Selling Appreciated Investment Property? A Tax-Deferral Pathway Worth Knowing

How a 1031 exchange, a Delaware Statutory Trust (DST), and a 721 UPREIT exchange can work together to defer taxes and convert a single property into a diversified, professionally managed real estate portfolio.

THE CHALLENGE OF SELLING OUTRIGHT

An outright sale of long-held investment real estate can trigger several layers of tax at once: federal capital gains tax, depreciation recapture (unrecaptured Section 1250 gain taxed at up to 25%, with any Section 1245 recapture from cost segregation taxed at ordinary rates), the 3.8% net investment income tax, and state income tax. State treatment varies widely. High-tax states can add a substantial layer — Maryland, for example, applies an additional 2% tax on net capital gains for filers with federal AGI above $350,000 — and many states, including Maryland, withhold tax at settlement on sales by nonresidents unless an exemption is applied for in advance. A few states do not conform to federal deferral at all. For many long-term owners, the combined bill can consume a meaningful share of the sale proceeds.

Beyond taxes, direct ownership carries burdens that a traditional 1031 exchange into another single property does not solve: active management responsibilities, concentration in one asset and one market, and an asset that is difficult to divide among heirs.

1 STEP ONE: THE 1031 EXCHANGE

Section 1031 of the Internal Revenue Code allows an owner of investment or business real estate to defer gain by reinvesting sale proceeds into "like-kind" replacement property as part of a qualifying exchange. Key rules, per IRS guidance:

- **Deferral, not forgiveness.** Gain is postponed, not eliminated. Basis carries over into the replacement property, and deferred depreciation recapture rides along with it.
- **Real property only.** Both properties must be held for productive use in a trade or business or for investment. A primary residence does not qualify; a vacation home qualifies only if it satisfies strict rental-use tests (Rev. Proc. 2008-16). For exchanges completed after 2017, only real property is eligible.
- **Strict timelines.** Replacement property must be identified in writing within **45 days** of closing and acquired within **180 days** — or by the due date of that year's tax return including extensions, **whichever comes first**. Both clocks run concurrently from the same closing, so late-year sales usually require filing an extension to get the full 180 days.
- **Identification limits.** Generally three properties of any value; or any number totaling no more than 200% of the value sold; or more, only if at least 95% of what is identified is acquired.
- **Replace both value and debt.** To defer fully, the taxpayer must reinvest all net proceeds *and* replace the debt retired at closing (or contribute equivalent cash).
- **No touching the cash.** Proceeds must be held by a **qualified intermediary (QI)**. Cash or debt relief ("boot") is taxable to the extent received; actual or constructive receipt of the proceeds disqualifies the exchange entirely.
- **Reported on IRS Form 8824** in the year of the exchange.

2 STEP TWO: THE DST

A Delaware Statutory Trust holds professionally managed commercial real estate. Under IRS Revenue Ruling 2004-86, an investor who acquires a beneficial interest in a properly structured DST is treated as owning an undivided fractional interest in the underlying real estate, so DST interests can qualify as replacement property in a 1031 exchange. In practice:

- **Precise sizing.** Proceeds can be matched to one or more DST offerings, including the leftover amount from a larger exchange. Minimums for exchange funds are typically $25,000 to $100,000 per offering.
- **Debt is built in.** Offerings carry fixed, non-recourse leverage at a stated loan-to-value, letting an investor replace debt from the relinquished property without personally guaranteeing new financing.
- **Truly passive.** The trust's manager and a master tenant handle all operations under a master lease. Investors receive distributions (typically monthly) and a year-end grantor letter with the figures needed to complete Schedule E — no leasing, repairs, or bookkeeping.
- **Property types.** DSTs commonly hold apartment, industrial, medical office, self-storage, and net-lease assets sponsored by national real estate firms.
- **Structural trade-off.** To preserve 1031 treatment, the ruling strictly limits the trustee's powers (the "seven deadly sins"): no new capital, no new or renegotiated borrowing, no reinvesting sale proceeds, limited capital expenditures, no new leases. DSTs are fixed by design, and the sponsor — not the investor — controls the hold and the exit.
- **Accredited investors only.** DSTs are private placements under Regulation D, offered by sponsors solely to accredited investors, generally with meaningful minimums.

RISK SUMMARY — READ ALONGSIDE THE BENEFITS ABOVE

DST interests are illiquid, have no public market, and may lose value, including loss of principal. Distributions are not guaranteed. Offerings carry commissions, offering costs, and ongoing fees, and the purchase price generally reflects a mark-up over the property's estimated value. The 721 UPREIT step is permanent and taxable to unwind. Missing an exchange deadline generally makes the entire sale taxable. **The full risk discussion on page 2 should be read before any decision.**

THE PATHWAY AT A GLANCE

Appreciated Investment Property
Client sells rental or commercial property
Embedded gain and depreciation recapture

SALE →

Qualified Intermediary
Proceeds held by QI; client never touches cash
45 days to identify; 180 days or return due date, whichever is earlier

1031 EXCH. →

1031 Exchange into DST Interests
TAX DEFERRED
Fractional interest in professionally managed real estate
Tax deferred under §1031 and Rev. Rul. 2004-86

↓ TYPICALLY 2+ YEARS — A SPONSOR CONVENTION, NOT A STATUTORY REQUIREMENT

Holding Period
DST pays passive income, typically monthly
No statute sets a minimum hold; a pre-arranged conversion can jeopardize the original 1031

721 EXCH. →

721 UPREIT Exchange
TAX DEFERRED ONE-WAY
DST interests exchanged for OP units of a diversified REIT (optional, sponsor-initiated)
Tax deferred under §721; a one-way step

→

Diversified REIT Portfolio
Many properties across multiple sectors and markets; continued tax-deferred income; units divisible among heirs
Tax reporting shifts from Schedule E to a partnership K-1

At death, heirs generally receive a **step-up in basis** under current law, which can permanently eliminate the deferred gain. Deferral can continue for life.

WHY PAIR THE 1031 WITH A 721 UPREIT?

Consideration	Direct ownership / plain 1031	1031 → DST → 721 pathway
Tax on sale	Deferred (if exchanged)	Deferred at each step
Management	Active landlord duties	Fully passive
Diversification	Single asset, single market	Diversified portfolio
Income	Property-dependent	Regular distributions; not guaranteed
Control	Owner controls hold, financing, and sale	Sponsor controls hold, sale, and any conversion
Liquidity	Property can be sold or refinanced	No public market; exit on the sponsor's timetable
Tax reporting	Schedule E	Schedule E, then a partnership K-1 after a 721 conversion
Estate planning	Hard to divide	OP units easily divided; step-up at death
Future flexibility	Can 1031 again	**OP units cannot be 1031-exchanged again**

⚠ Critical: Set Up the Exchange Before You Close

You cannot take possession of the sale proceeds. Not for a day, not in escrow you control. Under IRS rules, if the seller has actual or constructive receipt of the cash, the transaction is a taxable sale, and no later action can fix it. The qualified intermediary must be in place, with exchange documents signed, before the sale of the relinquished property closes. Several states also require an advance filing to avoid withholding at settlement — Maryland, for example, requires an exemption application at least 21 days before settlement — so state rules should be confirmed early.

1 Call FBB › 2 Engage QI › 3 File state exemption, if required › 4 Close via QI › 5 Identify (45 days) › 6 Complete (180 days)

IMPORTANT RISKS AND CONSIDERATIONS

- **Illiquidity and loss of principal.** DST interests have no public market. Secondary sales, where possible, typically occur at a material discount. Investors should expect to hold for the full sponsor period, commonly five to ten years, and may lose some or all of their investment.
- **The 721 step is a one-way door.** Once DST interests convert to OP units, the investor permanently exits the 1031 system. Selling or redeeming OP units, or converting them into REIT shares, is a taxable event. Conversion is typically at the sponsor's option and on the sponsor's timetable.
- **Step-transaction risk.** No statute sets a minimum holding period, but a 721 conversion arranged at the time of the exchange can support an IRS argument that the DST was never held for investment, placing the original 1031 deferral at risk.
- **Fees and pricing.** DST offerings include selling commissions, offering costs, and ongoing fees, and the purchase price generally reflects a mark-up over the property's estimated value. This load reduces the equity working for the investor from day one.
- **Real estate risk.** Vacancy, rents, interest rates, financing terms, and market conditions affect distributions and value. Distributions are not guaranteed and may be reduced or suspended.
- **Deadlines are unforgiving.** Missing the 45- or 180-day window generally makes the entire sale taxable. Limited relief exists only in federally declared disasters.
- **Structural risk.** Master tenant or guarantor default, trustee-power restrictions, and a possible "springing LLC" conversion — which would forfeit future 1031 eligibility — are disclosed in every offering memorandum.
- **Suitability and state tax.** Accredited investors only. Concentration, time horizon, liquidity needs, and estate objectives should be reviewed with your FBB advisor and your own tax counsel before any sale. State conformity, withholding, and clawback rules vary and can change outcomes materially.

HOW FBB CAN HELP

FBB Capital Partners is a fee-only fiduciary. We are compensated solely by our clients. **We are not a broker-dealer**, we do not sell or place DST interests or any other securities, and neither FBB nor any related person receives commissions, selling concessions, or other transaction-based compensation in connection with a DST or 721 UPREIT. Any purchase would be made through a third-party broker-dealer or sponsor. Our role is to help clients evaluate whether a 1031/DST/721 pathway fits their broader financial plan, coordinate with their tax and legal advisors and qualified intermediaries, and perform independent due diligence on sponsors and offerings.

Considering a sale of investment property? **Engage FBB and a qualified intermediary before you close.** If you take possession of the proceeds, even briefly, the exchange is disqualified and the entire gain becomes taxable.

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