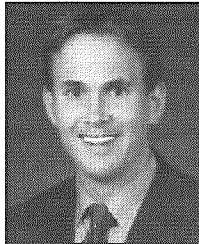


1031 EXCHANGE

By James Brennan, Wachovia Wealth Management

Exploring REITs as investment vehicles

Within the last several years the demand for alternative investment vehicles has grown. Investors that historically would have chosen sole ownership of investment property are delving into more sophisticated real estate ownership structures. This article will discuss one popular investment vehicle, the real estate investment trust ("REIT") and the bloom of the UpREIT whereby REIT ownership becomes a viable option for real estate investors.



James Brennan

receives most of its income from passive real estate-related investments and is allowed a deduction for dividends distributed to shareholders in computing its taxable income, thereby avoiding double taxation. To qualify for this treatment, a REIT must comply with the complex provisions of Sections 856 through 859 of the Internal Revenue Code ("IRC") and is subject to the provisions of Section 860. The characteristics and tax treatment of a REIT provide its investors with the advantage of pooling capital for a participating investment in real estate-related assets, and at the same time receiving tax treatment as if they directly invested in the assets. Therefore, a REIT that distributes 100% of its income will have no

federal income tax liability. By law, a REIT must distribute at least 90% of the sum of its income. To the extent that the REIT retains income, it must pay tax on such income just like any other corporation.

Beginning with its second taxable year, a REIT must meet two ownership tests: it must have at least 100 different shareholders, and 5 or fewer individuals cannot own more than 50% of the value of the REIT's stock during the last half of its taxable year.

REITs own a majority, if not all, of their properties through an operating partnership ("OP"). Investors may transfer properties on a tax-deferred basis to an OP in exchange for OP units under Section 721 of the IRC.

An UpREIT can provide

an investor with a great exit strategy by exchanging out of their investment real estate and into units of a REIT that often allow for increased liquidity once the REIT becomes publicly traded. The taxpayer gains complete control and flexibility over the recognition of the capital gain tax by determining the timing and the quantity of shares sold in the REIT. Due diligence needs to be undertaken in selecting a REIT, as the strength of your units is only as good as the REIT. Moreover, an investor needs to be comfortable with the investment philosophy of the REIT and its performance. Finally, and perhaps most importantly, investors contemplating an UpREIT would need to identify a REIT interested in acquiring the

property they are planning to exchange.

Investors planning a series of 1031 exchanges should take heed. Once you exchange property for OP units you cannot switch back into sole or fractional interests without paying capital gains taxes. In other words, after performing an UpREIT, you will be unable to defer taxes through a 1031 exchange with your OP units down the road.

REITs are going to continue to be one of the most attractive investment vehicles in the real estate industry. While Tenant-in-Common interests may be more readily accessible to individual investors, it would be prudent for all investors to educate themselves and potentially incorporate REIT ownership into their overall real estate strategy. ■