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PRIVATE MARKETS

Tax-deferred exchanges: *A sophisticated solution for property owners*

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When property owners sell appreciated real estate, they generally incur taxes on the gains in the year the property is sold. A 1031 UPREIT program allows investors to defer those taxes, while also offering a range of potential additional benefits, including enhanced portfolio diversification and the opportunity for regular income. This unique combination of advantages is why many investors use 1031 UPREIT programs to enhance their retirement and estate planning as well as to support a sound overall tax management strategy.

1031 UPREIT PROGRAM

A 1031 UPREIT program targets tax deferral by leveraging and combining the tax-advantages offered by a number of existing **federal and state tax codes,** as well as a structure called a **Delaware Statutory Trust (DST).**

IS YOUR PROPERTY ELIGIBLE FOR AN EXCHANGE?

Eligible property types for a 1031 Exchange are those that have been held for investment purposes or for productive use in a business or trade.

THESE MIGHT INCLUDE:

- RENTAL OR INVESTMENT HOMES
- APARTMENTS
- SHOPPING CENTERS
- UNIMPROVED LAND
- OFFICE BUILDINGS
- WAREHOUSES
- FARMLAND

Terms in bold are defined in the glossary below.

Glossary

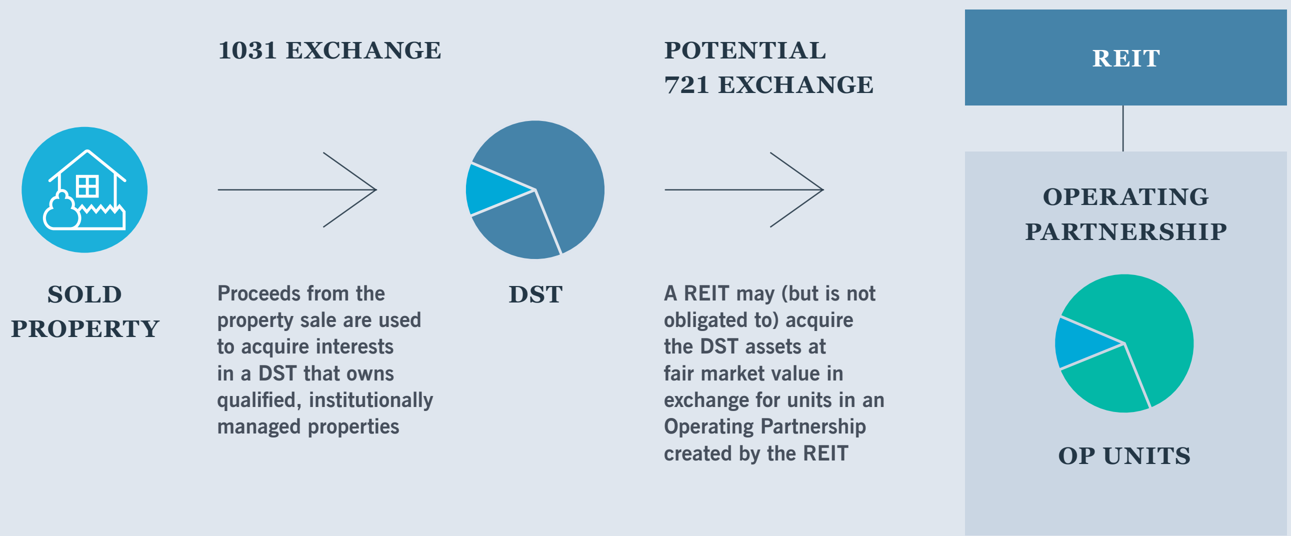
Internal Revenue Code (IRC) Section 1031 – Originally enacted as part of the Revenue Act of 1921, allows a seller of a business or investment property to defer taxes on capital gains and depreciation recapture generated from the sale of certain qualified property, provided the sale proceeds are used to acquire a "like-kind" replacement property.

IRC Section 721 – States that no gain or loss shall be recognized upon a contribution of property to a partnership in exchange for an interest in the partnership.

IRS Revenue Ruling 2004-86 – Provides guidance on how DSTs are classified for federal tax purposes, including that a properly structured DST that owns real estate may qualify as like-kind property, allowing a taxpayer to acquire an interest in a DST without recognition of gain or loss under Section 1031 of the IRC.

Delaware Statutory Trust (DST) – A trust, governed by Delaware state law, that may own income-generating, institutional-quality real estate and issue beneficial interests to investors. DSTs are often used to facilitate 1031 exchanges.

HOW DOES A 1031 UPREIT PROGRAM WORK?



An investor first sells an investment property or property used for a business or trade. The proceeds are used to acquire a **like-kind property.** In that transaction, which is called a **1031 Exchange** an interest in a DST that owns real estate can qualify as the like-kind property.

At the discretion of the **Real Estate Investment Trust (REIT)**, it may acquire the DST property at fair market value as part of a **721 Exchange**. If and when the REIT exercises its **Fair Market Value Option (FMV Option)** to purchase the property, DST investors receive **Operating Partnership (OP) Units** in exchange for their DST interests.[1]

Like-kind property – A property of the same nature or character, even if it differs in grade, quality or asset class, and regardless of whether it is improved or unimproved.

1031 Exchange – A transaction that leverages IRC Section 1031 to defer capital gains on the sale of a property.

Real Estate Investment Trust (REIT) – A company that owns, operates or finances income-producing real estate. Modeled after mutual funds, REITs allow investors to access real estate investments through shares and potentially benefit from regular income streams and long-term capital appreciation.

721 Exchange – A transaction that leverages IRC Section 721 to defer capital gains on the contribution of property to a partnership in exchange for interests in the partnership.

Fair Market Value Option (FMV Option) – A right granted to the OP to purchase DST investors' interests at fair market value in exchange for OP Units in a 721 Exchange after all investors have held their interests in the DST for at least two years. This right may or may not be exercised.

Operating Partnership Units (OP Units) – Represent an ownership interest in a REIT's Operating Partnership. OP Units function like REIT shares; they pay the same ongoing gross distributions and have the same net asset value (NAV) per unit as a REIT common share of the same class.

1 The FMV Option may or may not be exercised. Therefore, investors should acquire a beneficial interest in a DST with the understanding that they may not ultimately receive OP Units, and the option consideration paid may be cash or OP Units.

1031 EXCHANGE

- An investor sells an investment property or property used for a business or trade. A personal primary residence does not qualify for a 1031 Exchange
- The proceeds from the sale must be placed with a **Qualified Intermediary,** who functions like an escrow agent.
- Within 180 days, the proceeds are then used to acquire a like-kind property, which could be an interest in a DST, on a tax-deferred basis.

To qualify as like-kind, the property held by the DST does not have to be the same as the property sold. For example, a property owner could sell a rental home and acquire an interest in a DST that holds an industrial warehouse or commercial building. In most cases, the DST will have been created by the REIT and will own real estate sourced from the REIT's existing investment portfolio or its acquisition pipeline.

While holding DST interests, the investor may earn income secured through a **Master Lease** between the DST and a subsidiary of the REIT's OP. All payment and performance obligations of the subsidiary are guaranteed by the OP.[2]

Qualified Intermediary – A third party that holds the proceeds from the sale of a relinquished property and uses them to purchase a like-kind replacement property selected by the investor.

Master Lease – An agreement that governs the lease of properties from a DST by the Operating Partnership. The terms of the Master Lease govern rent payments to the DST and an investor's distributions from the DST will not be reduced by any tenant vacancy or capital expenditures.

2 There can be no assurance that investors will receive income in any amount, or at all.

721 EXCHANGE

Many REITs have subsidiary **Operating Partnerships,** also referred to as "OPs," through which they own their investments. This structure, known as an **Umbrella Partnership Real Estate Investment Trust (UPREIT),** allows a REIT to acquire properties from sellers on a tax-deferred basis in exchange for interests (or units) in its OP.

As the general partner of an OP with an FMV Option a REIT may choose to cause the DST investors to execute a 721 Exchange, or UPREIT transaction. The REIT conducts this exchange by providing DST investors interests in the REIT's Operating Partnership in exchange for the property held by the DST. DST investors can receive OP Units of the Operating Partnership and no longer own interests in the DST. For tax purposes, the DST investors are treated as having contributed their shares of the property held by the DST to the OP in a tax-free contribution to a partnership (i.e., the OP).

After all investors in the DST have held their interests for at least two years, the OP has the right pursuant to the FMV Option to acquire investors' DST interests at fair market value (FMV) in exchange for OP Units. Investors are not guaranteed to receive OP Units however, as the OP is not obligated to exercise the FMV Option.[3]

If the FMV Option is exercised, DST investors receive OP Units that typically make periodic cash distributions and track the performance of the REIT common shares of the same class. In addition, there is often also a redemption program whereby OP units can be redeemed for REIT common shares or cash at the OP's election.

OP Units are generally structured to be economically equivalent to the REIT common shares of the same class. Each OP Unit pays the same gross distributions and has the same **net asset value (NAV)** as a REIT common share of the same class. OP Units have similar advantages to common REIT shares – fractional interest in a diversified REIT. The ultimate result for an investor is owning OP Units of an institutionally managed REIT portfolio of real estate assets.

Operating Partnership (OP) – A specialized entity structure commonly used by REITs to own, manage and maintain operational control of income-producing assets.

Umbrella Partnership Real Estate Investment Trust (UPREIT) – A REIT structure where a REIT owns its properties through a subsidiary Operating Partnership; allows property owners to exchange their property for Operating Partnership Units (OP Units) using a 721 Exchange.

Net asset value (NAV) – Represents the total value of the REIT's assets minus its liabilities.

3 The FMV Option may or may not be exercised. Therefore, investors should acquire a beneficial interest in a DST with the understanding that they may not ultimately receive OP Units, and the option consideration paid may be cash or OP Units.

Sample transaction

By deferring taxes related to a sale of real estate, an investor who utilizes a 1031 UPREIT program can retain significant capital that would have otherwise gone to pay taxes to invest in a replacement property.

	SELL PROPERTY	SELL PROPERTY AND COMPLETE 1031 EXCHANGE[4]	
Original Purchase price	$1,000,000		
Depreciation	$700,000		
Adjusted cost basis	$300,000		
Sale price	$2,000,000		
Total taxable gain[5]	$1,700,000		
Depreciation recapture tax	-$175,000		
Federal long-term capital gains tax	-$200,000		
Net investment income tax	-$64,600		
State tax	-$226,100		
Total taxes due	-$665,700		Tax deferral
Net proceeds available for re-investment	$1,334,300	$2,000,000	**$665,700**

4 The sample transaction is a hypothetical transaction for illustrative purposes only. There can be no assurance that a property will be sold for a gain, or at all.

5 Depreciation recapture tax = 25% of depreciation
Federal long-term capital gains tax = 20% of total taxable gain minus depreciation
State tax = Assumes highest possible rate of 13.3%
Net investment income tax = Assumes subject to 3.8% of total taxable gain

1031 UPREIT program timeline

An investor has 180 days to complete a 1031 Exchange. As a first step, the investor must set up an account with a Qualified Intermediary before closing on the sale of their property. Once the investor's property has been sold, the Qualified Intermediary retains the sale proceeds. The investor then has 45 days to identify potential replacement properties and must complete the exchange within 180 days of the sale date. After all investors have held interest in the DST for at least two years, the investor may receive OP Units (if the FMV Option is exercised).[6]

PHASE ›››

Pre-sale
- Investor — Identify Qualified Intermediary

Sale (DAY 0)
- Investor — Deposit proceeds with Qualified Intermediary

Identification (DAY 45)
- Investor — Identify up to three potential replacement properties or DSTs, or other properties of up to 200% of the value of the relinquished property

Exchange (DAY 180)
- Investor — Finalize purchase of identified property or beneficial interest in a DST
- Qualified Intermediary — Transfer payment to seller of replacement property

Conversion (YEAR 2-3)
- REIT Operating Partnership — May exercise the FMV Option to purchase the DST assets
- Investor — If the FMV Option is exercised by the Operating Partnership, investors' DST beneficial interests are converted into OP Units

6 The FMV Option may or may not be exercised. Therefore, investors should acquire a beneficial interest in a DST with the understanding that they may not ultimately receive OP Units, and the option consideration paid may be cash or OP Units.

Why choose a 1031 UPREIT program

A 1031 UPREIT program can be leveraged to help investors achieve multiple goals:

1

Plan for retirement. Investors can defer the realization of capital gains and other taxes on the sale of investment property until they are no longer earning income and can expect to be in a lower tax bracket.

2

Pass on assets tax-efficiently. Tax deferrals can continue until death, when heirs acquire the property with a stepped-up cost basis.

3

Remove the burdens of ongoing property management, such as building maintenance and repairs, rental administration and tenant management.

4

Maintain a real estate allocation through a passive investment in institutional-quality, professionally managed real estate.

If the FMV Option is exercised, investors receive OP Units in the REIT, which offers additional potential advantages:

- **Enhanced portfolio diversification** through exposure to a large professionally managed portfolio of institutional-grade real estate assets
- After holding OP Units for at least one year, investors gain access to **liquidity** as they may redeem their OP Units for cash or REIT shares based on the fair market value of their OP Units. Redeeming OP Units is not a tax deferred transaction.[7] However, investors often find peace of mind knowing they may have the option to redeem should they need liquidity.[8]
- As OP Unit holders, **investors do not need to conduct additional 1031 Exchanges to maintain continued tax deferral.**
- OP Units can be divided among multiple heirs, giving them each a **stepped-up cost basis** and the flexibility to determine when and how much to liquidate.

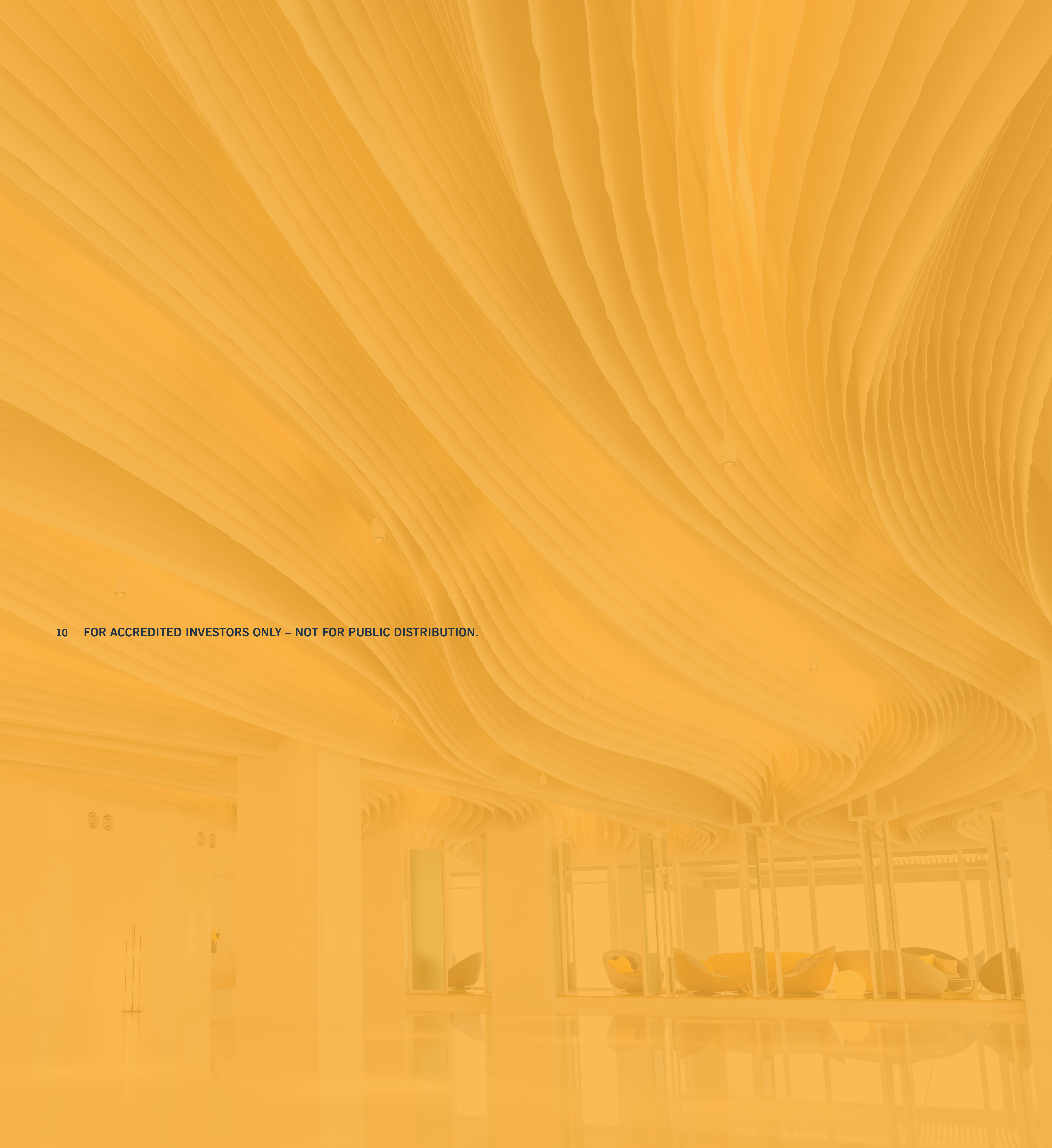
7 Subject to the terms of the limited partnership agreement.
8 REIT share redemptions are subject to the terms of the REIT's share repurchase program.

How to select a real estate manager for a 1031 UPREIT program

If the REIT's OP exercises its FMV Option and investors receive OP Units they should plan to hold those OP Units for as long as they wish to maintain their tax deferral. For that reason, investors should evaluate the REIT as a long-term investment. Below are some key factors to consider:

- **Balance sheet strength.** Evaluate whether the REIT has the financial strength to be able to pay OP unit holders a stable and attractive distribution and generate NAV growth over time.
- **Performance track record.** OP Units are likely to perform similar to common shares of the REIT. Although past returns are no guarantee of future performance, investors should examine the REIT's performance track record, including how well it has been able to withstand various real estate and economic cycles.
- **Diversification level.** Diversification protects investors from the decline in value of any single property or sector. Investors should consider the diversification level of the REIT and the composition of its overall real estate portfolio.
- **Sponsor organization.** REITs and DSTs are offered by a variety of sponsor companies whose real estate expertise and experience range widely. In addition to the sponsor's history and track record of real estate investing, evaluate the organization's history of honoring redemption requests and treating investors favorably overall.

1031 UPREIT programs offer investors a way to benefit from continued exposure to the growth and income-generation of the real estate sector – without the hassle of owning and managing a property. Many investors have used these programs to achieve their retirement planning, estate planning and overall tax-management objectives.



Both a 1031 Exchange and a direct sale involve market, leverage and sponsor/operating risks and should be considered when evaluating this program:

1031 Exchange includes the risk of failed exchanges due to non-compliance with rules, market downturns impacting the replacement property, limited liquidity, limited flexibility in how you use the sales proceeds, and potential future tax liabilities upon ultimate sale of the replacement property without another exchange.

Direct sales include the risk of exposure to market fluctuations and potential investment risks based on how the proceeds are reinvested.

Both methods involve different fees and costs associated with the transaction and should be carefully considered before making a decision.

If you are looking for a tax-deferred exit strategy for your real estate, speak to your financial professionals about whether a 1031 UPREIT may be right for you.

Endnote

This material is for educational purposes only. This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity.

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This material does not constitute tax advice. Investors should carefully consider the tax implications of these kinds of transactions. Operating partnerships issue K-1s for tax reporting purposes. Return of capital, depreciation and deductibility of REIT distributions may vary compared to common REIT shares. The tax implications of these kinds of transactions, as well as the structuring required to implement them, are complex. Investors should consult with their tax professionals to understand the tax implications for their specific situations. This communication includes a brief and general description of Section 721 and Section 1031 of the Internal Revenue Code. Transactions structured pursuant to these provisions are complex. All investors should consult their own tax advisors regarding the structuring of these transactions and their tax consequences as applicable to their particular circumstances.

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