Western Real Estate Business
November 2012
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WESTERN REIT UPDATE

DEFERRING TAX GAINS BY SELLING ASSETS TO REITS

By Roger Laty

When a REIT identifies a property that it wants to purchase, it often has the option of paying for the property with partnership units (often referred to as OP Units), cash or a combination of the two.

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From a REIT's perspective, paying with cash is easiest and most cost-effective. For sellers that want to monetize their real estate holdings, receiving OP Units allow them to roll over all of their equity into liquid, stock-like assets without having to pay the tax bill on disposition. This also allows the seller to continue receiving a return on 100 percent of their equity in the real estate, which will often exceed the returns they can achieve on the after-tax proceeds of a taxable disposition. Although more complicated and costly, REITs nevertheless are open to paying with OP Units when the right asset or assets are involved and they want to gain a competitive edge in the acquisition process.

OP Units are typically equivalent to and convertible into shares of REIT stock. Upon this conversion, which is typically within the control of the seller, the deferred gain from the real estate is triggered (on a pro-rata basis). Since the conversion is typically a planned event, the resulting tax liability is either paid with the proceeds of the immediate sale of the REIT shares, or the gain may be offset by unrelated losses available to the seller. While the conversion is a taxable event and within the control of the seller, it is important to note that what the REIT does with the property after its acquisition can impact the length of the sellers' tax deferral. For example, if the REIT sells the asset in a taxable sale a few years after it is acquired, the seller's deferred tax gain may be triggered, thus ending the deferral period. Accordingly, the seller needs to ensure the REIT agrees to and cooperates with the seller to make sure that the gain is deferred for the desired period of time.

It is not uncommon for individual sellers to plan to hold the OP Units until death so the income tax on the deferred gains can be eliminated with the basis step-up that is currently available under the tax rules. In order to increase the chances for such a plan to become reality, it is critical for the sellers to be represented by advisors who are experienced in this specialized area. With this in place, all the issues are identified early and become part of the overall negotiation process. The final agreement between the seller and the REIT is typically documented in a "Tax Protection Agreement" or similar document. This will spell out all the commitments the REIT agrees to that will allow the seller to defer the gain. Any subsequent violation of such an agreement typically obligates the REIT to reimburse the seller for the income taxes that become due as a result of the violation, plus a gross up to cover the income taxes on the reimbursement.

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