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Alternative Structures for Section 1031 Exchanges

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In this article, Homayoun, Rhim, and Michael discuss alternatives to the traditional section 1031 exchange for investing proceeds from the sale of property.

I. Background

With the recovery of the real estate sector from the carnage of the Great Recession, the desire to avoid tax on gain realized in dispositions of appreciated real estate has brought renewed vigor to the 1031 exchange market. In addition to traditional direct exchanges, interests in a tenancy in common (TIC) and a Delaware Statutory Trust (DST) can also be used as like-kind property for purposes of section 1031. A lesser-known strategy, but one that has been available for many decades, allows a taxpayer to defer taxes on the sale of property by first contributing the property to a deferred sales trust. Finally, a "swap and drop" permits reinvestment into a fractional interest in a diversified real estate portfolio.

In March 2002, the IRS issued Rev. Proc. 2002-22[1] (the TIC guidance), which specifies conditions under which the IRS will consider a request for a ruling on whether a TIC interest constitutes a direct interest in real property, as opposed to an interest in a business entity (for example, a partnership). This classification, of course, is critical for like-kind exchange purposes because section 1031 does not apply to an exchange of interests in a partnership or other business entity.[2]

While the guidelines are rather impractical, the TIC guidance was largely responsible for the emergence of a booming TIC industry in the early 2000s, with investors aggressively pursuing exchanges of real estate for undivided fractional interests in real property. In fact, from 2002 through 2006, investors seeking tax deferral flooded the market with more than $10 billion of equity.[3]

The financial crisis of 2007 and 2008 and the related turmoil in the credit markets greatly cooled the TIC market. While the real estate economy has gradually but steadily improved, the TIC industry has not come close to approaching its pre-financial-crisis levels. Instead, the DST has surpassed the TIC structure and is now the preferred (but not exclusive) structure for tax-deferred exchanges of undivided fractional interests in real property.

Although TICs and DSTs are both used to facilitate tax-deferred exchanges under section 1031, that is where the comparisons stop. A DST is considered a legal entity for federal income tax purposes, while a TIC arrangement represents a co-ownership of property among several different investors. TICs and DSTs, therefore, are subject to markedly different tax rules, and each structure has its own separate requirements and limitations. Accordingly, the ability to take some actions within a TIC structure does not necessarily mean that those actions are permissible in a DST structure, or vice versa.

[1] 2002-1 C.B. 733.

[2] *See* section 1031(a)(2)(D).

[3] OMNI Brokerage, *TIC Talk* (2d Quarter 2006).

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II. TICs

The TIC guidance lists conditions that a TIC must satisfy to be treated as an interest in real property and not as an interest in a business entity. It is important to note, however, that the TIC guidance does not serve as a safe harbor. Rather, unlike the DST guidance, the TIC guidance simply lists the conditions under which the IRS will consider a request for a ruling.

While the IRS has issued a few private rulings concerning the TIC guidance, as a practical matter, almost all TIC transactions are based on the opinion of tax counsel. Accordingly, if a co-ownership arrangement satisfies substantially all the conditions in the TIC guidance, tax counsel will generally provide a "should"-level tax opinion that supports non-partnership classification for federal income tax purposes.

A co-ownership arrangement that does not satisfy substantially all the conditions of the TIC guidance may receive a "more likely than not"-level of tax opinion, although the opinion level will depend on the specific conditions that the taxpayer satisfies (or fails to satisfy). Moreover, as discussed below, in some cases it might be permissible to deviate from some guidelines in the TIC guidance without altering the opinion level.

A. Voting

Co-owners must retain the right to approve the hiring of any manager; the sale or other disposition of the property; leases of the property; or the creation or modification of a blanket lien.[4] Under the TIC guidance, the following actions require unanimous approval of the co-owners: sales, leases, or re-leases of all or a portion of the property; negotiation or renegotiation of debt secured by a blanket lien; the hiring of a manager; or negotiation of a management agreement (including an extension or renewal).[5]

This condition suggests that a TIC is an inappropriate structure for a co-owner that wishes to unilaterally direct the sale or lease of the property or make other major decisions that require unanimous consent of all the co-owners. In fact, based on this fundamental condition, a single dissenting co-owner can effectively prevent a sale of the property, even if the co-owner is deemed to be acting unreasonably.

Although this condition is critical to avoid partnership classification, the IRS has issued a ruling that allows co-owners that hold more than 50 percent of the co-ownership interests to purchase (at fair market value) the interest of a co-owner that votes not to (1) sell all or a portion of the property, (2) incur indebtedness to be secured by the property, or (3) modify any lease (or guarantee of a lease).[6] The same ruling also allows the manager to lease or re-lease a portion of the property's total leasable space without obtaining the consent of the co-owners, as the TIC guidance otherwise requires.[7]

Also, the IRS has issued rulings in co-ownership arrangements that include deemed consent provisions (that is, a co-owner is deemed to consent to a matter if the co-owner does not provide formal written consent within a specific time).[8] The amount of notice required under the deemed consent provision will be an important consideration in determining its validity. For instance, one ruling indicates that 60 days' written notice is sufficient for the renewal of a management agreement.[9]

B. Restrictions on Alienation

Each co-owner must have the right to transfer, partition, and encumber the co-owner's undivided interest in the property, without the agreement or approval of any person.[10] Also, the co-owners, sponsor, or lessee may have a right of first offer regarding any co-owner's exercise of the right to transfer the co-ownership interest in the property.[11]

This condition also is fundamental, and taxpayers should generally not deviate from its requirements.

[4] *See* TIC guidance section 6.05.

[5] *Id.*

[6] LTR 200513010.

[7] *Id.*

[8] *See* LTR 200327003; and LTR 200513010.

[9] LTR 200327003.

[10] *See* TIC guidance section 6.06.

[11] *Id.*

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C. Options

A co-owner may issue an option to purchase the co-owner's undivided interest (a "call" option), but a co-owner may not acquire an option to sell the co-owner's undivided interest to the sponsor, lessee, co-owner, lender, or person related to the foregoing (a "put" option).[12]

Although the TIC guidance specifically provides that a co-owner may not acquire a put option to sell the co-owner's undivided interest to another co-owner, the IRS recently issued a private letter ruling that allowed a put option to sell property held by the taxpayer before entering into the co-ownership agreement.[13] Timing considerations regarding the put option appeared to be an important factor under this ruling.

D. Debt

Under the TIC guidance, co-owners must share in any debt secured by a blanket lien in proportion to the co-owners' undivided interests.[14]

Lenders, however, often require the sponsor to guarantee certain nonrecourse carveout obligations ("bad boy acts") of the co-owners. Despite the restrictive language of the TIC guidance, such a sponsor guarantee alone should not cause tax counsel to deliver a weaker or less confident tax opinion.

E. Business Activities

Co-owners' activities must be limited to those activities "customarily performed" in connection with the maintenance and repair of rental real estate.[15] Those activities generally include the furnishing of heat, cleaning of public areas, and removal of trash.

Although there is some support under the tax law for more substantive activities,[16] construction activities would likely result in a lower level of tax opinion (for example, "more likely than not," as opposed to "should").

F. Loans

Under the TIC guidance, persons that are related to any co-owner, sponsor, manager, or lessee may not make a loan that encumbers the property or that is used to acquire an undivided interest in the property.[17]

However, despite this guideline, it is not uncommon to have bridge financing to complete the purchase of the property from a third-party seller. Bridge financing may come from an outside lender or the sponsor, but in either case it should not adversely affect the tax opinion of counsel.

III. DSTs

Rev. Rul. 2004-86[18] (the DST guidance) addresses whether a DST will be treated as an investment trust or business entity for federal income tax purposes.[19] If the DST is treated as an investment trust, interests in the DST will be treated as interests in the property owned by the DST for purposes of section 1031, and therefore beneficial owners can exchange their relinquished property for interests in the DST. Alternatively, if the DST is treated as a business entity, interests in the DST will be treated as interests in a partnership or other business entity, which will not qualify as replacement property under section 1031.

The primary advantage of a DST is that it is a legal business entity established under Delaware law. Accordingly, from a financing perspective, a DST will have only one borrower (the DST), whereas a TIC offering can have up to 35 borrowers. A DST, therefore, is much more attractive to lenders than a TIC, and financing is likely to be available on terms that are more favorable.

Another advantage concerns the number of permissible investors. While there can be a maximum of only 35 co-owners in a TIC offering,

[12] *See* TIC guidance section 6.10.

[13] LTR 201622008.

[14] *See* TIC guidance section 6.09.

[15] *See id.* at section 6.11.

[16] *See Appleby Estate v. Commissioner*, 41 B.T.A. 18 (1940) (holding that co-owners who demolished a building and constructed a parking garage are not partners).

[17] *See* TIC guidance section 6.14.

[18] 2004-2 C.B. 191.

[19] Unlike the TIC guidance, the DST guidance is a revenue ruling that sets forth substantive rules of law. Taxpayers, therefore, would be well advised to operate within its parameters.

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the DST guidance does not place any limits on the number of beneficial owners.[20] With more potential investors, a DST can have lower minimum investments and be marketed to a broader pool of investors.

A DST, however, also has several limitations and restrictions. Most notably, under the DST guidance, beneficial owners can have no right to participate in any aspect of the operation or management of the DST.[21] The DST guidance also places significant limitations on the powers of the trustee, which have come to be known as the "seven deadly sins." In general, the trustee cannot:

1. dispose of the DST's property and then acquire new property;
2. enter into new leases;
3. renegotiate a lease with an existing tenant;
4. renegotiate the debt used to acquire the property;
5. refinance the debt used to acquire the property;
6. invest cash received from the property to profit from market fluctuations; or
7. make more than minor, non-structural modifications to the property.

Engaging in any of those sins would cause the DST to lose its status as an investment trust and instead be treated as a partnership or other business entity — a "deadly" result for section 1031 purposes. Accordingly, based on these limitations, a DST can be engaged only in the passive holding of real estate, which is why it is more appropriate for a property that requires little or no action by the beneficial owners (for example, property subject to a master lease or ground lease). Conversely, property that requires active management is not suitable for a DST.

In light of those limitations, if the assets of the DST are in danger (for example, the loan to the DST is in default or default is imminent), a properly structured DST typically includes a provision that authorizes the trustee to contribute the assets to a newly formed limited liability company (which is often called a "springing LLC") and subsequently distribute membership interests in the springing LLC to the beneficial owners in liquidation of the DST.[22] That provision provides greater flexibility to address issues that may otherwise be prohibited under a DST.

IV. Differences Between TICs and DSTs

As evident from the discussion above, while interests in a TIC and DST can each be used as like-kind property for purposes of section 1031, TICs and DSTs are subject to different tax rules, and each structure has its own separate requirements and limitations. The chart at the end of this article illustrates the differences between TICs and DSTs in a comparative, tabular format.

V. Deferred Sales Trust

Another tool in the planning arsenal is the deferred sales trust. Unlike a TIC or DST, the IRS has not issued specific guidance on deferred sales trusts, but the concept is rather straightforward and the general approach has been in use for decades. In general, under this arrangement, a seller sells an appreciated asset to an irrevocable trust on an installment basis. The trust subsequently sells the property outright and takes possession of the sales proceeds, which are invested in accordance with the terms of the trust agreement. The trust has little or no gain because its cost basis is stepped up in the purchase from the seller. The seller receives a promissory note and has all legal rights and privileges, including the right to call the note in the event of default.

Under the installment sale rules of section 453, the taxpayer generally recognizes gain only when deferred principal payments are received under the note, rather than in the year in which the sale occurs. Accordingly, rather than recognizing the entire tax burden in the year of the sale, the use of a deferred sales trust effectively defers taxes until the trust makes principal payments to the taxpayer. Thus, the taxpayer is able to, in effect, reinvest the sales proceeds on a gross proceeds

[20] In fact, a DST can have hundreds of beneficial owners or investors.

[21] Some investors, however, may prefer a more passive role and leave the decision making to the trustee or manager. In fact, the TIC guidance's requirement of unanimous voting regarding major decisions (for example, a sale or lease of the property) could lead to stalemates if even one co-owner dissents.

[22] Alternatively, the trustee may simply convert the DST into a LLC under state law.

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basis rather than an after-tax basis with a resulting increased yield on the investment.

For a deferred sales trust to be valid, the trustee must be independent and the seller cannot be treated as a dealer for federal income tax purposes. Also, the benefits of installment reporting on some large sales may be limited by section 453A, which imposes an interest charge on the deferred tax liability. This section applies if the property has a sales price that exceeds $150,000 and the total balance of all non-dealer installment obligations arising during, and outstanding at the close of, the tax year is more than $5 million.

Given the lack of specific guidance from the IRS, more risk might be involved with a deferred sales trust than with a TIC or DST. For instance, the IRS may invoke the "step transaction" doctrine to collapse the transfer to the trust and the trust's subsequent sale of the property.[23] Moreover, as noted above, it will be critical to have a trustee that is completely independent from the seller and his or her family. Nevertheless, this strategy may assume greater prominence if section 1031 becomes a victim of tax reform.

VI. Swap and Drop Transactions

As previously noted, section 1031 does not apply to an exchange of interests in a partnership.[24] In other words, an exchange of qualifying property for a partnership interest will result in a taxable exchange, even if the partnership owns property that would otherwise qualify for a deferred exchange under section 1031.

Because of this exclusion, taxpayers with investments that are held in limited partnerships or limited liability companies sometimes enter into "swap and drop" and "drop and swap" transactions.

In general, in a "swap and drop" transaction, a taxpayer exchanges real property for like-kind replacement property in a section 1031 exchange. The taxpayer then immediately contributes the replacement property to a partnership in exchange for a partnership interest. Similarly, in a "drop and swap" transaction, a partnership distributes real property to the partners, pro rata as tenants in common. Each tenant in common can elect to exchange its real property interest for like-kind replacement property in a section 1031 exchange.

As discussed below, the IRS and the courts have differing views on the validity of these transactions. Tax reform also could impact these transactions.

A. IRS's Position

Historically, the IRS's position was that transfers to or from a partnership or corporation before or after an exchange will cause the exchange to fail the "held for" requirement under section 1031(a).[25]

For instance, in Rev. Rul. 75-292,[26] a taxpayer transferred land and buildings used in its trade or business to an unrelated corporation in exchange for an office building. The taxpayer contributed the replacement property to a newly formed corporation immediately after the exchange. The IRS ruled that the taxpayer's transfer of the replacement property to its wholly owned corporation violated the "held for" requirement under section 1031(a), thereby causing the exchange to be taxable.[27]

Although most rulings focus on the "held for" requirement under section 1031(a), the IRS also could challenge the transaction on other grounds. For example, the IRS could invoke the "step transaction" doctrine and argue that the steps of the transaction should be integrated and treated as a sale for federal income tax purposes. Thus, in applying the step transaction doctrine to a typical "swap and drop" transaction, the IRS could recharacterize the transaction as an exchange of real property for an interest in a partnership,

[23]The step transaction doctrine generally seeks to determine whether multiple distinct events should be respected as separate and unrelated events or should be considered as part of a single integrated transaction. This determination is a facts and circumstances analysis, with the taxpayer's subjective intent being an important factor.

[24]Section 1031(a)(2)(D).

[25]In fact, in 2008, the IRS amended Form 1065, IRS, "U.S. Return of Partnership Income," to require a partnership to disclose whether the partnership distributed any property received in a like-kind exchange or contributed any such property to another entity.

[26]1975-2 C.B. 333.

[27]*See also* Rev. Rul. 75-291, 1975-2 C.B. 332 (section 1031 does not apply when a taxpayer acquires property solely for exchanging it for like-kind property); Rev. Rul. 77-337, 1977-2 C.B. 305 (same); and LTR 9645005.

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which, as described above, does not qualify under section 1031.

To the extent that the replacement property is acquired and held in a co-tenancy arrangement, the IRS could also argue that the co-tenancy is in substance a partnership, and therefore the exchange of the relinquished property for an interest in the partnership represents an invalid exchange under section 1031(a)(2)(D).

B. Case Law

By contrast, the courts have taken a different view of these transactions and have generally respected exchanges that include partnership and corporate distributions and contributions as nontaxable.

For instance, in *Magneson*,[28] the taxpayer exchanged property for a TIC interest in replacement property. Immediately thereafter, the taxpayer and the other tenants in common contributed the replacement property to a limited partnership in exchange for partnership interests. The Court of Appeals for the Ninth Circuit held that the exchange satisfied the "held for" requirement under section 1031(a), despite the immediate transfer of the replacement property to a partnership.

In *Bolker*,[29] a taxpayer adopted a plan to liquidate its wholly owned corporation. Upon receiving the distributed property, the taxpayer entered a contract to exchange the property for replacement property in a section 1031 exchange. The Court of Appeals for the Ninth Circuit held that the exchange qualified under section 1031 because the taxpayer intended to hold property for qualified use at the time of the adoption of the plan of liquidation. The court emphasized that the taxpayer did not intend to liquidate the relinquished property into cash or convert the property to personal use.

Mason[30] involved the liquidation of two partnerships and a subsequent exchange of real property by the former partners. The Tax Court held that the taxpayers exchanged the underlying property — as opposed to interests in a partnership — and therefore the exchange qualified for nonrecognition treatment under section 1031.

A recent California State Board of Equalization decision is helpful, especially for California taxpayers or property located in California. *Rago Development Corp.*[31] involved two taxpayers that exchanged their properties for TIC interests in replacement property. Under the terms of a loan agreement, after holding the replacement property as tenants in common for seven months, the taxpayers contributed their respective interests in the replacement property to the new LLC. Following the transfer to the LLC, the taxpayers held the same percentage interests that they held as tenants in common, and the contributed property was the sole asset of the LLC.

The California Franchise Tax Board challenged the transaction and argued that (1) the taxpayers did not hold the property for investment before the exchange because the taxpayers subsequently contributed the property to a LLC; and (2) the transaction was in substance an impermissible exchange of property for interests in a partnership.

The BOE held that the exchange qualified for nonrecognition treatment under section 1031. The BOE found that the taxpayers' subsequent transfer of the property to the LLC did not vitiate the taxpayers' intent to hold the property for investment. The taxpayers' intent, according to the BOE, was evidenced by the taxpayers holding the property for seven months as tenants in common before contributing the property to the LLC and by the lender requiring the transfer. The BOE also specifically found that the transaction should not be recharacterized as an exchange of property for interests in a partnership because each step of the transaction had independent economic substance.

C. Planning Considerations

It is unclear whether the IRS is actively challenging "swap and drop" and "drop and swap" transactions. The perhaps surprising dearth of litigated cases suggests that the IRS is

[28] *Magneson v. Commissioner*, 81 T.C. 767 (1983), *aff'd*, 753 F.2d 1490 (9th Cir. 1985).

[29] *Bolker v. Commissioner*, 81 T.C. 782 (1983), *aff'd*, 760 F.2d 1039 (9th Cir. 1985).

[30] *Mason v. Commissioner*, T.C. Memo. 1988-273.

[31] *Rago Development Corp.*, 2015-SBE-001 (June 23, 2015).

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not significantly monitoring or enforcing this issue. When the lack of reported cases is coupled with the presence of a significant and thriving "cottage industry" involving qualified intermediaries that have regularly facilitated transactions of this type over the past 30 years, one can only assume that the IRS is not actively seeking to enforce the "held for" requirement to impose a significant holding period. Moreover, the few cases in which the issue has surfaced have generally supported the taxpayers in these transactions. In fact, a recent case involving a non-safe-harbor, reverse like-kind exchange has shown the Tax Court's interpretation of section 1031 to be significantly liberal.[32]

However, one must be cautious in drawing conclusions from lack of activity by the IRS as the agency charged with enforcing this provision. But it seems there may well be tacit acceptance of these transactions. Perhaps this lack of interest is because — given the section 704(c) allocation rules as well as the enhanced disguised sale rules applicable to contributions of leveraged property — the opportunities for abuse have been essentially eliminated.[33]

Nevertheless, taxpayers can take steps to mitigate the risks of a challenge by the IRS. For instance, in a "swap and drop" transaction, after acquisition of the replacement property, the taxpayer should consider holding the replacement property as long as possible before contributing it to a partnership. The longer the taxpayer holds the replacement property, the less likely the IRS can argue that (1) the taxpayer failed the "held for" requirement under section 1031(a), or (2) the step transaction doctrine should apply to recharacterize the transaction as an exchange of property for an interest in a partnership.

Moreover, to the extent that the replacement property is acquired and held in a co-tenancy arrangement, the taxpayer should endeavor to satisfy as many of the TIC guidance's conditions as possible. By doing so, the taxpayer can effectively mitigate the risk of the IRS treating the co-tenancy arrangement as a partnership.

[32] *See Bartell v. Commissioner*, 147 T.C. 140 (2016).

[33] *See* final, temporary, and proposed Treasury regulations (T.D. 9787 and T.D. 9788) under sections 707 and 752; *see also* Richard M. Lipton, Samuel P. Grilli, and Nicole D. Renchen, "New Regulations on Partnership Debt and Disguised Sales: Is the Road to Hell Paved With Good Intentions? (Part 1)," 126 *J. Tax'n* 53 (Feb. 2017); and Lipton, Grilli, and Renchen, "New Regulations on Partnership Debt and Disguised Sales: Is the Road to Hell Paved With Good Intentions? (Part 2)," 126 *J. Tax'n* 100 (Mar. 2017).

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Tenancy in Common vs. Delaware Statutory Trust

Issue	TIC	DST
Title	Each co-owner must hold title to the property (directly or through a disregarded entity) as a tenant in common under local law.	The DST owns the property.
Number of co-owners	No more than 35 co-owners. A husband and wife, as well as persons who inherit from a deceased co-owner, are considered one co-owner for these purposes.	No ownership limitation for federal income tax purposes.
Entity treatment	Co-owners must not hold themselves out as being partners or shareholders, file entity tax returns, or conduct business under a common name. Co-owners should not have held the property through a partnership or other entity immediately before becoming co-owners.	Beneficial owners should not hold themselves out as being partners or shareholders or file entity tax returns. Conducting business under a common name should not be problematic.
Ownership agreements	Co-owners may enter into a limited ownership agreement that may run with the land.	A DST will have a governing Trust Agreement.
Voting	Co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the property, leases of the property, or the creation or modification of a blanket lien. The following actions require unanimous approval of all of the co-owners: sales, leases or re-leases of all or a portion of the property; negotiation or renegotiation of debt secured by a blanket lien; the hiring of a manger; or negotiation of a management agreement (including an extension or renewal). The use of a global power of attorney is not permissible for these purposes. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of co-owners holding more than 50 percent of the undivided interests in the property. The Service has privately ruled that co-owners, which hold more than 50 percent of the co-ownership interests, may purchase (at fair market value) the interest of a co-owner that votes not to (i) sell all or a portion of the property, (ii) incur indebtedness to be secured by the property, or (iii) modify any lease (or guarantee of a lease). A deemed consent provision, with reasonable notice (for example, 60 days), should suffice for voting purposes.	Beneficial owners have no right to participate in any aspect of the operation or management of the DST.
Restrictions on alienation	Each co-owner must have the right to transfer, partition and encumber the co-owner's undivided interest in the property, without the agreement or approval of any person. However, restrictions on the right to transfer, partition or encumber that are required by a lender, and that are consistent with customary commercial lending practices, are permissible. The co-owners, sponsor or lessee may have a right of first offer with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the property. A co-owner may agree to offer a co-ownership interest for sale to other co-owners, sponsor or lessee at fair market value before exercising any right to partition. The Service has privately ruled that a buy-sell agreement in a co-ownership with two co-owners is permissible.	Beneficial owners may generally transfer DST interests, but cannot have approval rights with respect to the sale or transfer of the property. The manager and the beneficial owners can have a right of first refusal to purchase a selling beneficial owner's DST interest.
Sale proceeds	Upon a sale of the property, any debt secured by a blanket lien must be satisfied and the remaining proceeds must be distributed to the co-owners.	Upon a sale of the property, any debt secured by a blanket lien must be satisfied and the remaining proceeds must be distributed to the beneficial owners.

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Tenancy in Common vs. Delaware Statutory Trust *(Continued)*

Profits and losses	Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property. None of the co-owners, sponsor or manager may advance funds to a co-owner to meet expenses associated with an ownership interest, unless the advance is recourse to the co-owner and is not for a period exceeding 31 days.	Revenues and costs must be shared in accordance with the beneficial owners' pro rata interests in the DST. A loan of additional funds by a beneficial owner to the DST is not permissible.
Debt	Co-owners must share in any debt secured by a blanket lien in proportion to the co-owners' undivided interests. A guarantee of standard non-recourse carve-outs (that is, "bad boy" acts) should be permissible for these purposes.	Debt should generally be shared pro rata within the DST.
Options	Co-owners must share in any debt secured by a blanket lien in proportion to the co-owners' undivided interests. A guarantee of standard non-recourse carve-outs (that is, "bad boy" acts) should be permissible for these purposes.	The DST Guidance does not address options. While not entirely clear, it may be advisable to forego options in a DST structure.
Business activities	Co-owners' activities must be limited to those activities "customarily performed" in connection with the maintenance and repair of rental real estate. Such activities include the furnishing of heat, cleaning of public areas and trash removal. Construction activities are not permissible. In determining the co-owners' activities, all activities of the co-owners, their agents and any related parties are taken into account.	Beneficial owners may not participate in any aspect of the operation or management of the DST. The Trustee's activities are generally limited to the collection and distribution of income. The Trustee may not make more than minor, non-structural modifications to the DST's property, unless otherwise required by law.
Management agreements	Co-owners may enter into management agreements with sponsors, co-owners and persons related to them, but not with lessees. Management agreements must be renewable no less frequently than annually, and must not provide for fees that are based in any way on the profits or income of the property or that exceed the fair market value of the manager's services. The manager may maintain a common bank account for the collection and deposit of rent, the payment of expenses and the disbursement of the net proceeds to the co-owners within three months of receipt.	A DST may have a manager and enter into management agreements, but the manager should be unrelated to the beneficial owners. The manager may generally have the power and authority to manage substantially all of the affairs and limited investment activities of the DST. The manager also may have primary responsibility for performing administrative actions in connection with the DST, as well as the sole power to determine when it is appropriate to sell the property. The management agreement should not involve the sharing of income or loss between the DST and the manager. The Trustee may maintain an investment account with permitted investments. The Trustee must disburse revenues on a quarterly basis. The Trustee is permitted to reserve for operating expenses.
Leases	All leasing arrangements must be bona fide leases for federal income tax purposes. Rent must reflect the fair market value for the use of the property, and the determination of the amount of the rent must not depend on the income or profits derived by any person from the property.	The Trustee may not enter into new leases or renegotiate a lease with an existing tenant.

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Tenancy in Common vs. Delaware Statutory Trust *(Continued)*

Loans	Persons that are related to any co-owner, sponsor, manager or lessee may not make a loan that encumbers the property or that is used to acquire an undivided interest in the property. Bridge financing to complete the purchase of the property from a third party seller should be permissible.	The Trustee may not renegotiate existing debt or enter into new financing.
Sponsor payments	Payments to sponsors for undivided interests or for services must reflect fair market value of the co-ownership interest and must not be based on income or profits from the property.	The DST Guidance does not address sponsor payments.
Income from property	The TIC Guidance does not include restrictions on investments.	The Trustee cannot invest cash received from the property to profit from market fluctuations. All cash must be invested in short-term obligations that mature prior to the next distribution date, and the DST must hold these obligations until maturity. Cash, in excess of reserves, must be distributed quarterly.
Property dispositions	The property may be sold upon the unanimous vote of the co-owners.	Beneficial owners cannot have approval rights with respect to the sale of the property. The Trustee may not dispose of the DST's assets and reinvest the proceeds. However, the Trustee may sell the DST's assets and dissolve the DST.
Additional investments	Additional investments are permissible.	The DST may not purchase assets or accept additional contributions of assets (including cash).

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SUBMISSIONS TO *TAX NOTES*

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