

FORTITUDE INVESTMENT GROUP



THE INVESTOR'S GUIDE TO A 721 EXCHANGE

For real estate owners contemplating an Investment Property exit strategy or seeking to manage their tax liabilities, the 721 Exchange, also known as an UPREIT transaction, presents a compelling opportunity. This strategy allows property owners to exchange real estate or Delaware Statutory Trust (DST) interests for Operating Partnership Units (OP Units) in a Real Estate Investment Trust (REIT).

Similar to the 1031 Exchange, a 721 Exchange offers a sophisticated approach to real estate investment and estate planning by enabling the investor to defer capital gains and depreciation recapture taxes while also gaining access to a diversified investment portfolio of institutional quality properties.

- 721 EXCHANGES



REITs and UPREITs

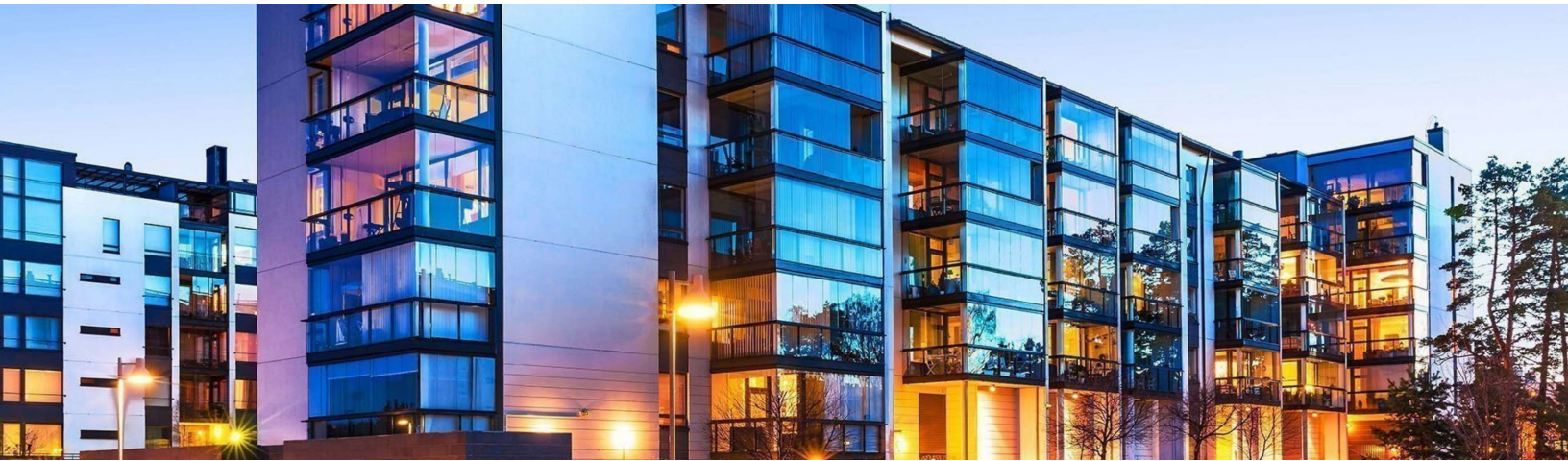
Real Estate Investment Trusts (REITs) are investment vehicles that own, operate, and manage a diversified portfolio of real estate assets. They offer public investors a way to participate in the real estate market without directly owning property. Most investors are familiar with REITs that are listed on the public market. Publicly-traded REITs are highly correlated with the stock market and are subject to market volatility.

Umbrella Partnership REITs (UPREITs) are a variation of the REIT model structure that involves an operating partnership (the “Umbrella Partnership”) in which the REIT holds a majority interest. UPREITs are valued based on Net Asset Value (NAV) audits and property appraisals, tend to be either Publicly Listed Non-Traded (PLNT) or Private REITs and require investors to be accredited. In contrast, UPREITs have a low correlation to the publicly traded markets.



The 721 Exchange

REITs have historically and continue to focus on institutional caliber assets for their 721 exchanges. This largely excludes smaller individual investors from participating in a direct property for OP Units, 721 exchange. In response, the DST space has evolved as the “bridge” between individual investors and a REIT OP Unit investment.



DST 721 Process:

- 1. 1031 Exchange into DST:** Investors initially use a 1031 Exchange to acquire DST Interests. DSTs are fractional interests in real estate that allow for tax deferral on gains from a previous property. These DST interests are offered by a REIT that is acting as a DST sponsor. The DST interest hold periods tend to range from 2-10 years.
- 2. 721 Exchange into REIT:** Since the DST's property/portfolio aligns with the REIT's acquisition strategy, the REIT eventually purchases the DST property up into the REIT and investors can contribute their DST equity interests to the REIT in exchange for OP Units.



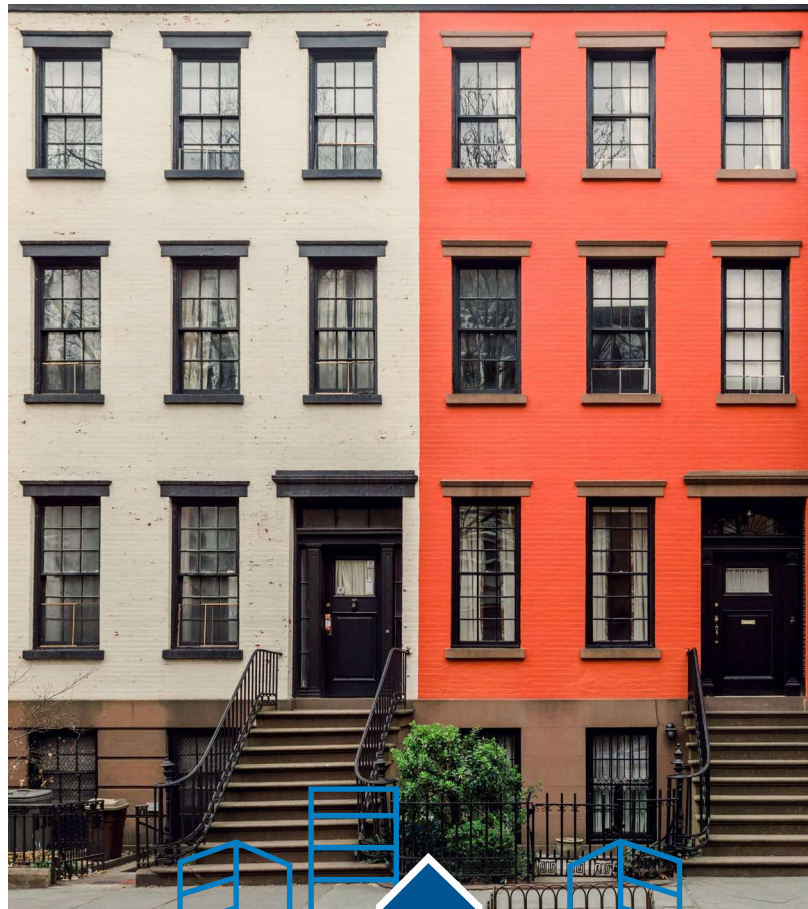
Tax Incentives for Savvy Investors

Structured UPREIT DST:

In a Structured UPREIT DST offering, the entire equity investment from the DST is transferred to the REIT, and investors receive Operating Partnership (OP) units instead of cash. Investors cannot cash out or participate in future 1031 Exchanges with this capital. This setup benefits the REIT by providing additional capital to acquire new or recapitalize existing assets, effectively “dropping down” the property from the REIT’s balance sheet.

Optional UPREIT DST:

This option is the most flexible of all DST’s available since at the end of the DST hold period, investors can cash out, 1031 exchange into another DST or back into investment property, and they also have the option of receiving UPREIT OP units in exchange for their DST interests. REITs that offer this type of DST are generally focused on acquiring new properties and are willing to issue OP units to investors in exchange, but do not mandate it.



Advantages of the 721 Exchange

Tax Deferral: Capital gains and depreciation recapture tax deferral enables investors to reinvest 100% of their exchange proceeds into a diversified real estate portfolio.

Liquidity: OP Units can be converted into REIT shares and redeemed back to the REIT, offering investors liquidity options that are not available with individual properties or DST Interests. Redemption windows are typically open quarterly and are subject to UPREIT guidelines. Unit redemption is restricted through the first 12 months after the 721 exchange.

Gain Realization Control: After the initial 12-month hold, OP Unit holders can choose if and when to convert their OP units to REIT shares and redeem them back to the REIT for cash. This provides investor control over if and when they will realize their capital gains. Heirs receive a stepped-up basis upon an estate event.

Diversification: UPREITs typically own a variety of property types across different markets, which reduces concentration risk and provides exposure to multiple real estate sectors. Since PLNR and Private UPREITs have the advantage of low correlation with the stock market volatility, their managers are more likely to focus on long-term investment goals than public REITs which must pay closer attention to short term fluctuations.

Estate Planning Benefits: Heirs inheriting the REIT units can immediately redeem them with minimal or no capital gain taxes at the stepped-up basis. Traditional DST's without an UPREIT option are less liquid and investors and their heirs are expected to adhere to the sponsor's prescribed hold period, regardless of an estate event.

Simplified Tax Reporting: Investing in a REIT simplifies the tax reporting process for 721 Exchange investors. REITs often handle the calculation and tracking of depreciation, and file composite state tax returns. This reduces the complexity and administrative burden associated with multi-state tax filings, which is often a challenge for individual property owners or DST investors.



Evaluating REITs

When considering a REIT investment through a 721 Exchange, several factors should be assessed:

Acquisition Principles: A disciplined acquisition strategy with a clear pipeline of opportunities is essential for long-term growth. Avoid REITs that raise capital too quickly without a strategic plan for deploying it.

Alignment of Interests: Ensure that the REIT managers' interests align with those of investors. Consider their level of co-investment and the structure of their fees. Managers should be incentivized to grow the REIT's value and make acquisitions that benefit investors. If consistent passive income is your priority, choose a REIT focused on stable distributions rather than speculative assets.

Adjusted Funds from Operations (AFFO): Examine the REIT's AFFO history and current performance. AFFO provides insight into the REIT's ability to cover dividends and maintain financial stability. Consistent and adequate dividend coverage is crucial to avoid potential value dilution.

Balance Sheet Strength: A strong Debt Service Coverage Ratio and ample liquidity indicate a REIT's ability to handle financial obligations and capitalize on acquisition opportunities. A robust balance sheet supports flexibility and stability.

Macroeconomic Positioning: The REIT should have a diversified asset base designed to weather various economic conditions. This diversification helps mitigate the effects of market volatility and can help ensure stability across economic cycles.

Moderate Leverage: Evaluate the REIT's use of leverage. Excessive leverage can increase financial risk and lead to refinancing pressures. A moderate approach to leverage typically provides a better balance between risk and return.

WALT and WADT: High Weighted Average Lease Term (WALT) and Weighted Average Debt Term (WADT) contribute to portfolio stability. These metrics indicate the REIT's ability to manage lease expirations and debt maturities effectively. A well-coordinated approach ensures that assets and liabilities are balanced, reducing financial sensitivity to rate fluctuations.



Risks and Considerations



Market Risk:

REIT investments are subject to market fluctuations and the performance of the underlying real estate assets. Ensure that the REIT's portfolio is well-managed and diversified.



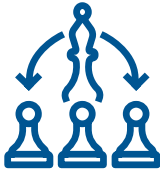
Liquidity Risk:

There may be limitations on transferring or liquidating DST Interests and OP Units. Assess the liquidity options available and the REIT's policies on conversions and redemptions.



No Future 1031:

Once a 721 exchange takes place the investor can no longer perform future 1031 exchanges with that capital.



Tax Risks:

Converting OP Units to REIT shares triggers a taxable event. Additionally, future changes in tax legislation could impact the benefits of 1031 Exchanges and step-up in basis provisions.



UPREIT Conversion from DST

If the DST rolls up into an UPREIT structure, the investor's interests in the DST typically convert into units in the REIT's operating partnership. This transition is often structured to avoid immediate tax recognition, maintaining the deferred gain on the original 1031 exchange. However, this deferral remains contingent on the REIT holding the specific property or other qualifying properties.

Tax Liability on REIT Property Sale

When the REIT eventually sells the property acquired during the DST phase, the event triggers a taxable sale. The original investor may now owe taxes on any deferred capital gains and depreciation recapture from the initial 1031 exchange. This can be a surprise, as investors often expect that moving into a REIT through an UPREIT roll-up maintains indefinite tax deferral, similar to holding replacement property in a 1031 exchange.

Implications for Investors

If the property is sold:

Capital Gains Tax: The investor is subject to capital gains tax based on the gain deferred through the original 1031 exchange, plus any appreciation in value.

Depreciation Recapture: Depreciation recapture tax will apply based on the amount of depreciation taken on the original property and any taken during the DST phase.

Potential State Taxes: In some cases, state taxes may also apply, especially if the REIT-owned property is located in a state that taxes capital gains on real estate.

Avoiding Immediate Tax by Retaining Units

An investor who chooses to retain operating partnership units rather than converting them into REIT shares may be able to continue deferring taxes, even after a property sale, but only until they ultimately dispose of or redeem those units.

In summary

The sale of property by a REIT, initially held through a DST and converted into an UPREIT structure, can trigger a taxable event that eliminates the capital gains deferral. It's crucial for investors to recognize this risk and plan accordingly, often with the advice of tax professionals, to potentially mitigate or prepare for the tax liability.



In Conclusion

By exchanging property or DST interests for OP Units in a REIT, investors can benefit from enhanced liquidity, a diversified real estate portfolio and favorable tax treatment. However, the complexity of this strategy requires careful consideration and consultation with financial, legal, and tax advisors.

Explore Your Options

You can access our investment offerings on our website, www.1031DST.com, at your convenience, or feel free to **schedule a meeting** with our team any time!



Important Disclosures

This is for informational purposes only and does not constitute an offer to purchase or sell an investment.

This material is not to be interpreted as tax or legal advice. Please speak with your legal and tax advisors for guidance regarding your particular situation.

Because investor situations and objectives vary this information is not intended to indicate that an investment is appropriate for or is being recommended to any individual investor.

Potential cash flows/returns/appreciation are not guaranteed and could be lower than anticipated.

Diversification does not guarantee a profit or protect against a loss in a declining market. It is a method used to help manage investment risk.

There are material risks associated with investing in private placements, Delaware Statutory Trusts (“DSTs”) and real estate securities including the potential loss of the entire investment principal, illiquidity, tenant vacancies impacting income and revenue, general and real estate market conditions, lack of operating history, interest rate risks, competition, including the risk of new supply coming to market and softening rental rates, general risks of owning/operating commercial and multifamily properties, short term leases associated with multi-family properties, financing risks, potential adverse tax consequences, general economic risks, development risks, long hold periods, and investors should read the PPM carefully before investing paying special attention to the risk section.

Risks associated with 1031 exchange- A 1031 exchange has an identification period of 45 days from the sale of the relinquished property to identify a potential replacement property or properties depending on the value of the previous property. To defer all capital gains tax, you must reinvest the entire net proceeds from the sale of the relinquished property into the replacement property and acquire debt on the new property that is equal to or greater than the debt on the property that was just sold and relinquished.

An UPREIT (umbrella partnership real estate investment trust) is a REIT structure that allows property owners to exchange their property and defer taxes on the sale of property in exchange for UPREIT units though capital gains taxes on UPREIT units are subject to standard REIT taxation. UPREITs are generally subject to Internal Revenue Code (IRC) Section 721 exchanges.

This is for informational purposes only and is not an offer to buy/sell an investment. There are risks associated with investing in Delaware Statutory Trust (DST) and real estate investment properties including, but not limited to, loss of entire principal, declining market value, tenant vacancies and illiquidity. Diversification does not guarantee profits or guarantee protection against losses. Potential cash flows/returns/appreciation are not guaranteed and could be lower than anticipated. Because investors situations and objectives vary this information is not intended to indicate suitability for any particular investor. This information is not meant to be interpreted as tax or legal advice. Please speak with your legal and tax advisors for guidance regarding your particular situation.

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