IS A REIT RIGHT FOR YOU?

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Real estate investment trusts (REITs) have been around since the 1960s. The original REIT legislation was intended to provide the "average investor" with an opportunity to pool funds to buy real property. In a way, the REIT was the mutual fund equivalent for real estate. REITs have become increasingly popular in recent years. Not just for the average investor, but even for sophisticated real estate developers looking to attract capital and expand operations.

The rules for owning and managing a REIT can be complicated, but they are not onerous. Many property owners and real estate investors find the advantages of a REIT far outweigh the regulatory requirements, particularly when outside advisors assist. The discussion below may help you determine if a REIT is right for you.

Types of REITs

REITs generally fall into one of the three categories.

PUBLIC REITS

These are the REITs Congress envisioned in the 1960s: a publicly traded vehicle governed by the rules of the Securities and Exchange Commission (SEC). These REITs are generally large and raise capital on a regulated market, such as the New York Stock Exchange or NASDAQ. These REITs are subject to a great deal of governmental oversight and require frequent public filings.

NON-TRADED REITS

Non-traded REITs are subject to the same oversight and public filings required of a public REIT, but the stock is not traded. Instead, once all the capital has been contributed, the investors must exit their investment by having the REIT buy them out. As you can imagine, this type of REIT investment is not as liquid as a public REIT; however, these REITs often provide a fixed return attractive to investors who are looking for a long-term, nonvolatile investment—oftentimes with capital appreciation.

PRIVATE REITS

These have become more popular in recent years and are generally used for small equity raises or tax planning. Since they are not subject to the oversight of the SEC, these REITs are generally less costly to set up and operate. On the tax side, tax-exempt and foreign investors can often reduce or eliminate US tax by using a private REIT. These benefits are discussed in more detail below.

To decide whether a REIT is right for you, you need to determine what type of REIT fits into your development and equity raise plans. For most smaller real estate developers, the private REIT makes the most sense since it requires a smaller equity raise or would likely attract investors that must invest through a REIT (such as tax-exempt organizations and foreigners). Furthermore, a private REIT can always grow and become public.

On the other hand, larger developers often have the infrastructure, expertise, and asset size to go through an initial public offering and form a publicly traded REIT. The large developer will usually have a compelling story to bring to Wall Street and raise capital, which can be used to pay down debt and buy out a portion of the pre-REIT investors.

Advantages of REITs

To determine if a REIT is right for your organization you also need to understand the benefits REITs offer over other investment vehicles, such as partnerships and corporations.

NO FEDERAL OR STATE INCOME TAXES

Since a REIT is allowed a deduction for distributions to shareholders, it typically pays little to no federal or state income taxes. This allows investors to generally achieve a better return on their investment since the REIT's income is only taxed once. If the assets were held by a C corporation, for example, the income would generally be taxed twice—once at the corporate level and then again at the shareholder level. Thus REITs generally have a lower effective tax rate than C corporations.

FOREIGN INVESTORS CAN ESCAPE US TAX

Foreign investors can use private REITs to sell stock and avoid US tax all together. In some situations, the private REIT will need to be domestically controlled for the foreign investor to enjoy this benefit. Additionally, foreign investors that hold 5 percent or less of a public REIT can generally escape US tax on the sale of their stock and capital gain dividends. Finally, for many investors, there is little to no tax on operating income due to favorable treaties between the US and foreign countries.

TAX-EXEMPT INVESTORS CAN AVOID US TAX

Tax-exempt investors often use private REITs to convert rental income or gain from property sales which may be subject to US tax, to dividends which is generally not subject to US tax. Consequently, many tax-exempt investors require their investment in real estate to be "blocked" by a private REIT. Tax-exempt investors can enjoy the same benefit by investing in public REIT stock.

GOOD WAY TO BUY OUT FOUNDING MEMBERS

REITs are a good vehicle to raise capital. Therefore, a public or private offering is often used to "retire" the founding members in addition to paying off debt and investing in new projects.

INVESTORS LIKE TO OWN STOCK

Partnerships or limited liability companies taxed as partnerships often provide many of the tax advantages of a REIT (such as no federal taxes). Investors, however, often understand or prefer to own shares of stock instead of partnership interests. Simply put, potential investors often like the "feel" of stock.

INVESTORS CAN CONTRIBUTE PROPERTIES "TAX FREE"

A REIT can offer investors, with appreciated assets or partnership interest, negative capital to diversify their investment "tax free." This is done by having the investor contribute the property to a partnership owned by the REIT. The contributor participates in the REIT as if he or she were a shareholder of the REIT, but because the investor actually owns an interest in the partnership under the REIT, the "conversion" to a REIT is typically tax free. This structure is commonly referred to as an umbrella partnership real estate investment trust (UPREIT). The UPREIT transaction can also be accomplished without ending a property owner's management of the property and allows the owner to "diversify" the investment property supporting the cash flow. In order to be "tax free," sufficient debt must still be allocable to the partner contributing property to the UPREIT. Debt allocation rules are extremely complex and debt structuring is an often negotiated item among investors and UPREITs in order to properly plan for the possible tax implications.

INVESTORS CAN BENEFIT FROM CAPITAL GAIN RATES

A REIT can distribute capital gains to shareholders. For example, if the REIT sells a building for capital gain, individual shareholders will be taxed at capital gain rates on the cash distributed.

Disadvantages of REITs

In contrast to the potential benefits of using a REIT discussed above, there are also some potential disadvantages of the REIT structure.

A REIT CAN BE MORE EXPENSIVE

A REIT is generally more expensive to operate compared to a corporation or partnership. This is due to the fact a REIT requires annual and year-end testing to make sure the REIT is in compliance with the IRS rules. Additionally, there may be costs associated with due diligence on acquisition to make sure the assets are "REIT qualified." Nevertheless, the additional costs involved are often more than offset by the tax and operating benefits.

LIMIT TO TYPE OF ASSETS AND FEES

REITs cannot invest in certain types of assets since they cannot be an "operating" business (see "What to hold in a REIT" below). Additionally, REITs cannot "flip" properties for gain. Instead, they need to hold on to properties for long-term appreciation (usually at least two years). Non-REIT developers are not subject to these limitations and may be able to take advantage of market opportunities that REITs must pass on.

LOSSES DO NOT PASS TO INVESTORS

Although ordinary and capital gains pass to REIT investors, losses, on the other hand, get trapped in the REIT. The REIT may be able to use the losses to retain cash in the REIT, but unlike a partnership, investors in the REIT will not be able to use the losses on their own tax returns to offset income.

ORDINARY DIVIDENDS TAXED AS ORDINARY RATES

Ordinary dividends from a REIT are subject to ordinary income tax rates. However, because a C corporation is subject to corporate level tax, any ordinary dividends distributed to shareholders are generally taxed at capital gain rates to the shareholders.

DIVIDENDS SUBJECT TO NET INVESTMENT INCOME TAX

REIT dividends are subject to the 3.8 percent net investment tax. In some situations rental income and the gain from the sale of real estate held in a partnership may escape this tax. Therefore the effective tax rate of real estate held through a partnership may be lower than real estate held through a REIT.

CANNOT MAKE INSIDE BASIS ADJUSTMENTS WHEN STOCK IS PURCHASED

Under section 754 of tax code, a partnership can adjust the inside basis of assets for any increase in value when a partnership interest is purchased, allowing the purchaser to deduct the additional amount paid as depreciation. This benefit is not available to a REIT.

STOCK FOR SERVICES IS TAXABLE

Partnerships can offer employees "profit interests." For the most part, these types of interests are not taxable to the employee when he or she receives them. Unfortunately, there is not a similar opportunity for REIT shares. If a REIT issues stock to an employee it will be taxable, unless the stock has restrictions.

Real estate developers need to consider the many advantages and disadvantages of using the REIT structure over a corporation or partnership. Nevertheless, the benefits of using a REIT often far outweigh the downsides of such an investment vehicle.

What to hold in a REIT

REITs are best suited for income-producing properties or assets, such as offices, lodging facilities, apartments, and most traditional brick-and-mortar properties and mortgages. Note lodging and assisted living properties have special rules. REITs that hold these types of assets must set up a special entity called a taxable REIT subsidiary (TRS) and lease the property to the TRS. This is required so the REIT is not viewed as operating an active business. A TRS is simply a C corporation owned by the REIT that makes a special election.

Other types of property, such as condos, raw land, and debt with no collateral, are typically not well suited to REITs because they do not produce rental income or are sold quickly. In some cases, these "bad" assets can be turned into "good" assets by having them held in a TRS. By holding the assets through a TRS, any operating income or gains will be subject to "double taxation" because the TRS is taxed as a C corporation.

As mentioned earlier, a number of rules govern how a REIT is set up and managed. IRS and other regulatory bodies' penalties can be severe if these rules are not met.

Set-up considerations

Typically, REITs are corporations or business trusts. Initial considerations include what form to choose and where to incorporate the entity.

INCORPORATION

REITs can be set up in many different ways. Many people default to the state of Maryland because Maryland has been the state of choice for REITs for many years. Maryland law is accommodating to REITs, and many of the larger brokerage firms (if the REIT is going to be raising capital publicly) prefer Maryland incorporation. Local entities are also popular for REITs that plan to attract investment from a single state or region.

FINANCING

Another consideration revolves around financing. REITs funded by private financing can be structured differently from those traded on an exchange, and recent changes in federal and state laws offer more flexibility and typically reduced expense. The financing the REIT intends to pursue typically dictates the REIT's corporate and offering structures.

Again, a REIT can be an excellent way of attracting private capital from accredited investors because of the tax benefits, flexibility, and relatively high dividend yields.

PROPERTY TRANSFER

Another consideration involves how owners of multiple properties will transfer those properties to the REIT and how multiple investors (such as funds) will provide equity. Conveying owners' interests in properties is time consuming, and different properties, each with their own facts and circumstances, will require different strategies depending upon how they are held and financed.

TESTING

Finally, the penalties for improper set-up or management of a REIT can be draconian, including the loss of tax benefits and other substantial penalties. Adverse consequences can be avoided by using competent outside professionals and conducting regular compliance testing to ensure the REIT meets numerous tax requirements.

Bottom line

REITs are becoming increasingly popular as a way to hold property and attract investment with tax benefits and flexibility that many other investments cannot match. The process of setting up and managing a REIT can be complicated, but with experienced advisors, you should be able to evaluate whether a REIT is right for you and make an informed decision.