What is an IRC Section 721 UPREIT?

1031 Knowledge

A Real Estate Investment Trust (REIT) is similar to a mutual fund for real estate investors and offers the benefits of a diversified portfolio that is professionally managed along with distributing almost all of the net income to investors. Although a REIT can do a 1031 exchange at the entity level, individual REIT shares are considered personal property and do not qualify for a 1031 exchange since only real property qualifies. For tax deferral in a 1031 exchange, a taxpayer must exchange real property for other "like-kind" real property.

WHAT IS AN UPREIT?

An Umbrella Partnership REIT (UPREIT), under IRC §721, provides tax deferral benefits to commercial property investors who contribute their property into a new tiered ownership structure that includes an operating partnership (OP) and the REIT who is a partner in the OP. In exchange for the commercial property contributed to the UPREIT, the taxpayer receives units in the operating partnerships (OP Units). The capital gain taxes remain deferred as long as the UPREIT holds the property and the investor holds the OP Units. The advantage is this structure provides an exit strategy for commercial property owners who otherwise might have significant capital gain tax liabilities on the sale of appreciated property. In addition, the taxpayer benefits from additional diversification because they have an interest in a portfolio of commercial properties instead of just one property. This structure is not appropriate for every taxpayer as the taxpayer must have property that the REIT wants to add to their portfolio and typically this will be a larger commercial asset.

A hybrid of the above scenario has been developed for investors who perform a 1031 exchange into a Delaware Statutory Trust (DST) ownership property that a REIT may acquire later. The DST property can later be contributed into an UPREIT structure under Section 721, allowing the taxpayer to ultimately acquire OP Units that are essentially the equivalent to an interest in the REIT itself. To summarize, a taxpayer that ultimately wants this outcome first performs a 1031 exchange into a DST and holds this property for investment. Later, the sponsor may offer the taxpayer the opportunity to perform a 721 UPREIT for OP Units in their REIT.

HOW ARE OP UNITS VALUED?

OP Units are generally convertible into REIT common stock. The Board of Directors typically establishes the price of the common stock in a private REIT while the market value prices the OP Units with the stock of a public REIT. OP Units in a public REIT are more liquid than those issued by a private REIT. An UPREIT's Preferred OP Units are generally redeemable at par. The terms and redemption options are negotiated on a case-by-case basis. The Common OP Units in an UPREIT can often be sold in the following ways:

- Free Convertibility: Common OP Units can usually be converted into shares of common stock at the taxpayer's option.
- Annual Repurchase Option: Some REITs provide a repurchase option for taxpayer up to a fixed percentage of the investor's initial common OP Unit holdings.
- 100% Repurchase Option on Death: Upon a taxpayer's death, an UPREIT can, at the election of the estate, repurchase Common OP Units at fair market value.

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