# REAL ESTATE INVESTMENT TRUSTS

Real estate investment trusts (REITS) are corporations which own and manage a portfolio of real estate properties and mortgages and they can be publicly or privately held. They provide a way for individual investors to participate in the income generated through real estate ownership without the expenses and effort of having to purchase and manage real estate themselves. REITs are gaining popularity again as a result of the real estate recovery which started back in 2010.

The introduction of REITs occurred back in 1960 by Congress as a way for average investors to invest in large-scale, income producing real estate holdings. In doing so, they structured them in the same way one would purchase equities. In the case of REIT investors, they earn a pro-rata share of the economic benefits that are derived from the production of income through commercial real estate ownership.

As of last year, there were 166 publicly-traded REITs in the U.S. that were registered with the SEC, and collectively, they had an equity market capitalization of over $580 billion. In addition, there are REITs registered with the SEC but that are not publicly traded, as well as REITs that are not registered with the SEC or traded on a stock exchange. The IRS shows that there are about 1,100 REITs in the U.S. (based on filed tax returns).

## TYPES OF REITs

There are three main forms of REITs:

- Equity REITs – These invest in and own the underlying properties. Revenues are generated primarily by the properties' rents, and they are responsible for the equity value of their real estate assets.
- Mortgage REITs – These deal in investment and ownership of property mortgages. This type of REIT loans money for mortgages to owners of real estate, or purchases existing mortgages or mortgage-backed securities. Revenues come primarily from the interest that they earn on the mortgage loans.
- Hybrid REITs – Combines equity and mortgage REITs as they invest in both properties and mortgages.

Most REITs specialize in a single type of real estate. For example, there are retail REITs, office REITs, residential REITs, healthcare REITs, and industrial REITs. The assets owned by a REIT may include office buildings, shopping malls, apartments, hotels, resorts, self-storage facilities, warehouses, and mortgages or loans. In some cases, REITs will invest specifically in one type of real estate while others may focus on investing in one region, state or country.

## QUALIFICATIONS FOR REIT CLASSIFICATION

To qualify as a REIT, the company's assets and income must be tied to a real estate investment and must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends. In addition to this, other requirements include:

- Be an entity that would otherwise be taxed as a corporation had it not been for its REIT status;
- Be managed by a board of directors or trustees;
- Have shares that are fully transferable;
- Have a minimum of 100 shareholders after its first year as a REIT;
- Have no more than 50 percent of its shares held by five or fewer individuals during the second half of the taxable year;
- Invest at least 75 percent of its total assets in real estate assets and cash;
- Have at least 75 percent of its gross income come from its real estate holdings, including rents from real property and interest on mortgages financing real property;
- Derive at least 95 percent of its gross income from such real estate sources and dividends or interest from any source; and
- Have no more than 25 percent of its assets consist of non-qualifying securities or stock in taxable REIT subsidiaries.

## TAXATION OF REITs

A company that qualifies as a REIT is allowed to deduct the dividends paid to its shareholders from its corporate taxable income. As a result, most REITs distribute 100 percent of their taxable income to their shareholders, which then enables a REIT to avoid being subject to corporate taxes. Instead, taxes are paid by shareholders both on the dividends received and any realized capital gains. Most states do not require REITs to pay state income tax. However, unlike a partnership, a REIT cannot pass through any tax losses to its investors.

## ADVANTAGES AND DISADVANTAGES OF INVESTING IN REITs

### ADVANTAGES

- Dividend Yield: Since a corporation must give back a minimum of 90 percent of profits to its shareholders in the form of dividends, the average REIT has a 6 percent annual dividend yield.
- Diversification: REITs provide diversification since they are not as correlated with other types of investments.
- Security: They hold tangible assets such as buildings and land and typically sign long-term lease agreements with their tenants. As a result, REITs are often considered to be one of the most secure corporations to invest in.
- Liquidity: For publicly-traded REITs, investors are able to liquidate their holdings at any time.

**DISADVANTAGES**

- Slower Potential for Capital Appreciation: Since REITs can only invest no more than 10% of their annual earnings back to their main business lines every year, most REITs usually grow at a slower rate compared to other companies.
- Non-Guaranteed Income: Even though REITs are often viewed as secure investments, there is a risk of the dividend payments being reduced or eliminated.
- Sector Risk – since REITs are invested in buildings, homes, and land, they are vulnerable to cyclical downturns in the real estate market.
- Potential Higher Tax Rates: Since REITs already have tax-advantaged status compared to various other companies, about two-thirds of the dividends paid out by REITs will not be entitled to the lower qualified dividend tax rate.

As with any investment, one must monitor their REIT holdings as they can experience periods of significant downturn (most recently, this occurred in 2008). REITs are just like other corporations which need to continue to have the resources available in order to remain in business.

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