

# Analysis on using UPREITs in real estate finance in United States

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**Abstract:** This paper gave an overview introduction about umbrella partnership real estate investment trust (UPREIT) to the readers who are not related to real estate and accounting major. To show how UPREIT defer capital gain taxes, makes good cash flow and maximize profit in real estate finance, the paper included the theory and structure of UPREIT (real estate investment trust), partnership issues, advantage and disadvantage, and created a proforma to demonstrate how UPREIT works.

**Key words:** UPREIT; real estate; finance; property; tax

## 1 Introduction

An umbrella partnership real estate investment trust (UPREIT) is a kind of REIT (real estate investment trust) that holds all or most of its properties through a partnership (typically called the “operating partnership”) in which the REIT holds an interest. The UPREIT was designed to give real estate owners access to public capital markets, while permitting them to defer their capital gain taxes, which would be recognized if they directly contributed their properties to a REIT. UPREIT was first used in the early 1990s by real estate owners seeking an alternative source of financing. The UPREIT structure was created to avoid the taxation of taxable income on the transfer of appreciated property to a REIT, an exchange of partnership interests generally does not result in taxable transaction, and provides an attractive tax deferred exit strategy to sellers of real estate who may incur significant tax liabilities in a cash sale. UPREIT has accounted for nearly two thirds of all newly formed REITs since 1992. Today, over half of the largest REITs are organized as UPREITs<sup>[1]</sup>.

This paper will give an overview introduction about UPREIT to the readers who are not related to real estate and accounting major. To show how UPREIT defers capital gain taxes, make good cash flow and maximizes profit in real estate finance, the paper will include the theory and structure of UPREIT, partnership issues, advantage and disadvantage, and create a proforma to demonstrate how UPREIT works.

## 2 The UPREIT structure and financing concept

Before talking about the structure of UPREIT, a brief introduction of REITs will be referred firstly. REITs are public trade real estate firms that own a special tax status. Similar with mutual funds, in contrast to public corporations REITs do not pay income or capital gains taxes at the corporate level. In exchange, they must pay out at least 95 % of their taxable income to their partnerships and investors as dividends to avoid taxation.

Typically, REITs are the sole owners of the real estate, each share of stock represents an ownership interest in the company’s properties or its development operations. Unlike REITs, investors in an UPREIT do not own the UPREIT’s properties directly. In a typical UPREIT structure, one or more individuals or partnerships owning real estate contribute their holdings to an OP (operating partnership) in exchange for limited partnership units. At the same time, a REIT is formed and issues are shared to the public. The REIT then contributes the proceeds received from the UPREIT shareholders to the operating partnership in exchange for a general partnership interest. The proceeds are used to reduce debt or acquire additional property or used for any other UPREIT purposes. The limited partners also get rights to put their partnership interest to the operating partnership or to the UPREIT in exchange for cash or UPREIT shares<sup>[2]</sup>. Fig. 1 illustrates how a simple UPREIT structure is set up.

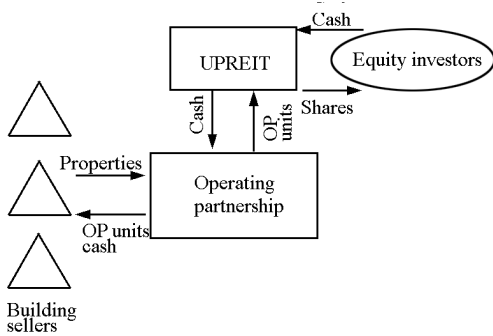


Fig. 1 The UPREIT structure<sup>[3]</sup>

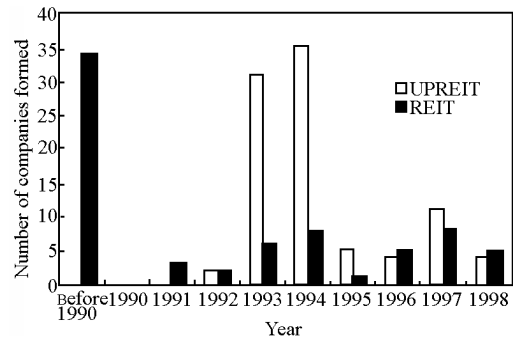


Fig. 2 Creations of UPREITs vs. traditional REITs<sup>[3]</sup>

The capital gains tax benefits of the UPREIT structure are the main purpose of this paper. Unlike a regular REIT, which must pay for properties taxes for cash or stock, an UPREIT's structure permits the issuance of OP units in exchange for properties. Therefore, transferring real estate properties to an UPREIT is not taxable because the seller only receives OP units, not cash or stock, even though OP units are typically exchangeable one-for-one into common shares and get the same dividend as common shares. In this case, the Internal Revenue Service (IRS), which is the United States federal government agency that collects taxes and enforces the internal revenue laws, treats this kind of deal as a tax-free exchange, which means the property sellers defer their capital gains tax liability until either they elect to dispose of their OP units or convert them into shares of the REIT, or the UPREIT sells the contributed properties<sup>[3]</sup>. UPREITs that are long-term investors are favorable to sellers seeking long-term tax deferral.

The creation of the first UPREIT by the Taubman Realty Group in December 1992 introduced such kind of firms' appearing. Fig. 2 shows how many public real estate corporations were formed each year including traditional REITs and UPREITs. By December 1992, 40 traditional equity REITs existed. In 1993 and 1994, 66 new UPREITs formed while only 14 new traditional REITs did. The number of new UPREITs declined substantially in 1995 and after that they were created at roughly the same rate as traditional REITs.

From Fig. 2 some significant reflections can be found. Why the creations of UPREITs show such sharp curve in few years? Next sections will explain this phenomenon from comparing the advantages and disadvantages aspects of using REIT and UPREIT structures.

### 3 Advantages and disadvantages of using UPREITs

Nowadays, the majority of the United States' real

estate is currently held in a partnership format.

1) The UPREIT structure is developed to enable the issuers of the REIT to defer the tax liability if they sell the properties for cash or exchange them to stock in the REIT;

2) The creation of the operating partnership in UPREIT provides the REIT with the option of issuing either shares of common stock in the REIT or operating partnership units to get acquisitions;

3) The UPREIT structure also enables developers to raise money for expansion through the stock market instead of financial institutions;

4) The umbrella REIT structure can be used to reduce indebtedness on the partnership's properties and also may provide liquidity for institutional investors, such as pension funds.

Despite UPREIT has so many advantage, why isn't every REIT converted to UPREIT?

1) One reason is many developers and property owners prefer to retain private entities so that they will not have to share the future appreciation in their properties with other UPREIT's investors;

2) Some reports indicate that the structure only benefits the issuers and investment bankers. It results in a more complicated structure, which places an additional entity between the public shareholders and the properties;

3) The UPREIT structure also creates the possibility of conflicts of interest between the firm's shareholders and managers, because the UPREIT structure is not free. The conflict of interest arises from the different capital gains tax bases of the owners of the operating partnership units and the shareholders. Due to the decentralization of power divided by involved more partners in UPREITs and different tax basis between contributors and shareholders, there must be more extra cost to spend for deal with these conflicts.

With the above discussion, the sharp curve of Fig. 2 can be explained. Due to the initial benefit of becoming an UPREIT, many original property owners

can access equity capital markets without incurring a capital gains tax on their existing properties. In this case, there is a great boom of new UPREITs' creation in the years of 1993 – 1994. But after that when the disadvantage of UPREITs emerge while adopting the UPREIT structure might lower the share price relative to that for a regular REIT, and the conflict of interest between different groups and the more cost caused by confliction make the creation of UPREITs decline tremendously after 1994.

#### 4 Effect on the proforma

According to the structure and advantage and disadvantage of UPREIT, it is clear that using UPREIT will get some financing benefits. Then this paper will analyze the value of the UPREIT structure and the role of capital gains taxes. Because real estate property is depreciated for tax purposes, the proportion of the asset value that is considered a capital gain can be large. Hence, being able to defer, or even avoid capital gains taxes by selling a property to an UPREIT potentially can get a sizeable benefit. To an UPREIT, the capital gains tax may be like a subsidy similar to an investment tax credit, which can low the price paid on properties and increase the yield. The size of the subsidy will depend on the value to the property seller of the tax deferral, which includes the capital gains tax rate and how long the tax deferral lasts.

In the remainder of this section, this paper will compare the two after-tax proceeds formula between REIT and UPREIT.

If a property owner wants to sell its property to a traditional REIT, he/she will receive cash or liquid stock for today's market value of the property,  $V_0$ . A capital gain tax at a rate  $\tau_c$  must be paid on any taxable gain, and today's value minus the cost basis,  $B$  (The cost basis  $B$  has considered the depreciation factor in this formula). The total after-tax proceeds of REIT in today's dollars value will be<sup>[3]</sup>:

$$S_{\text{UPREIT}} = V_0 - \tau_c(V_0 - B) - B \quad (1)$$

If the owner wants to sell this property to an UPREIT, capital gains taxes can be deferred until the units were converted into shares or cash. The value of this option in today's dollars is the discounted value of today's sale price minus the discounted value of the capital gains tax liability plus the discounted after-tax return from investing in the UPREIT by holding OP units. Defining  $H$  as the seller's expected holding period of the OP units,  $r_{\text{REIT}}$  as the annual pre-tax return to an UPREIT OP unit,  $\delta$  as the proportion of that return paid out as dividends,  $\tau_{\text{DIV}}$  as the tax rate on dividend income,  $r$  as the discount (capitalization) rate after-tax

opportunity return, and  $B_{\text{UP}}$  as the extra cost using UPREIT structure, so the total after-tax proceeds from a sale to an UPREIT would be<sup>[3]</sup>:

$$S_{\text{UPREIT}} = \left[ \frac{V_H - \tau_c(V_H - B)}{(1+r)^H} \right] + \sum_{t=1}^H \frac{V_0(1 + (1-\delta) \cdot r_{\text{REIT}})^{t-1} \cdot \delta \cdot r_{\text{REIT}} \cdot (1 - \tau_{\text{DIV}})}{(1+r)^t} - B - B_{\text{UP}} \quad (2)$$

The first term (in brackets) reflects that the after-tax proceeds deferred by  $H$  year are converted to today's discount value.  $V_H - \tau_c(V_H - B)$  means after  $H$  years the after-tax proceeds, and use it in discount rate formula:  $PV = \frac{V_n}{(1+r)^n}$  to get the deferred discounted value of today's. In addition,  $V_H = V_0(1 + (1-\delta) \cdot r_{\text{REIT}})^H$ , which includes the expected capital gain in the OP units is received.

The second term starting with the sum values of the discounted cash flow from the stream of dividend payments. The REIT generates a return of  $r_{\text{REIT}}$  every year on the current equity value of the company,  $\delta$  percent of which is paid out as dividends and taxed at the rate  $\tau_{\text{DIV}}$ . The remainder of the return  $(1-\delta) \cdot r_{\text{REIT}}$  is retained by the company and creates capital appreciation. The stream of dividend payments increases over time, with the dividend yield remaining constant by assumption and the equity value of the company increasing due to capital gains. All lump sums and flows are discounted at the after-tax opportunity cost rate,  $r$ .

From Eq. (1) and Eq. (2), it is easy to calculate the benefit  $V$  of UPREIT get more than the REIT's<sup>[3]</sup>.

$$V_{\text{profit}} = S_{\text{UPREIT}} - S_{\text{REIT}} \quad (3)$$

In attention, this equation does consider the extra management cost of complicated UPREIT structure and the declined price in share of REIT factors, this section only considered the ideal condition of UPREIT to avoid more complicated formula and calculation.

Now according to some data importation to these three formulas, next step of this part will calculate the benefit using UPREIT structure above using REIT structure. We assume the  $V_0 = 1\,000\,000$ , capital gains tax rate  $\tau_c = 30\%$  (for a long term situation it is usually  $15\%$ ). Cost basis considered depreciation  $B = 500\,000$ , so:

$$\begin{aligned} S_{\text{REIT}} &= V_0 - \tau_c(V_0 - B) - B \\ &= 1000\,000 - 30\% \times 500\,000 - 500\,000 \\ &= 350\,000 \end{aligned}$$

Then we assume  $r_{\text{REIT}} = 10\%$ ,  $\delta = 90\%$ ,  $\tau_{\text{DIV}} = 20\%$ , discount (capitalization) rate  $r = 8\%$ ,  $H = 3$  year, and  $B_{\text{UP}} = 9\,000$ . So

$$V_H = V_0(1 + (1-\delta) \cdot r_{\text{REIT}})^H = 1\,030\,301,$$

$$S_{UPREIT} = \left[ \frac{V_H - \tau_C (V_H - B)}{(1+r)^H} \right] + \sum_{t=1}^H \frac{V_0(1 + (1 - \delta) \cdot r_{REIT})^{t-1} \cdot \delta \cdot r_{REIT} \cdot (1 - \tau_{DIV})}{(1+r)^t} - B - B_{UP}$$

$$= 691\,595 + 65\,455 + 60\,099 + 55\,182 - 500\,000 - 9\,000$$

$$= 363\,331$$

Hence,

$$V_{profit} = S_{UPREIT} - S_{REIT} = 363\,331 - 350\,000 = 13\,331$$

So the benefit created by using UPREIT structure can create more 13 331 dollars, which arise 3.81 % more profit than using REIT structure. Because the variables  $r_{REIT}$ ,  $\delta$  and  $\tau_{DIV}$  usually not change much, so the variables gains tax rate  $\tau_c$  and discount (capitalization) rate  $r$  are the crucial factors to determine the real estate financing benefit. If the gains tax rate  $\tau_c$  do not change with time, it is easy to find that the more years property owner holds the operating partnership, the more dividend and  $r_{REIT}$  will be, and the more money the owner will earn when he sells the property.

**Table 1 The standard proforma converted by above equations**

Assumptions			
Total today's market value of the property	1 000 000		
Total project cost (has considered the depreciation factor in this proforma)	500 000		
Annual pre-tax return to an UPREIT OP unit	0.1		
Proportion of that return paid out as dividends	0.9		
Tax rate on dividend income	0.2		
Years of holding period of the OP units	3		
Capital gains tax rate	0.3		
Discount (capitalization) rate	0.08		
	Year 1	Year 2	Year 3
The income from dividend (after tax)	65 455	60 099	55 182
Operating expenses	3 000	3 000	3 000
Income on dividend	62 455	57 099	52 182
Total capital gain on using UPREIT after tax	363 331		
Total capital gain on using REIT after tax	350 000		
Capital gain gap between REIT and UP-REIT	13 331		

## 5 Conclusion

According to the above discussion, there are a number of advantages associated with UPREIT. The UPREIT structures have the potential to inject billions

### Author

Wang Xiaoxiao, male, born in 1982, a PhD candidate at College of Architecture, Illinois Institute of Technology and a member of American Planning Association. He has got a master degree of Urban and Regional Planning in Michigan State University in spring 2008. He has published 25 papers in English and Chinese languages with or without co-authors, which are involved with urban planning, landscape architect, sociology, geography, history, transportation, agriculture, economy, and law. He can be reached by email: slswa@hotmail.com

of dollars in capital into the real state industry, especially in this depressed period. In addition, the original property owners receive operating partnership units rather than shares of common stock in the REIT, enabling the owners to defer their tax liabilities. In the same condition, the structure allows the firm to acquire additional properties in transactions which also defer the sellers' tax consequences. Finally, these transactions provide substantially greater liquidity for mutual fund investors.

However, there are still some problems in UPREIT structure. One is confliction; one is the drop price in share. The price in share declines not very obviously and can be covered by the more benefit gain from the deferral of taxes. About the conflictions in UPREIT structure, one way is to make the UPREIT the sole general partner in the REIT and the UPREIT's shareholders own at least 50 % of the umbrella partnership, thus resolving the control issue. In addition, it is also useful to appoint a majority of independent directors to the UPREIT's board. Arguably, independent unaffiliated directors are more likely to represent the interests of shareholders if there is a conflict with the REIT's managers<sup>[4]</sup>. Despite these difficulties exist, many experts believe that the positives outweigh the negatives, and predict that more UPREITs will be established in the coming years. Over the past decade, the UPREITs structures have been embraced by the REITs industry very well and are now incorporated in the organizational structures of many REITs. From the perspective of the REITs, it appears that the popularity of UPREITs should continue for the foreseeable future.

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