What’s UP with that? - by Kyle Kadish

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Investors have multiple tools to defer tax liabilities when selling investment properties. The best known is likely a 1031 exchange - which has been around in some form or fashion for over 100 years. Installment sales have existed as part of the code for more than 75 years. Newer legislation (2017) created Qualified Opportunity Zones (QOZs) - which have been discussed in these pages previously. One of the lesser-known strategies - with a long legacy of success - falls under IRC §721.

Generally, rules under 721 allow a taxpayer to contribute appreciated assets to a partnership in a nontaxable transaction. Transferring a single asset to an existing portfolio immediately diversifies an investor's holdings. Unlike a 1031 exchange, the rules around 721 are not exclusive to investment real estate - many use this strategy to remove a concentrated position efficiently (maybe you own 5,000 shares of AAPL stock). The rationale and economics of 721 are highly similar regardless of which assets contributed to the partnership.

Specific to investment real estate, the investor contributes property to an operating partnership of a Real Estate Investment Trust (REIT). Any REIT accepting contributions of property through a 721 transaction is considered an Umbrella Partnership Real Estate Investment Trust, or UPREIT. It is important to note that only some REITs are structured to receive property; even a percentage of the 1,100 existing REITs acquiring properties as an UPREIT is a large pool of potential buyers. Tax deferral is the beginning of multiple benefits an investor could recognize with this contribution.

As mentioned above, the 721 transaction is tax-free for the contributor. Ownership of the operating partnership units will remain free from gain and recapture throughout their holding period. The owner only creates a tax liability when selling the operating partnership interest in a taxable transaction. REITs often feature liquidity provisions not offered in direct real estate investments; increased liquidity options allow for partial conversion enabling the owner to manage their taxable gain systematically.

Contributing property to a REIT allows an investor to participate in a more extensive portfolio of passive, income-producing real estate. The investor immediately benefits from a portfolio diversified by multiple properties, locations, tenants, lease terms, and debt laddering. The REIT is responsible for all acquisitions, dispositions, management, accounting, reporting, and investor distributions. In addition, the expanded portfolio exposure will often further insulate distributions and cash flow. Furthermore, REITs provide high transparency and oversight through an independent board of directors.

A 721 contribution might be the right solution for estate and tax planning purposes. Family members can divide their operating partnership units, as well as partners of a partnership. This divisibility of operating partnership units permits some to hold and others to sell. The flexibility permits individualized tax and financial planning. Like other real property assets, heirs can receive units on a stepped-up basis.

As an investment, the owner has a benefit in the future economics of the REIT. Beginning with income, REITs must pay 90% of their taxable income in dividends each year. In addition, REITs can acquire properties on an ongoing basis and execute transactions or mergers with other real estate businesses. Entering a REIT through a 721 transaction provides an investor the potential for capital appreciation and distributions of operating income from the REIT's entire portfolio.

Real estate investors should consider a 721 contribution as a tax-efficient transaction when seeking an exit from property. Triple-net lease properties will generate the most interest by REITs actively acquiring assets through this mechanism. REIT exposure has exploded in the past decade in industrial, medical office, self-storage, data centers, and cell tower assets. Acquisitions have also been prevalent in residential and retail properties. The 721 transaction allows a UPREIT to acquire property with many benefits to the contributor.

Advantage Wealth Solutions believes investors can only maximize investment returns after minimizing tax liabilities. Our continuously expanding roster of real estate clients consistently seek multiple tax mitigation strategies.

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