The §721 Tax Deferred "UPREIT" Transfer

An alternative to section 1031 exchanges is the use of an Umbrella Partnership Real Estate Investment Trust (UPREIT), which involves a tiered ownership structure encompassing a realty operating partnership (OP) and a REIT that is the general partner of the OP.

Property owners wishing to divest their realty can contribute their property to the OP in exchange for ownership interests in the OP on a tax-deferred basis under IRC section 721. This interest is convertible after a period of time into cash or shares of the REIT.

This structure is often problematic if the REIT does not want the property owned by the taxpayer.

Should this be the case, an alternative is for the taxpayer to exchange for a property the REIT has deemed an acceptable addition to its portfolio. This could mean a property already identified and about to be acquired by the REIT.

The problem is that when the taxpayer subsequently contributes the exchanged property to the UPREIT, the exchange may be disqualified due to the requirements of section 1031(a) which specifies that the property be held for investment or business purposes and not for immediate resale as in Magneson v. C.I.R., 753 F.2d 1490 (1985). A creative solution to this problem may be for the UPREIT to be given the option to acquire the property through a "call" option.

Essential to this structure is for the UPREIT to have the right, but not the obligation, via the "call" option contract to complete the placement of the property into the UPREIT. Otherwise, the IRS would likely apply the "step transaction rule" and take the position that the property was immediately contributed at the time the option was granted.

- A “step transaction” is when the IRS treats a series of formally separate “steps” as a single integrated transaction because the IRS views the steps as integrated, interdependent and focused towards a particular end result.
- Since the "call" option provides the right but not the obligation, it has been deemed unlikely that such a position would be defendable by the IRS.

Of course, the relinquished property in a §1031 transaction may not garner the equity capital necessary to purchase 100% ownership of an institutional grade, REIT quality property. There also may be concerns about diversification when the investor is making decisions about appropriate replacement properties.

The §1031 TIC Exchange - §721 "UPREIT" Opportunity

In the alternative, an investor may wish to consider the concept of incorporating a §721 "UPREIT" transfer into the structure of a §1031 Tenant-In-Common (TIC) program. This is simply a combination of these two proven tax-deferral mechanisms under the Internal Revenue Code.

Essentially, investors may have the opportunity to take the tenancy-in-common interest they acquired pursuant to their §1031 exchange and contribute it back to the REIT on a tax-deferred basis in exchange for the REIT's Operating Partnership (“OP”) Units. These OP Units are the substantial economic equivalent of the REIT's common shares, and are convertible into the REIT's common shares on a one-for-one basis.

This program may provide a wide range of benefits to investors completing tax-deferred real estate exchanges including:

- Assuming that the REIT is actively acquiring new properties, the program may serve as a source of readily available replacement properties for investors completing 1031 exchanges.

- TIC interests acquired as the replacement property in a §1031 exchange can be "right sized" to match an investor's exact needs.
- Investors requiring indebtedness in order to avoid "mortgage boot" pursuant to their §1031 exchanges may be able to borrow precisely the amount they need.

Benefits Upon Receipt of OP Units

- Access to a diversified portfolio of institutional-quality properties which are leased to creditworthy corporate tenants and managed by an experienced team of real estate professionals.
- Regular quarterly dividends and returns substantially equivalent to those of the REIT's common stock.
- A standardized redemption program that provides investors with far more liquidity than owning whole properties or tenancy-in-common interests.

The decision to redeem OP Units is strictly in the investor's hands (unlike tenancy-in-common programs where the sale of the property requires 100% co-owner approval).

- Redemption of OP Units can occur in stages, allowing an investor to manage taxable gain recognition.
- An investor's heirs receive a step-up in tax basis in the OP Units, effectively eliminating the Federal income tax on any capital gain inherent in the OP Units at the time of their transfer to such heirs.
- OP Units are an effective estate planning tool since multiple heirs can make independent decisions with respect to the sale of their inherited OP Units (unlike an investment in property where a single decision must often be made collectively).

How Does It Work?

Step #1

- ☑ The investor enters into a real estate purchase and sale agreement (the "Relinquished Property Purchase and Sale Agreement") for the sale of the Relinquished Property to a third-party buyer.
- ☑ The investor also enters into a qualified intermediary exchange agreement with a Qualified Intermediary and assigns its rights under the Relinquished Property Purchase and Sale Agreement to the Qualified Intermediary.
- ☑ The sale of the Relinquished Property takes place and the sales proceeds are deposited into an account (the "Exchange Account") held by the Qualified Intermediary.

Step #2

- ☑ The investor (through a newly-formed LLC) enters into a real estate purchase and sale agreement with the REIT or a subsidiary thereof for the purchase of a tenancy-in-common interest in a high-quality property owned by the REIT or a subsidiary thereof
- ☑ The Qualified Intermediary uses the proceeds from the sale of the Relinquished Property held in the Exchange Account to acquire the Replacement Property.
- ☑ The Qualified Intermediary then transfers the Replacement Property to the investor's newly-formed LLC.

Step #3

- ☑ The investor leases the Replacement Property to the REIT or a subsidiary thereof pursuant to a Master Lease.
    - Through the provisions of a "call" option, the REIT is afforded the right, but not the obligation, to acquire the Replacement Property from the investor for a fixed purchase price.

Step #4

- ☑ If the REIT exercises the "call" option:
    - The investor will transfer the Replacement Property to the REIT in exchange for OP Units.
    - The transfer of the Replacement Property to the REIT is subject to any liabilities securing the Replacement Property.

Because there is a possibility that the "call" option will not be exercised, the investor must acquire the Replacement Property with the understanding that he or she will be holding the Replacement Property for investment purposes and may not ultimately receive OP Units.

Once an investor receives OP Units, how can he or she redeem those units?

- The REIT Operating Partnership has the right to redeem investors for either cash or REIT common stock.
    - The receipt of cash or REIT common stock in exchange for OP Units brings an end to an investor's tax deferral.
- Assuming an investor receives REIT common stock, the investor may liquidate such stock (prior to its listing) pursuant to the REIT's redemption program.

With respect to the redemption of OP Units, it is important to keep in mind the following:

- Like REIT common stock, OP Units are best suited for investors with a medium to long term investment horizon.
- Unlike investments in TIC interests, investments in OP Units can be liquidated in whole or in part, with the decision to liquidate resting solely in the hands of the investor.
- Should the REIT become listed on a national securities exchange or an over-the-counter market, OP Unit holders would no longer be subject to the REIT's redemption program.
    - Instead, investors can simply convert their OP Units into the REIT's common shares and sell them in the secondary market at whatever price the market dictates.