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BUILDING VALUE

Investors Broaden Reach With 1031-721 Exchange

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If you like 1031s, you're going to love 721s.

As the market for 1031 exchanges is growing, so are the options for individual real-estate investors who conduct them. The latest is the 1031-721 exchange.

In 1031 exchanges, real-estate owners defer capital-gains taxes on the sale of property by purchasing another property of equal or greater value, according to rules set by the Internal Revenue Service. One variation is 1031 fractional exchange programs, also known as tenant-in-common programs, which allow sellers to make an exchange by buying an interest in a real-estate property as opposed to an entire property. Each investor receives proportional fractional distributions of the income generated from the property.

Now, some real-estate companies are broadening the reach of individual investors even more by allowing them to exchange full or fractional ownership in a single property for partnership units in a large portfolio of investment-grade properties. Known as real-estate investment trust operating partnership units, these can even later be converted into REIT stock.

REAL INTEREST

Ever since the IRS issued guidelines in March of 2002 for investors conducting tenant-in-common 1031 exchange programs, the market for such programs has grown. The programs allow people to exchange a real-estate property for an interest in another property. They can benefit smaller investors who otherwise might not have been able to buy a huge real-estate asset on their own or who didn't want the responsibility of day-to-day property management. However, in these structures, any sale, leasing, financing or hiring of a manager at the property must be approved by unanimous vote. Chart shows amount of tenant-in-common exchanges.*

These kinds of exchanges aren't new. Large, mostly institutional investors have long conducted such exchanges, mainly because it was often unlikely that a REIT would want the kind of properties owned by individual investors. But now some programs, like the one recently launched by Denver-based REIT Dividend Capital Trust, are offering individual investors the chance to conduct 1031-721 exchanges.

A 721 exchange generally works like this: An investor sells a property and buys a replacement property or a tenant-in-common interest, then after a period of time exchanges the property or interest for operating partnership units in a REIT. Investors still defer taxes because the exchange for units wouldn't trigger capital-gains taxes. And they receive dividends.

A REIT also can decide to sell tenant-in-common interests in a property it owns or is planning to buy. The investor who sells a property and buys an interest being sold by the REIT would, after a period of one to five years, have the right to convert the interest into REIT operating partnership units. In both scenarios, the investor has the option of converting the operating partnership units into REIT shares. Dividend Capital Trust sometimes assists the investor in identifying a replacement property it would be interested in eventually buying, or a tenant-in-common interest in a property the REIT would want to own.

"You are sharing in a pool of properties [in terms of the REIT's portfolio], not just one," giving the investor diversification, says Louis S. Weller, a principal at Deloitte & Touche LLP's national real-estate tax services group in San Francisco.

While investors doing this get diversity in terms of investments, there also is risk. For one thing, there's a loss in the investor's ability to keep exchanging. You cannot exchange back the operating partnership units for ownership or fractional ownership in a single property. You can only convert the units into REIT shares. And taxes will be incurred in that transaction.

There's also the risk of the REIT executives managing the properties badly, or some of the properties in the portfolio performing poorly, which could drag down the overall portfolio and the value of the ownership units. It also exposes the investor's investment to stock-market whims, not just property performance.