1031 INVESTMENT STRATEGIES LLC
1031 Eligible Fractional Commercial Real Estate

721 EXCHANGES

A TAX DEFERRAL STRATEGY FOR REAL ESTATE

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INTRODUCTION TO REITS & OPERATING PARTNERSHIPS

Real estate investment trusts (REITs) typically own their real estate in an operating partnership known as an OP. The OP is structured as a partnership to obtain favorable tax treatment under the Internal Revenue Code. Section 721 of the Code provides favorable treatment for owners who exchange their real estate for OP units. This is commonly referred to as a 721 exchange, OP transaction or UPREIT.

OP Unit holders receive a share of cash flow from each of the properties in the OP. They typically receive the same rate of return on their equity as REIT stockholders receive on their stock.

Summarized below are numerous benefits to owners who enter into OP transactions, including the reduction of risk by diversifying compared to ownership of a single property. Also, OP distributions are protected compared to ownership of a single property because the OP owns a large portfolio of properties.

WHAT IS A 721 EXCHANGE/OP TRANSACTION?

In a Section 721 exchange, the owner exchanges real estate for OP units of a REIT. Instead of receiving cash in a taxable transaction, the owner receives OP units. Unlike a taxable sale, the gain is deferred under Section 721.

Section 721 is similar to Section 1031 governing like-kind exchanges, another popular method of deferring gain on the sale of investment real estate. Section 721 exchanges have become a popular strategy among real estate owners looking for diversification and other benefits described below.

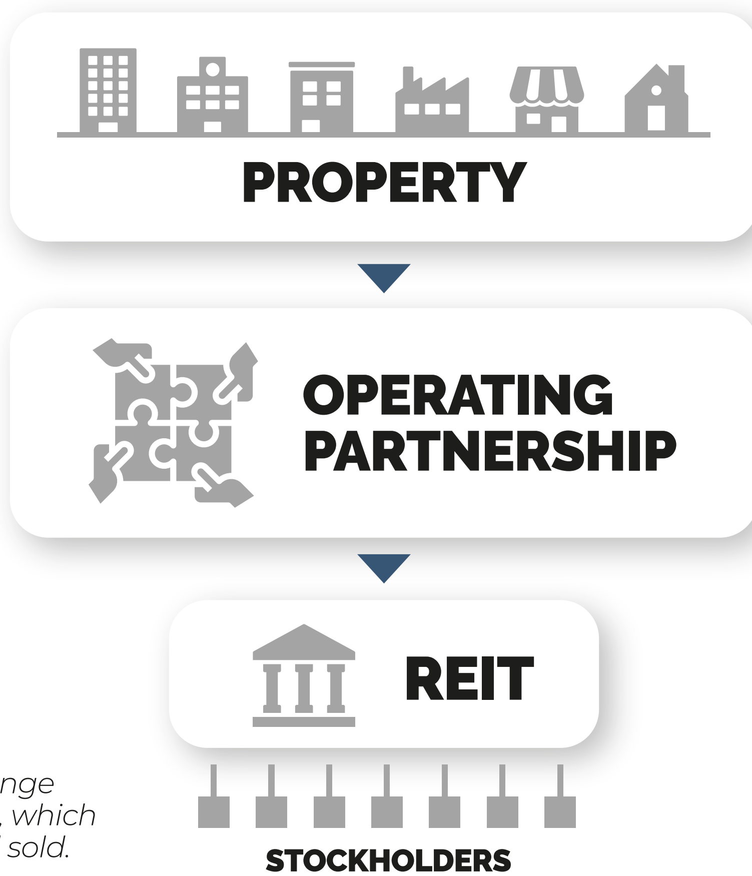
TAX BENEFITS OF SECTION 721

Section 721 defers taxation for owners of real estate who contribute their property to an OP. The gain that would be recognized in a taxable sale is deferred. The gain is deferred until the owner elects to sell the OP units in a taxable transaction. The owner has the ability to hold OP units indefinitely or time the sale to coincide with tax or financial planning strategies.

The tax deferral becomes permanent (the tax is essentially forgiven) upon death. The heirs, upon death of the OP holder, receive a stepped-up tax basis in the OP units (tax basis equal to fair market value). This means that the heirs can then sell free of taxes (federal and state). In this way, the deferral becomes permanent upon death.

Section 721 is a popular alternative to a taxable sale for real estate owners interested in a taxfavored investment with an institutional partner.

OP/UPREIT STRUCTURE



A 721 transaction allows an investor to exchange real property for operating partnership units, which may then be converted into REIT shares and sold.

BENEFITS OF SECTION 721 EXCHANGES/OP TRANSACTIONS

Owners of real property enjoy numerous benefits from a 721 exchange:

1 **No Taxable Gain.** The gain that would be recognized in a taxable sale is deferred under Section 721. The gain is deferred until the holder of OP units elects to sell in a taxable transaction. The gain will be forgiven upon death of the holder.

2 **Diversification.** Owners who exchange real estate for OP units have the safety net of a more diversified investment because the OP owns a large portfolio of properties. Owners can reduce their risk by diversifying in this manner compared to ownership of a single property. Also, the OP's portfolio of properties helps protect owners' distributions of cash flow.

3 **Liquidity.** Liquidity. REITs typically provide a liquidity option that is not available in a direct real estate investment. OP units may be exchanged for REIT shares and, then, sold on the market to create liquidity for some or all of the investment. Liquidity in this manner is not available to direct owners of real estate.

4 **Estate and Tax Planning.** OP units are conducive to estate and tax planning because they can be divided among the partners of a partnership or members of a family. The divisibility of OP units permits some to hold and others to sell. This flexibility permits individualized tax and financial planning.

5 **Passive Investment.** Owners are able to convert actively managed real estate into a passive investment where a professionally managed, institutional REIT provides turn-key management and accounting services.

6 **Transparency.** REITs provide a high level of transparency and oversight by an independent board of directors.

These benefits can be obtained in a 721 exchange without triggering taxable gain (federal or state).

Target Property
For an OP transaction to be a viable strategy, the target property must meet the REIT's investment criteria. REITs typically acquire investment grade properties and also interests in such properties, for example, DST interests.

BENEFITS OF 721/ UPREIT TRANSACTIONS

OP units may provide investors the following benefits:

- Ownership of a diversified portfolio of institutional quality real estate via ownership of OP units
- Realization of the economic benefits of the REIT's entire portfolio, including capital appreciation and distributions of operating income
- Management of tax gain through partial conversion and liquidation of OP units over time
- Deferral of taxes (federal and state) upon contribution
- Exchangeability of OP units into REIT shares
- Full divisibility of OP units
- Upon death, receipt by heirs of a stepped-up basis in OP units

HOW IT WORKS

MECHANICS OF A 721 EXCHANGE

The process is simple. The property owner and the REIT mutually agree on the fair market value for the property. The purchase price is typically determined by independent third-party appraisals.

Debt secured by the real estate will be assumed by the OP or repaid at closing. The owner will be released from all liability on their loan.

The real estate owner receives OP units with a value equal to 100% of their equity in the property (fair market value of the property less any debt assumed by the OP).

LIQUIDTY OPTION — EXCHANGE OP UNITS FOR REIT SHARES

The process is simple. The property owner and the REIT mutually agree on the fair market value for the property. The purchase price is typically determined by independent third-party appraisals.

Debt secured by the real estate will be assumed by the OP or repaid at closing. The owner will be released from all liability on their loan.

The real estate owner receives OP units with a value equal to 100% of their equity in the property (fair market value of the property less any debt assumed by the OP).

GLOSSARY

721 Exchange – A Section 721 exchange permits real estate owners to contribute their property to a partnership in exchange for interests in that partnership on a tax-deferred basis.

1031 Exchange – A Section 1031 exchange allows real estate owners to exchange their property for like-kind replacement property on a tax-deferred basis.

DST – Delaware statutory trust. An investment vehicle that allows a group of investors to purchase fractional interests in real estate.

FMV – Fair market value. The price that a property is likely to bring on the open market.

OP – Operating partnership. The entity through which a REIT typically acquires and owns its real estate.

OP Units – Operating partnership units, representing ownership of the OP that owns the REIT's real estate. These units may be converted into REIT shares.

REIT – Real estate investment trust. A company that owns income-producing real estate.

UPREIT – Umbrella partnership real estate investment trust. A REIT structure with an OP that allows owners of real estate to exchange their property for OP units.

THE 721 ADVANTAGE

A Section 721 exchange offers many potential benefits, including:

- Deferral of federal and state taxes
- Ownership via the OP of a professionally managed, diversified portfolio of institutional-grade real estate
- Realization of the economic benefits of the REIT's entire portfolio, including capital appreciation and distributions of operating income
- Ability to convert OP units into REIT shares that can be sold on the market
- Management of tax 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)

GENERAL DISCLOSURE

RISK FACTORS

There is no guarantee of success. Investors could incur a loss of all or a portion of their investment.

- No public market exists for DST Interests, and one is highly unlikely that any such market will develop.
- There are substantial restrictions on the transfer of DST Interests.
- There is no specified time that any property held by a DST will be liquidated and the DST may not be able to sell any or all of the properties at a price equal to or greater than the purchase price paid for the DST Interests.
- Delaware statutory trusts are a relatively new vehicle for real estate investment and are inflexible vehicles to own real property.
- If a property is transferred (or the DST is converted) to a Springing LLC, investors will likely lose their ability to participate in a future Code Section 1031 Exchange with respect to the transferred property or properties.
- Investors typically have no voting rights and will have no control over management of the DST or the properties.
- There is no guarantee that investors will receive any return.
- There is no guarantee of success. Investors could incur a loss of all or a portion of their investment.
- There typically are substantial restrictions on the transfer of DST Interests.
- There is no guarantee that an investor will be able to exchange their DST Interests for OP Units in an UPREIT.
- As a partner in a partnership, a holder of OP Units may be allocated taxable income in excess of cash distributions it receives. Such holder may need to find alternative sources of cash to pay the tax liability on its allocated income.
- In the event that an operating partnership sells the property contributed pursuant to a 721 Transaction, any "built-in gain" recognized upon such sale will be entirely allocated to the contributing investor. Such investor may have only limited rights to prevent or delay such a sale in accordance with a "tax protection agreement".
- The qualification requirements for a REIT are complex. There is no guarantee that, after a 721 Transaction, the REIT will continue to qualify as a REIT, which could adversely affect its operations and its ability to make distributions.