Real Estate Investment Trusts

Many individuals are attracted to the benefits of investing in real estate, such as current income or the potential for capital gain. Direct investment in real estate, however, can require large amounts of capital, as well as the time and expertise to properly manage real estate properties. At times, the cyclical nature of real estate can make such investments difficult to sell.

One alternative to direct real estate investment is the real estate investment trust (REIT). REITs allow small investors to share in both the risks and rewards of real estate investing.

What Is a Real Estate Investment Trust?

First authorized by Congress in the 1960s, REITs bring together capital from many individuals specifically to invest in a diversified portfolio of income real estate, or in real estate-related debt (mortgages). A REIT can take the form of a trust, association or corporation. Individuals invest in a REIT by purchasing shares, similar to shares of common stock. The shares of many REITs are publicly traded on major stock exchanges and over-the-counter markets.

Full-time managers conduct the day-to-day operations of a REIT. If a REIT is successful, shareholders can receive dividend income (from rental income and mortgage interest) and capital gain from the profitable sale of real estate assets. Some REITs specialize in a single type of commercial property or region of the country. Other REITs diversify their investments over various types of property or in different geographical areas.

Types of Real Estate Investment Trusts

REITs are usually classified according to their investment focus:

- **Equity REIT:** Equity REITs directly own and operate income properties such as apartment buildings, discount outlet centers, mobile home parks, office buildings, industrial parks, or hotels. Income is generated from property rents. Capital gain income is also possible if properties are sold at a profit.

- **Mortgage REIT:** Mortgage REITs invest their money in various types of mortgages, usually for existing properties. In some cases REIT funds will back mortgages on new construction. Income is generated from the interest received on the mortgages.
- **Hybrid REIT:** As the name suggests, hybrid REITs invest in both direct ownership of real estate as well as mortgage loans.
- **Finite life real estate investment trust (FREIT):** FREITs are a type of equity REIT which have a stated goal of liquidating the real estate portfolio by a specific date. The primary investment goal of a FREIT is to maximize potential capital gain.

Income Tax Issues

The Internal Revenue Code (IRC) contains a number of conditions which a trust must meet to qualify as a Real Estate Investment Trust, including the requirement that a REIT pay out at least 90% of its taxable income.[1] If a REIT meets these conditions, the income paid to the shareholders is not taxed twice (as it would be in a regular corporation), but is taxed only once, in the hands of the shareholders.

- **Ordinary income distributions:** Income from sources such as rents and mortgage interest received is fully taxed to the shareholder as ordinary income.[2]
- **Capital gain distributions:** Capital gain from the profitable sale of real estate investments is long-term gain, regardless of the length of time an individual has owned his or her shares in the REIT.[3]
- **Qualified business income deduction:** If certain requirements are met, for tax years after 2017 and before 2026, IRC Sec. 199A(b)(1) allows a taxpayer to deduct 20% of the total amount of "qualified" REIT dividends. For this purpose, a "qualified" dividend has a specific meaning. The guidance of tax professionals in claiming this deduction is highly recommended.

If a shareholder sells his or her shares in a REIT, the gain or loss for federal income tax purposes generally depends on how long the shares were owned.[4]

[1] See IRC Sec. 857(a)(1).

[2] Currently, federal income tax law taxes "qualified" stock dividends at marginal rates lower than those generally applicable to ordinary income. Unless certain, narrow conditions are met, ordinary income distributions from a REIT will <u>not</u> qualify for these lower qualified dividend rates.

[3] Capital gain distributions from a REIT will generally be taxable at the favorable federal capital gains rates available to taxpayers.

[4] State or local law may provide for different tax treatment of income received from a REIT.

Investment Uses

Many investors are attracted to mortgage REITs because of the relatively high level of current income; REITs in general tend to provide a current yield greater than long-term U.S. Treasury bonds. Equity REITs are often sought for their long-term appreciation potential and as a hedge against inflation. Many investors view real estate as a separate asset class – distinct from other financial assets such as stocks or bonds – and thus value REITs for their diversification benefits.

How to Invest

- **Direct ownership:** Individuals can invest in a publicly traded REIT by purchasing shares through a stockbroker or other securities-licensed professional, holding the shares in their own names.
- **Indirect ownership:** Open-end investment companies, known as mutual funds, are an indirect method of REIT ownership. Mutual funds pool the resources of many individuals and offer an investor access to a diversified portfolio of professionally managed securities. There are many mutual funds that specialize in REITs,[1] including those with a global orientation.

Possible Risks

- **Market risk:** As with all stocks, the value of shares in publicly-traded REITs can fluctuate. An investor who sells shares in a REIT could receive more, or less, than the original purchase price. Factors that can influence market risk include the general level of real estate property values, REIT dividend payouts, management skill, and broad stock market trends.
- **Interest rate risk:** Shares of REITs, especially mortgage REITs, are sensitive to changes in the general level of interest rates. Mortgage REITs respond much like bonds, generally increasing in value as interest rates fall and decreasing in value if interest rates rise.

[1] The Securities and Exchange Commission requires that all prospective mutual fund investors be given a prospectus. The prospectus contains valuable information concerning how an investment works, its goals and risks, and any expenses and charges involved.