Real Estate Income Tax Strategies Estate Planners Need to Know and Evaluate

51st Annual Notre Dame Tax & Estate Planning Institute

November 7, 2025

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I. Background and Introduction

Generally, § 1031 of the Internal Revenue Code of 1986[1] (the "**I.R.C.**" or the "**Code**") allows investors to defer capital gains on the exchanges of real property[2] held for productive use in a trade or business for other real property which meets the "like-kind"[3] requirement.[4] One can consider the exchange as the following separate steps: (1) an exchanger selling his or her property (the "**Relinquished Property**"), and (2) the same exchanger receiving property of "like-kind" (the "**Replacement Property**"). The exchange is not required to occur in any order; the exchanger can first sell Relinquished Property and receive Replacement Property after (known as a "**Forward Exchange**") or first receive the Replacement Property and subsequently sell his or her Relinquished Property (also known as a "**Reverse Exchange**").[5]

Courts historically have offered flexibility[6] for taxpayers structuring like-kind exchange transactions under the notion that the taxpayer is "continuing their investment."[7] Courts have allowed investors to enter multiple party "three-corner"[8] exchanges, "deferred"[9] exchanges, and reverse exchanges. Further the desire to avoid or reduce taxes is *generally*[10] immaterial in the § 1031 context.[11]

Nonetheless, investors seeking to take advantage of the tax-deferral must follow strict deadlines and requirements to ensure tax compliance and non-recognition of gain upon exchange. Further, varying treatment of like-kind exchanges on the state-level may force § 1031 investors to maneuver more carefully

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[1] All statutory references will be to the Internal Revenue Code of 1986 unless otherwise indicated.

[2] The Tax Cuts and Jobs Act (2017) amended § 1031(a) to read *real property* and consequently removed personal property from the scope of like-kind exchanges.

[3] Treas. Reg. § 1.1031(a)-1(b) provides that the "nature and character" of the property dictates whether real property has been exchanged for real property of "like-kind". *See infra*.

[4] I.R.C. § 1031(a).

[5] *See* Rev. Proc. 2000-37, 2000-2 CB 308 (2000) (addressing "parking" transactions with Exchange Accommodator Titleholders (singularly an "**EAT**") by providing a safe-harbor for "reverse like-kind exchanges"). "True" reverse exchanges not involving an EAT are invalid. *See Bloomington Coca-Cola Bottling Co. v. Commissioner,* 189 F.2d 14 (7th Cir. 1951).

[6] Courts have a permissive attitude towards § 1031 exchanges and afford great latitude with structures. *See e.g., Fredericks v. C.I.R.*, 67 T.C.M. 2005 (1994).

[7] Courts reason, based on original congressional intent behind the creation of § 1031 and its predecessor, that when a taxpayer does not "cash-out" their relinquished investment, then he or she is continuing his or her old investment and should not recognize gain if fundamentally in the same position as before. *See e.g., Id.* at 4.

[8] A three-corner exchange involves the taxpayer's desire to exchange his or her property for replacement property with a buyer, but the buyer does not own the property yet to exchange with the taxpayer. When multiple parties are involved, 9th Circuit courts have still allowed these transactions. See e.g., *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963), revg. 38 T.C. 215 (1962) (holding that a "three-corner" exchange constitutes an exchange within the meaning of § 1031). *See Biggs v. Commissioner*, 69 T.C. 905, 915 (1978), affd. 632 F.2d 1171 (5th Cir. 1980) (holding a 1031 exchange exists even when multiple parties are involved in a "three-corner" exchange).

[9] *See e.g., Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979) (holding that simultaneous transfer of a deed is necessary for a viable 1031 exchange). *See also* Treas. Reg. § 1.1031(k)-1 for treatment of deferred exchanges. The k-regulations, introduced in 1991, codifies deferred exchanges.

[10] Emphasis added considering § 1031(f)(4).

[11] *Mercantile Trust Co. of Baltimore et al., Trustees v. Commissioner*, 32 B.T.A. 82 (1935).

when planning an exchange. Failing to navigate these deadlines and requirements can trigger IRS and state tax authority auditing and the recognition of any gain[12] from the completion of the transaction(s).

II. Requirements of the Like-Kind Exchange

A. Intent at the Outset of the Exchange Period

Taxpayers must intend on entering into a § 1031 exchange at the outset of the exchange period for it to constitute an exchange under § 1031 and to avoid recognition of gain. The substance-over-form doctrine is critical here as it instructs courts to look beyond formalities and to the actual intent and actions of the parties involved, but the application of the doctrine is usually in the taxpayer's favor, which is a departure from its use in other contexts.[13] The parts of the transaction must be interdependent parts of an overall plan to fall within the ambit of § 1031.[14] The intent between parties at the outset must be to engage in an exchange of properties, and this is a fact-dependent inquiry.[15] Courts consider factors such as language within agreements and the steps executed to effect an exchange, but the intent itself is not sufficient to render the transaction an exchange; where taxpayers seek to recognize loss from a contemplated sale, they may be surprised as the IRS and courts characterize the sale as a § 1031 exchange.[16]

B. Real Property, Qualified Purpose, and Like-kind Requirement

Only real property which is held by the taxpayer for either productive use in a trade or business or for investment can be exchanged for like-kind property. Before the Tax Cuts and Jobs Act ("**TCJA**") of 2017, both personal and real property could be exchanged in a § 1031 exchange. For example, a car could be exchanged for other personal property of the same general asset class, such as another car.[17] After the TCJA's codification, the term *property* in § 1031 was replaced with *real property*, which is further defined in Treasury Regulations promulgated in 2020.

Treas. Reg. § 1.1031(a)-3 and case law help define what constitutes real property for § 1031 purposes. Under the Treasury Regulations, the IRS defines real property broadly as "land and improvements to land . . . [some] intangible interests in real property, [and] property that is real property under State or local law . . .". Its breadth has allowed many forms of property to be considered real property for 1031 purposes, such as tenancy-in-common (TIC) interests,[18] option contracts,[19] leasehold interests, and interests in Delaware Statutory Trusts (singularly a "**DST**").[20]

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[12] If the transaction(s) do not fall under § 1031, then the transaction(s) are taxable events subject to the rules of § 1001(c) (*i.e.*, the gain is equal to the fair market value of the new property minus the adjusted basis under the rules of § 1011).

[13] *Helvering v. Clifford*, 209 U.S. 331 (1940); *Commissioner v. Tower*, 327 U.S. 280 (1946).

[14] *Biggs*, 69 T.C. 905 at 913.

[15] *See id*.

[16] *See e.g., id.*; *see Carlton v. United States*, 385 F.2d 238, 243 (5th Cir. 1967) (where the Court found that intent is necessary but not sufficient to render a sale a § 1031 exchange where taxpayer receives cash and then repurchases property); *but see Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652 (5th Cir. 1968) (holding a § 1031 exchange existed when contracts are separated only in form and not in substance – especially when the purchases of property are contingent upon each other).

[17] Treas. Reg. § 1.1031(a)-2.

[18] Rev. Rul. 57-244, 1957-1 C, B. 247 (1957).

[19] Treas. Reg. § 1.1031(a)-3(a)(5)(i).

[20] *See* Rev. Rul. 2004-86, 2004-2 C.B. 191.

The relinquished property and the replacement property must each be held for "**qualified use**," which means either (1) investment purposes or (2) productive use in a trade or business. Section 1031(a)(2) provides that real property held primarily for sale in the ordinary course of business is excluded from the ambit of § 1031, as is property held primarily for personal use.[21] Examples are condominiums built for sale to customers, residential subdivisions, and vacation homes used for personal use instead of being primarily rented out.

The term "held for investment" is otherwise ambiguous and undefined, but courts have attempted to analyze the requirement by considering whether at the outset of the exchange, the primary intent of the taxpayer with respect to the property was investment.[22] Courts have also allowed in some cases[23] for taxpayers to take advantage of § 1031 and satisfy the qualified purpose requirement if they intended on an exchange. At times, the mixed question of law and fact regarding taxpayer intent raises the so-called "**dealer-investor**" issue, a notoriously difficult inquiry with no clear guidance.[24]

The like-kind requirement of § 1031(a) requires courts to compare the exchanged properties to discern the "nature and character" of the Relinquished Property and Replacement Property interests and identify whether they are substantially alike to determine whether the transaction(s) constitute a § 1031 exchange. The ambiguity behind "nature or character" allows flexibility within the like-kind requirement.[25] For example, in *Koch v. Commissioner*,[26] the court considered factors such as "the physical properties, the nature of the title conveyed, the rights of the parties, and the duration nature or character of the properties" when determining like-kind status.[27] After finding an identical kind is unnecessary, the court in *Koch* held that the receipt of parcels subject to 99-year leases were still like-kind to the taxpayer's relinquishing of two properties held in fee simple because the corporation exchanging the property to the taxpayer held the parcels in fee simple; therefore, a fee-simple interest was being exchanged for a fee-simple interest.[28] In the real property context, like-kind status is almost infinitely broad, making the issue less prominent when advisors are evaluating potential exchanges.[29]

C. Identification Period and Exchange Period for Deferred-Exchanges

In the context of deferred-exchanges, the identification period, or the period when Replacement Property must be identified, begins on the day the Relinquished Property is transferred and "ends at midnight on the 45th day thereafter."[30] The exchange period ends at midnight on the earlier of (i) 180 days after the Relinquished Property is transferred, or (ii) the due date of the taxpayer's return of the tax

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[21] *See* Rev. Rul. 59-229, 1959-2 C.B. 180 (1959).

[22] *See e.g.*, *Reesink v C.I.R.*, 103 TCM (CCH) 1647 (TC 2012); *see Moore v. C.I.R.*, 93 TCM (CCH) 1275 (TC 2007) (holding that "the same factual inquiry whether the property in question was held for investment" existed in both § 1031 and § 212(2)).

[23] *See e.g.*, *124 Front Street, Inc. v. Commissioner*, 65 T.C. 6 (1975); *see also Bolker v. C.I.R.,* 760 F.2d 1039, 85-1 T.C. (CCH) P 9400 (9th Cir. 1985) (holding an intent to exchange is opposite of the intent to liquidate or follow personal pursuits); *but see* Rev. Rul. 75-291, 1975-2 C.B. 332 (holding that § 1031 does not apply to a taxpayer who acquired property solely for the purpose of exchanging it for like-kind property).

[24] See Matthew E. Rappaport, "Forget What You Know: Keefe Shows There's No Hope for Dealer-Investor Jurisprudence," 38(2) J. Tax'n Invs. 39 (Winter 2021).

[25] Treas. Reg. § 1.1031(a)-1(b).

[26] *Koch v. Commissioner*, 71 T.C. 54 (1978)

[27] *Id.*

[28] *Id.*

[29] Treas. Reg. 1.1031(a)-1(c) provides that a 30 year or more lease can be exchanged for real estate as they are *like-kind*. Rev. Rul. 55-749, 1955-2 C.B. (holding an interest in perpetual water rights are like-kind to land).

[30] Treas. Reg. § 1.1031(k)-1(b)(2)(i).

imposed.[31] These deadlines are totally inflexible with the lone exception of federally declared disasters.[32] The property must be identified by describing the real property in a written and appropriately delivered document. When identifying Replacement Properties, one of the following three rules must be followed: the three-property rule, the 200-percent rule, or the 95-percent rule.[33] Taxpayers overwhelmingly use the first two rules because the third rule mandates successful closing of multiple properties, greatly increasing the stakes of identification and subsequent developments in the real estate transactions germane to the exchange.

The three-property rule requires a maximum of three properties be identified without regard to their fair market value. Alternatively, under the 200-percent rule, any number of properties can be identified. The aggregate value of the properties must not exceed 200 percent of the value of the Relinquished Property or Properties.[34] The 95-percent rule allows a 1031 exchange to exist if it would not otherwise exist because either the three-property rule or 200-percent rule fails to apply. If both fail to apply, the 95-percent rule allows successful identification if all of the following are true: (i) any Replacement Property is identified before the end of the identification period; (ii) any Replacement Property is received before the end of the exchange period; (iii) and the identified Replacement Property received is 95 percent of the aggregate fair market value of all identified Replacement Property or more.[35] The sole scenario where the 95-percent rule becomes necessary is when a taxpayer leverages up significantly to buy multiple parcels of replacement property, in which case neither of the other two identification rules will accommodate the candidate replacement properties.

D. Receipt or Constructive Receipt of Property and Boot

Courts have generally held that receipt of property during the exchange is evidence of a sale.[36] After the sale of the Relinquished Property, it's common for a qualified intermediary[37] to hold the funds in trust for the taxpayer be used to ultimately earmark[38] the Relinquished Property funds towards the purchase of Replacement Property or Properties. However, simply because money or non-like-kind property is received in addition to like-kind property at the closing of the sale of the relinquished property does not render the transaction outside the scope of § 1031(a); instead, if other non-like-kind property is received, and but for the existence of this property, the transaction would otherwise fall within the scope of § 1031 as an exchange, then the taxpayer recognizes gain only to the extent of the fair market value of the non-like-kind property.[39]

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[31] Treas. Reg. § 1.1031(k)-1(b)(2)(ii).

[32] See Rev. Proc. 2018-58, 2018-50 I.R.B. 990 (provides additional postponements of deadlines for taxpayers qualifying for relief with respect to section 1031 like-kind exchange transactions are affected by federally declared disaster).

[33] *See generally* Treas. Reg. § 1.1031(k)-1(c).

[34] *Id.*

[35] *Id*.

[36] *See e.g*., *Carlton,* 385 F.2d 238 at 242.

[37] Qualified intermediaries ("**QIs**") hold the funds from the Relinquished Property during deferred exchanges as to avoid receipt or constructive receipt of the Relinquished Property proceeds. Treas. Reg. § 1.1031(k)-1(g)(4) provides the safe harbor rules for qualified intermediaries.

[38] *Cf. Id*. at 243 (holding that a 1031 exchange did not exist where taxpayer received Relinquished Property proceeds and did not earmark or restrict them towards the purchase of replacement property even though replacement property was purchased with the funds). *See* Treas. Reg. 1.1031(k)-1(g)(6) restrictions.

[39] § 1031(b) and Treas. Reg. § 1031(b)-1 provides that gain or "boot" is recognized when non-like-kind property is received in addition to like-kind property and the transaction is a § 1031 exchange. Consideration in the form of assumption of liabilities falls within the scope of § 1031(b).

E. Related-Party Transactions and Basis-Shifting

When the IRS and courts identify exchanges between related parties as defined in § 1031(f), they scrutinize basis-shifting with caution when it occurs between high- and low-basis properties.[40] Section 1031(f)(4) provides that there shall be no non-recognition of gain or loss for dispositions principally purposed to avoid Federal income taxation.[41] If there was a prearranged plan to avoid federal income taxation, and a subsequent sale, the transaction would fall into a category of transactions which led Congress to adopt § 1031(f).[42]

A real-life example of basis shifting exists in *Teruya Bros., Ltd. v. Comm'r*.,[43] where the taxpayer used a qualified intermediary to transfer Relinquished Property to a related party, who then transferred the property to an unrelated third party. The 9th Circuit held that the related parties had a net tax benefit from structuring the transaction this way instead of a direct sale from the taxpayer to the third party.[44] The 9th Circuit subsequently held that there was no non-recognition of gain because, pursuant to § 1031(f)(4), the evidence suggested the taxpayer's principal purpose behind the transaction's structure was to improperly avoid federal income tax behind 1031 exchanges.[45]

Nonetheless, § 1031(f) does not serve as a bar to non-recognition under § 1031, and the design of the provision forces courts to look to the aggregate of the economic positions in the transaction to determine whether it qualifies for non-recognition.[46] Section 1031(f)(1) provides that if a transaction occurs between related parties, and either party disposes of the received property within two years of the completion of the exchange, then § 1031 does not apply. Section 1031(f)(2) dovetails with § 1031(f)(1) to exclude certain dispositions – primarily those that are not purposed to avoid federal taxation. Together, the two provisions suggest related party transactions are not barred *per se* but instead scrutinized to ensure preservation of congressional intent behind § 1031(f).

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[40] *See e.g.*, *Ocmulgee Fields, Inc. v. C.I.R.,* 132 T.C. 105 (2009).

[41] Section 1031(d) provides that the basis of the replacement property shall be the basis of the Relinquished Property adjusted according to the rules set forth in the statute.[41] Because the taxpayer's basis in the Relinquished Property carries over to the Replacement Property, taxpayer can exchange high basis property for low-basis property with a related party, then sell the Replacement Property. The property's basis increase because of the carry over incentivizes these basis-shifting transactions between related parties.

[42] "Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment." (H. Rept. 101–247, at 1340 (1989).

[43] *Teruya Bros., Ltd. v. Commissioner*, 580 F.3d 1038 (9th Cir. 2009); *Cf. N. Cent. Rental & Leasing, LLC v United States*, 3:10-CV-00066, 2013 WL 11941564 (D.N.D Jan. 7, 2013) (denying government's motion for summary judgment after finding a genuine issue of material fact as to whether taxpayer's principal purpose behind the transaction's structure as a like-kind exchange was to improperly avoid federal income tax.)[43]

[44] *Id.* The 9th Circuit further noted that taxpayers seemed to avoid the provisions of this section by not structuring the transaction in a way where § 1031(f)(1)(c) would be triggered by disposition of received property within two years.

[45] *Id. See also* Bradley T. Borden, *Malulani and the Entrenchment of Mechanical Analysis of Related-Party Exchange Rules*, 20 J. Passthrough Entities 15 (2017), Brooklyn L. Sch. Legal Studies Research Paper No. 505, https://ssrn.com/abstract=2965728.

[46] *Id.* at 1045.

III. Delaware Statutory Trusts

A. Background

DSTs are business trusts governed by the Delaware Statutory Trust Act (DSTA), codified in chapter 38 of Title 12 of the Delaware Code in 1988.[47] As unincorporated associations, DSTs are instruments under which "property is held, managed, administered, controlled, invested, reinvested, and/or operated, or business or professional activities for profit are carried on, by a trustee or trustees for the benefit of such person or persons as are or may become entitled to a beneficial interest in the trust property."[48] As separate legal entities,[49] DSTs may be held legally responsible for debts and other obligations or liabilities incurred by the trustee or other authorized persons.[50] DSTs may carry on any lawful business or purpose(s) with certain exceptions; nonetheless, a trust that conserves and collects business assets and/or does business is not automatically a business trust.[51] An additional aspect of a DST is that each beneficial owner of the DST generally enjoys protection of the underlying assets from that beneficial owner's creditors and the creditors of any other beneficial owner.[52]

Prior to the IRS issuance of Rev. Rul. 2004-86 and its guidance on § 1031 transactions in which DSTs are Replacement Property in an exchange, tenancy-in-common (TIC) structures were the popular investment designations as Replacement Property for real-estate investors. Upon the issuance of Rev. Rul. 2002-22, which provides IRS guidance on requirements for TIC interests as real property, there was confusion among investors in the TIC industry as to whether DSTs were viable as Replacement Property. Rev. Rul. 2004-86 provides that they can be if structured correctly.

B. Mechanics

DSTs are not only viable vehicles for investment if the relevant state requirements are met, but they can be utilized for deferral of gain in like-kind exchanges. Rev. Rul. 2004-86 provides guidance for those syndicating DST interests.[53] In the facts of the Revenue ruling, A owned property subject to a bank mortgage. A then enters into a net lease with Z.[54] Next, A contributes the owned property to a DST in exchange for an interest in the DST. The DST assumes the rights and obligations under the net lease. B and C attempt a § 1031 exchange and exchange their Relinquished Property for all of A's interests in the DST.

The IRS found the following: for federal tax purposes, DSTs are a trust under Treas. Reg. § 301.7701-4(c)(1) because the trust does not have the power to (i) dispose of the contributed property; (ii) renegotiate the lease with Z or enter into other leases; (iii) renegotiate the terms of the loan; (iv) invest cash received to profit off of market fluctuations; (v) or make more than minor non-structural

[47] Del. C. tit. 12, § 3801 et seq.
[48] Del. C. § 3801(a).
[49] *Id*.
[50] Del. C. § 3804(a).
[51] Del. C. § 3802. There are also rules concerning investment trusts and real estate investment trusts, respectively.
[52] Del. C. § 3801(b); Del. C. § 3805(a)—(b).
[53] The ruling itself does not specifically list seven prohibitions, nor does it use the term "seven deadly sins." Instead, expert analysis of the ruling introduced this term to industry parlance and reorganized the takeaways into the list of seven "don'ts" for structuring DSTs.
[54] In real-life transactions, this master tenant, Z, is often an operating affiliate of the DST sponsor. The rent under the master lease fixes the cash-on-cash return promised to the DST investors in the vehicle's offering documents; if the underlying property doesn't perform as projected, the tenant typically underpays. If the underlying property overperforms, the DST investors' participation in the upside is somewhat limited by the master lease structure.

modifications to the contributed property.[55] The IRS further found that the trustee was only allowed to reinvest money from the cash reserve into short-term obligations, and further, B and C, after owning an interest in the DST would become grantors pursuant to § 677, retaining an interest in the income from the portion of the trust. Therefore, when a DST has multiple beneficial owners, it is a multi-grantor trust under the § 671 regulations; this means that for federal income tax purposes, each beneficial owner holds a fractional undivided interest in the DST's underlying real estate.[56]

IV. Real Estate Investment Trusts

A. Background of REITs

Real Estate Investment Trusts ("**REITs**") represent a unique intersection of real estate investment and federal tax policy designed to democratize access to income-producing real estate while balancing complex tax, corporate, and investor interests. Since their inception in 1960, REITs have evolved through legislative reforms, regulatory guidance, and judicial interpretation, resulting in a sophisticated legal framework that continues to shape the real estate investment landscape in the United States.

REITs were established by Congress under the Eisenhower regime through the Real Estate Investment Trust Act of 1960, codified in the Internal Revenue Code as part of Subchapter M (I.R.C. §§ 856–859).[57] The legislative intent was to provide small investors with the opportunity to pool resources and invest in large-scale, income-producing real estate, thereby enjoying the benefits of professional management, diversification, and liquidity previously reserved for institutional investors and wealthy individuals. Initially, REITs were limited to passive ownership of real estate, with management functions outsourced to third parties. The Tax Reform Act of 1986 marked a pivotal shift, allowing REITs to internally manage properties and broadening the scope of permissible activities.[58]

A REIT is a business entity that is taxable as a corporation for federal income tax purposes and makes a valid REIT election with the IRS.[59] However, unlike corporations, REITs are designed to function as pass-through entities for federal income tax purposes. Under § 857, a REIT is generally not subject to entity-level taxation on income distributed to shareholders, provided it meets the requirement to distribute at least 90% of its taxable income annually.[60] Most REITs will distribute 100% of their taxable income. Therefore, the dividends-paid deduction[61] is a cornerstone of REIT tax efficiency, preventing double taxation at both the corporate and shareholder levels. However, these benefits all hinge on the upkeep of the REIT qualification, which often requires legal and accounting assistance to ensure proper compliance is maintained.

[55] Cf. Rev. Rul. 78-371.
[56] Practitioners should be careful to navigate what happens when an exchanger invests in a DST that has assets other than real property, such as lender-mandated reserves or excess cash devoted to a small but substantial value-add within the strictures of Rev. Rul. 2004-86.
[57] Real Estate Investment Trust Act of 1960, Pub. L. No. 86-779, §§ 10–11, 74 Stat. 998, 1004–10 (1960) (codified as amended at 26 U.S.C. §§ 856–859).
[58] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, (1986).
[59] I.R.C. § 856(a).
[60] I.R.C. § 857(a)(1).
[61] *See* I.R.C. § 561.

B. Mechanics of REITs

Qualification as a REIT requires deliberate intention and structuring. For a business entity to qualify as a REIT it must meet the following requirements:[62]

(1) be organized as a corporation, trust, or association;

(2) be managed by one or more trustees or directors;

(3) have transferable shares or transferable certificates of beneficial interest;

(4) be taxable as a domestic corporation but for the operation of §856 through §860;

(5) not be a financial institution or insurance company;

(6) be owned by 100 or more persons;

(7) not be closely held; and

(8) elect to be taxed as a REIT or have in effect such an election made for a previous taxable year.

The requirements described in 1 through 5 above must be met during the entire taxable year. The requirement described in 6 above must be satisfied during at least 335 days in a 12-month taxable year except for the first year a REIT election is made. Next, the requirement in 7 above must be met during the last half of each taxable year, except for the first year a REIT election is made.[63] Finally, assuming a business entity meets these requirements, it must then include with its tax return a valid REIT election as outlined in § 856 and comply with an extensive set of tax rules and regulations to maintain its REIT status. To retain qualification, the REIT's deduction for dividends paid during each taxable year must be equal to or greater than 90% of the REIT's taxable income (excluding net capital gains),[64] plus 90% of the net income from foreclosure property (less tax on such income),[65] less any excess non-cash income.[66] Any taxable income retained and not paid as dividends will be subject to corporate tax on the amount retained.[67] The dividends paid deduction is defined by § 561, and only distributions that qualify for this deduction will count towards meeting the REIT distribution requirement.

On major drawback of REITs is that they cannot act as dealers in property, meaning that they cannot sell inventory to customers in the ordinary course of their business. This ensures that REITs remain passive investments. Furthermore, REITs must be widely held, with at least 100 shareholders and no more than 50% of shares owned by five or fewer individuals during the last half of the taxable year.[68] These provisions are designed to prevent the use of REITs as closely held tax shelters and to ensure broad investor participation.

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[62] Bloomberg BNA Portfolio 742-4th: Real Estate Investment Trusts, II. Organizational Requirements, A. In General; I.R.C. § 856(a).
[63] *Id.*
[64] *See* I.R.C. § 857(a)(1)(A)(i).
[65] Tax on net income form foreclosure property is computed at 21%, the highest rate specified in I.R.C. § 11; *See* I.R.C. § 857(a)(1)(A)(ii).
[66] Determined under I.R.C. § 857(e); See I.R.C. § 857(a)(1)(B).
[67] IRC § 857(b)(1).
[68] "5/50 rule"; *See* IRC § 856(a)(5)-(6), § 856(h).

For the most part, the benefits of investing in REITs will outweigh their restrictions. Firstly, REITs allow for simplified tax reporting, allowing investors to utilize a singular K-1. Also, investing in REITs does not require additional investor state tax returns on withholding. Finally, individual investors in REITs can benefit from the 20% pass-through deduction found under § 199A which was passed in the 2017 Tax Cuts and Jobs Act and made permanent under the One Big Beautiful Bill Act in 2025.

V. Umbrella Partnership Real Estate Investment Trusts

A. Background of UPREITs

The genesis of the Umbrella Partnership Real Estate Investment Trust ("**UPREIT**") structure can be traced to the early 1990s, emerging as a response to the limitations imposed by the "investment company" rules under § 351(e), which generally precluded tax-free contributions of diversified real estate assets to a REIT in exchange for stock.[69] Prior to the advent of UPREITs, private real estate owners faced significant tax obstacles when seeking to access public capital markets because contributions of real estate to a REIT often triggered immediate recognition of gain due to the investment company rules and the potential for liabilities in excess of basis under § 357(c). The UPREIT structure, first implemented in 1992, provided a solution by allowing real estate owners to contribute their assets to a newly formed operating partnership (the "**umbrella partnership**" or operating partnership – "**OP**") in exchange for partnership units, rather than directly to the REIT.[70] The REIT, in turn, would serve as the general partner of the OP and would contribute the proceeds from its public offering to the OP in exchange for additional partnership interests.[71] This innovation enabled the deferral of gain recognition under § 721(a), as contributions to partnerships are generally nonrecognition events, and provided greater flexibility in the allocation of liabilities.

Following its humble beginnings, the proliferation of UPREITs has been rapid and transformative. In 2024, the total investment into UPREITs reached $1.42 trillion,[72] underscoring the structure's widespread adoption and impact on the real estate capital markets. The viability of the UPREIT structure was briefly called into question by the proposed partnership anti-abuse regulations in 1994.[73] However, the final regulations included an example[74] that effectively sanctioned the UPREIT structure, provided certain conditions were met. Subsequent statements by Treasury officials and the National Association of Real Estate Investment Trusts further solidified the acceptance of UPREITs as consistent with the intent of Subchapter K.

B. Mechanics of UPREITS

The UPREIT structure is characterized by a two-tiered arrangement in which a publicly traded REIT serves as the general partner of an OP, while legacy real estate owners and new investors hold limited partnership interests in the OP.[75] Upon formation, the initial real estate owners contribute their properties or partnership interests to the OP in exchange for OP units, which are economically equivalent to REIT

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[69] IRC § 351(e).
[70] John C. Hart & Andrew B. Purcell, *The Umbrellas of Subchapter K*, Simpson Thacher & Bartlett LLP, 7-9 (Jan. 2020).
[71] *Id.*
[72] *See* FTSE Nareit Real Estate Index Historical Market Capitalization, 1972 – 2024 at https://www.reit.com/data-research/reit-market-data/us-reit-industry-equity-market-cap.
[73] *The Umbrellas of Subchapter K* at 15-16; *See also* Prop. Treas. Reg. § 1.701-2, 59 FR 25584 (May 17, 1994).
[74] Treas. Reg. § 1.701-2(d), Example 4.
[75] Some UPREITs are LLCs, but the same principle applies, much as it would in private equity and hedge funds.

shares but afford the holders the benefit of tax deferral under § 721(a).[76] The REIT, having raised capital through a public offering, contributes the proceeds to the OP in exchange for additional OP units. In some cases, a portion of the public offering proceeds is used to acquire OP units from the initial owners, providing immediate liquidity. The OP units held by the legacy owners are typically exchangeable, on a one-for-one basis, for REIT shares or their cash equivalent, thereby granting the holders access to public market liquidity at the time of their choosing. By extension, OP unit holders could customize the timing of the recognition event that a contribution to a REIT would normally entail under the corporate tax rules described in the previous section.

A fundamental feature of the UPREIT structure is the maintenance of "structural parity" between OP units and REIT shares. This is achieved by ensuring that any issuance of additional REIT shares is mirrored by a corresponding issuance of OP units to the REIT, and that distributions of OP units are equivalent to dividends on REIT shares. This parity preserves the economic equivalence of the two instruments and prevents dilution of either class of interest. The REIT, as general partner, typically controls the OP, while the limited partners retain exchange rights for REIT shares but generally lack operational control. To protect the tax deferral afforded to contributing partners, UPREITs often employ tax protection agreements ("**TPAs**"), which indemnify the contributing partners for any tax liability triggered by a sale of contributed property or a reduction in their share of partnership liabilities within a specified protection period.

From a tax perspective, the UPREIT structure leverages the nonrecognition provisions of § 721(a) for partnership contributions, as opposed to the more restrictive rules governing corporate contributions under § 351. The partnership context also provides greater flexibility in the allocation of liabilities, allowing contributing partners to avoid gain recognition that might otherwise arise under § 357(c) if liabilities exceed basis. The exchange of OP units for REIT shares is a taxable event, at which point the built-in gain is recognized by the exchanging partner. To the extent the OP disposes of contributed property, the built-in gain is allocated to the contributing partner under §§ 704(c), 737, and the corresponding regulations.

VI. 1031 Exchange into DSTs and Subsequent UPREIT Conversion

A sophisticated variant of the UPREIT structure involves the use of a Delaware Statutory Trust as an initial investment vehicle for taxpayers seeking to defer gain under § 1031, with a planned conversion into an UPREIT structure at a later stage.[77] This approach is increasingly prevalent in the real estate industry, particularly for investors seeking both the benefits of § 1031 like-kind exchange deferral and eventual access to the liquidity and diversification offered by REITs.[78]

A. 1031 exchange into DSTs

In this structure, a taxpayer sells relinquished real property and, pursuant to § 1031, reinvests the proceeds into beneficial interests in a DST that holds replacement real estate. Once again, the DST is structured to qualify as a grantor trust for federal income tax purposes, ensuring that each investor is

[76] *See* I.R.C. § 721(a).

[77] Although the conversion into an UPREIT structure is often telegraphed in the offering documents for the DST, it is usually not legally binding; the UPREIT usually holds an option to compel the DST's contribution of its real property to the partnership in exchange for OP units. Some practitioners are wary of the application of the step transaction doctrine in this transactional structure, and some believe the holding in *Magneson* applies to put the technique on safer ground. *See Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985).

[78] Investors should understand that once the DST beneficial interests get converted to OP units, any subsequent like-kind exchange will no longer be possible because partnership interests are not considered eligible real property.

treated as owning an undivided fractional interest in the underlying real estate, thereby satisfying the requirements for a valid like-kind exchange under § 1031.[79]

After a suitable holding period often dictated by business objectives, market conditions, or the terms of the DST offering, the DST may be dissolved or converted into a limited partnership or limited liability company taxed as a partnership. At this stage, the former DST investors receive interests in the partnership ("**OP units**") in exchange for their DST interests. The partnership can be structured as the OP in an UPREIT arrangement, with a REIT serving as the general partner and public face of the enterprise;[80] alternatively, the DST's real estate can be contributed to an existing UPREIT.

B. UPREIT Conversion

The conversion from DST to UPREIT is structured to avoid triggering gain recognition for the former DST investors. This is accomplished by ensuring that the exchange of DST interests for OP units qualifies as a nonrecognition event under § 721(a), which governs contributions of property to a partnership.[81] The partnership, now functioning as the OP, holds the real estate assets, and the REIT holds a controlling interest in the OP. The former DST investors, now limited partners in the OP, are granted the right to exchange their OP units for REIT shares (or cash) at a future date, providing a path to liquidity and diversification.

This two-step process—first, a 1031 exchange into a DST, followed by a § 721 contribution into an UPREIT—enables investors to achieve both immediate tax deferral and long-term flexibility. The IRS has generally respected this structure, provided that the DST is not formed as part of a legally binding plan to contribute the property to a partnership, and that a sufficient period elapses between the 1031 exchange and the UPREIT conversion to avoid "step transaction" concerns.

The step transaction doctrine is a judicially created principle in U.S. tax law that empowers the IRS and courts to collapse a series of formally separate but related steps into a single integrated transaction for tax purposes, thereby giving effect to the substance rather than the form of the arrangement. Rooted in the broader doctrine of substance over form, the step transaction doctrine is invoked when multiple steps, though legally distinct, are in reality prearranged components of a unified plan designed to achieve a specific tax result. Courts typically apply one or more of three tests to determine whether the doctrine should apply: the end result test (focusing on whether the steps were intended from the outset to achieve a particular outcome), the mutual interdependence test (examining whether the steps are so interdependent that the legal effect of one would be fruitless without completion of the others), and the binding commitment test (assessing whether there was a binding obligation to complete the subsequent steps at the time the first step was taken).[82] This doctrine serves as a critical enforcement tool for the IRS to prevent taxpayers from obtaining unintended tax benefits through the artificial segmentation of what is, in substance, a single transaction. To avoid recharacterization by the IRS these deals will abide by a waiting period before the conversion of DST into UPREIT can take place. The precise length of this "seasoning" period is a matter of facts and circumstances, but practitioners often recommend holding the DST interest for at least two years before conversion.

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[79] This also presumes the DST is structured correctly under Rev. Rul. 2004-86.
[80] *The Umbrellas of Subchapter K* at 7-11.
[81] This is why some promoters of the DST-to-UPREIT vehicle refer to the structure as a "721 exchange."
[82] *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *See also Commissioner v. Clark*, 489 U.S. 726, 738 (1989).

C. Use of Tax Protection Agreements in UPREIT Transactions

A critical feature of UPREIT structures, particularly for former DST investors and other contributors of appreciated property, is the use of TPAs. TPAs are contractual arrangements between the OP and the contributing partners, designed to preserve the tax deferral benefits of the initial contribution.

The principal risk addressed by a TPA is the premature recognition of built-in gain attributable to the contributed property. Under §§ 704(c), 737, and the corresponding regulations, if the OP disposes of the contributed property in a taxable transaction, the built-in gain is allocated to the contributing partner, triggering immediate tax liability. Similarly, a reduction in the contributing partner's share of partnership liabilities may result in a deemed distribution under § 752(b), potentially causing gain recognition if the distribution exceeds the partner's outside basis.[83]

To mitigate these risks, TPAs typically provide that, for a specified "protection period" (often seven to ten years), the OP will not sell, transfer, or otherwise dispose of the protected property, nor reduce the contributing partner's share of liabilities below a negotiated threshold, without compensating the partner for any resulting tax liability. The indemnification may cover the full amount of tax triggered or, in some cases, only the present value of the accelerated tax liability relative to the end of the protection period. TPAs may also obligate the OP to maintain a minimum level of nonrecourse debt allocable to the contributing partner and may include provisions for replacement debt if the original financing is repaid.

The drafting of TPAs requires careful attention to the scope of protection (*e.g.*, whether it covers only the original built-in gain or subsequent appreciation), the duration of the protection period, the calculation of indemnification payments (including assumptions about tax rates and character), and the treatment of state and local taxes. The agreements may also address the consequences of mergers, conversions, or other extraordinary transactions, and may include gross-up provisions to account for taxes on indemnification payments.

For institutional-grade DST-to-UPREIT offerings, the sponsors will often not allow or offer a TPA at all. The presence or absence of a TPA in connection with these vehicles is a matter of negotiating leverage: in a transaction where a taxpayer contributes a significant amount to a DST offering sponsored by a private REIT with less than $200 million in total assets, the taxpayer is more likely to have the leverage to demand a TPA; but even when a taxpayer is making a $40 million contribution to a DST sponsored by a publicly traded REIT, the sponsor might consider a TPA a non-starter as a matter of policy. Practitioners should be aware of the existence of TPAs, advise taxpayers investing in DST-to-UPREIT vehicles to consider obtaining one, and contemplate the general viability of an investment if the taxpayer is refused the accommodation.

VII. Conclusion and Takeaways

Section 1031 remains one of the most powerful deferral mechanisms available to real estate investors and their advisors. The contemporary landscape is defined by a confluence of statutory change, ever-tightening regulatory prescriptions, and a body of case law that continues to police transactions through substance-over-form principles. Taxpayers who wish to avail themselves of non-recognition must therefore satisfy a mosaic of requirements that begin with demonstrable exchange intent, continue through the 45-/180-day identification and exchange windows, and extend to meticulous attention to boot, constructive receipt, and basis-shifting in related-party settings.

[83] *The Umbrellas of Subchapter K* at 88-90.

Within that framework, alternative replacement vehicles have evolved from niche solutions into mainstream planning tools. Rev. Rul. 2004-86 confirmed the DST's viability for § 1031 purposes while subchapter M provides the statutory scaffold for REIT pass-through treatment. The UPREIT, in turn, offers an elegant bridge between private real estate ownership and the public capital markets, melding the partnership nonrecognition rules of § 721 with REIT liquidity. When sequenced properly, a forward or reverse exchange into a DST followed by a delayed contribution to an operating partnership can achieve a taxpayer's deferral benefits without triggering immediate recognition. Yet each added layer brings incremental challenges: seasoning periods to blunt step-transaction challenges, tax-protection agreements to shield contributors from premature gain, and continuous monitoring of liability allocations to avoid phantom income under § 752.

The practical import for practitioners is two-fold. First, flawless execution matters. Courts have shown a willingness to collapse multi-step plans where documentation is sparse, exchange proceeds drift outside safe-harbor control, or related parties use basis-shifting to "cash-out" of appreciated positions. Second, strategic patience pays dividends. Allowing sufficient time between the initial § 1031 exchange and any subsequent UPREIT conversion, and embedding robust TPAs, can mean the difference between success and failure.

Accordingly, we recommend that tax counsel adopt a "belt-and-suspenders" approach: adhere strictly to required formalities and integrate TPAs. At their best, the combination of § 1031, DST structures, and UPREIT mechanics can deliver continued investment, capital formation, and economic growth while preserving the taxpayer's ability to defer gain.