

Part I

Section 7701.—Definitions

26 CFR 301.7701-1: Classification of organizations for federal tax purposes

(Also: §§ 671, 677, 761, 1031, 1.761-2, 301.7701-1, 301.7701-3, 301.7701-4.)

Rev. Rul. 2004-86

ISSUE(S)

(1) In the situation described below, how is a Delaware statutory trust, described in Del. Code Ann. title 12, §§ 3801 - 3824, classified for federal tax purposes?

(2) In the situation described below, may a taxpayer exchange real property for an interest in a Delaware statutory trust without recognition of gain or loss under § 1031 of the Internal Revenue Code?

FACTS

On January 1, 2005, A, an individual, borrows money from BK, a bank, and signs a 10-year note bearing adequate stated interest, within the meaning of § 483. On January 1, 2005, A uses the proceeds of the loan to purchase Blackacre, rental real property. The note is secured by Blackacre and is nonrecourse to A.

Immediately following A's purchase of Blackacre, A enters into a net lease with Z for a term of 10 years. Under the terms of the lease, Z is to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, Z is to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. Z may sublease Blackacre. Z's rent is a fixed amount that may be adjusted by a formula described in the lease agreement that is based upon a fixed rate or an objective index, such as an escalator clause based upon the Consumer Price Index, but adjustments to the rate or index are not within the control of any of the parties to the lease. Z's rent is not contingent on Z's ability to lease the property or on Z's gross sales or net profits derived from the property.

Also on January 1, 2005, A forms DST, a Delaware statutory trust described in the Delaware Statutory Trust Act, Del. Code Ann. title 12, §§ 3801 - 3824, to hold property for investment. A contributes Blackacre to DST. Upon contribution, DST assumes A's rights and obligations under the note with BK and the lease with Z. In accordance with the terms of the note, neither DST nor any of its beneficial owners are personally liable to BK on the note, which continues to be secured by Blackacre.

The trust agreement provides that interests in DST are freely transferable. However, DST interests are not publicly traded on an established securities market. DST will terminate on the earlier of 10 years from the date of its creation or the disposition of Blackacre, but will not

terminate on the bankruptcy, death, or incapacity of any owner or on the transfer of any right, title, or interest of the owners. The trust agreement further provides that interests in DST will be of a single class, representing undivided beneficial interests in the assets of DST.

Under the trust agreement, the trustee is authorized to establish a reasonable reserve for expenses associated with holding Blackacre that may be payable out of trust funds. The trustee is required to distribute all available cash less reserves quarterly to each beneficial owner in proportion to their respective interests in DST. The trustee is required to invest cash received from Blackacre between each quarterly distribution and all cash held in reserve in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. In addition to the right to a quarterly distribution of cash, each beneficial owner has the right to an in-kind distribution of its proportionate share of trust property.

The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to DST. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with Z or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law. The trust agreement further provides that the trustee may engage in ministerial activities to the extent required to maintain and operate DST under local law.

On January 3, 2005, B and C exchange Whiteacre and Greenacre, respectively, for all of A's interests in DST through a qualified intermediary, within the meaning of § 1.1031(k)-1(g). A does not engage in a § 1031 exchange. Whiteacre and Greenacre were held for investment and are of like kind to Blackacre, within the meaning of § 1031.

Neither DST nor its trustee enters into a written agreement with A, B, or C, creating an agency relationship. In dealings with third parties, neither DST nor its trustee is represented as an agent of A, B, or C.

BK is not related to A, B, C, DST's trustee or Z within the meaning of § 267(b) or § 707(b). Z is not related to B, C, or DST's trustee within the meaning of § 267(b) or § 707(b).
LAW

Delaware law provides that a Delaware statutory trust is an unincorporated association recognized as an entity separate from its owners. A Delaware statutory trust is created by executing a governing instrument and filing an executed certificate of trust. Creditors of the beneficial owners of a Delaware statutory trust may not assert claims directly against the

property in the trust. A Delaware statutory trust may sue or be sued, and property held in a Delaware statutory trust is subject to attachment or execution as if the trust were a corporation. Beneficial owners of a Delaware statutory trust are entitled to the same limitation on personal liability because of actions of the Delaware statutory trust that is extended to stockholders of Delaware corporations. A Delaware statutory trust may merge or consolidate with or into one or more statutory entities or other business entities.

Section 671 provides that, where the grantor or another person is treated as the owner of any portion of a trust (commonly referred to as a “grantor trust”), there shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that the items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that, for purposes of subchapter J, a grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.

Under § 1.671-2(e)(3), the term “grantor” includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in § 301.7701-4(c).

Under § 677(a), the grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed, or held or accumulated for future distribution, to the grantor or the grantor's spouse.

A person that is treated as the owner of an undivided fractional interest of a trust under subpart E of part I, subchapter J of the Code (§§ 671 and following), is considered to own the trust assets attributable to that undivided fractional interest of the trust for federal income tax purposes. See Rev. Rul. 88-103, 1988-2 C.B. 304; Rev. Rul. 85-45, 1985-1 C.B. 183; and Rev. Rul. 85-13, 1985-1 C.B. 184. See also § 1.1001-2(c), Example 5.

Section 761(a) provides that the term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of the unincorporated organization, exclude such organization from the application of all or part of subchapter K, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income and the organization is availed of (1) for investment purposes only and not for the active conduct of a business, (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or

extracted, or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities.

Section 1.761-2(a)(2) provides the requirements that must be satisfied for participants in the joint purchase, retention, sale, or exchange of investment property to elect to be excluded from the application of the provisions of subchapter K. One of these requirements is that the participants own the property as coowners.

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(2) provides that § 1031(a) does not apply to any exchange of stocks, bonds or notes, other securities or evidences of indebtedness or interest, interests in a partnership, or certificates of trust or beneficial interests. It further provides that an interest in a partnership that has in effect a valid election under § 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of the partnership and not as an interest in a partnership.

Under § 301.7701-1(a)(1) of the Procedure and Administration Regulations, whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Generally, when participants in a venture form a state law entity and avail themselves of the benefits of that entity for a valid business purpose, such as investment or profit, and not for tax avoidance, the entity will be recognized for federal tax purposes. See Moline Properties, Inc. v. Comm’r, 319 U.S. 436 (1943); Zmuda v. Comm’r, 731 F.2d 1417 (9th Cir. 1984); Boca Investings P’ship v. United States, 314 F.3d 625 (D.C. Cir. 2003); Saba P’ship v. Comm’r, 273 F.3d 1135 (D.C. Cir. 2001); ASA Investings P’ship v. Comm’r, 201 F.3d 505 (D.C. Cir. 2000); Markosian v. Comm’r, 73 T.C. 1235 (1980).

Section 301.7701-2(a) defines the term “business entity” as any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more owners is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded.

Section 301.7701-3(a) provides that an eligible entity can elect its classification for federal tax purposes. Under § 301.7701-3(b)(1), unless the entity elects otherwise, a domestic

eligible entity is a partnership if it has two or more owners or is disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-4(a) provides that the term “trust” refers to an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting and conserving it for the beneficiaries. Usually the beneficiaries of a trust do no more than accept the benefits thereof and are not voluntary planners or creators of the trust arrangement. However, the beneficiaries of a trust may be the persons who create it, and it will be recognized as a trust if it was created for the purpose of protecting and conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them.

Section 301.7701-4(b) provides that there are other arrangements known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but that are not classified as trusts for federal tax purposes because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business that normally would have been carried on through business organizations that are classified as corporations or partnerships.

Section 301.7701-4(c)(1) provides that an “investment” trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. See Comm’r v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power to vary the investment of the certificate holders.

A power to vary the investment of the certificate holders exists where there is a managerial power, under the trust instrument, that enables a trust to take advantage of variations in the market to improve the investment of the investors. See Comm’r v. North American Bond Trust, 122 F.2d at 546.

Rev. Rul. 75-192, 1975-1 C.B. 384, discusses the situation where a provision in the trust agreement requires the trustee to invest cash on hand between the quarterly distribution dates. The trustee is required to invest the money in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. Rev. Rul. 75-192 concludes that, because the restrictions on the types of permitted investments limit the trustee to a fixed return similar to that earned on a bank account and eliminate any opportunity to profit from market fluctuations, the power to invest in the specified kinds of short-term investments is not a power to vary the trust’s investment.

Rev. Rul. 78-371, 1978-2 C.B. 344, concludes that a trust established by the heirs of a number of contiguous parcels of real estate is an association taxable as a corporation for federal tax purposes where the trustees have the power to purchase and sell contiguous or adjacent real estate, accept or retain contributions of contiguous or adjacent real estate, raze or erect any building or structure, make any improvements to the land originally contributed, borrow money, and mortgage or lease the property. Compare Rev. Rul. 79-77, 1979-1 C.B. 448 (concluding that a trust formed by three parties to hold a single parcel of real estate is classified as a trust for federal income tax purposes when the trustee has limited powers that do not evidence an intent to carry on a profit making business).

Rev. Rul. 92-105, 1992-2 C. B. 204, addresses the transfer of a taxpayer's interest in an Illinois land trust under § 1031. Under the facts of the ruling, a single taxpayer created an Illinois land trust and named a domestic corporation as trustee. Under the deed of trust, the taxpayer transferred legal and equitable title to real property to the trust, subject to the provisions of an accompanying land trust agreement. The land trust agreement provided that the taxpayer retained exclusive control of the management, operation, renting, and selling of the real property, together with an exclusive right to the earnings and proceeds from the real property. Under the agreement, the taxpayer was required to file all tax returns, pay all taxes, and satisfy any other liabilities with respect to the real property. Rev. Rul 92-105 concludes that, because the trustee's only responsibility was to hold and transfer title at the direction of the taxpayer, a trust, as defined in § 301.7701-4(a), was not established. Moreover, there were no other arrangements between the taxpayer and the trustee (or between the taxpayer and any other person) that would cause the overall arrangement to be classified as a partnership (or any other type of entity). Instead, the trustee was a mere agent for the holding and transfer of title to real property, and the taxpayer retained direct ownership of the real property for federal income tax purposes.

ANALYSIS

Under Delaware law, DST is an entity that is recognized as separate from its owners. Creditors of the beneficial owners of DST may not assert claims directly against Blackacre. DST may sue or be sued, and the property of DST is subject to attachment and execution as if it were a corporation. The beneficial owners of DST are entitled to the same limitation on personal liability because of actions of DST that is extended to stockholders of Delaware corporations. DST may merge or consolidate with or into one or more statutory entities or other business entities. DST is formed for investment purposes. Thus, DST is an entity for federal tax purposes.

Whether DST or its trustee is an agent of DST's beneficial owners depends upon the arrangement between the parties. The beneficiaries of DST do not enter into an agency agreement with DST or its trustee. Further, neither DST nor its trustee acts as an agent for A, B, or C in dealings with third parties. Thus, neither DST nor its trustee is the agent of DST's beneficial owners. Cf. Comm'r v. Bollinger, 485 U.S. 340 (1988).

This situation is distinguishable from Rev. Rul. 92-105. First, in Rev. Rul. 92-105, the beneficiary retained the direct obligation to pay liabilities and taxes relating to the property. DST, in contrast, assumed A's obligations on the lease with Z and on the loan with BK, and Delaware law provides the beneficial owners of DST with the same limitation on personal liability extended to shareholders of Delaware corporations. Second, unlike A, the beneficiary in Rev. Rul. 92-105 retained the right to manage and control the trust property.

Issue 1. Classification of Delaware Statutory Trust

Because DST is an entity separate from its owner, DST is either a trust or a business entity for federal tax purposes. To determine whether DST is a trust or a business entity for federal tax purposes, it is necessary, under § 301.7701-4(c)(1), to determine whether there is a power under the trust agreement to vary the investment of the certificate holders.

Prior to, but on the same date as, the transfer of Blackacre to DST, A entered into a 10-year nonrecourse loan secured by Blackacre. A also entered into the 10-year net lease agreement with Z. A's rights and obligations under the loan and lease were assumed by DST. Because the duration of DST is 10 years (unless Blackacre is disposed of prior to that time), the financing and leasing arrangements related to Blackacre that were made prior to the inception of DST are fixed for the entire life of DST. Further, the trustee may only invest in short-term obligations that mature prior to the next distribution date and is required to hold these obligations until maturity. Because the trust agreement requires that any cash from Blackacre, and any cash earned on short-term obligations held by DST between distribution dates, be distributed quarterly, and because the disposition of Blackacre results in the termination of DST, no reinvestment of such monies is possible.

The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to DST. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with Z or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law.

This situation is distinguishable from Rev. Rul. 78-371, because DST's trustee has none of the powers described in Rev. Rul. 78-371, which evidence an intent to carry on a profit making business. Because all of the interests in DST are of a single class representing undivided beneficial interests in the assets of DST and DST's trustee has no power to vary the investment of the certificate holders to benefit from variations in the market, DST is an investment trust that will be classified as a trust under § 301.7701-4(c)(1).

Issue 2. Exchange of Real Property for Interests under § 1031

B and C are treated as grantors of the trust under § 1.671-2(e)(3) when they acquire their interests in the trust from A. Because they have the right to distributions of all trust income attributable to their undivided fractional interests in the trust, B and C are each treated, by reason of § 677, as the owner of an aliquot portion of the trust and all income, deductions, and credits attributable to that portion are includible by B and C under § 671 in computing their taxable income. Because the owner of an undivided fractional interest of a trust is considered to own the trust assets attributable to that interest for federal income tax purposes, B and C are each considered to own an undivided fractional interest in Blackacre for federal income tax purposes. See Rev. Rul. 85-13.

Accordingly, the exchange of real property by B and C for an interest in DST through a qualified intermediary is the exchange of real property for an interest in Blackacre, and not the exchange of real property for a certificate of trust or beneficial interest under § 1031(a)(2)(E). Because Whiteacre and Greenacre are of like kind to Blackacre, and provided the other requirements of § 1031 are satisfied, the exchange of real property for an interest in DST by B and C will qualify for nonrecognition of gain or loss under § 1031. Moreover, because DST is a grantor trust, the outcome to the parties will remain the same, even if A transfers interests in Blackacre directly to B and C, and B and C immediately form DST by contributing their interests in Blackacre.

Under the facts of this case, if DST's trustee has additional powers under the trust agreement such as the power to do one or more of the following: (i) dispose of Blackacre and acquire new property; (ii) renegotiate the lease with Z or enter into leases with tenants other than Z; (iii) renegotiate or refinance the obligation used to purchase Blackacre; (iv) invest cash received to profit from market fluctuations; or (v) make more than minor non-structural modifications to Blackacre not required by law, DST will be a business entity which, if it has two or more owners, will be classified as a partnership for federal tax purposes, unless it is treated as a corporation under § 7704 or elects to be classified as a corporation under § 301.7701-3. In addition, because the assets of DST will not be owned by the beneficiaries as coowners under state law, DST will not be able to elect to be excluded from the application of subchapter K. See § 1.761-2(a)(2)(i).

HOLDINGS

(1) The Delaware statutory trust described above is an investment trust, under § 301.7701-4(c), that will be classified as a trust for federal tax purposes.

(2) A taxpayer may exchange real property for an interest in the Delaware statutory trust described above without recognition of gain or loss under § 1031, if the other requirements of § 1031 are satisfied.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 78-371 and Rev. Rul. 92-105 are distinguished.

DRAFTING INFORMATION

The principal author of this revenue ruling is Christopher L. Trump of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Christopher L. Trump on (202) 622-3070 (not a toll-free call).