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Unwinding Real Estate Assets: Understanding Delaware Statutory Trusts (DSTs) and 721 UPREIT Exchanges

Real estate investors tend to think in long time horizons. They buy carefully, improve patiently, and hold through cycles. But eventually, a familiar question arises: “If I sell, I’ll owe a significant capital gain — and depreciation recapture. What are my options besides just writing a large check to the IRS?”

For many investors, the traditional answer has been a Section 1031 exchange. But as portfolios grow and properties mature, investors often find themselves wanting less management burden, more diversification, or more estate planning flexibility — without triggering immediate taxation.

Two structures increasingly discussed in these situations are:

- Delaware Statutory Trusts (DSTs)
- Section 721 UPREIT exchanges

Each approach can serve different strategic goals. This paper intends to outline how they work, when they may be useful, and what tradeoffs to consider.

All in the Family – A Client Scenario

Several years ago, George and Weezie Jefferson sold their chain of dry-cleaning businesses but retained ownership of the land and the buildings. Those parcels have provided an income stream for their Upper East Side lifestyle while appreciating significantly over time.

Their adult son, Lionel, has his own electrical engineering business and no interest in managing the family’s real estate assets. As George ages, he worries about environmental liability, concentration risk, tenant credit quality, and the increasing complexity of management. But selling these assets at his advanced age would result in staggering capital gains tax liabilities. George wants to simplify but not at the cost of unnecessary erosion of capital due to taxes.

Option 1: Delaware Statutory Trust (DST)

A Delaware Statutory Trust is a legal structure that allows multiple investors to own fractional interests in institutional real estate. Importantly, the IRS recognizes

qualifying DST interests as “like-kind” property for purposes of a 1031 exchange. A DST is not an alternative to a 1031 exchange; it is a specific type of replacement property permitted in a 1031 exchange. When George sells the property and completes a 1031 exchange, he acquires a fractional interest in a DST property, deferring both capital gain and depreciation recapture.

Why the Jeffersons Might Consider a DST:

- Passive Ownership: No tenants, no chemicals, no remediation costs.
- Diversification: Instead of rolling into one replacement property, George can diversify across multiple assets, geographies, or sectors.
- Estate Planning Continuity: DST interests receive a step-up in basis at death, potentially eliminating deferred gain.
- Simpler Transition Out of Active Management: For aging investors, DSTs can function as a “glide path” from active landlord to passive real estate owner.
- Preserves 1031 Optionality: When the DST eventually sells the underlying property, George may execute another 1031 exchange (into another DST or direct real estate). Alternatively, he could pursue a staged transition into a 721 UPREIT structure.

But DSTs are not perfect solutions either, and George should also consider the potential limitations:

- Illiquid (typically 5–10 year hold periods)
- Limited control
- Dependent on sponsor quality
- Fees and structure complexity
- Still real estate risk

If George is prioritizing tax deferral and passive ownership over control, then a DST might be a good approach. However, if income and/or charitable planning are important components as well, then a DST might not be the ideal solution.

Option 2: Moving On UPREIT

A Section 721 (UPREIT) exchange allows an investor to contribute property into an operating partnership (often affiliated with a REIT) in exchange for operating partnership units (OP units) rather than cash.

Unlike a 1031 exchange, there is no requirement to acquire like-kind replacement property, and the contributed property becomes part of a larger, diversified real estate platform. The investor defers gain at contribution. The OP units typically generate periodic cash distributions, which are often taxed primarily as ordinary income. Over time, OP units are typically redeemable for REIT shares. When those shares are sold, the investor recognizes the deferred gain from the original property contribution, which commonly is a combination of deferred capital gain from the original property and depreciation recapture at 25%.

Once converted, the REIT shares can then be sold to provide an additional source of liquidity. Possibly subject to transfer restrictions in the operating agreement, OP units

may be contributed to a charitable vehicle like a Donor Advised Fund, allowing the donor to avoid recognition of the built-in gain while receiving an income tax charitable deduction equal to fair market value. (George has been a charitable donor to organizations serving impoverished residents in his childhood neighborhood and to various military veteran causes.)

Why George Might Prefer a 721 UPREIT

- **Diversification at Scale:** Instead of owning one building, the investor now owns a share of a diversified portfolio.
- **Estate Planning Flexibility:** If OP units are held until death, heirs may receive a step-up in basis. But this is not an all-or-nothing decision.
- **Potential Liquidity Over Time:** Unlike DSTs, OP units often provide optional future liquidity through conversion.
- **Institutional Management:** Management transitions to a professional platform.

Other Considerations for a 721 UPREIT: A 721 exchange introduces its own complexities:

- **Loss of Control:** The investor becomes a minority owner in a larger platform.
- **Sponsor Alignment Risk:** Performance depends on management discipline and capital allocation decisions.
- **Liquidity Is Taxable:** Accessing principal through conversion and sale triggers recognition of deferred gain.
- **Valuation Complexity:** OP units are not publicly traded securities.
- **Structural Restrictions:** Transfer limitations may affect estate or charitable planning flexibility. Specifically, once an investor selects deferral via 721, then future 1031 exchanges are no longer available because partnership units would not qualify as like-kind property.
- **Legislative Risk:** As with any tax-deferral strategy, future tax law changes could alter outcomes.

Feature	DST (via 1031)	721 UPREIT
Immediate tax deferral	Yes	Yes
Management responsibility	None	None
Liquidity	Typically fixed hold	Gradual, optional
Charitable flexibility	Limited	More flexible
Estate step-up strategy	Yes	Yes
Control	None	None

Where This Fits in Broader Planning

For clients at our level, these decisions rarely stand alone. They intersect with:

- Concentration risk management
- Income needs in retirement
- Estate planning and generational transition

- Charitable planning (CRT, DAF funding opportunities)
- Overall portfolio allocation

In many cases, biting the bullet (i.e., paying the capital gains tax liability and redeploying the net proceeds in traditional public markets) may well be the most rational choice. Tax deferral should not override sound investment judgment. But for investors who want to preserve capital, simplify operations, and remain tax-efficient, DSTs and 721 exchanges represent meaningful structural alternatives.

A Word on Tax Deferral

Tax deferral can be powerful, but it is not a strategy by itself. In the absence of a step up in basis at death or a charitable transfer, deferral carries a risk of simply postponing gain recognition into a less favorable tax regime in the future. The decision to defer, exchange, contribute, or sell should follow a clear articulation of goals: income needs, diversification objectives, estate intent, and charitable priorities. The structure should serve the strategy, not the other way around.

A Structural Fork in the Road

A DST preserves participation in the 1031 exchange framework, allowing investors to continue exchanging into new real property over time. A 721 UPREIT contribution, by contrast, represents a transition out of the 1031 cycle and into long-term alignment with a specific REIT platform. While both structures defer tax, they create different future flexibility. The decision is less about deferral itself and more about whether the investor values continued exchange optionality or prefers institutional scale and simplified ownership. Once the 721 path is chosen, the ability to execute future like-kind exchanges is generally forfeited.

Final Thoughts

For George, the right choice may be less about maximizing return than simplifying life, reducing risk, and aligning assets with purpose. At a certain stage, the objective shifts from accumulation to stewardship — from building the portfolio to positioning it intentionally for the next chapter.

The appropriate path for any thoughtful investor depends not on the structure itself, but on how an asset fits within one's broader personal, financial, and legacy goals. And of course, thoughtful coordination between tax counsel, legal advisors, and portfolio strategy is always essential.

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