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Taxes

This less-used tool in real estate investing might serve you better than the more popular 1031 exchange.

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For investors looking for a way to defer capital gains taxes when selling a real estate investment property, there are a variety of strategies to leverage depending on circumstances.

Usually, a 1031 exchange comes to mind; however, an often-underutilized tool that

also the potential for further diversification.

By executing a 721 exchange, an investor can expand their real estate portfolio across a range of assets worth millions or even billions of dollars. This allows them to diversify their holdings instead of being limited to owning just one or two properties.

In contrast, 1031 exchange rules allow investors to defer capital gains taxes by exchanging one (or more) physical investment properties for another of equal or greater value. This method is often used by investors looking to diversify their real estate portfolio without incurring immediate tax liability. However, the investor must reinvest in a like-kind investment property. Like-kind property refers to a property with the same character or nature or that is part of the same class. The property's grade or quality does not matter.

Most real estate properties will be like-kind to other properties. The initial property may be a multifamily housing complex, and you could exchange it for an industrial warehouse property. Many clients leverage Delaware Statutory Trusts (DSTs) as an investment vehicle, as they offer a turn-key solution that qualifies for 1031 exchanges.

A DST is a legal entity with a flexible approach to the design and operation of the entity. Investors own a pro rata interest in the trust and have the right to receive interest and distributions based on their investment in the trust. This form of real estate ownership allows an investor to enjoy the perks of a real estate allocation without the headaches of direct real estate ownership, like property upkeep and tenants. DSTs can hold one or multiple properties to offer additional exposure for investors and a ready-made solution for a 1031 exchange.

On the flip side, investors relinquish a level of control around the management of the property and have limited liquidity, making it difficult to cash out of the DST.

However, some investors may want to consider utilizing a 721 UPREIT over a DST

Although something to keep in mind is that non-traded REITs have varying redemption plans, so liquidity isn't a guarantee. Additionally, liquidity can be further restricted, as an investor's ability to sell shares is often determined by the fund manager.

Older investors who have completed DST 1031 exchanges throughout their life could be attracted to the idea of moving into 721 UPREIT exchanges. Perhaps they are tired of completing the exchange process every five to 10 years and are ready to prepare for a completely hands-off experience.

Although, once you complete a 721 exchange, you are no longer able to continue exchanging. Any movement of money from the UPREIT will be a taxable event going forward. Meaning if you decided to convert your OP units to REIT shares for potential liquidity, that would be a taxable event. Since this is the case, there is no longer an option to participate in the appreciation of the assets until you pass them on to your heirs. Investors looking to continue exchanging to participate in realized appreciation may prefer a DST.

We also see investors choose DSTs over UPREITs if they aren't interested in further diversification. If you have been investing in multifamily apartment complexes throughout your career, there may be a particular DST asset you believe in after completing the proper due diligence. You may disagree with the REIT's acquisition strategy and want to have control over the particular asset or assets you invest in.

REITs are generally open-ended investment pools where the assets are deployed totally at the managers' discretion, and investment objectives and strategies may shift over time.

Lastly, both 721 UPREITs and DST 1031 exchanges offer an option for investors to

while a 1031 exchange offers more limited options for diversification, it allows investors to continue reallocating their real estate portfolio without incurring immediate tax liability.

ABOUT THE AUTHOR

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