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PERSPECTIVES

Benefits of the 721 Transaction / UPREIT Transaction – Defer, Diversify, and Hedge

A Tax Deferral Strategy for Real Estate Owners

Owners of real estate properties looking for an exit strategy and the opportunity to diversify their real estate holdings while deferring capital gains taxes may find utilizing IRC Section 721 (a "721 Transaction"), also referred to as an "UPREIT Transaction", to be a preferred tax mitigation strategy. Rather than exchanging property for property, a 721 Transaction allows an investor to contribute property directly to a REIT's operating partnership (the entity through which the REIT acquires and owns its real estate) in exchange for operating partnership units ("OP Units"). This type of transaction may be especially helpful for property owners with significant gains where a sale would trigger a taxable event, or for those looking for an estate planning tool that efficiently passes down highly appreciated real estate in a tax-efficient manner among heirs. A 721 Transaction may also be a viable option for those who wish to diversify away from potential uncertainties surrounding the future of IRC Section 1031.

721 Transaction/UPREIT Transaction Defined

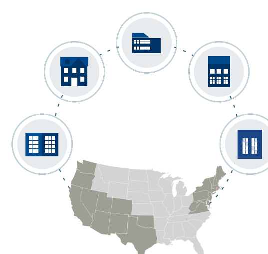
Section 721 of the Internal Revenue Code allows owners of property (including real estate) to contribute, on a tax-deferred basis, their physical property to a partnership in exchange for interests in the partnership. Real estate investment trusts ("REITs") often hold their portfolio of real estate through an operating partnership (known as an Umbrella Partnership Real Estate Investment Trust, or "UPREIT" structure) to allow holders of real estate to effectively exchange their property for economic interests in the REIT (in the form of OP Units of the operating partnership) by contributing that property to the operating partnership in a 721 Transaction. The OP Units typically have economic rights that are identical to the rights of the shares of the REIT and after a relatively short holding period can be converted into shares of the REIT (in a taxable transaction) for additional liquidity. The 721 Transaction can be an alternative or complementary solution to a traditional Section 1031 exchange. A 721 Transaction tends to appeal to a property owner seeking the potential benefits of a larger real estate portfolio including diversification, professional management, economies of scale, access to capital, increased liquidity, and additional estate planning benefits, all while deferring the recognition of a capital gain on their original property.

How It Works

A 721 Transaction is completed when an individual contributes an investment property to the operating partnership of a REIT. Instead of receiving cash for the sale of the property, the investor receives OP Units of the operating partnership in the UPREIT structure.

Relinquished Property Sale

Investor sells investment property in anticipation of executing a 1031 Exchange



REIT Operating Partnership Units Issued in Exchange for Investment Property

Property is exchanged into operating partnership units in a REIT

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A DST 721 or "Two-Step" Transaction

The typical real estate investor does not hold real estate that a REIT would want to acquire in an UPREIT Transaction. However, the possibility of acquiring OP Units for a real estate investment may be achievable to investors indirectly through a Section 1031 exchange into a Delaware Statutory Trust ("DST"). Interests in a DST ("DST Interests") are fractional interests in real property, such as a multifamily property, typically acquired by investors seeking replacement property to defer gain that was realized on a disposition of a relinquished investment property.

In this scenario, the investor sells his investment property to a third party and uses the proceeds from the sale to purchase a DST Interest equal to the value of the relinquished property. Because DST Interests are treated as investment property for US tax purposes, a REIT that wants to acquire a property held by a DST can cause its operating partnership to acquire all the DST Interests from their holders in exchange for OP Units. Exchanging into DST Interests therefore can open access to institutional-grade real estate held by a DST, and thereby open access to the more diversified real estate portfolios held by REITs in their UPREIT structures.

The investors that contribute their DST Interests to an operating partnership will be treated as having contributed investment property to the operating partnership in a 721 Transaction (a "DST 721 Transaction"). A DST 721 Transaction should generally not occur less than two years after the initial acquisition of the DST Interests by their holders, nor can there be any promise or guarantee, at the time of such initial acquisition, that the DST 721 Transaction will occur.

Relinquished Property Sale

Investor sells investment property in anticipation of executing a 1031 Exchange

Property Exchanged for Fractional DST Interests

Exchange funds are used to purchase fractional interests in a DST and held for at least two years

REIT Operating Partnership Units Issued in Exchange for DST Interests

Interests in the DST are contributed to a REIT's operating partnership in exchange for operating partnership units in a 721 Transaction

A 721 Transaction (whether involving a DST or otherwise) can be used in conjunction with public, private, or publicly registered non-traded REITs, each of which has unique investment characteristics to consider.

It is important to understand that at the time an investor converts OP Units for shares in the REIT to get liquidity, a taxable event occurs and there is no longer an opportunity to defer taxes. However, this conversion will normally take place at the discretion of the investor or estate and may often occur after a step-up in cost basis in the event of the investor's death.

Benefits and Considerations

Compared to an individual owning a single property in a single market, 721 Transactions, when completed in conjunction with a larger diversified REIT, allow individuals to achieve greater diversification while removing concentration risk. While both the Section 1031 exchange and the 721 Transaction are tax-deferred transactions, REIT portfolios are generally more diversified than single asset Section 1031 investments or DSTs. In addition, an individual property or a DST does not typically offer partial liquidity. The OP Units of a REIT, acquired via a 721 Transaction, typically provide the ability to convert OP Units into REIT shares to achieve partial or full liquidity. Partial liquidity may benefit real estate owners who prefer to spread their tax liability over time or simply want to access their capital.

Investors also receive any distributions generated by the DST prior to a DST 721 Transaction and also typically receive distributions generated by the OP Units after such transaction. In addition, depending on the investor's cost basis and other relevant factors, ownership of DST Interests and OP Units may have additional tax benefits primarily due to depreciation and other items. However, investors should recognize that they typically will not have investment decision rights in the DST, the operating partnership or the REIT aside from determining when to exercise liquidity in the REIT (subject to availability determined by the company).

A final consideration is the risk that Congress could limit or eliminate the ability to complete a Section 1031 tax-deferred exchange. Changes to IRC Section 1031 have repeatedly been discussed as part of past tax code overhauls under Democratic and Republican administrations. As part of the 2017 Tax Cuts and Jobs Act, Section 1031 exchanges were eliminated for all assets other than real estate, and more recently, legislative proposals have been made to cap the amount eligible for a 1031 exchange. Investors concerned with the prospect of losing the ability to complete a Section 1031 exchange in the future may be attracted to the 721 Transaction alternative as it may still offer a way to defer taxes. Legislative proposals have also been made to eliminate the tax-free step-up in cost basis upon an investor's death on gains exceeding $1 million, which could limit the ability to convert the OP Units to REIT shares on a tax-free basis.

Case Study — Two Medical Partners Own Their Building and Want to Retire

Two doctors own a medical facility. As property owners, they are responsible for maintenance, taxes, utilities, insurance, accounting, dealing with tenants, and the general upkeep of the property. They want to retire and sell the building but are concerned about the low tax basis of the real estate and the large potential capital gain and depreciation recapture that they would recognize upon a sale. Instead, the doctors take the proceeds from the sale of their property and complete a Section 1031 exchange by acquiring interests in a DST.

After two years:

1. Their DST Interests are exchanged for OP Units of a large, diversified REIT generating monthly distributions.
2. They are no longer dealing with the burdens of active real estate ownership, have mitigated the risk of owning a single property, and have indefinitely deferred the recognition of a taxable event.
3. Typically, they have access to partial or full liquidity of their REIT interests and, under current law, would still receive a step-up of basis upon their death, a key consideration for estate planning.

The 721 Transaction / UPREIT Transaction is complex and should only be considered with the counsel of your financial, legal, and tax advisors familiar with this type of exchange.

Risk Factors

There is no guarantee of success. Investors could incur a loss of all or a portion of their investment.

- No public market exists for DST Interests, and it is highly unlikely that any such market will develop.
- There are substantial restrictions on the transfer of DST Interests.
- There is no specified time that any property held by a DST will be liquidated and the DST may not be able to sell any or all of the properties at a price equal to or greater than the purchase price paid for the DST Interests.
- DSTs are a relatively new vehicle for real estate investment and are inflexible vehicles to own real property.
- If a property is transferred (or the DST is converted) to a Springing LLC, investors will likely lose their ability to participate in a future Code Section 1031 Exchange with respect to the transferred property or properties.
- Investors typically have no voting rights and will have no control over management of the DST or the properties.
- There is no guarantee that investors will receive any return.
- There typically are substantial restrictions on the transfer of DST Interests.
- There is no guarantee that an investor will be able to exchange their DST Interests for OP Units in an UPREIT.
- As a partner in a partnership, a holder of OP Units may be allocated taxable income in excess of cash distributions it receives. Such holder may need to find alternative sources of cash to pay the tax liability on its allocated income.
- In the event that an operating partnership sells the property contributed pursuant to a 721 Transaction, any “built-in gain” recognized upon such sale will be entirely allocated to the contributing investor. Such investor may have only limited rights to prevent or delay such a sale in accordance with a “tax protection agreement”.
- The qualification requirements for a REIT are complex. There is no guarantee that, after a 721 Transaction, the REIT will continue to qualify as a REIT, which could adversely affect its operations and its ability to make distributions.

To Learn More:

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