PUBLICATION

REITs – A Vehicle for Investments in Real Estate

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A REIT is a corporation, trust or association that is governed by specific sections of the Internal Revenue Code (the Code) and elects to be treated as a "REIT" thereunder.

Congress created REITs so that large-scale real estate investments would be accessible to a broader range of the public, permitting investment in a single economic pursuit geared to the production of income through commercial real estate ownership. REITs also offer greater diversification through investing in a portfolio of properties rather than a single building or property and also enable investors to participate in large real estate interests that are selected and managed by professionals experienced in such selected real estate interests. The REIT industry has grown into a significant asset class and has attracted the attention of major institutional investors.

Today's REITS are generally equity REITs, typically self-managed and self-administered. Usually they are fully- integrated real estate operating companies whose portfolios are focused by property type and location. Management typically has many years of operating experience and is incentivized through its ownership of a portion of the REIT equity.

One of the major advantages associated with REITs is the ability to deduct dividends paid to shareholders in calculating any entity-level tax. As a result, the federal tax treatment allows most REITs to pay at least 100 percent of their taxable income to their shareholders and therefore owe no entity-level tax. Taxes are paid by the shareholders on the dividends received and any capital gains; thereby ensuring a single level of tax. Most states accept this federal tax treatment.

There are many different types of REITs, some of which are public, registered with the Securities and Exchange Commission in the United States and traded on one of the major stock exchanges, and some are private. Between 1993 and 1998, approximately 150 REITs became public while many others merged to create even larger companies. As a result, the number of publicly traded REITs as of June 30, 2006 grew to approximately 177.

REITs generally fall into three major categories: mortgage, equity or hybrid. REITs that specialize in property ownership are called equity REITs. Equity REITs own, invest and sometimes manage and operate and/or develop income-producing real estate (i.e., a health care REIT, with some minor exceptions, cannot operate a hospital). An equity REIT must acquire and develop its properties primarily to operate them as part of its own portfolio rather than to resell them once developed. An equity REIT derives its revenue principally from rent payments. REITs that concentrate their activities and assets in financing are called mortgage REITs. Mortgage REITs lend money directly to real estate owners and/or the operators of the real estate, often extending the credit through mortgaged-back security interests in the real estate. REITs that combine property ownership and lending or financial activities are known as hybrid REITs.

Many REITs further specialize by investing in particular types of property, specific geographic areas or specific ownership or lending arrangements. For example, there may be REITs specializing in healthcare facilities, shopping centers, apartment complexes, hotels and office buildings.

The structure of a REIT typically falls within two categories: traditional and UPREIT (sometimes reference is made to a DownREIT which is really only a slight variation of an UPREIT). A traditional REIT structure is one in which the assets of the REIT are owned by the REIT directly rather than through an operating partnership. An UPREIT structure is one in which the REIT does not own a direct interest in properties, but rather in an operating partnership that holds the REIT's assets and conducts business for the REIT and may also own interests in joint ventures in addition to the properties. One of the major advantages of an UPREIT is the ability of the contributing property owners to defer all or most of any gain realized on the contribution of appreciated real estate to the operating partnership. However, this structure may also create conflicts because of the two different sets of fiduciary duties, especially in change of control transactions due largely in part to the different tax positions of the REIT shareholders and the unitholders of the operating partnership.

To qualify as a REIT, a company must meet certain requirements under the Code. The organizational and operational rules applicable to REITs are not easily generalized; therefore, the following are listed only in very summary terms. For a more detailed review and understanding of the applicable rules, see Sections 856 through 860 of the Code.

Generally, the company must (1) be a taxable corporation, business trust or similar association; (2) be managed by a board of directors or trustees; (3) have shares that are fully transferable; (4) have a minimum of 100 shareholders (though not in its first year); (5) have no more than 50 percent of the shares held by five or fewer individuals during the last half of each taxable year (though not in its first year); (6) invest at least 75 percent of the total assets in real estate and generate 75 percent of its income from rents; (7) pay a dividend of at least 90 percent of the REIT's taxable income; and (8) not engage in certain prohibited transactions. REITs often form taxable REIT subsidiaries to engage in activities that would otherwise be prohibited.

This article has mentioned broad concepts and generalizations relating to REITs. The intricate details involving REITs require careful and expert advice and attention. The attorneys in the REIT and Real Estate Capital Market Group have extensive practical, hands-on experience in forming REITs, taking REITs public and raising money in private placements, closing acquisitions of properties to be owned and/or developed by REITs (traditional and UPREITs) and providing tax advice to public and private REITs.