CHAPTER 6

Getting Technical

Before discussing factors that influence REIT performance in Chapter 7 and the various metrics used to analyze REITs in Chapter 8, there are a few technical items specific to REITs that are helpful to understand.

REIT Structures

As discussed at the outset of this book, REITs are companies that own or finance income-producing commercial real estate. The majority of REITs are equity REITs, which generally derive the bulk of their income from rental revenue paid by tenants. Prior to 1992, equity REITs owned their commercial properties directly or through joint ventures. As Figure 6.1 illustrates, the investing public buys shares in the REIT, which invests the monies into rentable properties and in turn pays a dividend back to shareholders from the net income derived from operating the rental properties. As with any other stock, the dividend represents an investor's current return, or yield, on their REIT shares.

So with a traditional REIT structure (Figure 6.1), shareholders essentially owned a portion of the REIT's business enterprise, prorated according to how many shares they owned of the REIT as a percentage of total shares outstanding. If an investor owned 5 percent of a REIT's outstanding shares, they essentially owned 5 percent of that REIT's assets and operations.

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Stephanie Krewson-Kelly and R. Brad Thomas
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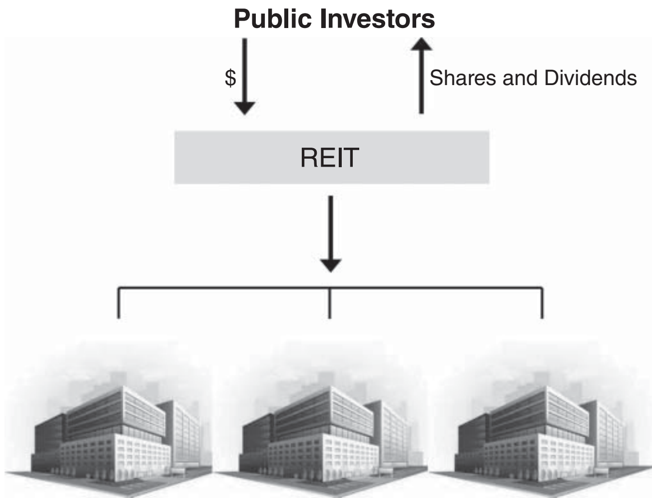

Figure 6.1 REIT Structure

UPREITs

Beginning in 1992, the REIT corporate ownership structure underwent a radical change with the introduction of the Operating Partnership Unit (OP unit) and the Umbrella Partnership REIT (UPREIT) structure. Taubman Centers, Inc. (NYSE: TCO) is credited for innovating the UPREIT structure with its initial public offering (IPO) in 1992.

UPREITs differ from traditional REITs in two ways. First, and as shown in Figure 6.2, in the UPREIT structure, the REIT does not own its properties directly. Instead, the REIT owns (usually a great majority of) units in a limited partnership called an operating partnership (OP), which in turn owns and operates the properties. As Figure 6.2 illustrates, the UPREIT owns an interest in and is the sole general partner of its OP. When an UPREIT sells common shares or issues debt to the investors, it contributes the proceeds raised to its OP in exchange for additional OP units. The OP technically is the legal entity that buys and/or develops properties and operates them. From the money it earns from operating the properties, it "dividends" money back to the UPREIT, which pays dividends to the investors. The OP, therefore, is a pass-through mechanism that is transparent to public shareholders. Second, UPREITs have an additional currency besides cash and common stock with which its management team can acquire properties: the OP unit.

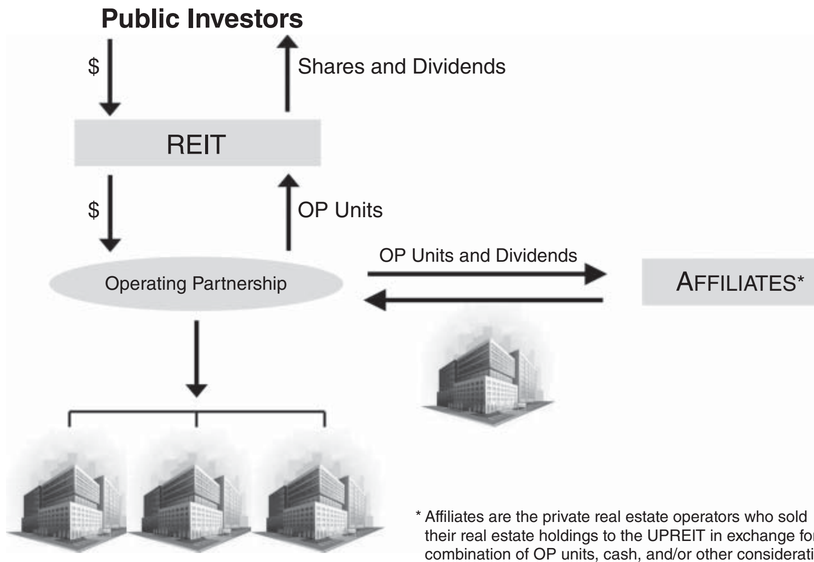

Figure 6.2 UPREIT Structure

OP Units

As is the case for all U.S. partnerships, the operating partnership of an UPREIT can issue OP units to the seller of property as a form of consideration, similar to issuing common shares. OP units are economically the same as shares of common stock in that the OP unit holders receive the same distributions per unit as the UPREIT's stockholders receive on their common shares. Unlike common stock, OP units are not publicly traded and the owner cannot vote regarding UPREIT corporate governance matters. In nearly every instance, OP unit holders can convert each unit on a one-for-one basis into common stock of the UPREIT or for cash (at the UPREIT's option). When unit holders convert to common shares, they become shareholders of the UPREIT. Converting OP units to shares also triggers a taxable event.

It is the nontraded (that is, *illiquid*) characteristic of the OP unit that enables the IRS to view them similarly to like-kind exchanges when a REIT tenders them as consideration for limited partnership (LP) interests in an acquisition property. Said more simply, by accepting OP units rather than cash or stock as payment for a property, the seller of the property may defer the tax liability that otherwise would have been triggered at the time of the asset sale.

Generally, the IRS views the contribution of limited partnership units of real property in exchange for partnership interests, including OP units, as a nontaxable event. As a result, the party that contributed real estate in exchange for OP units may be able to defer the recognition of capital gains (and the associated taxes) until such time as they convert their OP units into shares of the UPREIT or cash.

Because OP units enable REITs to acquire properties on the same basis as regular contributions of properties to partnerships, since 1992 most REITs have opted to adopt the UPREIT structure. Many REITs that were publicly traded before 1992 have converted to the UPREIT structure over time.

OP Units and Estate Planning

Private real estate operators typically own their assets in LPs with each limited partner (investor) having rights to his or her *pro rata* share of the partnership's profits and losses. The Tax Code requires landlords to depreciate the value of a property (excluding land value) over the "useful life" of the building. In the cases where private landlords have owned their properties for a number of years, for income tax purposes, they likely have a very low or even negative basis in each asset. Consequently, the sale of their assets at current market values would trigger a meaningful gain on sale, resulting in a significant tax liability.

Because OP units are similar to any other partnership contribution in the eyes of the IRS, a seller may defer his current tax liability* by accepting a UPREIT's OP units as part of or the entire sales price, instead of cash or common stock. Equally important is the fact that, upon the OP unit holder's death, the basis in his or her OP units is stepped up to the then-current market value of the REIT's common stock. The seller's heirs can then convert the OP units into common shares of the REIT without triggering a capital gain.

*Note: Before entering into a transaction, sellers of property should consult with their tax accountant to determine their ability to defer taxes according to then-current U.S. Tax Code.

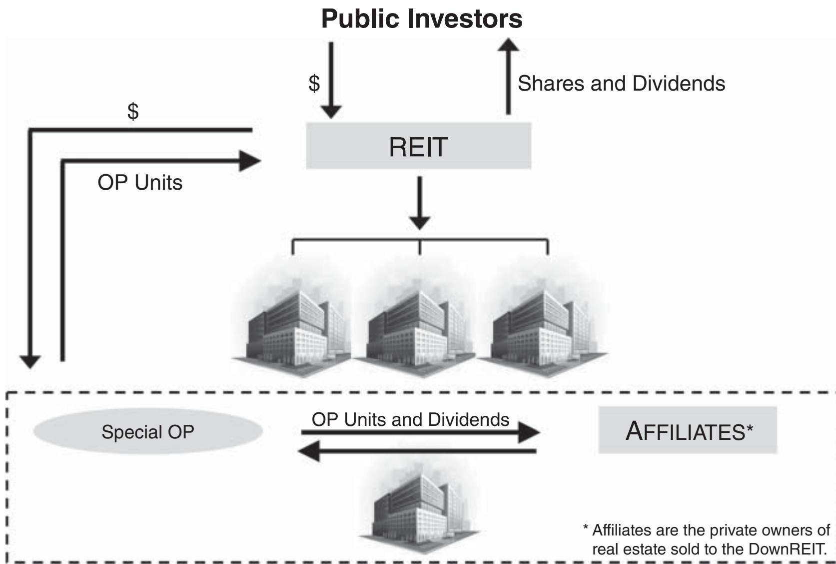

Figure 6.3 Corporate Structure of a DownREIT

DownREITs

In some instances, older REITs found it too costly to convert to an UPREIT structure. For example, the legal process of contributing properties from the REIT to a new OP could trigger potentially massive state-level transfer taxes. To compete with UPREITs in bidding for privately held assets with tax-efficient purchase proposals, some REITs began acquiring assets using DownREIT structures. REITs formed OPs that issued DownREIT OP units to acquire specific portfolios of assets, usually from one seller or partnership. Figure 6.3 shows a REIT that owns assets directly as well as in a DownREIT structure.

Issues emerged with this somewhat restrictive structure, however, such as the REIT's ability to later sell assets owned in a DownREIT. Additionally, DownREIT unitholders often had different voting rights than public shareholders of the REIT, which proved to be an unsustainable conflict. The DownREIT structure has been improved to eliminate prior conflicts and today is a useful tool that many traditional REITs like Kimco Realty (NYSE: KIM) employ when necessary to acquire assets in a tax-efficient manner.

Publicly Traded, Public Nonlisted, and Private REITs

The focus of the chapters leading up to this point has been to provide information and data on publicly traded REITs. In the past two decades, however, private REITs and REITs that are public but nonlisted on any exchange have proliferated. The biggest difference between publicly traded REITs and their public nonlisted REIT (PNLR) cousins is liquidity. However, there are many other differences associated with private and nontraded REITs. Table 6.1 summarizes the major differences between REIT structures.

Volatility versus Liquidity

Investors in PNLRs and private REITs often cite the lack of daily price changes (or *volatility*) among the benefits of investing in these entities. They like the fact that they do not have to worry about the daily price movements in their investments, as do shareholders in publicly traded REITs. However, this semblance of stability comes at the steep price of not having liquidity. Shareholders of publicly traded REITs own liquid investments that can be sold instantly in the stock market. It can take weeks or months to redeem an investment in a private REIT or PNLR; in some instances, redemptions may be forbidden for a specified period of time. If investors need liquidity, they should avoid investing in private REITs and/or PNLRs. Moreover, a FINRA rule going into effect in April 2016 requires customer statements for PNLR investments to show the shareholder's net investment (i.e., subtracting commissions) for the first couple of years and then the shareholder's share of net asset value of the PNLR thereafter. This new rule will make the PNLR shareholder's investment more transparent and therefore possibly more volatile than in the past.

Transparency and Corporate Governance

Publicly traded REITs and PNLRs must file quarterly and annual periodic statements with the SEC. Accordingly, shareholders in these REITs enjoy a high level of transparency and ultimately benefit from a greater alignment of shareholder–advisor interests. In contrast, private REITs do not have to disclose their financial statements.

Table 6.1 Comparison of Public versus Nontraded and Private REIT Structures

	Publicly Traded REITs	Public Nonlisted REITs	Private REITs
Overview	REITs that file with the SEC and whose shares trade on national stock exchanges.	REITs that file with the SEC but whose shares do not trade on national stock exchanges.	REITs that are not registered with the SEC and whose shares do not trade on national stock exchanges.
Liquidity	Shares are listed and traded on major stock exchanges and can be bought and sold instantly during market hours through financial advisors and on-line brokerage houses. Most publicly traded REITs are listed on the NYSE.	Shares are not traded on public stock exchanges. Redemption programs for shares vary by company and are limited. Generally, a minimum holding period for investment exists. Investor exit strategy generally linked to a required liquidation after some period of time (often 10 years) or, instead, the listing of the stock on a national stock exchange or a merger into a traded company at such time.	Shares are not traded on public stock exchanges. Existence of, and terms of, any redemption programs varies by company and are generally limited in nature.
Transaction	Brokerage costs the same as for buying or selling any other publicly traded stock.	Typically, fees of 10–15 percent of the investment are charged for broker-dealer commissions and other up-front costs, although some PNLRs are now spreading out the fees over several years. On-going management fees and expenses also are typical. Back-end fees may be charged.	Varies by company.
Management	Typically self-advised and self-managed.	Typically externally advised and managed, although many have internal management before a liquidity event.	Typically externally advised and managed.

(continued)

Table 6.1 (*continued*)

	Publicly Traded REITs	Public Nonlisted REITs	Private REITs
Minimum Investment	One share.	Typically $1,000–$2,500	Typically $1,000–$25,000; private REITs that are designed for institutional investors require a much higher minimum.
Independent Directors	Stock exchange rules require a majority of directors to be independent of management. NYSE and NASDAQ rules call for fully independent audit, nominating, and compensation committees.	Subject to North American Securities Administrators Association (NASAA) regulations. NASAA rules require that boards consist of a majority of independent directors. NASAA rules also require that a majority of each board committee consist of independent directors.	Not required.
Investor Control	Investors reelect directors.	Investors reelect directors.	Investors reelect directors.
Corporate Governance	Specific stock exchange rules on corporate governance.	Subject to state and NASAA regulations.	Not required.
Disclosure Obligation	Required to make regular financial disclosures to the investment community, including quarterly and yearly audited financial results with accompanying filings to the SEC.	Required to make regular SEC disclosures, including quarterly and yearly financial reports.	Not required.
Performance Measure-ment	Numerous independent performance benchmarks available for tracking public REIT industry. Wide range of analyst reports available to the public.	No independent source of performance data available.	No public or independent source of performance data available.

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Costs and Fees

Publicly traded REITs list their costs (both property level and corporate general and administrative expenses [G&A]) on their quarterly financial statements, where analysts and investors can scrutinize how efficiently properties and the company in general are managed. In contrast, private REITs are not compelled to disclose any such information. PNLRs historically have been criticized for charging large upfront fees of 12 percent or more, in part to pay financial advisors large commissions for marketing their shares. During the investment period, they also charge fees for buying and managing properties, and then more fees to various advisors, as well.

The real problem with the fees charged by PNLRs is that historically they were not transparent to investors. When an investor would buy a share in a PNLR, typically for $10, the value per share listed on the investor's statement would be the gross $10, not an amount that was net of fees and other costs, which typically consumed $1.20 per share or more. Said another way, the PNLR investor did not realize they were starting out this investment by using at least 12 percent of their initial investment to pay brokers, startup costs, and advisory fees incurred by the PNLR sponsor.

In 2015, the Financial Industry Regulatory Authority (FINRA) addressed these and other disclosure issues associated with PNLRs by modifying NASD Rule 2340 (Customer Account Statements). According to FINRA's January 2015 "Regulatory Notice," effective April 11, 2016, public PNLRs must include per share amounts that reflect current value, "developed in a manner reasonably designed to ensure that per share estimated value is reliable" (FINRA Regulatory Notice, January 2015). As a result, investors in PNLRs now have a better line of sight on how efficiently their investment is being put to use. However, their overall transparency is less than that offered by publicly traded REITs, which trade on stock exchanges.

Externally Advised and Externally Managed REITs

The 223 REITs that composed the FTSE NAREIT All REITs Index at the end of 2015 are publicly traded and, therefore, do not have the features of private REITs and PNLRs discussed earlier. However, there is a small population of publicly traded REITs that are externally advised and externally managed, which is similar to how REITs were structured before the 1986 Tax Act (see section in Chapter 7,

Improvements to the REIT Structure . . .). The externally advised structure may have conflicts of interest between the REIT advisor and REIT shareholders; these conflicts can lead to suboptimal capital allocation decisions. Furthermore, research published over the years by Green Street Advisors, an independent REIT and real estate research firm, has shown that the average annual total returns of externally managed REITs often lag that of the industry. First, externally advised REITs do not have any employees; instead, they pay a fee to an external, third-party advisor, whose employees oversee the REIT's daily operations. The advisor also earns a fee on any assets the REIT acquires. An incentive for the advisor may be to maximize the amount of properties the REIT owns, not to maximize the performance or profitability of those assets. The conflict between the advisor and shareholders may not be apparent immediately, but over time, externally advised and managed REITs tend to underperform other REITs in the same property sector. To learn if a REIT is an externally advised or managed REIT, be sure to read the "Company Description" located in the first few pages of any recent form 10-Q or 10-K that the REIT has filed with the SEC. If the company states that it is "a self-advised, self-managed real estate investment trust," then it does not have the fee-oriented conflicts of interest just described.

Qualifying as a REIT

Just as The Walt Disney Company (NYSE: DIS) and Apple, Inc. (NASDAQ: AAPL) must comply with aspects of Internal Revenue Code (the Code) that govern C-corporations, a REIT must adhere to certain provisions in order to qualify for and maintain its tax status. A summary of the principal provisions of the Code for REITs follows:

Distribution requirements—a REIT must:

- Pay dividends equal to at least 90 percent of its taxable income. (From 1980 until January 1, 2001, the minimum distribution requirement was 95 percent of taxable income.)

Qualification requirements—a REIT must:

- Be a corporation formed in one of the 50 United States or the District of Columbia.
- Be governed by a board of directors or trustees.
- Have shares that are fully transferable.

- By its second taxable year, have a minimum of 100 shareholders.
- Have no more than 50 percent of its shares held by five or fewer individuals during the last half of each taxable year; this is known as the "5 or fewer rule," or the "5/50 test."

Annual income requirements—annually, a REIT must:

- Derive at least 75 percent of gross income from rents from real property or, as with mortgage REITs, interest on mortgages on real property and gains from the sale of real property; this is known as the 75 percent Income Test.
- Derive at least 95 percent of its gross income from items qualifying under the previously defined 75 percent Income Test, plus dividends and interest income, and gains from the sale of stock or other non–real estate investments (the 95 percent Income Test).
- Derive 5 percent or less of its income from nonqualifying sources, such as third-party management or leasing fees provided to properties the REIT does not own. As a result, REITs often use a structure known as a taxable REIT subsidiary (TRS) to pursue real estate–related business opportunities that enhance management's ability to deliver higher levels of tenant services. Because the TRS is taxed like a regular operating company, the REIT is allowed to own up to 100 percent of each TRS's stock.

Quarterly investment requirements—at the end of each quarter, a REIT must:

- Invest at least 75 percent of its total assets in real estate assets, mortgage loans, cash, and government securities.
- Not own more than 10 percent of another company, other than another REIT, a qualified REIT subsidiary (QRS), or a taxable REIT subsidiary. In the case of TRSs, no more than 25 percent (20 percent after 2017) of a REIT's total asset value may reside in one or more TRS.
- A REIT cannot own stock in any corporation other than a TRS whose value exceeds 5 percent of the REIT's total asset value.

Note that a REIT's board of directors votes on which methodology it will use to measure *total asset value*. Methodologies include using gross asset value (also known as *undepreciated book value*), or methods prescribed by lenders.

REITs Are Not Limited Partnerships

Even though the IRS can treat OP units similar to other contributions to partnerships, REITs are *not* partnerships and have no relation to the real estate limited partnerships (RELPs) of the 1980s. REITs are C-corporations that are allowed a dividends-paid deduction when calculating corporate income taxes. Many REITs are publicly traded, whereas most partnerships are not. Table 6.2 summarizes the many differences between REITs and partnerships.

Table 6.2 Comparison of REITs and LPs

	REITs	Limited Partnerships
Liquidity	Yes. The shares of most REITs are listed and traded on stock exchanges	No. When liquidity exists, generally much less than REITs
Minimum Investment Amount	None	Typically $2,000–$5,000
Reinvestment Plans	Yes, including some at discounts.	No
Ability to Leverage Property Investments without Incurring UBIT* for Tax-Exempt Accounts	Yes; this makes REITs suitable for individual IRAs, 401(k), and other pension plans.	No
Investor Control	Yes, investors reelect directors	No, controlled by general partner who cannot be easily removed by limited partners
Independent Directors	Yes, stock exchange rules or state law typically require majority to be independent of management	No
Beneficial Ownership	At least 100 shareholders required; most REITs have thousands	Shared between any number of limited and general partners
Ability to Grow by Additional Public Offerings of Stock or Debt	Yes	Rarely
Ability to Pass Losses on to Investors	No	Yes
Information to Investors	Form 1099	Form K-1
Subject Investors to State Taxes	Only in state where investor resides	Yes, for all states in which it owns properties

*UBIT stands for Unrelated Business Income Tax.

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