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1031 Exchanges with a Twist

By Jonathan C. Kinney

Now that the recession appears to be fading into memory, Section 1031 Exchanges are on the rise. Section 1031 of the Federal Tax Code allows property owners to defer taxes by exchanging the sale property into one or more other real properties. Because the 1031 Exchange has a short time period in which to identify the replacement property (or properties) – 45 days – investors have often found themselves in a quandary in finding replacement property that meets their investment criteria.

Tenant-In-Common Investments

Historically, when one investor could not find an appropriate investment by themselves, they often considered a tenant-in-common investment. The tenant-in-common investment vehicle is basically the co-ownership of property between a number of investors who enter into either a co-ownership agreement, master lease agreement and/or management agreement along with other documents necessary to convey real estate to the tenants-in-common owners and manage the property.

The basic problem with tenant-in-common deals is that Internal Revenue Service (IRS) requirements mandate that certain fundamental decisions, such as selling or refinancing the property, entering into a lease agreement or a brokerage agreement must be agreed upon by all individual investors. From experience, an agreement where one individual investor has the right to block the will of the majority of the other investors can lead to disaster, particularly in times of declining valuations. In the past few years, a number of tenant-in-common deals were held up or "sabotaged" by individual investors trying to obtain a better position vis-à-vis the other investors. Many investors also balk at executing an individual environmental guaranty and a "bad boy" loan guaranty carve out.

Delaware Statutory Trust

In response to the need for a tenant-in-common type of investment – without the complications inherent in the tenants-in-common ownership structure – the Delaware legislature adopted an entity that has become known as a Delaware Statutory Trust.

The particulars of a Delaware Statutory Trust are as follows:

> The Delaware Statutory Trust requires compliance with the requirements of the IRS Revenue Ruling 204 – 86. At a minimum, the Delaware Statutory Trust must be a special purpose entity, must be bankruptcy remote and structured in a fashion wherein the beneficiaries of the trust are not making decisions regarding the operation of the Trust's real estate.

The IRS ruling also establishes prohibitions on the powers and activities of the trustees. These prohibitions have become known as the "seven deadly sins," which include:

1. The trustee cannot renegotiate the terms of the existing mortgage loans nor can it obtain any new mortgage financing from any party except where the tenant is bankrupt or insolvent;

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2. The trustee cannot enter into new leases or renegotiate existing leases except where a property tenant is bankrupt or insolvent;
3. Once the initial offering is closed, there can be no future capital contributions to the Delaware Statutory Trust by either current or future beneficiaries;
4. The trustee cannot reinvest the proceeds from the sale of the real estate;
5. The trustee is limited to making the following types of capital expenditures with respect to the property: (a) expenditures for normal repair and maintenance of the property; (b) expenditures for minor non-structural capital improvements of the property; and (c) expenditures for repairs or improvements required by law;
6. All cash, other than necessary reserves, must be distributed on a current basis; and
7. Any cash held by a Delaware Statutory Trust can only be invested in short term debt obligations.

Realistically, the only type of real estate that will work in the Delaware Statutory Trust are master lease transactions – so called triple net long-term leases to investment-grade tenants. The beneficiary's only right in a Delaware Statutory Trust is the distribution of income. There are no rights in the operation or management of the property, as that is left to the trustee (who must be a Delaware resident or entity by statute). A "Delaware Trustee" is normally a professional real estate or investment company.

The main advantage of a Delaware Statutory Trust is that there is only one loan to the borrower, and individual beneficiaries of the trust do not have to be involved in the lending process. The Delaware Statutory Trust is the borrower on all financing property.

There is no limitation to the number of beneficiaries permitted under a Delaware Statutory Trust. Arguably a Delaware Statutory Trust may be able to allow its beneficiaries to do a tax-free exchange on their pro rata share of the Delaware Statutory Trust property when it is eventually sold.

The primary downside of a Delaware Statutory Trust is the lack of official IRS recognition and "acquiescence" in its use in a 1031 Exchange. While there are a large number of examples of Delaware Statutory Trusts being used in a 1031 Exchange, other than Revenue Ruling 2004 – 86 and certain private letter rulings, there is no IRS "good housekeeping seal of approval" for Delaware Statutory Trusts. However, most, but not all, real estate commentators are currently comfortable with the use of the Delaware Statutory Trust in a 1031 Exchange.

The legislation establishing the Delaware Statutory Trust has also contemplated what happens if the trust commits one of the "seven deadly sins" by providing that a Delaware Statutory Trust can convert to a limited liability company (LLC) upon pre-agreed terms. Fortunately, Delaware law treats the conversion as if the new LLC was the same legal entity as a Delaware Statutory Trust. Effectively the real estate is not being transferred, and the borrower on the loan remains the same. Other provisions, such as being a special purpose entity and bankruptcy remote, remain in place.

The obvious downside, however, is that once the trust converts to an LLC, the LLC will be treated as a partnership for federal income tax purposes, and the investors will not be able to do a subsequent tax-free exchange of their interest in the LLC. Some commentators have proposed that the LLC could reconvert to a Delaware Statutory Trust once the problem that caused the initial conversion is taken care of (i.e., the elimination of one of the "seven deadly sins").

The main advantage of the Delaware Statutory Trust is that you can identify the trust's real estate as one of the three replacement properties by the end of the 45-day identification period for a 1031 Exchange. The trust can serve as a backup if the preferred exchanges are unable to be consummated for any reason during the statutory period. In other words, the Delaware Statutory Trust can be an effective backstop in a 1031 Exchange.

Most Delaware Statutory Trusts are set up by real estate syndicators or private investment corporations. Traditionally, they purchase the same types of properties that net lease companies, such as National Realty Trust, are purchasing. Selection of the trustee and the management company can be particularly important, should the company that is leasing the net lease property get into financial trouble and is forced into bankruptcy (i.e., Kmart, Circuit City and Montgomery Ward). Some due diligence on the tenant and the particular property is required even though the beneficiary of a Delaware Statutory Trust has no management responsibilities or obligations.

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Firearms in Estate Planning

By Lori K. Murphy

A little-discussed but important topic in estate planning is whether the client owns firearms of any variety. Although some estate planners view firearms just like all other tangible personal property (household items) owned by the client, ownership of guns needs to be specifically addressed in an estate plan.

Firearms are subject to federal and/or state laws.

Certain types of firearms are subject to federal law and some are subject to state laws. In some cases, the firearms must be registered with the Bureau of Alcohol, Tobacco, Firearms, and Explosives (ATF). For ATF-registered firearms, a "gun trust" is most often the appropriate estate planning tool. Some firearms

are banned altogether, such as ownership of semiautomatic assault weapons as mandated by the Brady Handgun Violence Protection Act. There are also firearms that classify as a "curio or a relic," if it was manufactured more than 50 years ago, and others that are considered antiques. However, in most cases, unless the firearm is a machine gun, the Commonwealth of Virginia does not require firearms to be registered.

The beneficiary must be able to own a gun or firearm.

When a client is identifying the proper recipient of a handgun or a firearm collection (including ammunition), it is important to discuss the beneficiary's background. For example, the Federal Gun Control Act prohibits certain people from owning guns, such as felons or those deemed mentally incompetent. The Commonwealth of Virginia echoes those restrictions by prohibiting gun ownership by certain legally incompetent and mentally incapacitated individuals, those convicted of certain drug offenses indicated by recent repeated misdemeanors, and those under the age of 18 (with some exceptions, including hunting).

Further, the beneficiary of a particular firearm would be subject to the restrictions on gun ownership in the beneficiary's own state of residence. As a point of comparison, the Commonwealth of Virginia restricts certain firearm ownership for those who are not citizens of the United States or mentally incompetent individuals. Handguns cannot be given to minors. Other states may restrict gun ownership further.

What happens if the firearm needs to be transported?

An additional consideration is whether the firearms will need to be transported. If a beneficiary resides in another state, then the other state's firearm regulations need to be reviewed prior to delivery of the firearm to that beneficiary. It may not make sense to research the other state's laws at the time of the estate plan drafting since the beneficiary may move to another state prior to the owner's death, but certainly the executor or trustee needs to verify that the beneficiary is allowed to receive a firearm from a decedent's estate. Many states require a criminal history record check before certain firearms can be transferred, as is the case in Virginia for dealers. Although the Virginia statutes do not expressly hold executors or trustees liable for failure to check the criminal history of a beneficiary, the statute is written such that the fiduciary may be guilty of a felony if they transfer an estate firearm to a person they know is ineligible to receive one.

Nominating a Fiduciary.

All of these restrictions impact the nomination of an individual to serve as the fiduciary in an estate plan, meaning the individual who is nominated to serve as executor or trustee. For example, a sibling who had once been convicted of a felony would not be an appropriate person to serve as an executor of an estate, especially in an estate that includes a firearm.

Conclusion.

The estate plan should include appropriate provisions for the executor or trustee to use estate assets to investigate the laws that impact the transfer of firearms. The estate plan should require the executor or trustee to determine which state and federal laws apply to the ownership of the firearm, whether the beneficiary resides out of state and is subject to that state's laws, whether the beneficiary is prohibited from receiving the firearm, and whether transport of the firearm is allowed across state lines. Further, if a client owns or intends to purchase certain firearms that are regulated by federal law, then a gun trust needs to be considered as part of the client's estate plan.

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Estate Administration 101: What You Need to Know to Effectively Administer an Estate Qualifying as Executor

By Lauren K. Keenan

Many people who are named executor in a friend or loved one's will haven't served in such a role before and have little basis of knowledge as to what will be expected of them. Clients often ask, "what does the executor do?" or "what is my role as executor?" It can be an intimidating post and oftentimes there may be complex family dynamics that make it a little challenging, to say the least. This article is intended to be the first in a series of articles which will serve as a "primer" to those who may be called to serve or those who may already be serving as executor to an estate. Future articles in this 101 series will address management of assets, filing of inventories and accountings, and other related topics.*

What is the Executor's Role?

The executor (sometimes also referred to as personal representative in Maryland and D.C.) is the point-person in charge of administering a decedent's estate and winding up the decedent's affairs after death. The executor is named in the decedent's will. The executor is tasked with protecting a decedent's property (the estate) until payment of outstanding debts and taxes are completed, and ensuring that the decedent's remaining property is distributed to the appropriate beneficiaries. This job is an important one. It's also one that can result in liability of an executor if it's not taken seriously. An executor has a fiduciary duty to the estate. This means that an executor must put aside his or her own self-interest and act solely in the best interest of the estate.

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Qualifying as Executor.

The first step to succeeding as an executor is qualifying. This should be done as soon after the decedent's death as possible. It can be very difficult task because in most cases the executor is also very close with the deceased and are still grieving their loss. It can be challenging to wear both hats of a grieving spouse, child, loved one or friend, while also attending to the business-like nature of opening and administering a probate estate.

In order to qualify as executor, simply take the decedent's original will and any additional codicils to the will to the probate office within the circuit court of the county or city of decedent's last place of residence. A codicil is a separate document that amends a person's will, rather than replacing it with an entirely new one. You can usually find the phone number for the probate clerk or probate office online. The clerk or office can also confirm you have the right jurisdiction for filing if you're unsure. In most cases, you'll need to make an appointment for probate of a will and the sooner you call the better. Busy jurisdictions can have long waiting periods to probate a will. Local jurisdictions as of late have been scheduling eight weeks out for new probate appointments. If there is no will, or you cannot find a will, the decedent is said to have died "intestate" or without a will and this is a slightly different process of qualification. This will not be discussed in this article. Your local probate office can assist you with qualification procedures in such cases.

Once you schedule your appointment with the probate office, you'll need to contact a bondsman to identify any surety requirements (particularly if you're an out of state resident serving as executor or administering an intestate estate). Bring the original will, a checkbook for any bond or surety requirements and your driver's license or other valid ID to your appointment. If you are co-executor, meaning you are serving in the role with another individual(s), the other executors must attend the meeting with you.

The result of a successful appointment with the probate office is receiving letters of qualification. These name you as executor to the estate and serve as proof of your authority to act on behalf of the estate. You can now begin the process of winding up the estate.

What Else Happens at Probate?

In addition to qualifying as executor, you'll often also complete and submit written notice of probate. Virginia's notice requirement states that written notices shall be provided to certain parties (including, decedent's spouse, all heirs at law, and all beneficiaries under the will). The notices inform the individuals receiving them that the decedent has died, that they are a legal heir or beneficiary to the decedent's estate (not necessarily receiving any property under the will), and that you are now serving as executor to the decedent's estate.

Notice further informs them of their right to copies of inventory and accountings of the estate. Notice is a critical step in the process and must be executed properly and within 30 days of qualification in Virginia (other state's timeframes for notice may vary). Within four months of qualification, Virginia code requires that an affidavit of notice is filed with the clerk's office to prove required notices were actually sent. If you have questions while serving as executor, always ask the probate office in the decedent's city or town, and if they can't answer a question, consult an estate planning attorney for guidance.

What Happens Next?

After qualifying as executor and completing the necessary notices, you'll begin the work of taking inventory of the decedent's assets and begin to carry out the various administrative tasks of being an executor.

The next article in this 101 series will address tips for safeguarding decedent's property and effective inventory practices, while the following article will address accounting requirements and deadlines.

**It's important to note that standards and requirements for administering an estate (particularly the timeframe for doing so) are state and locality specific. However, the overall process of administration tends to be similar in most jurisdictions. This article uses Virginia law as the basis for explaining the administrative process.*

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