COGENT
WEALTH MANAGEMENT

Tax-deferred real estate exchanges

An Educational Overview of IRC Sections 1031 and 721

An investment in real estate can provide unique investment portfolio benefits. Property owners may enjoy a steady stream of income, capital appreciation and property-related tax advantages. Yet some property owners may no longer be interested in actively owning and managing property, but still want an allocation to real estate. Under the Internal Revenue Code Sections 1031 (IRC Section 1031) and 721 (IRC Section 721), an owner of appreciated real estate can exchange investment property for an alternative real estate investment (or in the case of IRC Section 721, an interest in a real estate partnership) and defer the capital gains taxes normally associated with divestiture. These tax-deferred exchanges allow investors to maintain 100% of their pre-tax exposure to the real estate sector, rather than paying a portion of the proceeds from a sale to the government in taxes.

WHAT IS AN IRC SECTION 1031 EXCHANGE?

IRC Section 1031 provides tax deferral on the exchange of property held for productive use in a trade or business or for investment (the relinquished property) for another like-kind property also to be held for productive use in a trade or business or for investment (the replacement property).

Although an investor can simultaneously exchange relinquished property for like-kind replacement property, many investors take advantage of the delayed exchange structure, which allows an investor time to identify and acquire a replacement property.

LIKE-KIND PROPERTY

The like-kind requirement for real estate exchanges is considerably broad. In most instances, assuming all other requirements under IRC Section 1031 are satisfied, as long as an investor exchanges real property held for investment or used in a trade or business for other real property also to be held for investment or used in a trade or business, it will qualify. While a property held primarily either for personal use or for sale may not be exchanged, most other investment real property may be exchanged.

POTENTIAL ADVANTAGES

- Capitalize on the value of appreciated assets
- Continue to potentially build wealth through real estate investments
- Diversify, consolidate or upgrade real estate holdings
- Potentially reduce ongoing management burdens
- Accomplish retirement and estate planning objectives

For example, the following examples of real property are considered like-kind to each other:

Raw or unimproved land | Rental houses | Apartment buildings | Condominiums | Shopping centers | Warehouses | Office buildings
Hotels/motels | Leasehold interest (30+ years) | Beneficial interest in a Delaware Statutory Trust (DST) or other co-owned properties
Vacation homes and other homes held primarily for investment

DELAYED IRC SECTION 1031 EXCHANGE

BASIC EXCHANGE REQUIREMENTS

• **Use a Qualified Intermediary** — Throughout the exchange process, a Qualified Intermediary will create a reciprocal trade or exchange, prepare exchange documentation, hold exchange proceeds and protect the investor from actual or constructive receipt of the exchange funds (i.e., the investor cannot have the right to receive, pledge, borrow or otherwise receive the benefits of the exchange proceeds)

• **Identify Potential Replacement Property within 45 Days*** — Investors must identify in writing potential replacement properties within 45 days from the date the relinquished property was transferred. This is usually done with the Qualified Intermediary on a form provided with the exchange documentation

• **Acquire Replacement Property within 180 Days*** — The acquisition of one or more of the previously identified replacement properties must be completed within 180 days (or the tax filing deadline, whichever occurs earlier) from the date the relinquished property was transferred

• **Reinvest Net Proceeds** — All net proceeds or net equity received and held by the Qualified Intermediary from the relinquished property sale must be reinvested for full tax deferral**

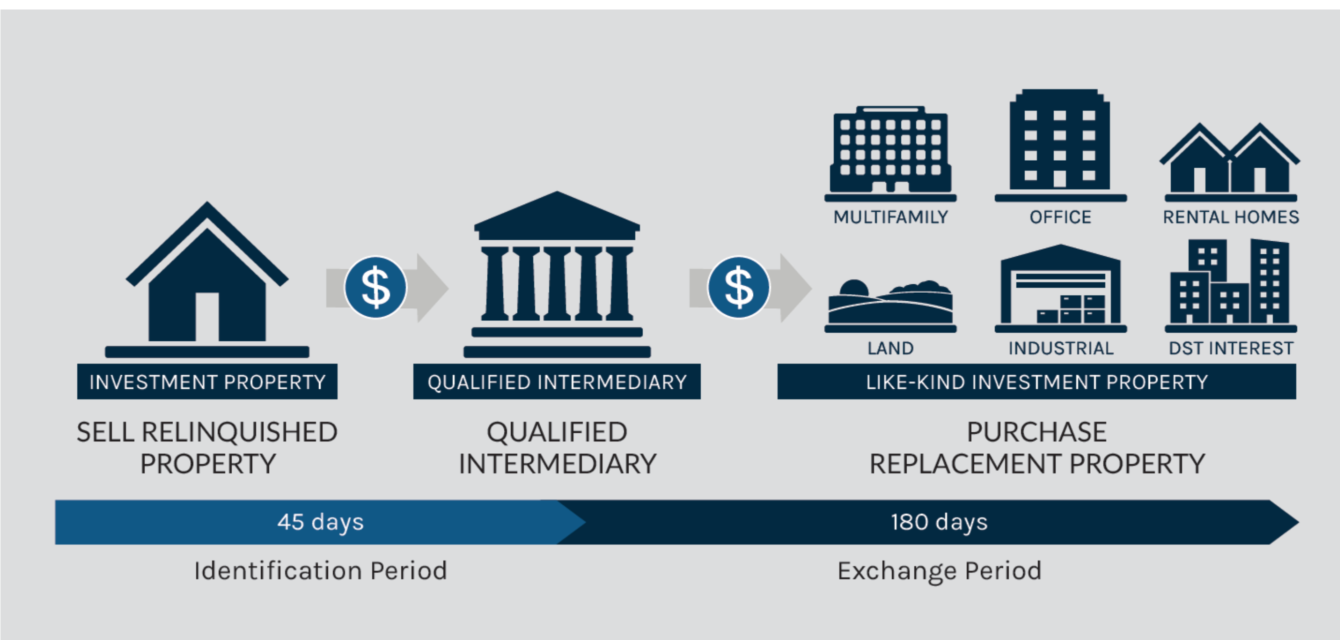
• **Replace Debt** — Any debt paid off or assumed by the buyer in connection with the transfer of the relinquished property must be offset with new or assumed debt used to acquire the replacement property. Alternatively, the investor may contribute additional cash from other sources to offset the debt the investor was relieved of upon the transfer of the relinquished property

* The failure to comply with the 45 and 180 day deadline could result in full recognition of taxable gain.

** An investor can retain some cash (referred to as “boot”) from the exchange and pay taxes only on the amount of cash received to extent of gain realized.

1031 Real Estate Exchange
Investors may defer capital gain taxes under IRC Section 1031 by exchanging property held for investment purposes or as part of a business for like-kind replacement property to be held for investment or business use.

DELAYED IRC SECTION 1031 EXCHANGE PROCESS



DELAWARE STATUTORY TRUST (DST) INVESTMENTS

Some investors hesitate to pursue an IRC Section 1031 exchange due to the stringent time requirements of identifying and acquiring replacement property, as well as the difficulties associated with finding a suitable replacement property. Additionally, many investors grow tired of managing their own investment property and seek to upgrade the quality of their real estate. For these investors, an investment in a Delaware Statutory Trust (DST) may be a potential exchange solution.

DST investments allow investors to exchange their relinquished property for a beneficial ownership interest in a Delaware Statutory Trust that owns a large, institutional-quality property, rather than exchanging it for an entire property. The diagram below outlines the exchange process when the investor acquires a DST investment.

A DST is an investment structure available for investors seeking institutional-quality replacement property as part of an IRC Section 1031 exchange. The IRS issued Revenue Ruling 2004-86 in 2004, which describes using a DST to acquire real estate wherein the beneficial interests in the trust may be treated as direct interests in replacement property for purposes of IRC Section 1031.

DST investments may offer investors the following benefits:

- Deferral of capital gains taxes
- Ease in complying with IRC Section 1031 requirements
- Access to institutional-quality real estate
- Professional property management through a master lease arrangement
- Pre-arranged financing (if applicable)
- Potential passive rental income
- Potential for appreciation
- Tax benefits of traditional investment real estate ownership

IRC SECTION 721 EXCHANGES

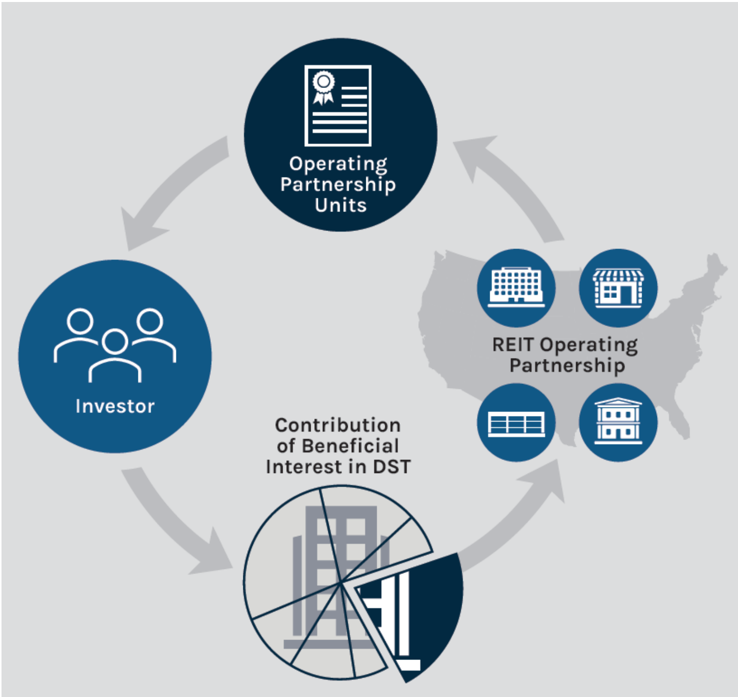
WHAT IS AN IRC SECTION 721 EXCHANGE?

Many real estate investment trusts (REITs) utilize IRC Section 721 as a way to acquire property from investors interested in selling their property, but who do not want to pay capital gains taxes or find another property as part of an IRC Section 1031 exchange. Rather than exchanging property for property, IRC Section 721 allows an investor to contribute property directly to a REIT's operating partnership (the entity through which the REIT acquires and owns its properties) in exchange for operating partnership units (OP Units). This type of transaction is sometimes referred to either as an IRC Section 721 exchange or an UPREIT transaction.

CONTRIBUTION OF A DST BENEFICIAL INTEREST

In order for an investor to contribute a property to a REIT through an UPREIT transaction, the property must meet the REIT's investment criteria, which typically includes a requirement for institutional-grade property. Few individual investors own this type of property, and therefore are not able to directly contribute a property to a REIT through an IRC Section 721 exchange. However, by exchanging a property that does not meet a REIT's criteria for a DST interest in a high-quality institutional-grade property, an investor may then have the opportunity to contribute that DST interest to a REIT in a tax-deferred IRC Section 721 exchange. The diagram below outlines the process of exchanging a DST interest for OP Units.

721 PROCESS AND BENEFITS



The ownership of OP Units may offer investors the following benefits:

- Access to a diversified portfolio of institutional quality real estate
- Deferral of capital gains taxes
- Realization of the economic benefits of the

REIT's entire portfolio, including capital appreciation and income (no income distributions are guaranteed)

- Convertibility of OP Units into REIT shares
- Management of taxable gain through partial conversion and liquidation of OP Units over time
- Full divisibility of OP Units
- Upon death, receipt by heirs of a stepped-up basis in OP Units (permanent tax-deferral)

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