loan AND the Signatory Trustee can make all the decisions needed for the DST (subject to the terms of the controlling Trust Agreement). The BI Holders generally have NO vote with regard to any action of the DST, and the Trust Agreement of the DST can actually eliminate any fiduciary duties which the Signatory Trustee might otherwise owe the BI Holders.
6. Lenders, now needing no protection from the serial bankruptcy risk, generally do not require the investor/BI Holders to form SPEs and do not require carve-out guarantees from the BI Holders of the DST.

B. Tax Treatment of DSTs

1. In order to complete a like kind exchange by purchasing a BI in a DST that owns real property, a potential exchanger who purchases a such a BI must be treated as acquiring an interest as a "grantor" in an "investment trust," which is equivalent to ownership of an undivided interest in real estate owned by such trust for federal income tax purposes, as opposed to a security or interest in a partnership, joint venture or corporation (collectively, a "business entity.
2. The determination of whether a BI will be treated for federal income tax purposes as ownership in real estate and not as a security or an interest in a business entity is dependent upon all of the surrounding facts and circumstances. On July 20, 2004, the IRS issued *Revenue Ruling 2004-86*, 2004-2 C.B. 191 (the "DST Ruling"), which ruled that, assuming the other requirements of Section 1031 are satisfied, a taxpayer's exchange of real property for a beneficial interest in the DST described in the DST Ruling (the "Rev. Rul. DST") may satisfy the requirements of Section 1031. The IRS based its determination on the following conclusions: (a) the Rev. Rul. DST is treated as an entity separate from its owners (and not as a co-ownership or agency arrangement), (b) the Rev. Rul. DST is an "investment trust" and not a "business entity" for federal income tax purposes, (c) the Rev. Rul. DST is a "grantor trust" for federal income tax purposes, with the holders of beneficial interests in the Rev. Rul. DST treated as the grantors of the Rev. Rul. DST, and (d) the holders of beneficial interests in the Rev. Rul. DST are treated as directly owning interests in real property held by the Rev. Rul. DST. The DST Ruling listed certain specific matters and trust provisions which would, in the IRS's view, cause a beneficial interest in the Rev. Rul. DST to not qualify for a Section 1031 exchange. In general, the Signatory Trustee must not have the power to "vary the investment" of the DST. The offending trust

provisions described in the DST Ruling have been referred to in the DST industry as the "Seven Deadly Sins". Thus, if a trust agreement gives the Signatory Trustee the power to commit *any one* of the Seven Deadly Sins, the DST does not qualify as an "investment trust", and the Section 1031 treatment is not available with regard to real property held by the DST. So, what are the *Seven Deadly Sins*?

C. The "Seven Deadly Sins"

1. Once the DST is initially funded, there can be no future equity contribution to the DST by either current or new co-investors or beneficiaries.
2. The Signatory Trustee of the DST cannot renegotiate the terms of the existing loans, nor can it borrow any new funds from any other lender or party.
3. The Signatory Trustee cannot reinvest the proceeds from the sale of its investment real estate.
4. The Signatory Trustee is limited to making capital expenditures with respect to the property to those for (i) normal repair and maintenance, (ii) minor non-structural capital improvements, and (iii) those required by law.
5. Any liquid cash held in the DST between distribution dates can only be invested in short-term debt obligations.
6. All cash, other than necessary reserves, must be distributed to the BI Holders on a current basis.
7. The Signatory Trustee cannot enter into new leases or renegotiate the current lease..

D. Necessity of Master Leases in Many DST Structures; Who Can Be the Master Tenant?

1. DSTs must be very passive—no new equity, no new leases, no new or renegotiated loans. Thus, it is a very useful vehicle for a true credit tenant, triple net lease, like a "big box" retail store, a CVS pharmacy or a Walmart..
2. For other properties that need ongoing leasing or other active landlord activity or management, usually a master tenant entity (an "MTE") will be formed to master lease the property from the DST,and then the MTE will conduct operations for projects such as apartments, ranches, and other projects that generate "bad" income or require prohibited activities.
3. The prohibition on future capital contributions makes the DST a difficult structure for multi-tenant retail or commercial properties due to the likely need for future tenant improvement and leasing commission dollars.
4. The DST Ruling makes the assumption that the MTE is not "related" to the Signatory Trustee or the BI Holders without (a) defining what "related" means or (b) discussing the reason for such assumption/requirement. In a syndicated DST, the MTE is not usually related to the BIs, although it usually is related to the Signatory Trustee. In non-syndicated deals, there usually is nobody available to be the MTE that is NOT related to the BIs—thus a related MTE is utilized. There are tax reasons beyond the scope of this article to use, in such circumstances, an S corporation instead of an LLC as the MTE.

E. Advantages of DSTs

1. <u>Centralized Management; No Need for Unanimity</u>. Because all management authority, as limited by the DST Ruling, is centralized in the Signatory Trustee, which can be an entity with various members and unlimited management allocation provisions, the management of DSTs is much more "normal" than that of TIC structures.
2. <u>Lender Preferred; No SPEs or Carveout Guarantees</u>. Lenders much prefer lending to a single entity than to multiple TIC borrowers. Moreover, when a DST is the borrower, there is not need for separate SPEs and no need for carveout guarantees.
3. <u>Very Limited Rights of BI Holders</u>. Whereas TIC owners have very broad management rights, many of which may not be waived for tax purposes, BI Holders generally have NO management rights, making the management much more like that of a limited partnership with a general partner.

4. Eliminates Re-Titling Difficult Assets. Once title in a particular property or pool of properties (for example, a pool of oil and gas royalties) is vested in a DST, interests in those assets may be transferred by simply transferring the beneficial interests, instead of the assets themselves. Such transfers will be treated (a) by the transferring BI Holder as a sale of real property, which can serve as the *beginning* of a new like kind change, and (b) by the purchasing BI Holder as the *acquisition* of real property, which allows that person to use the BI as replacement property to *complete* its like kind exchange.

F. Disadvantages of DSTs

1. Not Well Understood. DSTs are not well understood by clients or by many lenders. The education process can be the most difficult part of the transaction.

2. Very Inflexible; No Development Deals. Except with true "credit tenant" deals, a master lease will always be needed, and even then if future capital calls are contemplated the DST structure is not very workable. One simply cannot do a development deal in a DST.

3. Questions About Who Can Be the Master Tenant? See section V.D.4 above for a discussion of this issue.

4. Metrics and Terms of the Master Lease. For the master lease to be treated as a "true lease" for tax purposes, the MTE must have some economic reality, the ownership of the MTE should not be identical to that of the DST, and the metrics and terms of the master lease much meet the economic needs of the deal.

VI. ACQUISITION DST STRUCTURES

DSTs can be used to acquire real property so as to utilize such property as qualifying *replacement* property in a like kind exchange. Here are two examples of how that can be done.

A. Acquisition One—Mary and Todd Want to Buy a Ranch

1. See Appendix A attached hereto.

B. Acquisition Two—Mary and Todd Want to Buy Royalties Together

1. See Appendix B attached hereto.

VII. DISPOSITION DST STRUCURES (THE SYNTHETIC "DROP-AND-SWAP")

DSTs can also be used in disposition or ownership re-shuffle transactions to allow the subject real property to be treated as qualifying *relinquished* property in a like kind exchange. Here are two examples of how that can be done.

A. Mary, Todd and Adam Sell an Encumbered Apartment (a "Synthetic Drop-and-Swap")

1. See Appendix C attached hereto.

B. Don, Glenn, Joe and Timothy Want to Reshuffle the Ownership of Two Ranches

1. See Appendix D attached hereto.

VIII. PUBLICLY TRADED ROYALTY TRUSTS

There are a number of publicly traded royalty trusts on the market with the same core attributes that were the basis for the treatment of the Rev. Rul. DST in the DST Ruling: (a) they are treated as entities separate from their owners, (b) they are considered "investment trusts" and not "business entities" for federal income tax purposes, (c) they are "grantor trusts" for federal income tax purposes, with the holders of beneficial interests treated as the grantors, and (d) the holders of beneficial interests are treated as directly owning interests in real property held by the trusts. While these royalty trusts are not formed as DSTs (they are commonly Texas trusts), there is nothing in the DST

Ruling that depends on the precise domicile of trust used. There has been some question as to whether or not these publicly traded royalty trusts could qualify as either the relinquished or replacement property in an exchange qualifying for non-recognition under Section 1031(a).

Prior to Pub. L. No. 115-97, Sections 1031(a)(2)(C) and (E) provided that the non-recognition benefit provided by Section 1031(a) "shall not apply to any exchange of . . . securities . . . [or] certificates of trust or beneficial interests . . ." Paradoxically, while the interests in the Rev. Rul. DST are described in the DST Ruling as "beneficial interests," the DST Ruling concluded that because holders of beneficial interests would be treated as directly owning interests in real property held by the Rev. Rul. DST, "the exchange of real property . . . for an interest in [the Rev. Rul. DST] is . . . not the exchange of real property for a certificate of trust or beneficial interest under § 1031(a)(2)(E)." The DST Ruling did not address whether or not a beneficial interest in the Rev. Rul. DST would be considered a "security," despite the Rev. Rul. DST arguably falling under various potential definitions of the term "security" used in the Code. This left the treatment of publicly traded royalty trusts in doubt.

However, effective for exchanges completed after December 31, 2017, Pub. L. No. 115-97 repealed both Sections 1031(a)(2)(C) and (E).

IX. CONCLUSION

Both in acquisition and disposition situations where a TIC ownership structure seems necessary in order to access the benefits of Section 1031, it may well be easier and preferable, in a transactional and management sense, to use a Delaware Statutory Trust to own the subject property. Different tax rules apply, and DSTs present different positives and negatives to a TIC ownership structure, but sophisticated real estate counsel should be aware of this alternate way to accomplish the tax objectives of their clients.

Appendix A

Acquisition One—Mary and Todd Want to Buy a Ranch

Appendix A

USES OF DSTS—ACQUISITION TRANSACTIONS

- TWO-PARTIES WITH 1031 FUNDS WANT TO BUY A PROPERTY TOGETHER
  - MARY FACTS
    - RELINQUISHED PROPERTY AMOUNT REALIZED/QI FUNDS = $900
    - BASIS = $300; NO DEBT RELIEF
    - MARY DESIRES CONTROL
  - TODD FACTS
    - RELINQUISHED PROPERTY AMOUNT REALIZED/QI FUNDS = $100
    - BASIS = $50; NO DEBT RELIEF
  - REPLACEMENT PROPERTY FACTS
    - PURCHASE PRICE = $1,500
    - LENDER WILL LOAN $500
    - PROPERTY TO BE USED FOR RANCH OPERATIONS

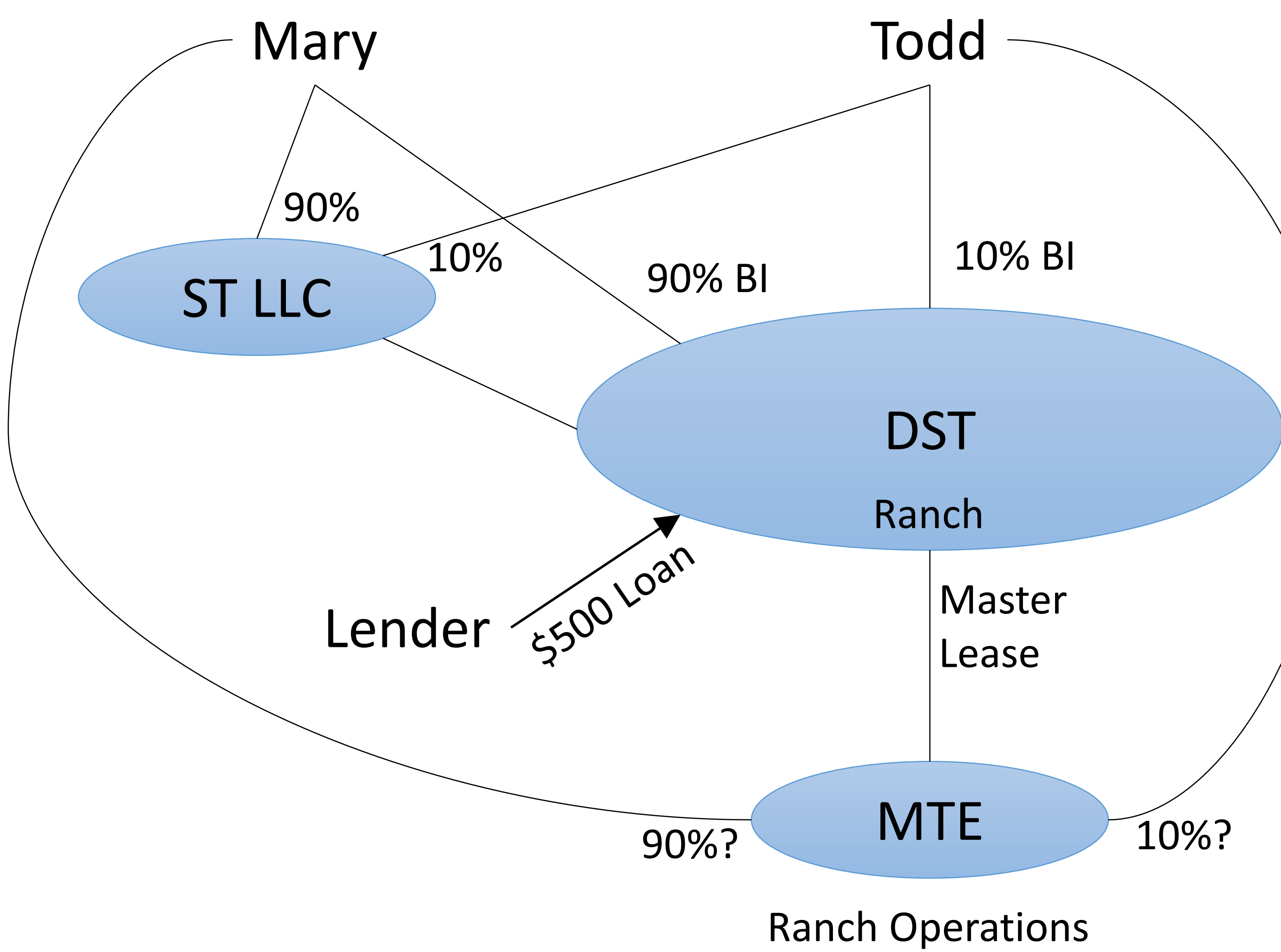
Appendix A

USES OF DSTS—ACQUISITION TRANSACTIONS

- ISSUES:
  - “BAD” INCOME MANDATES A MASTER LEASE
  - LENDER ATTITUDE TOWARD TIC VS. DST STRUCTURE
  - WHO CAN OWN THE MASTER TENANT ENTITY (MTE)?
  - TERMS OF THE MASTER LEASE
  - GOVERNANCE – WHO OWNS/CONTROLLS THE SIGNATORY TRUSTEE (“ST”)?
  - LIABILITY PROTECTION

Appendix A

USES OF DSTS—ACQUISITION TRANSACTIONS



Appendix B

Acquisition Two—Mary and Todd Want to Buy Royalties Together

Appendix B

ROYALTY PACKAGES

- SAME MARY AND TODD RELINQUISHED PROPERTY FACTS
- MARY AND TODD WANT TO PURCHASE A PACKAGE OF OIL AND GAS ROYALTIES ON 3,000 PROPERTIES
- TODD HAS OIL AND GAS EXPERTISE; MARY HAS NONE
- MARY AND TODD MAY IN THE FUTURE WANT TO MAKE THEIR INTERESTS IN THE ROYALTIES AVAILABLE FOR PURCHASE BY OTHER 1031 INVESTORS; SO WOULD LIKE TO AVOID RE-TITLING

Appendix B

ROYALTY PACKAGES

- ISSUES:
  - RE-TITLING ON SUBSEQUENT TRANSFERS
  - NEED MASTER LEASE? NO
  - POTENTIAL NEED TO RE-LEASE MINERAL RIGHTS IF LEASE LAPSES—PERMISSIBLE FOR SIGNATORY TRUSTEE? PLR 7807031

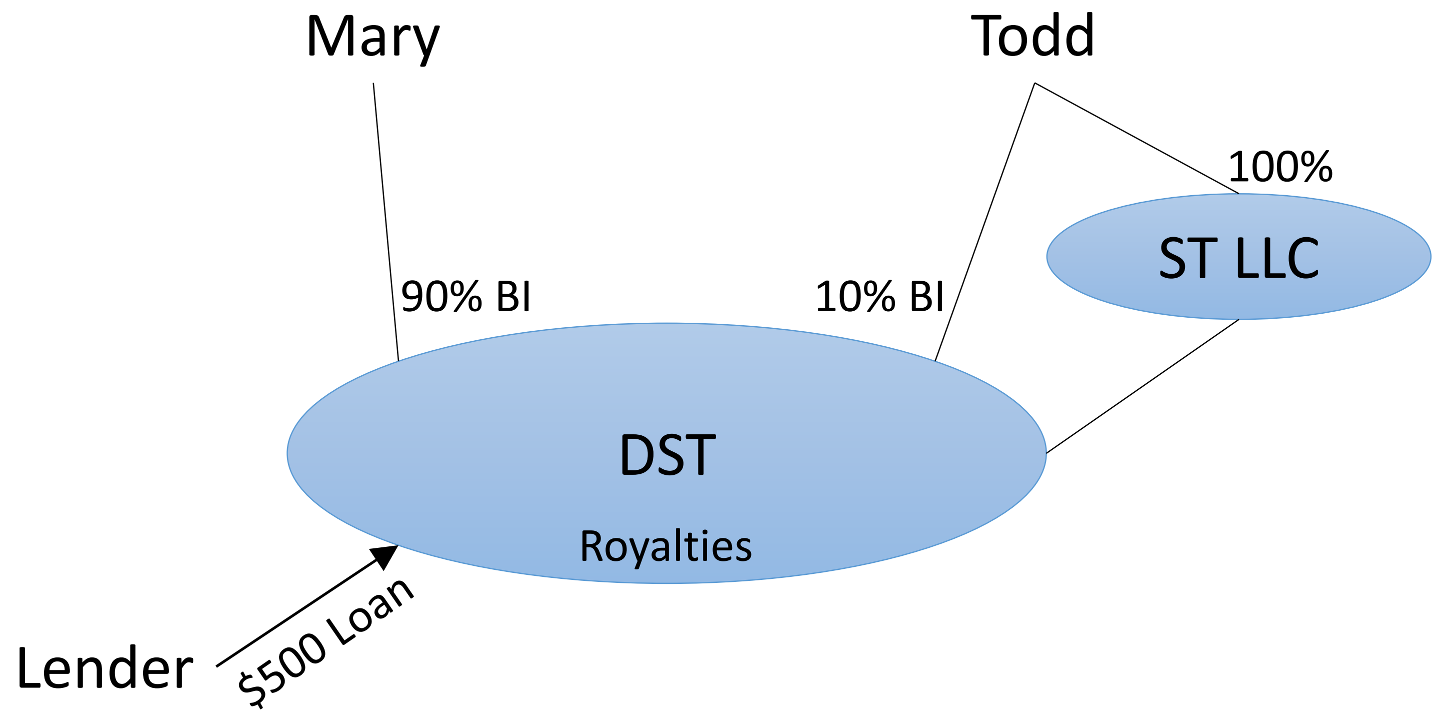
Appendix B

ROYALTY PACKAGES

- ISSUES (CONT'D):
  - ABILITY TO CONSOLIDATE MANAGEMENT
  - LENDER ATTITUDE TOWARD LENDING AGAINST ROYALTIES HELD BY MULTIPLE PARTIES
  - LIABILITY PROTECTION

Appendix B

ROYALTY PACKAGES



Appendix C

Disposition—Mary, Todd and Adam Sell an Encumbered Apartment (a "Synthetic Drop-and-Swap")

Appendix C

"SYNTHETIC" DROP-AND-SWAPS

- FACTS:
  - MARY IS A 80% MEMBER OF LLC; TODD IS A 10% MEMBER OF LLC; ADAM IS A 10% MEMBER OF LLC
  - LLC OWNS AN APARTMENT COMPLEX
    - FMV = $1,000
    - BASIS = $300
    - DEBT = $300

Appendix C

"SYNTHETIC" DROP-AND-SWAPS

- FACTS (CONT'D):
  - MARY AND TODD EACH WANT TO DO AN EXCHANGE, BUT NOT WITH EACH OTHER—ADAM WANTS TO CASH OUT
  - ASSUME NO MARKETING ACTIVITIES OF ANY KIND YET
  - LENDER WILL NOT CONSENT TO A "DROP-AND-SWAP" BECAUSE DOES NOT WANT THREE BORROWERS AND DEMANDS THAT MARY HAVE CONTROL

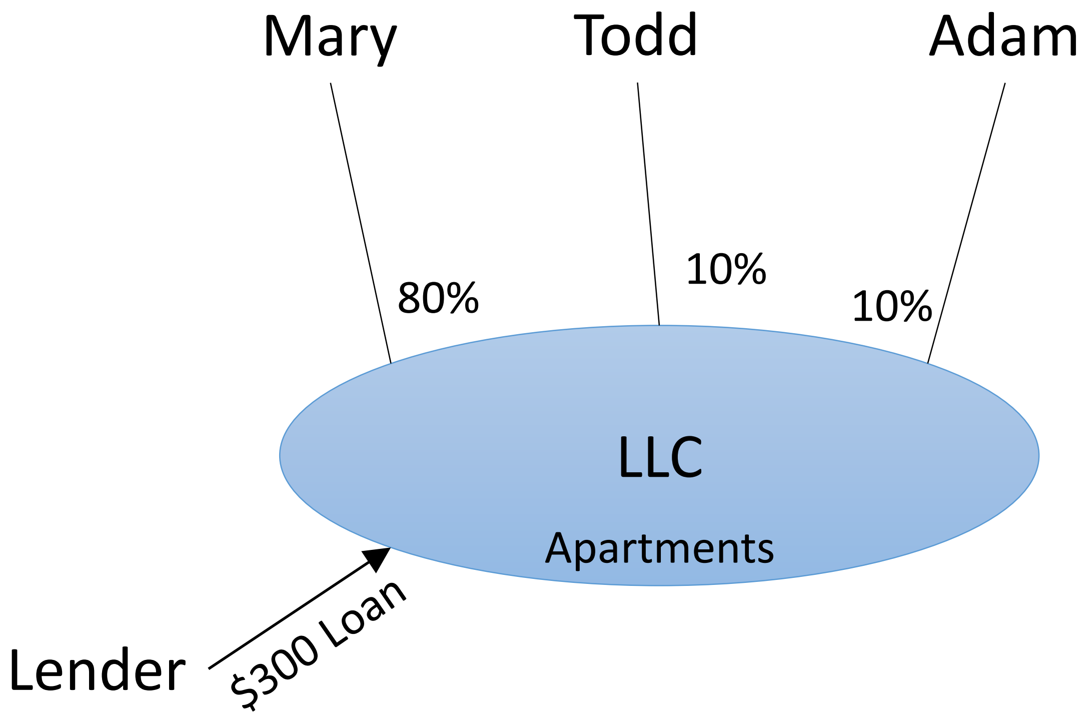
Appendix C

“SYNTHETIC” DROP-AND-SWAPS

- ISSUES:
  - ARE MASTER LEASES NEEDED? TIC NO; DST YES
  - IF DST IS USED; WHO OWNS THE MASTER TENANT?
  - WHO OWNS/CONTROLS THE SIGNATORY TRUSTEE?

Appendix C
"SYNTHETIC" DROP-AND-SWAPS

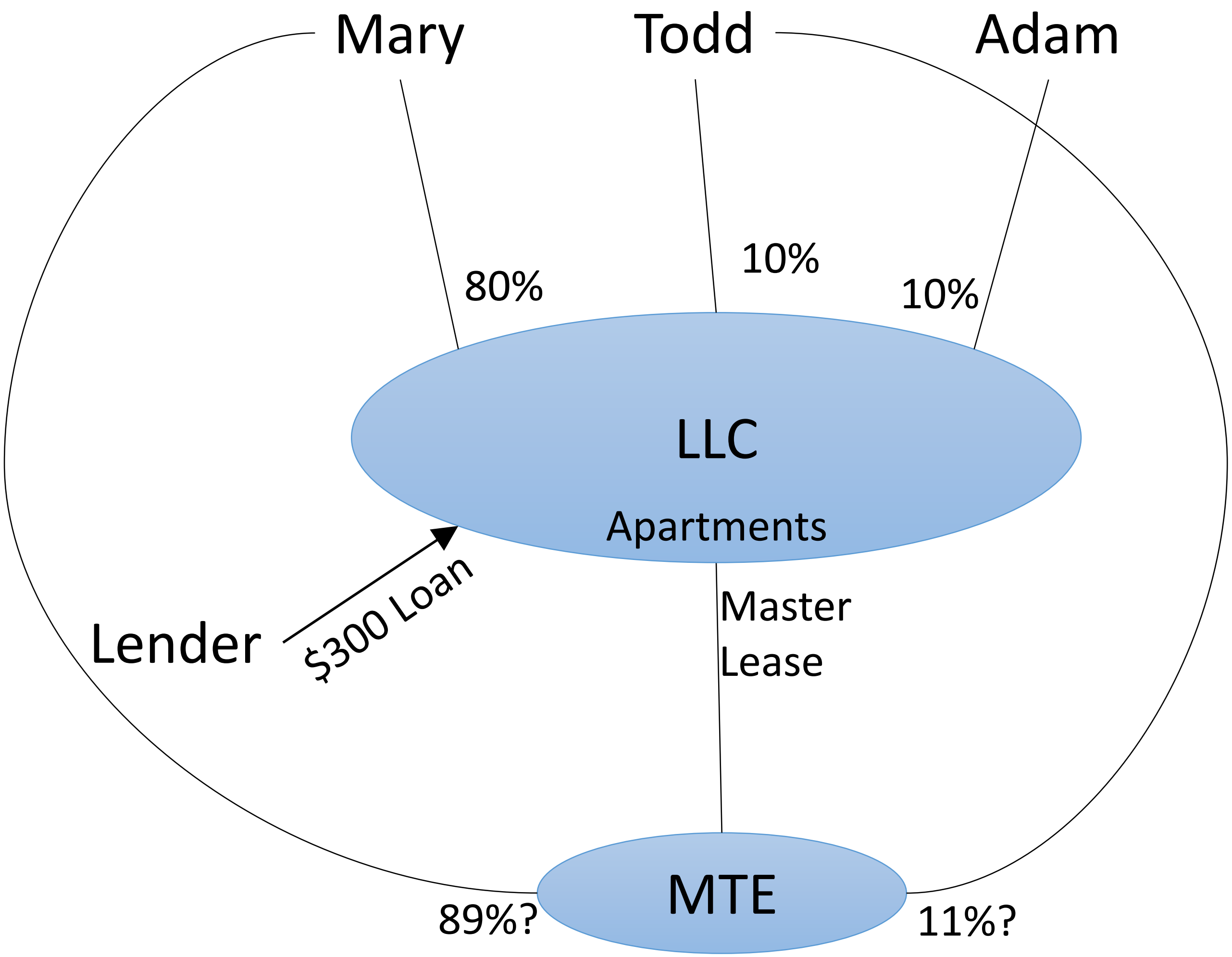
Starting Position



Appendix C

"SYNTHETIC" DROP-AND-SWAPS

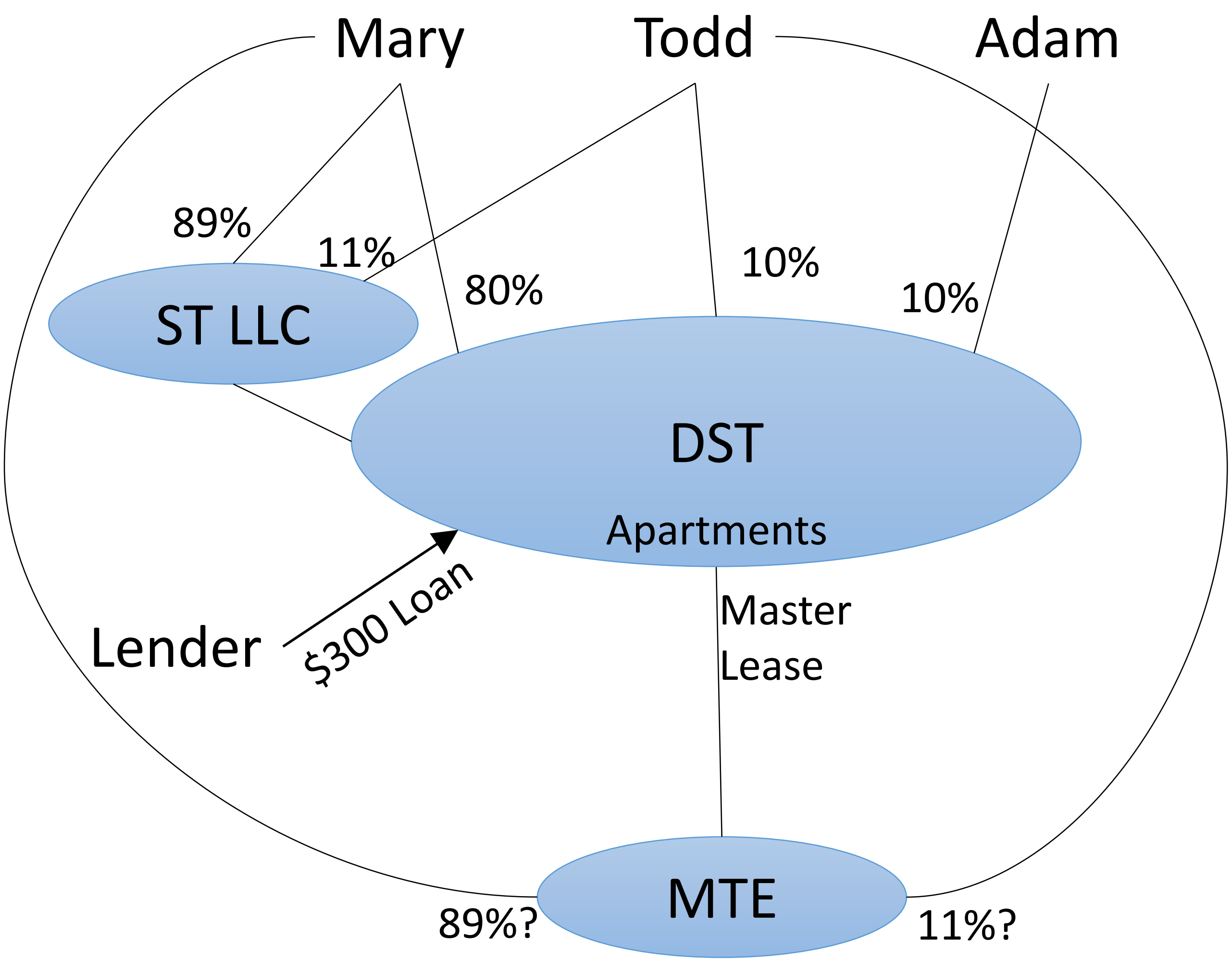
Master Lease Apartments to MTE



Appendix C

"SYNTHETIC" DROP-AND-SWAPS

Create ST LLC; Convert LLC to DST*



* LLC to DST conversion is a deemed liquidation of the LLC

Appendix C

"SYNTHETIC" DROP-AND-SWAPS

Sell Apartments

- MARY TREATED AS SELLING AN 80% INTEREST IN THE PROPERTY FOR $800; HER QI RECEIVES $560 CASH – SHE COMPLETES HER EXCHANGE

- TODD TREATED AS SELLING A 10% INTEREST IN THE PROPERTY FOR $100; HIS QI RECEIVES $70 IN CASH – HE COMPLETES HIS EXCHAHGE

- ADAM TREATED AS SELLING A 10% INTEREST IN THE PROPERTY FOR $100 – TAKES $70 CASH & PAYS TAX ON HIS SHARE OF REALIZED GAIN

Appendix D

Restructuring—Don, Glenn, Joe and Timothy Want to Reshuffle the Ownership of Two Ranches

Appendix D

RANCH RE-SHUFFLE TRANSACTION

- FACTS:
  - DON, GLENN, JOE AND TIMOTHY ARE EACH 25% MEMBERS IN AN LLC
  - LLC OWNS TWO OPERATING RANCHES (TEXAS RANCH AND NEW MEXICO RANCH), EACH OF WHICH HAVE THE FOLLOWING METRICS
    - FMV = $1,000
    - BASIS = $300
    - NO DEBT
    - TITLE IS MESSY, BACK TO THE QUEEN OF SPAIN

Appendix D

RANCH RE-SHUFFLE TRANSACTION

- FACTS (CONT’D):
  - GLENN AND TIMOTHY WANT TO BENEFICIALLY OWN ALL OF NEW MEXICO RANCH (WITH GLENN CONTROLLING THE OPERATIONS), AND DON AND JOE WANT TO BENEFICIALLY OWN ALL OF TEXAS RANCH (WITH DON CONTROLLING THE OPERATIONS)
  - NOBODY WANTS TO RECOGIZE GAIN ON THE RE-SHUFFLE OF OWNERSHIP

Appendix D

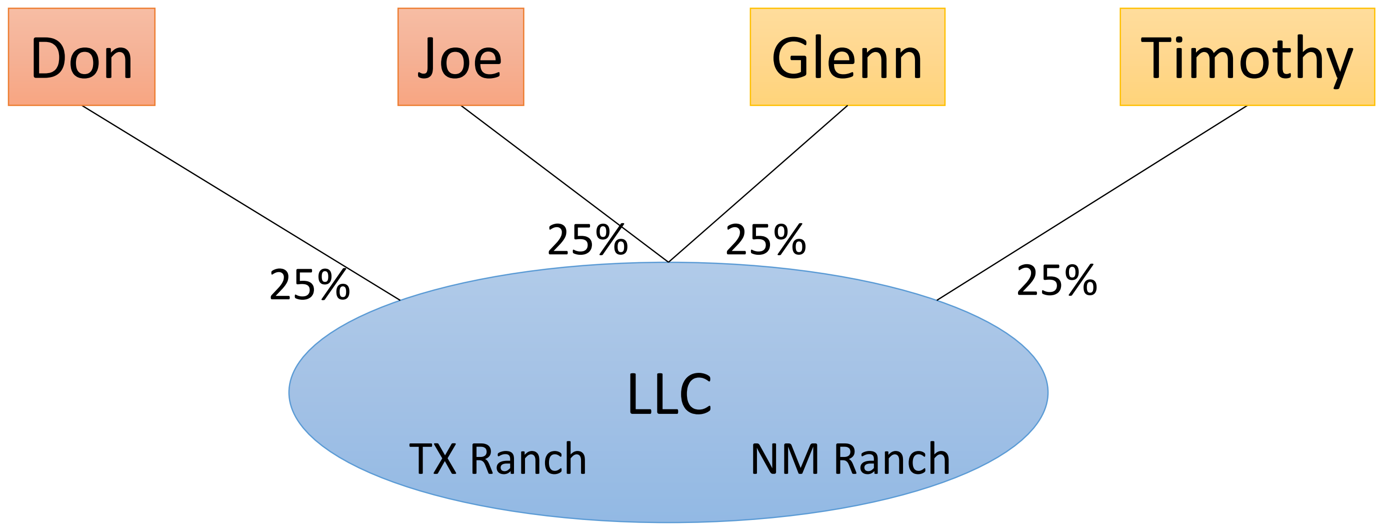
RANCH RE-SHUFFLE TRANSACTION

- ISSUES:
  - ARE MASTER LEASES NEEDED? TIC YES; DST YES
  - IF DST IS USED; WHO OWNS THE MASTER TENANT ENTITIES (MTEs)?
  - WHO OWNS/CONTROLS THE SIGNATORY TRUSTEE FOR EACH DST

Appendix D

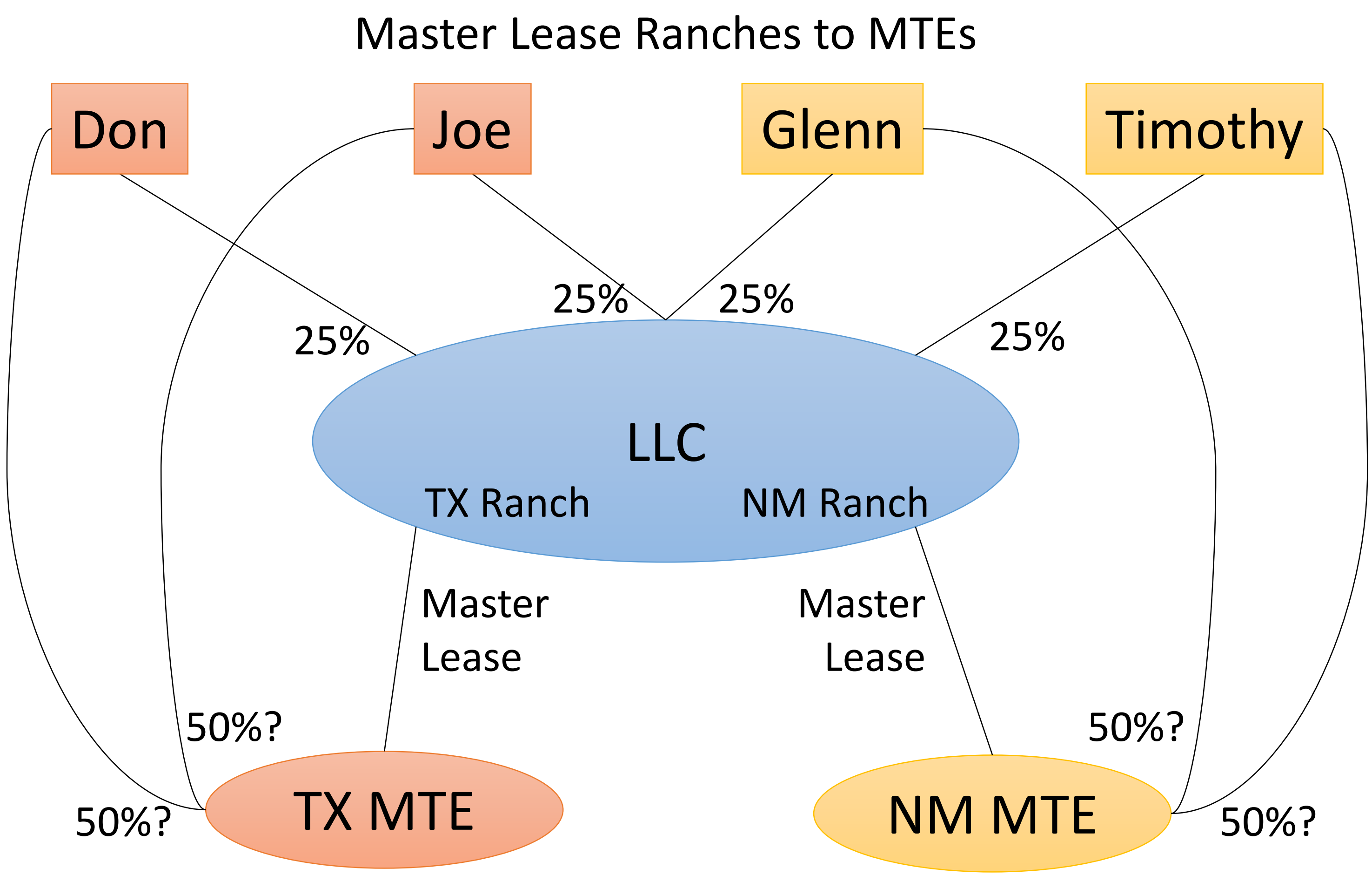
RANCH RE-SHUFFLE TRANSACTION

Starting Point



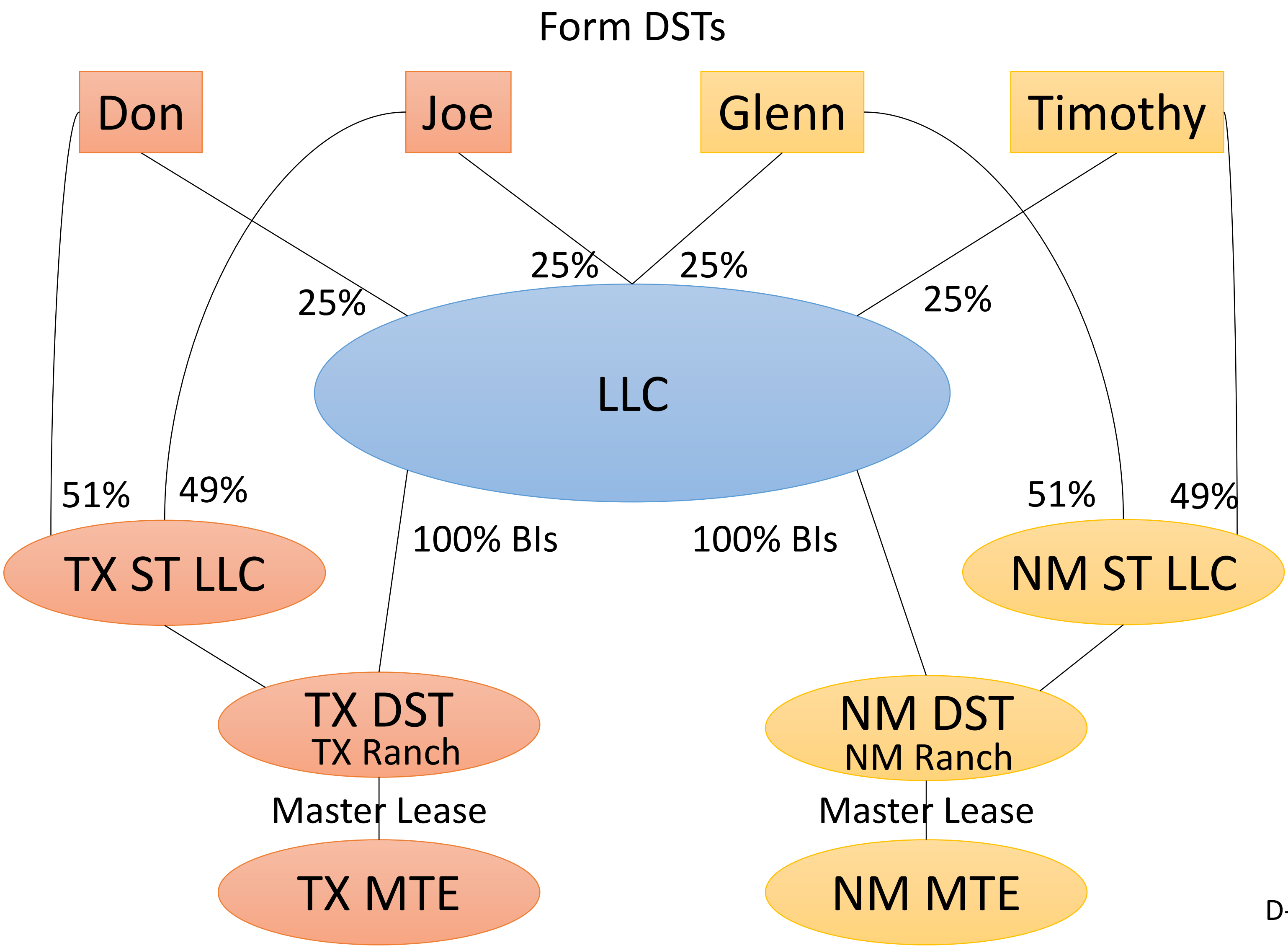
Appendix D

RANCH RE-SHUFFLE TRANSACTION



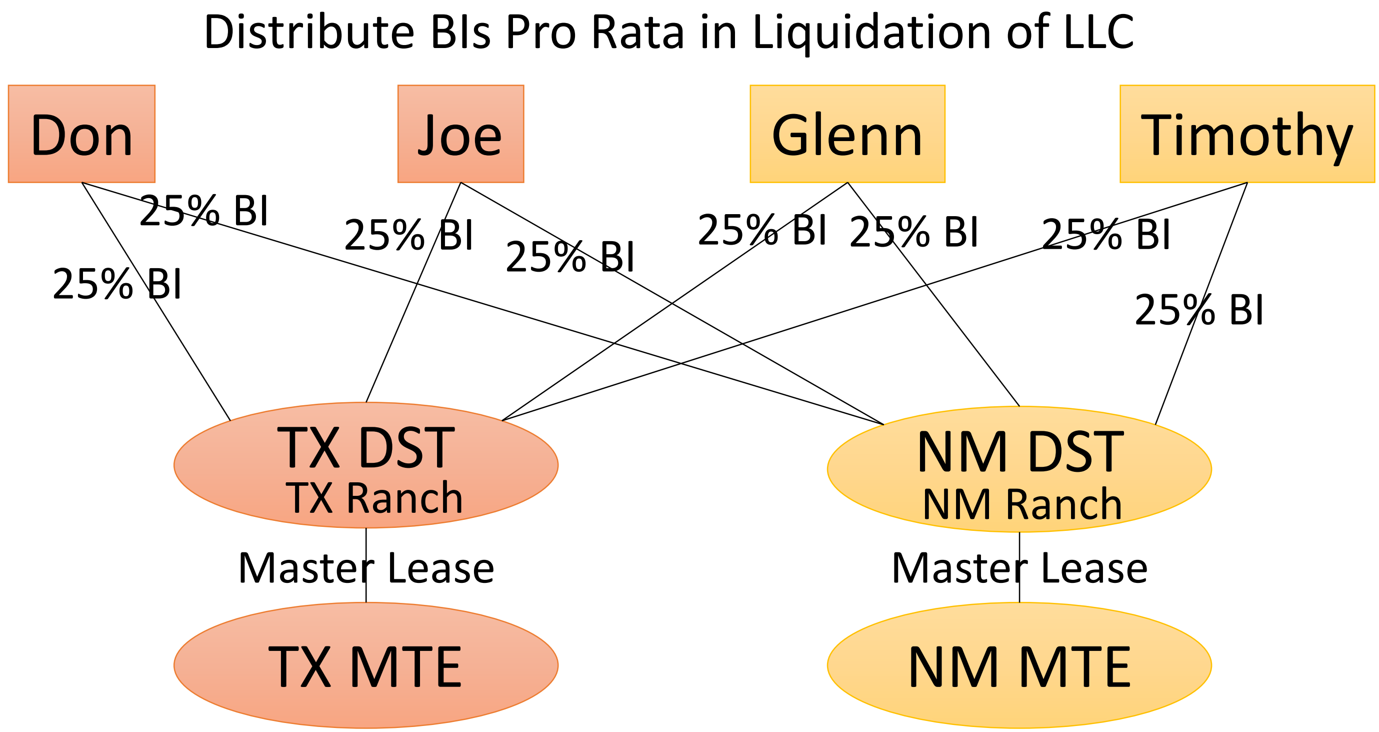
Appendix D

RANCH RE-SHUFFLE TRANSACTION



Appendix D

RANCH RE-SHUFFLE TRANSACTION



Appendix D

RANCH RE-SHUFFLE TRANSACTION