

721 Exchanges: Ending the 1031 Snowball

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Imagine a seamless transition from the burdens of property management to a diversified portfolio, all while maintaining your passive income stream. The 721 exchange program offers real estate investors a unique opportunity to reallocate their assets into more varied investment vehicles without triggering immediate capital gains taxes. This solution not only eases landlord responsibilities but also enhances portfolio diversification. If you are considering a 721 exchange, start with Evergreen to explore potential options within your individualized financial plan.

What is a 721 Exchange?

A 721 exchange, also known as a UPREIT (Umbrella Partnership Real Estate Investment Trust), allows property owners to contribute their property into an Operating Partnership (OP) in exchange for OP units. These units can then be converted into REIT (Real Estate Investment Trust) shares, providing a tax-deferral mechanism similar to a 1031 exchange. Here are the boilerplate steps for a 721 exchange process:

Before: Investor owns real estate property.

- The investor owns the real estate property outright. This property is used for investment or business purposes and is eligible for a tax-deferred exchange. A sale takes place, and funds are sent directly to a qualified intermediary (QI).

During: Investor exchanges property for OP units.

- With the same timeline-related rules as a 1031 exchange, the investor has 45 days to identify a replacement investment and 180 days to close. To pursue the 721 exchange, it is necessary that the proceeds are contributed to an entity that owns a larger-scale real estate investment which a REIT will eventually buy (often called a "DST"). These are usually multi-family apartment buildings which are purchased through pooling assets and run by the same manager as the REIT so that they can strategically purchase the property at a later date.
- The investor then transfers their ownership of the DST property to an Operating Partnership (OP) managed by a Real Estate Investment Trust (REIT). In exchange, the investor receives OP units, which represent a proportional ownership interest in the OP.

After: Investor converts OP units to REIT shares.

- After a required holding period (typically one year), the investor can convert the OP units into REIT shares. These REIT shares can be sold and the proceeds can be used how the investor sees best fit. (These withdrawals are a taxable event, in proportion to the piece taken out.)

The Benefits:

Why might a real estate investor opt for a 721 exchange program rather than holding onto their current property or a 1031 exchange?

1. **Relief from Landlord Duties:** A primary motivator is to relieve themselves of landlord duties that can be time-consuming, expensive, and frankly a headache. While it's possible to hire property managers, property managers are still the ultimate responsibility of the landlord and don't always meet expected standards while reducing the landlord's net cash flow. Both the DST and the REIT handle all operations regarding the properties. While issues can arise, you are not on the hook for difficult conversations or late-night emergencies like fixing a flooding sink. These removed responsibilities allow the investor to focus on other aspects of life.
2. **Mitigation of Concentration Risk:** Another reason an investor may choose a 721 exchange option is to address concentration risk. If there are concerns that their current investment property will retain its value in the future or maintain occupancy rates in declining markets, a 721 exchange allows you to swap targeted real estate investment in a single location for an investment-grade, diversified real estate portfolio across various industries and geographical markets.
3. **Liquidity Management:** The third compelling reason to consider a 721 exchange is its effectiveness in managing liquidity needs. After three (sometimes 4) years, an investor transitions from owning a physical building to holding shares in a REIT, a shift that facilitates fractional ownership but can complicate partial sales of real estate assets. Should the investor require access to a portion of their investment, they can selectively liquidate only the necessary amount, starting with the cost basis to optimize tax implications. Unlike direct property ownership, many REITs offer periodic liquidity options, such as monthly or quarterly, enhancing flexibility and easing the process of adjusting investment exposure according to financial requirements.
4. **Legacy Planning:** Lastly, a compelling reason to use 721 exchange programs is for legacy planning. Physical real estate can be hard to divide. If the final intention is to gift real estate to heirs, a 721 exchange takes pressure off personal representatives, minimizes potential conflicts of interest, and allows for a step-up in basis to wipe the capital gains slate clean. If potential heirs don't get along, this avoids putting them through a real estate transaction.
5. **Consistent Cash Flow:** Importantly, you continue earning pass-through income, which is reported on a **K-1** or **sometimes a 1099** for tax purposes, without the need to manage tenant contracts. REITs are required by tax law to distribute at least 90% of their taxable income to shareholders annually in the form of dividends. This income can come from various sources, including rental income, capital gains, and other types of real estate-related income.

Reasons Against a 721 Exchange:

1. **Management Control:** The most obvious reason to avoid a 721 exchange is the reluctance to hand over the reins on oversight and management of real estate investments. Investors accustomed to direct control might find the relinquishment of management duties unsettling.

2. **Timing:** If you don't have a three-year time horizon and need liquidity sooner, the 721 exchange process, which takes three years, might not be suitable. The extended timeframe can be a significant drawback for those needing quicker access to their capital.
3. **Debt Considerations:** If your investment real estate carries significant debt, you may not be an ideal candidate for a 721 exchange. It's crucial to have a detailed discussion with your fund manager and tax accountant if your property is leveraged.
4. **Complex Ownership Structures:** If your investment real estate has multiple owners and layers of ownership, it can complicate the exchange process. Entities such as partnerships or LLCs can participate in a 721 exchange, but the process may be more complex compared to individual ownership. Disentangling multiple ownership interests to make it work can be challenging. It is crucial to consult with a tax advisor to navigate these complexities and ensure the exchange is executed properly.

While there is no perfect answer for capital gains, the 721 exchange option not only addresses tax deferral opportunities but also adds benefits that appeal to retired real estate investors. Leveraging a 721 exchange as part of a comprehensive financial strategy can offer significant advantages for real estate investors seeking tax deferral and portfolio diversification. However, evaluating this solution requires careful consideration of various factors, including the investor's overall financial plan, lifestyle needs, and future goals. This is where the expertise of a CERTIFIED FINANCIAL PLANNER® becomes invaluable. We can conduct a thorough analysis of the investor's financial situation, assess current income needs, and project future cash flow requirements. By doing so, real estate investors can determine how much cash flow the real estate investment must generate to sustain their lifestyle and achieve long-term objectives. Additionally, a CFP® can navigate the complexities of the 721 exchange process, ensuring compliance with tax regulations and optimizing the investment structure. With guidance, investors can confidently incorporate a 721 exchange into their financial strategy, aligning their real estate holdings with their broader wealth management goals. If you are considering a 721 exchange, start with Evergreen to explore potential options within your individualized financial plan.

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