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Tax-Efficient Real Estate Sales

Over the last decade, high-net-worth individuals and family offices have increasingly been focused on direct investing in real estate. In general, those investments have yielded strong returns during what has been an unprecedented economic expansion. Now, as many forecasters are predicting a relatively near-term slow-down for this cycle, investors may be looking to exit their investments in real estate. In that regard, sellers of real estate should be mindful of these common techniques for minimizing the tax impact of real estate dispositions.

Real Estate Provides Significant Natural Tax Shelter

While this article focuses primarily on real estate disposition strategies, the starting point for analyzing real estate dispositions is that real estate ownership generally provides significant tax benefits during the ownership period. In general, the owner of investment real estate is entitled to take depreciation expense deductions, which reduce the owner's taxable income attributable to ownership. Frequently, even though a real estate investment is producing positive cash flow, the investment is generating little to no taxable income as a result of the depreciation expense deductions. When real estate is disposed, however, the disposition generally results in taxable gains, including "recapture" of prior depreciation expense. As a result, even if a property is sold for no gain or loss (measured by initial purchase price), the owner may be subject to tax on sale. Further, depending on whether the owner has borrowed a portion of its purchase price, the amount of tax due on sale can potentially exceed the owner's cash proceeds. Accordingly, when considering sale of a real estate investment, the strategies outlined below may be extremely beneficial.

1031 Exchange

The classic tax deferral strategy for selling real estate is known as a "1031 exchange." This technique is aptly named after Section 1031 of the Internal Revenue Code, which allows a seller of real estate not to recognize gain or loss on the sold property to the extent the real estate is exchanged for like-kind real property of at least equal value.

While they may have minimal utility to traditional private equity fund investors that are required to return capital to their investors on a fairly short timeframe, 1031 exchanges are an excellent strategy for high-net-worth individuals and family offices that are engaged in longer-term deployment of capital. That is because 1031 exchanges allow the investor to dispose of a particular real estate asset in exchange for another, without incurring tax at the time of the exchange.

There are a number of technical statutory requirements to properly complete a 1031 exchange, including the following (among others):

- There must be a reciprocal transfer of property, as distinguished from a transfer of property for cash only. In other words, the relinquished property must be exchanged for the replacement property rather than sold for cash that is used to buy the replacement property. In this regard, the seller must not have actual or constructive receipt of the proceeds from the sale of the relinquished property.
- Both properties must be held for productive use in a trade or business or for investment — but they cannot be held primarily for sale, and personal residences do not qualify.

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- Both properties must be of a "like-kind." This is interpreted broadly and, generally, all real estate located in the United States is considered "like-kind" as to other real estate located in the United States.
- In order to mitigate the challenges of directly exchanging property for property, however, applicable rules permit a "qualified intermediary" to hold the cash proceeds from the sale of relinquished property and use those proceeds to acquire replacement property as long as:
  - » The replacement property is identified within 45 days after the sale of the relinquished property.
  - » The replacement property is acquired within 180 days after the sale of the relinquished property (or by the tax return due date for the year in which the relinquished property is transferred, if earlier).

Alternately, the transaction can be structured as a so-called reverse 1031 exchange, whereby the new or "replacement" property is acquired first, and then the relinquished property is identified within 45 days, and sold within 180 days, thereafter. This is convenient in competitive or opportunistic acquisition situations where the buyer needs to move quickly, but it does put pressure on the execution of the sale promptly thereafter.

It is important to remember that 1031 exchanges are tax-deferred transactions, not tax-free transactions. If and when the replacement property is ultimately sold (not as part of another 1031 exchange), the original deferred gain, plus any appreciation since the acquisition of the replacement property, will be subject to tax.

Contribution to an Operating Partnership

Another tax deferral technique that may be attractive to high-net-worth individuals and family offices is to sell, or contribute, real estate to an umbrella partnership real estate investment trust (UPREIT). An UPREIT is a partnership that is typically structured with a publicly traded REIT as the general partner, and investors as limited partners. The UPREIT, in turn, directly or indirectly owns a large portfolio of properties.

In exchange for its contribution of real estate to the UPREIT, the contributor receives operating partnership units (OP units) in the UPREIT. The OP units have many of the same features as REIT shares, and they can even be converted to REIT shares at the contributor's election (often subject to timing and other restrictions).

There are a number of benefits to this type of transaction, including the following:

- The contributor is not required to recognize gain upon the contribution of real estate to the UPREIT.
- The contributor receives many of the same benefits as owning REIT shares, including diversification, current cash flow, participation in equity appreciation and, upon exchanging OP units for REIT shares, liquidity associated with owning a public security.
- In the case of a contributor that is an individual, OP units are a useful tool for estate planning because, upon death, the contributor's estate is entitled to step up the tax basis in its OP units, thereby potentially permanently avoiding tax on the built-in gain allocable to the contributor with respect to the real estate contributed to the UPREIT in exchange for the OP units.

As with 1031 exchanges, it is important to remember that OP unit transactions are tax-deferred transactions. In general, that tax is deferred until the contributor sells the OP units or converts them to REIT shares or until the UPREIT sells the applicable property. However, when structuring an OP unit transaction, it is extremely important to focus on a number of tax accounting matters, relating to, among other items, depreciation methods and allocation of indebtedness of the UPREIT, which can result in earlier tax on the deferred gains.

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