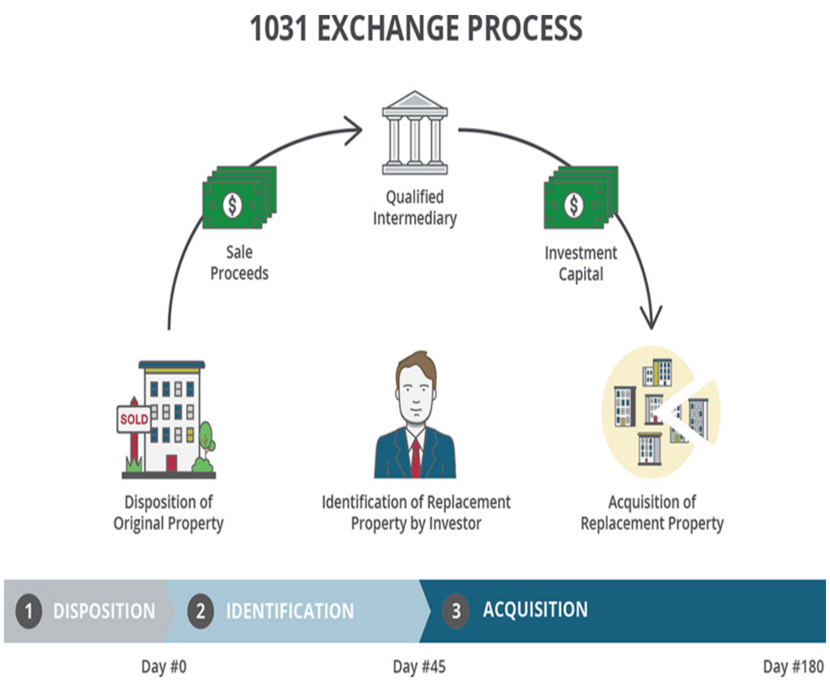
What is an UpREIT?

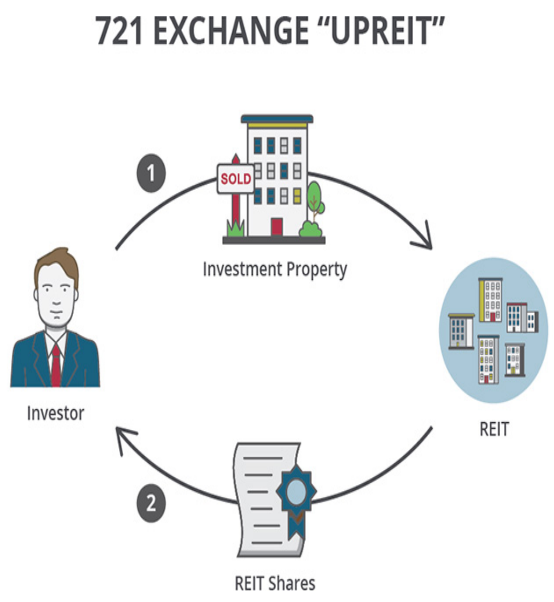
1031 Exchange vs. 721 Exchange

Most People know about a 1031 Exchange. 1031's are great for tax deferral – if: You want take the proceeds from a sale to place into another property. If relocation or retirement are part of the equation 1031's do not hold much value. A 721 exchange may be more appropriate.

1031 Exchange



721 Exchange



What is an UPREIT?

The term UPREIT (short for "Umbrella Partnership Real Estate Investment Trust") refers to an entity structure that has been used by REIT's since 1992 to allow selling property owners the ability to convert their ownership of one or more of their specific real estate properties into an interest which is, immediately, or can ultimately be converted into, a private or public security.

In the basic UPREIT structure, all REIT properties are acquired and owned directly or indirectly by its "umbrella partnership." The umbrella partnership is the entity through which the REIT operates and collects all income from the properties, which is why the umbrella partnership is commonly referred to as the "operating partnership." Thus, the REIT does not directly own any real estate properties in the UPREIT structure, rather it owns substantial interests in the operating partnership by being both its sole general partner and one of its limited partners.

In the case of our structure, Nexus Capital Real Estate, Inc. is the REIT and the managing member of Nexus Capital Real Estate, LLC, which is the "operating company" of the REIT.

What is an UPREIT transaction?

The partners of the operating partnership ("OP Unit Holders") are former property owners who took part in an "UPREIT transaction." In an UPREIT transaction, property owners contribute their properties in exchange for ownership units in the operating partnership ("OP Units").

The UPREIT structure allows for UPREIT transactions, and UPREIT transactions provide an attractive tax deferred exit strategy for owners of real estate who will recognize a significant taxable gain in a cash sale of a highly appreciated property with a low tax basis. If real estate is sold or contributed directly to the REIT, it would result in a stepped-up cost basis in the property for the REIT and a taxable event for the contributing property owner. However, by contributing the property to the operating partnership instead of the REIT, the contributing property owner's historical cost basis is maintained.

Indeed, the primary incentive for a selling property owner in entering into an UPREIT transaction is that it can be completed on a tax deferred basis. Again, the owner of the property being contributed to the operating partnership does not recognize immediate gain on the transaction because the owner does not acquire shares of stock in the REIT, but rather receives OP Units in the REIT's operating partnership. In addition, if the OP Units end up in the owner's estate, the ultimate recipients of the OP Units will receive a stepped-up basis equal to the value at death and the inherent gain resulting from the UPREIT transaction will not be subject to capital gains or income tax. The tax deferral or avoidance, as the case may be, gives REIT's utilizing the UPREIT structure a large advantage over cash purchasers of real estate.

While tax deferral/avoidance may be the primary incentive to entering into an UPREIT transaction, there are many other great benefits for selling property owners as a result of completing an UPREIT transaction.

Benefits of an UPREIT

- Provides a viable tax deferral/avoidance exit strategy to property owners facing significant capital gain tax liabilities on the sale of appreciated property with a low tax basis
- Diversification of real estate holdings (i.e., OP Unit Holders have an interest in a portfolio of properties instead of just one)
- Potential to convert liquid, long-term assets (i.e., real estate) into more saleable securities (i.e., OP Units → REIT Share → Cash)
- No property management responsibilities or concerns
- Quarterly income distributions
- Potential to recognize unrealized gains as earnings
- Professional management and expertise in capital markets
- Avoids risk of negative cash flow
- Estate simplification
- Allows the owner to dispose of its property in a way that maximizes its value
- Improved cash position through potential leveraging of OP Units

One of the more notable benefits of an UPREIT transaction is that, in becoming an OP Unit Holder, the property owner essentially converts an interest in one or more specific properties into an interest in a larger and more balanced portfolio of properties. The operating partnership's portfolio is often diversified as to property type and geography, and usually benefits from the economies of scale and management that a larger entity can offer.

Also noted as one of the more important benefits of an UPREIT transaction, is that such a transaction allows an interest in liquid real estate properties to become more easily saleable. This is because OP Units may be converted, subject to minor restrictions, on a one-for-one basis for shares of common stock of the private or publicly-traded REIT. While such a conversion to stock may trigger recognition of taxable gain, the flexibility permits the owner to unlock value and access capital as needed.

How are OP Units valued?

As mentioned above, OP Units are convertible on a one-for-one basis with shares of stock in the REIT. However, REIT shares essentially determine the value of OP Units. The price of common stock for a publicly traded REIT is valued by the marketplace. The price of common stock for a private REIT is generally established by its board of directors, but it is valued ultimately based upon the quality of the real estate assets it acquires.

Distributions

OP Unit Holders receive distributions equal to the dividends paid on the REIT shares.

Can OP Units be sold?

REIT's will typically facilitate the exchange of OP Units for REIT shares or for cash, either by purchasing the OP Units itself or by arranging sales to third parties. However, property owners contemplating the use of an UPREIT transaction should plan on a long-term hold (e.g., 5-7 years) of the OP Units in order to make full use of the tax shelter they provide.

Can OP Units be used as collateral for a loan?

Yes, in certain conditions, OP Units may be pledged as collateral for a borrowing by the OP Unit Holder, thereby achieving some further liquidity while still maintaining the tax deferral.

Who are good candidates for UPREIT transactions?

An UPREIT transaction makes sense if a property owner is looking to achieve one or more of the following: (a) defer capital gains tax when appreciated real estate is sold; (b) eliminate management hassles of owning real estate; (c) diversify through ownership of a portfolio of properties; (d) upgrade to institutional quality real estate; (e) receive consistent quarterly income. In addition, the following real estate holdings are good candidates for an UPREIT transaction:

- Family-owned properties with unresolved succession issues
- Properties with third-party tenants
- Partnerships that need to be dissolved
- Long-term assets with very low basis
- Surplus property generated by consolidations
- Property owners concerned they have too much of their net worth tied up in real estate