INVESTMENT CONCEPTS, INC.
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Real Estate Investment Trusts (REITs)

What is a REIT?

A real estate investment trust is a company that buys, develops, manages, and/or sells real estate such as skyscrapers, shopping malls, apartment complexes, office buildings, and housing developments. Rather than investing directly, investors in REITs put their money into a professionally managed portfolio of real estate. REITs make money from rental income, profits from the sale of the property, and other services provided to tenants. REITs also receive special tax considerations; they do not pay taxes as long as they pay out at least 90% of their net income to their shareholders. Thus, successful REITs can offer investors high yields, current income, and moderate growth.

There are several types of REITs. An equity REIT's main business is buying, renovating, managing, maintaining, and selling real estate. This is by far the most common type of REIT available today. An equity REIT may invest broadly or may be dominated by a particular segment of the market--for example, retail space or apartment buildings. Mortgage REITs make loans or invest in existing mortgages. Hybrid REITs combine the characteristics of equity and mortgage REITs. Additional corporate structures (e.g., the UPREIT and DownREIT) were developed in the early 1990s; these REITs typically focus on providing tax benefits to their shareholders.

A REIT may trade on the major exchanges, just like stocks, or may be what is called a "non-traded REIT." There are substantial differences between the two types. Publicly traded REITs are relatively easy to buy and sell (note that you will incur a brokerage commission when you buy and sell a traded REIT); the same is not true for non-traded REITs. Your ability to redeem shares of a non-traded REIT may be limited, and if you choose to redeem your shares, they may be worth less than you originally paid for them. Also, front-end fees can exceed those of exchange-traded REITs. However, non-traded REITs are subject to similar SEC disclosure requirements.

Caution: Before investing in a non-traded REIT, carefully consider its investment objectives, risks, fees, and expenses, which are contained in the prospectus available from the REIT. Read it carefully before investing. Special risks associated with a REIT and its underlying assets should be identified in the prospectus. Keep in mind that a specific offering may not meet its stated investment objectives.

Caution: Non-traded REITs are considered a high-risk investment and may not be appropriate for all investors. Investors must meet specific suitability standards. Some REITs may not qualify as a REIT as defined in the tax code, which could affect operations and negatively impact the ability to make distributions. If distributions include a return of principal to investors, the program will have less money to invest, which may lower its overall return. If distributions include borrowed funds, the distribution rate may not be sustainable. An investor's participation in a real estate program is an investment in the program and not a direct investment in real estate or any other asset owned by the program.

What are the strengths?

All REITs are governed by strict regulations

REITs are generally required to have at least 100 investors, and laws prevent a small number of those investors from owning a majority interest in the REIT. At least 75% of a REIT's assets must be in real estate, and at least 75% of its gross income must be derived from rents, mortgage interest, or gains from the sale of property. Also, REITs are required by law to pay out at least 90% of annual taxable income (excluding capital gains) to their shareholders in the form of dividends. This restriction, however, limits a REIT's ability to use internal cash flow for growth purposes.

REIT shares may be more liquid than a direct investment in real estate

If you need cash in a hurry, it is much easier to liquidate shares of a publicly traded REIT than it is to sell rental property, office buildings, or other real estate. Because exchange-traded REIT shares are typically traded on major exchanges, it is easier to buy and sell shares than to buy and sell properties in the private market. (However, as noted above, this is not true of non-traded REITs.)

Professional management

REITs are run by professionals. Once you have purchased shares in a REIT, your investment is in the hands of people who make their living by buying, selling, and managing real estate. You don't have to be an expert real estate trader, because the professionals are making the decisions for you.

REITs open up investment opportunities that might not be available to individual investors

Because you are pooling your money with the funds of many other investors, your initial cash outlay is much less than for other types of real estate investments. This makes REIT investing accessible for many people who can't afford to buy office buildings and apartments on their own. And because your money is pooled with that of other investors, your personal exposure to risk is lower than if you were investing directly in real estate.

REITs can provide current income

Because REITs are required to pay out 90% of their annual income in the form of dividends, you can expect to receive income from your REIT investment.

What are the tradeoffs?

Supply/demand imbalance

REITs depend on an adequate supply of tenants and/or buyers to occupy their properties. During certain periods (e.g., a building boom or an economic downturn), the supply of available space may exceed the demand by a significant margin, leaving REITs with property that is vacant or less than fully occupied. During these periods, it may also be difficult to make profits on rents because the excess supply of rental property will drive rental prices down. These factors can reduce a REIT's profitability.

Rising interest rates

When interest rates increase, a REIT's borrowing costs increase. This can affect a REIT's bottom line. In addition, increasing interest rates can foreshadow a weakening economy, which in turn can reduce the demand for space.

Other factors

REITs are also subject to the risks associated with the general real estate market, including possible declines in the value of real estate, changes in overall economic conditions, and the potential lack of availability of mortgage funds.

In addition to the general real estate risks mentioned above, other factors can pose a threat to individual real estate sectors. For example, recessions can impact REITs in the retail sector, while health-care reforms may have an effect on REITs that invest in hospitals and assisted-living facilities.

REITs are also subject to risks associated with the underlying REIT properties. These risks include increases in property taxes, changes in zoning laws, changes in neighborhood values, and the possibility of a natural disaster. These risks may be more significant to the extent that the REIT's investments are concentrated in a particular geographic region. Further, loss of management credibility can be devastating to any REIT.

As noted above, non-traded REITs are not considered as liquid as exchange-traded REITs, and can be very difficult to sell on the secondary market. Because non-traded REITs may involve substantial redemption fees, they are best suited for long-term investors who will not need access to their invested capital in the short term. Also, distributions are not guaranteed and can be suspended or halted altogether. REITs can involve substantial tax consequences, and you should make sure you understand those consequences before investing in a REIT. Finally, you should weigh the fees and expenses involved against the return you hope to receive, either from income or capital appreciation.

If you're going to invest in REITs, selecting several that are in different sectors of the real estate market and different geographic regions can help diversify your risk (though diversification alone can't guarantee a profit or protect against the possibility of loss).

Investing in a REIT

Find the right REIT

Investors can evaluate publicly traded REITs just as they would evaluate stocks. Among other things, investors should look at the company's earnings--both past performance and the potential for future growth--dividend yield, payout ratio, and price-earnings ratio. However, bear in mind that past performance is no guarantee of future results.

Caution: A third type of REIT--a private or private-placement REIT--also does not trade on public exchanges and is generally open only to accredited investors with a net worth of more than $1 million. Because they are unlisted, private REITs can be hard to value and trade. Also, they generally are exempt from the regulations that govern publicly traded REITs and do not have to meet the same disclosure requirements. They are not suitable for all investors, and you should make sure you are fully informed about the substantial risks they involve.

Monitor your investment

By keeping an eye on the real estate market, you may be able to detect subtle signs that suggest a change to your investment strategy. For example, overbuilding in a certain sector may be a sign that it's time to decrease your holdings in that area, perhaps by moving your money to a REIT that has a different focus.

What are the tax considerations?

REITs are typically not useful as a tax shelter

REITs are not allowed to pass losses through to their investors. Thus, their use as tax shelters is extremely limited.

Dividends are typically taxable income

You must typically pay income tax on the dividends you receive from your REIT investment. Also, dividends will be included when calculating whether some or all of your total investment income is subject to the 3.8% net investment income tax (also referred to as the unearned income Medicare contribution tax) that applies to individuals with an adjusted gross income (AGI) above $200,000 and couples filing a joint return with an AGI above $250,000.

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A portion of REIT dividend payments may be taxed at lower capital gains tax rates

Qualified dividends paid to individual shareholders from domestic corporations (and qualified foreign corporations) are taxed at long-term capital gains tax rates rather than at ordinary income tax rates. The maximum rates that apply to long-term capital gains range from 0% for individuals in the 10% and 15% marginal income tax brackets to 20% for taxpayers in the highest income tax bracket of 39.6%.

Note: A 3.8% net investment income tax may also apply to individuals with AGI that exceeds $200,000 ($250,000 for married couples filing jointly).

Generally, however, REIT dividends will not qualify for taxation at capital gains rates. Instead, REIT dividends are generally taxed at ordinary income tax rates. This is because most REIT dividends are composed of rents or other earnings that are being passed through to shareholders. To the extent that a REIT dividend represents qualified corporate dividends being passed through to REIT shareholders, though, the dividend will qualify for taxation at capital gains rates.

Further, if the REIT realizes a long-term capital gain from the sale of some of its real estate, it may designate a portion of the dividend paid during that year as a long-term capital gain distribution. The portion of the dividend considered capital gain income would also be subject to capital gains tax rather than ordinary income tax.

Capital gains tax liability may also result from the sale of REIT shares

You may be required to pay capital gains tax when you sell your REIT shares, if you sell them for more than you paid for them and the gain cannot be offset by capital losses. Any such gain will be included in calculating whether you are subject to the additional 3.8% net investment income tax.