

# WHAT IS AN IRC SECTION 721 UPREIT?

## "AN EXCHANGE ALTERNATIVE FOR COMMERCIAL INVESTORS"



### Compliments of

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 an exchange at the entity level, individual REIT shares are considered personal property and do not qualify for an IRC Section 1031 exchange. For tax deferral under §1031, an investor must exchange real property for other "like-kind" real property. There are many resources available on the internet to learn more about REITs, including the REIT industry trade organization, the National Association of Real Estate Investment Trusts at [www.nareit.com](http://www.nareit.com).

### WHAT IS AN UPREIT?

An Umbrella Partnership REIT (UPREIT), under IRC §721, provides tax deferral benefits to commercial property owners 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 investor 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 a viable exit strategy to commercial property owners who otherwise might have significant capital gain tax liabilities on the sale of appreciated property. In addition, the investor 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 investor as they must have property that the REIT wants to add to their portfolio and typically this will be a larger commercial property.

A hybrid of the above scenario has been developed for investors who perform a §1031 exchange into a tenant-in-common (TIC) ownership property that a REIT may acquire later. The TIC property can later be contributed into an UPREIT structure, allowing the §1031 investor to ultimately acquire OP Units that are essentially the equivalent to an interest in the REIT itself.

### 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 the following ways:

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



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