General Information on REITs, UPREITs and OP Units

Introduction

A REIT (or Real Estate Investment Trust) is an entity that combines the capital of many investors to acquire or provide financing for all forms of real estate. A REIT serves much like a mutual fund for real estate with retail investors obtaining the benefit of a diversified portfolio under professional management. A REIT, like a mutual fund, generally does not pay corporate income tax. This is one of the most attractive aspects of a REIT since there is no double taxation of the income to the shareholder. In exchange, a REIT must distribute nearly all of its net income to its shareholders.

In 1992, a new form of REIT, the UPREIT (or Umbrella Partnership REIT), emerged to address potential taxes related to the sale of property to REITs. In the typical UPREIT, the partners in an existing real estate partnership and a REIT become partners in a new partnership termed the Operating Partnership. In exchange for their property interests, the existing partners receive units in the Operating Partnership (OP Units). An exchange of partnership interests generally does not result in a taxable transaction, and provides an attractive tax deferred exit strategy to sellers of real estate who may incur significant tax liabilities in a cash sale. The following discussion answers several frequently asked questions about UPREITs and the benefits of using OP Units for a tax-deferred exchange.

What are the benefits of a sale to an UPREIT?

A seller can benefit from certain tax deferrals when exchanging property or a property interest for OP Units in an UPREIT. Because an exchange of property interests for OP Units will generally not represent a sale for tax purposes, a seller should benefit from tax deferral, diversification, liquidity and an opportunity to do estate planning. This is particularly relevant to the acquisition of affordable housing properties such as those that were syndicated to investors seeking tax deferrals under the Section 8 and other tax driven programs in the 1970s. In many cases, investors in these projects typically no longer receive tax benefits and are being taxed on phantom income. Unfortunately, the capital gains taxes on the sale of such properties are often a major impediment to their disposition, because the economic value of the property is not sufficient to pay the taxes and retire the debt. An OP Unit exchange with an UPREIT allows for the deferral of the capital gains taxes and can facilitate such dispositions.

Typically, taxes remain deferred as long as the UPREIT holds the property and the seller holds the OP Units. The seller will have to recognize the capital gain if the seller elects to dispose of its OP Units or converts them into shares of the REIT. UPREITs that are long-term investors are favorable to sellers seeking long-term tax deferral.

Can a seller receive OP Units and cash as consideration from an UPREIT?

A well-capitalized UPREIT can invest in properties with cash, OP Units or a combination of both.

Cash	A cash investment would generally represent a taxable transaction to the seller.
Common OP Units	UPREITs can invest with Common OP Units. One OP Unit is generally equivalent to one share of common stock in the REIT and is generally convertible into common stock, usually at the discretion of the seller. Each OP Unit generally receives the same annual distribution of income as a share of common stock, and generally has the same upside or downside potential as shares of common stock of the REIT.
Preferred OP Units	Preferred OP units can be issued where a seller seeks a higher level of safety of principal and certainty of return. Preferred OP Units are generally redeemable at par, usually at the discretion of the seller. Preferred OP Units usually pay a fixed dividend, have a preference in liquidation, but are not convertible into REIT common stock. Thus, if the value of a REIT's common stock increases, Preferred OP Unit holders will not participate in any appreciation.

The choice of consideration in any given investment will generally be negotiated between the REIT and the seller.

How are OP Units valued?

OP Units are generally convertible into REIT common stock. While the marketplace values a public REIT's common stock, the Board of Directors generally establishes the price of the common stock of a private REIT. Valuation in a private REIT is ultimately based upon the quality of the real estate assets it acquires.

How long is the tax deferral?

Once a property is exchanged for OP Units, capital gains taxes that would be due if the property were sold for cash are generally deferred until: 1) the seller exchanges the OP Units for REIT common stock; 2) the seller exchanges the OP Units for cash; 3) the subject property is sold by the UPREIT. As long as the seller holds the OP Units and the UPREIT owns the property, the seller should maintain the tax deferral. UPREITs with long-term holding periods, e.g. 10 to 15 years, can provide sellers with a corresponding long-term tax deferral or a tax-planning period. Under current tax laws, the seller's taxable gain is generally eliminated by a step-up in basis for income taxes if the OP units are owned at time of death.

What is the difference between a Section 1031 transaction and an exchange with an UPREIT?

A Section 1031 (like-kind exchange) transaction is the tax-free exchange of an individual property for a similar property. Such transactions are generally more expensive, riskier and lack the diversification and potential liquidity benefits of an UPREIT transaction. With a Section 1031 exchange, the seller runs the risk of not being able to identify, negotiate and close the transaction on a timely basis. An exchange utilizing the UPREIT transaction provides sellers with a viable, tax-deferred alternative to Section 1031 exchanges.

Can OP Units be sold?

The common stock and corresponding OP Units issued by a public REIT are generally more liquid than those issued by a private REIT. Therefore, private UPREITs will typically facilitate the exchange of OP Units for REIT shares or for cash, either through purchase by the UPREIT itself or by arranging negotiated sales to third parties.

An UPREIT's liquidity policy for Common OP Units can include the following:

- **Free convertibility.** Common OP Units can usually be converted into shares of common stock at the holder's option.

- **Annual repurchase option.** Many REITs provide a repurchase option for holders up to a fixed percentage (e.g., 10% or 20%) of a holder's initial Common OP Unit holding.

- **100% repurchase option on death.** Upon the holder's death, an UPREIT can, at the estate's election, repurchase all Common OP Units at fair market value.

An UPREIT's Preferred OP Units are generally redeemable at par. Terms and redemption options are negotiated on a case-by-case basis.

Can OP Units be used as collateral for a loan?

In certain conditions, OP Units may be pledged as collateral for a borrowing by the holder, thereby achieving some liquidity while still maintaining the tax deferral.