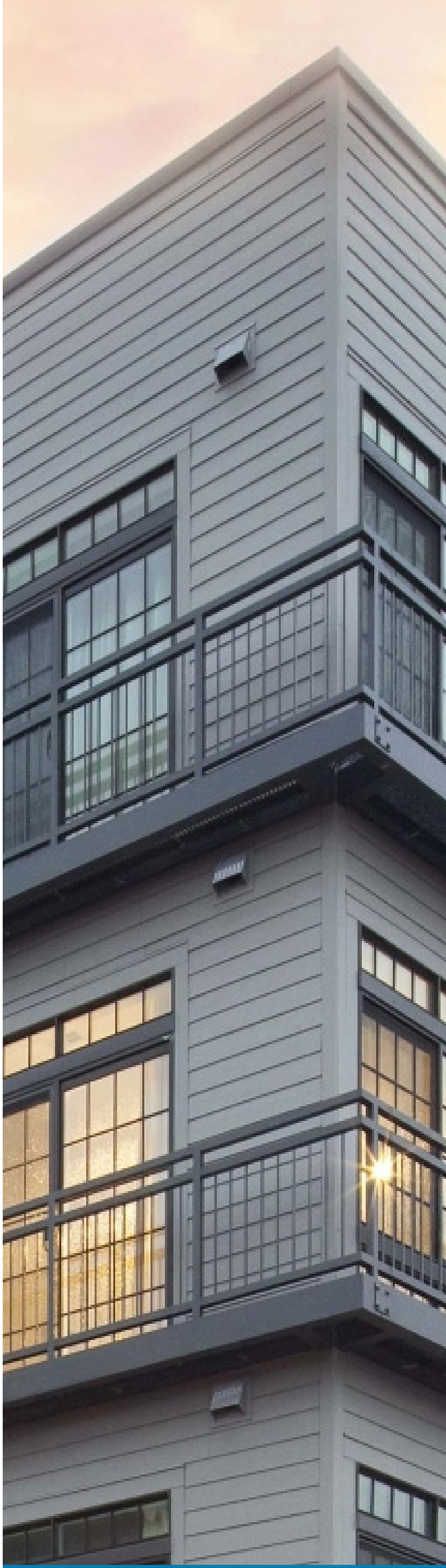
UPREIT Transactions

Features and Benefits of Multifamily UPREIT Transactions



The complications of real estate property management, the desire for diversification, and the nature and process of estate planning are all common reasons for real estate investors to want to exit their real estate investments. Unfortunately, sales of properties for cash are typically taxable events, which means that the investor becomes liable for taxes on the difference between the sales price and the investor's adjusted tax basis in the property. If the investor has held the property for a long time and substantially depreciated the asset and/or the property has appreciated in value, the tax burden may be significant. Luckily, there are ways for property owners to divest their low-basis multifamily real estate without triggering capital gains through certain tax-deferred transaction structures.

One tax-deferred option is a like-kind exchange under Section 1031 of the Internal Revenue Code (the "Code"), in which an investor exchanges a property for a new property of equal or greater value in what is called a "like-kind exchange". Depending on the exchange, the new property may be more or less management intensive than the original property. These types of transactions typically do not allow for increased investment diversification. Please see below for additional information on 1031 exchanges.

Another deferral mechanism is a tax-deferred contribution of property to a partnership under Section 721 of the Code, also known in the real estate industry as an UPREIT transaction (where "UPREIT" stands for umbrella partnership real estate investment trust), in which a property owner contributes property to a real estate investment trust's (REIT's) subsidiary operating partnership or company in exchange for partnership or membership interests in the operating entity. An UPREIT transaction can allow an investor to essentially trade one property (or a portfolio) for an equity interest in a larger, diversified portfolio that is managed by the REIT and its advisors. The transaction may offer the investor enhanced liquidity options as well.

This paper will explore the nuances, features, and benefits of UPREIT transactions.

1031 EXCHANGE

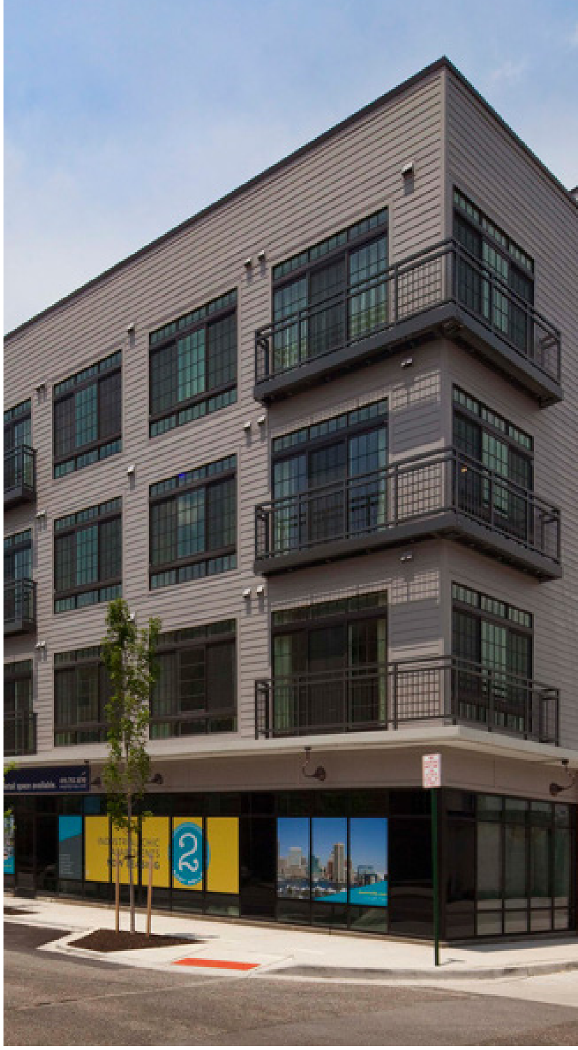
The 1031 exchange, or "like-kind exchange", is named after the corresponding section of the Internal Revenue Code. Section 1031 provides that no gain or loss will be recognized on the exchange of a property used in a trade or business or for investment if the property is exchanged for another property of like kind, meaning equal or greater value. Taxes that would otherwise be due upon the sale of the property may be deferred if the property is instead exchanged for another property. In terms of U.S. real estate, "like-kind" has generally been defined as any property (including land) that is classified as real estate in any of the 50 U.S. states and that otherwise meets the trade, business, and investment requirements of Section 1031. For example, a property owner could potentially exchange an office building into an apartment community.

Prior to 1979, property owners had to actually trade properties in order to qualify under this provision. Currently, a seller can state an intention to conduct a 1031 exchange and sell their property. The seller must then identify a replacement property within 45 days of closing on the sale of the original property and acquire the replacement property within 180 days of closing. A qualified intermediary such as an escrow agent or title company must facilitate the transaction so that the seller does not actually take possession of the proceeds from the sale. In practice, due to the tight time frame, property owners typically try to identify the replacement property before the close of the sale of the original property.

Property: Aerial view at "The Overlook" in Camp Hill, PA (property acquired via UPREIT)

WHAT IS A REIT?

An equity REIT is a corporation or trust that owns real estate, which may include commercial and/or residential properties. REITs were created to allow investors to participate in the ownership of commercial real estate and do not require that investors file a tax return in every state in which property is held. The structure is similar to a mutual fund that holds real estate, in that it allows investors the ability to purchase shares of a professionally managed, diversified portfolio and avoid the "double taxation" of its income (i.e., once at the corporate level and again at the shareholder level). In order to avoid the "double taxation" of its income, a REIT must comply with several requirements, one of which is that it must distribute at least 90% of its annual net taxable income to shareholders. REITs must be broadly held, and there are certain requirements regarding concentration of ownership that also must be met. REITs can be private, public and traded on an exchange, or publicly reporting but not traded on an exchange. REITs are allowed to depreciate their real estate; this non-cash expense reduces taxable income and shelters some of the distributions from current income taxation. This results in a "return of capital" that is applied towards reducing the shareholder's tax basis. The Tax Cuts and Jobs Act of 2017 included a new 20% deduction on REIT dividend income. This benefit to investors commenced in the 2018 tax year. Individual investors should consult with their tax advisors regarding their ability to utilize this 20% deduction.



Property: "2 East Wells" in Baltimore, MD
(property acquired via UPREIT)

Property: "The Overlook" in Camp Hill, PA
(property acquired via UPREIT)

WHAT IS AN UPREIT?

It is possible for a REIT to own properties directly (see figure 1). Alternatively, an umbrella partnership real estate investment trust, or UPREIT, is a structure where all of the properties are owned by an umbrella partnership (or "operating partnership"), and the REIT is the managing member of the operating partnership (see figure 2). Many REITs structure their operating partnerships as limited partnerships, but a growing number are formed as limited liability companies, which can provide the same tax treatment as a limited partnership. We refer to the umbrella entity as an "operating partnership" regardless of form, since it elects to be taxed as a partnership.

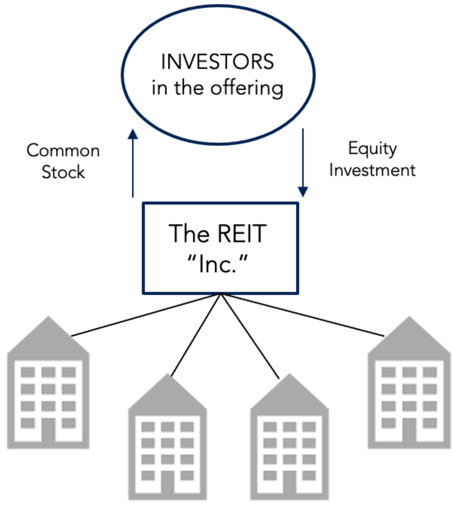


Figure 1

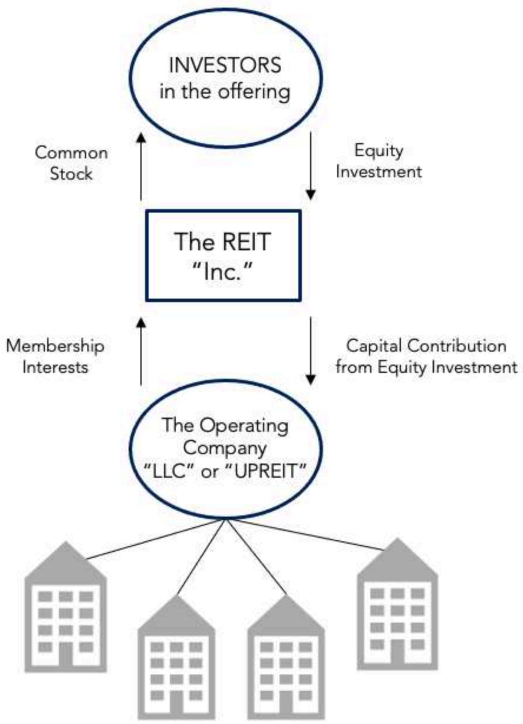


Figure 2

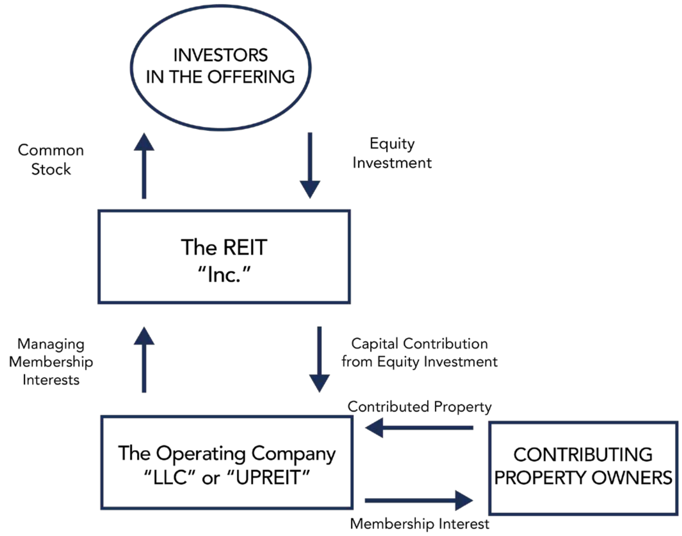


Figure 3

UPREIT TRANSACTION = 721 EXCHANGE

The presence of the operating partnership as an intermediate entity between the REIT and the properties allows the REIT to conduct UPREIT transactions (also known as a 721 exchange, named for Section 721 of the Internal Revenue Code) through the operating partnership. In an UPREIT transaction, property owners contribute properties to the operating partnership in exchange for units of equity interest in the operating partnership ("OP Units") in a tax-deferred transaction at the time of contribution (see figure 4). UPREIT structures generally provide that the OP Units are convertible into shares of the REIT's common stock on a one-for-one basis at the option of the OP Unitholder, providing the OP Unitholder with potential for future liquidity. The contributed properties retain their original tax basis, and the OP Unitholder's embedded taxable gains are not triggered until the OP Units are converted to REIT shares (on a one-to-one basis, generally), sold or redeemed for cash, or the contributed properties are sold by the REIT (other than pursuant to another tax-deferred transaction). If the properties are subject to mortgage debt, various structures may be used to avoid debt repayment or refinancing triggering tax. Upon death of the OP Unitholder, the OP Units may receive a step-up in tax basis (to current valuations at date of death) and heirs then receive a higher basis in the OP Units. Heirs can continue to hold the OP Units or convert them to REIT shares to simplify reporting or seek liquidity through a redemption or sale of shares.

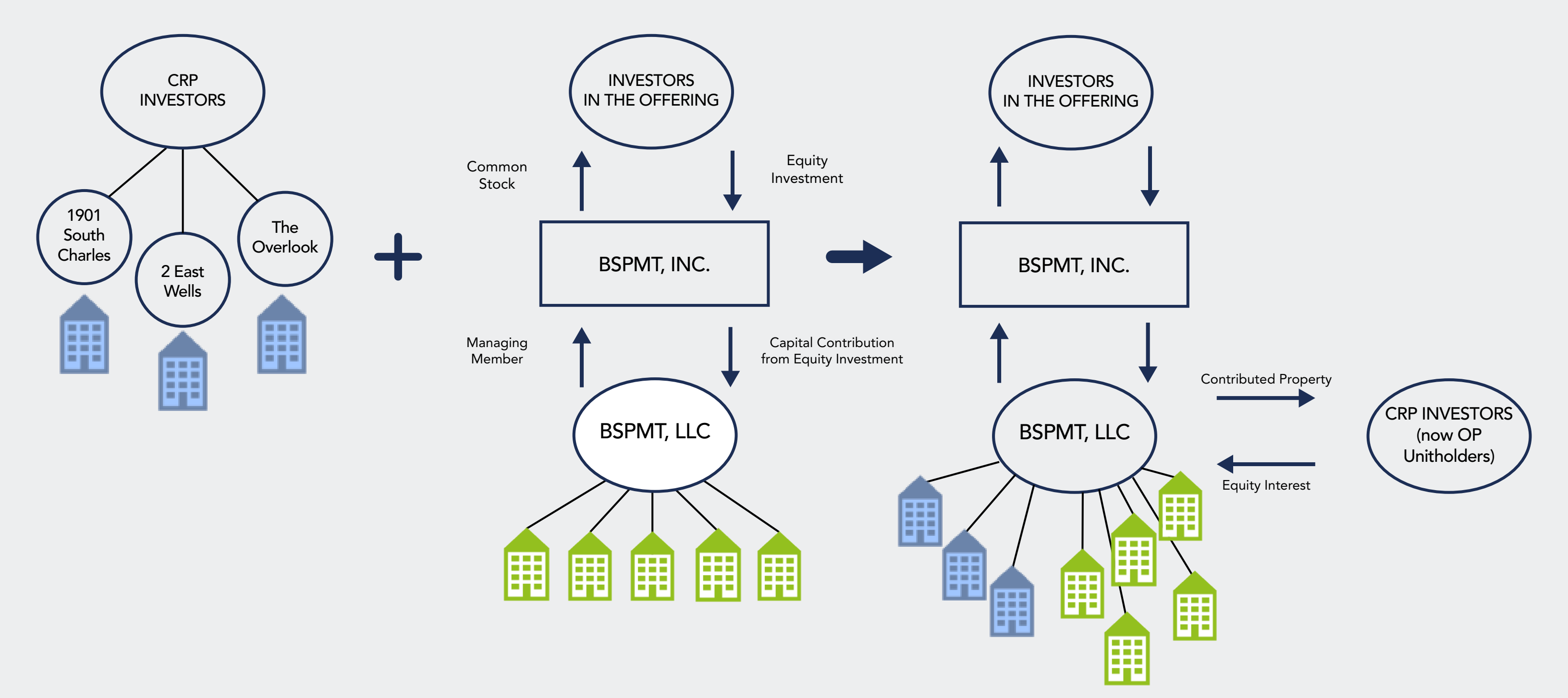


Figure 4

DETAILS OF AN UPREIT TRANSACTION

In an UPREIT transaction, a property owner contributes properties to the operating partnership in exchange for OP Units.

UPREITs are relatively straightforward transactions and necessitate that the properties that the current owner(s) wishes to exchange fit the REIT's "buy box" and investment objectives. Both parties then conduct due diligence. The property owner must confirm aligned interest with and qualification to participate in the REIT's investment offering and the REIT must ensure that the property and associated characteristics (leases, etc.) are to its liking. Both parties will then agree upon a value and negotiate a property contribution agreement. Upon closing, the owner will then receive the value of their equity in the form of OP Units in exchange for contributing the real estate to the operating partnership.

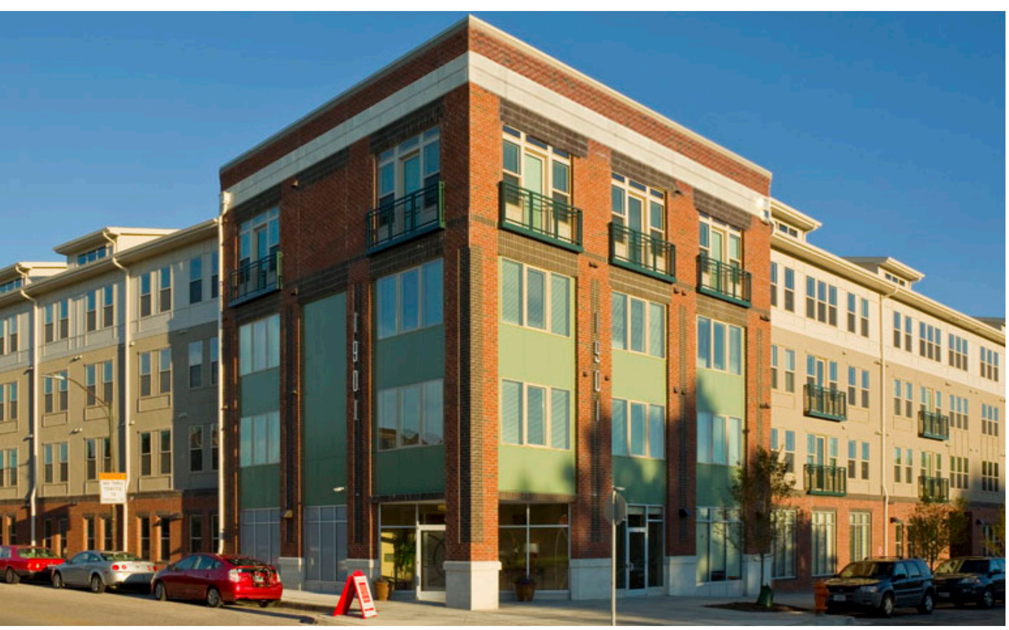
Property: Aerial view at "The Overlook" in Harrisburg, PA (property acquired via UPREIT)

In an UPREIT transaction, the contributing property owner receives OP Units, which have most of the benefits of common REIT shares. Generally, OP Units are equal in value to REIT shares, convertible into REIT shares on a one-for-one basis, and fluctuate in value in the same manner as REIT shares. OP Unitholders also receive distributions equal to those of the REIT shareholders.

The principle differences between OP Units and REIT shares are related to taxation and voting rights. OP Unitholders earn a portion of the total income from the operating partnership, including a proportional allocation of income from each of the states in which the REIT transacts business. Consequently, OP Unitholders will have income tax filing requirements in each of those states and receive a Schedule K-1 for each state in which the REIT holds property (depending on the REIT, this could equate to a large number of K-1 forms at tax time). Common REIT stock, on the other hand, generates income that is only taxable in the shareholder's state of residence, requiring only one state return (Form 1099) to be filed in connection with the shareholder's ownership of the REIT shares. Additionally, OP Unitholders do not have the same voting rights as REIT shareholders. OP Unitholders own interests in the operating partnership, not the REIT, and therefore are not entitled to vote on shareholder matters at the REIT level (e.g., election of directors).

UPREITs are tax-deferred transactions, meaning that the taxes owed on a built-in gain on the property are deferred until a future transaction triggers tax on the gain (e.g., the OP Units are converted to REIT shares or the REIT sells the property for cash). This allows the OP Unitholder the ability to unlock value and access capital as needed. As OP Units can be converted to REIT shares and sold or redeemed for cash over time, the impact of any taxes owed on the gain can be spread out over time. If the REIT sells the subject property, taxes will become due unless the property is sold as part of a 1031 exchange or other tax-deferred transaction. REITs often employ 1031 exchanges in the sale of their properties to help shield shareholders from capital gains taxation and comply with regulations limiting sales in a given tax year. If the property is sold for cash and the gain is not deferred, the OP Unitholder becomes responsible for the taxes on the difference between the property's fair market value at the time of contribution and the OP Unitholder's current adjusted tax basis. The taxation on any appreciation in the property's value since the time of contribution is allocated to all OP Unitholders (and shareholders) on a pro-rata basis.

If the contributing property owner dies, his or her OP Units receive a step-up in basis to the value at time of death, eliminating any taxes that would be due on that increase in value. The OP Units or shares can easily be divided among various heirs who can each make their own investment decisions, unlike in the case of a single property. Heirs can then continue to hold OP Units without incurring taxes or can opt to convert the OP Units to REIT shares. Ownership of OP Units as a result of an UPREIT transaction can provide an attractive estate planning feature for certain individuals or families.



Property: "1901 South Charles" in Baltimore, MD (property acquired via UPREIT)

Courtyard at "1901 South Charles"

HOW THE MATH WORKS

It's important to understand the mathematical implications of a cash sale, as the tax burden for a seller could be substantial if a low basis property is sold. When a property is contributed to an UPREIT, taxes are deferred; thus, no taxes are due upon closing. Below, a hypothetical example walks through the OP Units and distributions the contributor could expect to receive in connection with an UPREIT transaction versus a cash sale, assuming $1,000 in net proceeds, with an embedded capital gain of $1,000.

This hypothetical scenario assumes a Determined Share Value ("DSV" or "share price", which is the offering price of the REIT's common shares) of $50 and a 5% annualized distribution yield. Under this scenario, the contributor would receive 20 OP Units that would pay a total of $50 in distributions during the first year. Under a cash sale scenario, a 7.4% first year yield would be required on the $680 in after-tax proceeds to achieve the same $50 distribution. The example also considers the additional value appreciation that would be required in a cash sale scenario to recoup the amount lost to taxes. Please note that this example does not factor in any appreciation to the DSV.

Hypothetical Comparison of Yields: UPREIT Transaction v. Cash Sale

Sale Proceeds: $1,000 Embedded Capital Gain: $1,000

OP UNIT CONSIDERATION		CASH CONSIDERATION	
OP UNIT PRICE	$50	TAX ON CAPITAL GAIN	(32.0%)
UNITS ISSUED	20 Units	*Includes Federal Tax, Net Investment Income & State Tax Estimate*	
DIVIDEND AT 5% YIELD	$50 Annually	TOTAL TAX	$320
		NET CASH AFTER TAX	$680
		RETURN NEEDED TO REACH $50 ANNUAL DISTRIBUTION	7.4%
LOST VALUE TO TAXES	N/A	LOST VALUE TO TAXES	32%
VALUE APPRECIATION REQUIRED TO RECOUP LOST VALUE (I.E., GET BACK TO $1,000)	N/A	VALUE APPRECIATION REQUIRED TO RECOUP LOST VALUE (I.E., GET BACK TO $1,000)	47%

BENEFITS OF BEING AN OP UNITHOLDER

TAX DEFERRAL Tax deferral is often the primary incentive to conduct an UPREIT transaction, as exiting property owners otherwise may face significant tax liabilities on the sale of an appreciated property for cash with a low tax basis. There are, however, numerous other advantages to owning OP Units versus owning the physical real estate.

INCREASED DIVERSIFICATION One of the most notable benefits of becoming an OP Unitholder via an UPREIT transaction is the diversification of real estate holdings. The property owner converts an interest in one or more specific properties into an interest in a larger and more diversified portfolio of properties. The operating partnership's portfolio is often diversified by geography, and usually benefits from the economies of scale that a larger entity can offer.

One of the most notable benefits of becoming an OP Unitholder via an UPREIT transaction is the diversification of real estate holdings.

INCREASED POTENTIAL FOR LIQUIDITY AND REINVESTMENT Another benefit of entering into an UPREIT transaction is the ability to convert an illiquid asset like real estate into an equity interest that may afford the owner a greater deal of optionality, flexibility, and liquidity. Subject to certain restrictions, OP Units can be converted on a one-for-one basis into shares of common stock of the REIT. While such a conversion may trigger recognition of a taxable gain, the flexibility allows the owner to unlock value and access capital as needed. The OP Unitholder can convert a portion of OP Units into REIT shares over time instead of doing so all at once through the sale of a property. This, in turn, may help spread out and lessen the tax impact in any one year. The REIT's common stock can be held as shares with the potential for appreciation or be sold or redeemed for cash. The ability to sell REIT shares when issued may vary. The REIT shares may be issued pursuant to a registration statement filed with the U.S. Securities and Exchange Commission. Registered shares may or may not be listed on a stock exchange or be subject to transfer restrictions. Unregistered shares issued by private REITs will generally be subject to significant transfer restrictions, but liquidity may be available under a REIT's share redemption program.

REDUCED MANAGEMENT RESPONSIBILITIES Holding OP Units instead of the real estate relieves the OP Unitholder of property management responsibilities or liabilities. The REIT's professional management team or outsourced property manager takes care of collecting rents, maintaining the property, and managing tenants, while the OP Unitholders reap the benefits. Often, the REIT's management will have asset management and/or capital markets expertise, which may improve debt financing and pricing.

DISTRIBUTION INCOME OP Unitholders may still receive a steady income stream through distributions equal to the dividends paid on the REIT shares. If desired, these distributions can be reinvested into REIT shares which have the same value per share as OP Units. REIT shares and OP Units have the potential to increase in value and pay out higher distributions, and the OP Unitholder has the potential to recognize unrealized gains as dividend and share price increases, whereas unrealized gains are more difficult to tap by typical property owners.

SIMPLIFIED ESTATE PLANNING Estate planning may also become simpler as heirs no longer need to take over management of a property or facilitate its sale. Heirs inherit OP Units at a stepped-up tax basis upon the OP Unitholder's death, and the Units can be divided among several people in the desired proportions. The heirs can continue to hold the OP Units or convert them to REIT shares, either to hold or to sell or redeem.

TRANSACTION STRUCTURING OPTIONALITY Exiting property owners may elect to receive UPREIT transaction proceeds in the form of OP Units, cash, or a mix of the two. This offers optionality to investors who have shared interest in a property, as some may wish to continue to participate in ownership of the assets for the long term as OP Unitholders, while others desire liquidity and would prefer to exit with cash. An UPREIT transaction allows each exiting property owner to achieve their desired objective. Transactions involving a mix of consideration require careful tax structuring above and beyond traditional UPREIT transactions.

Property Aerial: "West Woods Haven" in Pensacola, FL (property acquired via UPREIT)

WHAT MAKES A GOOD CANDIDATE FOR AN UPREIT TRANSACTION?

An UPREIT transaction may make sense if a property owner is looking to achieve one or more of the following objectives: (a) defer taxes when appreciated real estate is sold; (b) eliminate management hassles related to owning real estate; (c) diversify through ownership of a portfolio of properties; (d) benefit from staggered debt maturities at conservative levels of leverage; (e) upgrade to institutional quality real estate; or (f) receive consistent supplemental income.

In addition, the following real estate holdings are potential good candidates for an UPREIT transaction:

- Family-owned properties with unresolved succession issues
- Partnerships or ownership groups faced with structuring, divergent interests, or estate planning considerations
- Assets with a low tax basis
- Surplus property generated by M&A activity or consolidations
- Debt maturities approaching or sub-optimal terms
- Property owners with a large portion of their net worth tied up in direct real estate holdings

Private REITs may require that its shareholders and OP Unitholders be accredited investors in order for the offering of OP Units to be exempt from the registration requirements of the federal securities laws. To qualify as an accredited investor, a person must meet the SEC's official definition and criteria and provide verification of certain minimum net worth or sustained annual income thresholds. Please visit the SEC's official website for details: **http://www.sec.gov/answers/accred.htm**

FREQUENTLY ASKED QUESTIONS: OP UNITS

If I cannot find a replacement property, can I use my 1031 proceeds for OP Units?

No. 1031 proceeds are not directly eligible for contribution in exchange for OP Units. In order to conduct an UPREIT transaction, the actual property or the ownership interests of the special purpose entity that owns the property must be directly contributed.

Can OP Units be sold?

REITs may facilitate the exchange of OP Units for REIT shares or for cash through the REIT's conversion and redemption policies. Alternatively, an OP Unitholder may negotiate a direct sale of units or shares on his or her own. However, property owners contemplating executing an UPREIT transaction should plan on a long-term hold (e.g. 5-7 years) of the OP Units in order to maximize tax sheltering benefits.

What happens when the property owner dies?

If the OP Units are owned at the time of death of an OP Unitholder, the estate gets a step-up in tax basis to the fair market value at that time, eliminating any potential taxable gain which might have existed prior to death.

Can OP Units be used as collateral for a loan?

In certain circumstances and generally only with a REIT's prior consent, OP Units may be pledged as collateral for a borrowing by the OP Unitholder, thereby achieving some further liquidity while still maintaining the tax deferral.

Property: Courtyard at "2 East Wells" in Baltimore, MD (property acquired via UPREIT)

POTENTIAL BENEFITS OF EXECUTING AN UPREIT TRANSACTION WITH BSP MULTIFAMILY TRUST, INC.

Individuals, families and syndicates seeking to divest of low basis multifamily real estate desire a partner with the expertise and experience to deliver tax deferral, portfolio diversification, and risk adjusted returns via the successful completion of UPREIT transactions.

Through UPREIT transactions, the Benefit Street Partners Multifamily Trust, Inc. ("BSPMT") team has acquired 42 properties across its managed funds with a value $403 million, including BSPMT's acquisition of three Class A multifamily apartment communities in Baltimore and Harrisburg in July 2018, and the September 2019 acquisition of West Woods Haven, a Class A multifamily community in Pensacola, Florida.

With a breadth of experience in real estate acquisitions, asset management, and capital markets, the BSPMT team seeks to assemble and manage a portfolio of income-generating multifamily properties. The REIT sources individual and portfolio acquisitions and strives to buy properties below replacement cost. Post-acquisition, BSPMT leverages strategic partnerships with third party property managers to allow for selective market entry, access to proprietary data, and local market knowledge.

Benefit Street Partners Multifamily Trust, Inc. is an open-ended, continuously offered multifamily fund utilizing a REIT structure. It is designed to offer accredited investors access to multifamily real estate via investment in an institutionally managed private fund. BSPMT's core multifamily investment strategy focuses on delivering total return throughout all economic cycles. BSPMT is structured as an UPREIT, with Benefit Street Partners Multifamily Trust, Inc. as the REIT, and Benefit Street Partners Multifamily Trust, LLC as the operating company (see figure 3 on page 3).

BSPMT employs a seasoned team of professionals with expertise and years of experience in their respective fields, including acquisitions, capital markets, finance, investor relations, and property management. By executing an UPREIT transaction with BSPMT, a property owner can convert existing real estate interests into OP Units of a growing private real estate offering. BSPMT's management has partnered with numerous property owners to execute UPREIT transactions, helping its investors to facilitate tax-deferred exit strategies for their real estate holdings.

FREQUENTLY ASKED QUESTIONS:

Why own an equity interest in BSPMT instead of direct real estate?

Executing an UPREIT with BSPMT allows a property owner to exit direct real estate holdings in exchange for OP Units in a growing diversified real estate offering, while deferring capital gains taxes.

Are BSPMT's quarterly distributions in cash? Can I reinvest them?

Yes, BSPMT's quarterly distributions on OP Units are paid in cash. Alternatively, they can be reinvested into common (REIT) shares at a 2% discount to the current Determined Share Value (DSV) .

How long must OP Units be held before they can be converted to common shares? Are there any additional restrictions?

OP Units can be converted to REIT shares on a quarterly basis and in any denomination to unlock liquidity and spread out capital gains taxation. However, to reap the maximum tax benefits, OP Unitholders should plan to hold their OP Units for a minimum of 5-7 years, as the OP Unitholder's deferred capital gains taxes would be triggered on the conversion of OP Units to common shares.

How frequently can OP Units be converted to common shares? How frequently can the common shares be sold? Is there a penalty for selling shares? Are there minimum or maximum amounts that can be sold at one time?

There is no limit to the number of OP Units that can be converted to common shares, unless such a conversion could impact BSPMT's REIT status. BSPMT currently permits conversions on a quarterly basis or in the event of certain extraordinary events. The common share account must be liquidated if it falls below the minimum investment level. BSPMT currently offers quarterly redemptions. The entirety of the REIT's redemption program is outlined in the Private Placement Memorandum (PPM), which is available by request.

If OP Unitholders have to file taxes in each state in which the Operating Partnership owns property, does BSPMT provide tax services?

No. BSPMT does not provide tax services, just the necessary K-1 forms. BSPMT will speak with the OP Unitholders' tax accountants upon request.

What happens when BSPMT sells the contributed property?

If BSPMT sells a property without conducting a 1031 exchange so that it can recycle the capital into new real estate in a tax-deferred manner, it would trigger a taxable event for the OP Unitholder. If the contributed properties were sold for cash, the gain, up to the fair market value at the time of contribution, would be allocated to the OP Unitholder that contributed the property. Any gain above that fair market value would then be allocated among the members in accordance with BSPMT's operating agreement (generally, pro rata). BSPMT's operating partnership is a pass-through entity, so the gain and any associated tax would flow through to the OP Unitholders, including the real estate offering.

Do the properties have to be owned "free and clear" or can they be encumbered with debt?

Properties can be encumbered with debt, which BSPMT can then assume or refinance, although the particular facts and circumstances of the transaction would determine the manner in which any debt encumbering a property is addressed. Careful structuring of transactions where the property is encumbered with debt is required to achieve desired tax outcomes.

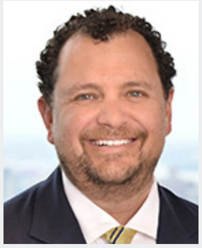
Is the tax treatment on the distributions on the OP Units different than on the common shares?

OP Unit distributions are treated as ordinary income for tax purposes. Distributions on common shares are treated as dividends for tax purposes, but distributions received from REITs are generally not eligible to be taxed at the preferential qualified dividend income rates applicable to individuals who receive dividends from taxable C corporations. The Operating Partnership is considered a "pass-through entity", with no tax at the company level, and, beginning in 2018, OP Unitholders may now benefit from a 20% deduction on qualified business income from the Operating Partnership under the recently enacted Tax Cuts and Jobs Act of 2017. The deduction for qualified business income is subject to numerous special limitation rules that may materially limit the benefits of the deduction for certain taxpayers. Also beginning in 2018, investors in the REIT may benefit from a 20% deduction on REIT dividend income. OP Unitholders and REIT shareholders should consult with their tax advisors regarding their ability to utilize these 20% deductions.

Property: "West Woods Haven" in Pensacola, FL (property acquired via UPREIT)

To learn more about UPREIT transactions, contact our team.

ACQUISITIONS CONTACTS



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Benefit Street Partners Multifamily Trust, Inc. is managed by Benefit Street Partners L.L.C. (BSP). BSP is a leading alternative asset management firm with approximately $31 billion in assets under management*, and is a wholly owned subsidiary of Franklin Resources, Inc. that, together with its various subsidiaries, operates as Franklin Templeton.

BENEFIT STREET PARTNERS

FRANKLIN TEMPLETON

*AUM is as of March 31, 2021 and refers to the assets under management for all credit funds and separately managed accounts managed by BSP. AUM amounts are unaudited and subject to change.