



WSB Investments Group
J. Eric Hanson, CRPC
Investment Executive
Infinex Financial Group
661 Main Street
Winchester, MA 01890
781-368-9295
jhanson@infinexgroup.com

Real Estate Investment Trusts (REITs)

Real Estate Investment Trusts (REITs)

What is it?

A real estate investment trust (REIT) is a company that buys, develops, manages, and/or sells real estate such as skyscrapers, shopping malls, apartment complexes, office buildings, or housing developments. Rather than investing directly, investors in REITs put their money into a professionally managed portfolio of real estate. REITs trade on the major exchanges, just like stocks. 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 percent of their net income to their investors. 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. 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.

What are the strengths?

All REITs are governed by strict regulations

REITs are generally required to have at least 100 investors, and there are laws that prevent a small number of those investors from owning a majority interest in the REIT. At least 75 percent of a REIT's assets must be in real estate, and at least 75 percent 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 percent of annual taxable income (excluding capital gains) to their investors in the form of dividends. This restriction, however, limits a REIT's ability to use internal cash flow for growth purposes.

REIT shares are 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 REIT than it is to sell rental property, office buildings, or other real estate. Part of the reason for this liquidity is that REIT shares are typically traded on major exchanges, making it easier to buy and sell REIT shares than to buy and sell properties in the private market.

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 percent 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 negatively impact a REIT's profitability.

Rising interest rates

When interest rates increase, a REIT's borrowing costs increase. This can negatively impact 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, possible declines in economic conditions, and possible 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.

If you're going to invest in REITs, you may want to buy several and make sure they're from different sectors and different geographic regions.

Use as a tax shelter is limited

Unlike other forms of real estate ownership, REITs are not allowed to pass losses through to their investors. Thus, if your REIT investment loses money, you will not be able to use this loss to offset other investment gains. Depending on your reasons for investing, not having this tax break could be a significant disadvantage.

How to do it

Find the right REIT

Because they are publicly-traded companies, investors can evaluate 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.

Monitor your investment

By keeping an eye on the real estate market, you may be able to detect subtle signs prompting a change to your investment strategy. For example, overbuilding in a certain sector may be a sign that it's time to move your money to a REIT that focuses on another type of property.

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.

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

For tax years beginning on or after January 1, 2003 and before January 1, 2011, qualifying dividends paid to individual shareholders from domestic corporations (and qualified foreign corporations) are taxed at long-term capital gains tax rates. For tax years prior to January 1, 2003, however, stock dividends were taxed at ordinary income tax rates, generally resulting in significantly more tax due.

Caution: Absent further legislative action, stock dividends will again be taxed as ordinary income beginning in 2011.

Generally, however, REIT dividends will not qualify for taxation at capital gains rates. Instead, REIT dividends will generally continue to be taxed at ordinary income tax rates. This is because most REIT dividends are comprised 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. If this gain cannot be offset by capital losses, you will have to pay capital gains tax on this amount.



WSB Investments Group
J. Eric Hanson, CRPC
Investment Executive
Infinex Financial Group
661 Main Street
Winchester, MA 01890
781-368-9295
jhanson@infinexgroup.com

Investment and insurance products and services are offered through INFINEX INVESTMENTS, INC. Member FINRA/SIPC. In Massachusetts, insurance products are offered through Infinex Insurance Agency of Massachusetts, Inc. Infinex and the bank are not affiliated. Products and services made available through Infinex are not insured by the FDIC or any other agency of the United States and are not deposits or obligations of nor guaranteed or insured by any bank or bank affiliate. These products are subject to investment risk, including the possible loss of value. NOT FDIC-INSURED. NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY. NOT GUARANTEED BY THE BANK. MAY GO DOWN IN VALUE.