

# Frequently Asked Questions About REITs

Answers to fundamental questions about REITs

Real Estate Investment Trusts, or **REITs**, are a practical way for all investors to invest in large-scale, income-producing, professionally managed companies that own commercial real estate. As an investment, REITs provide portfolio diversification plus strong and reliable dividend income. Publicly traded REITs have demonstrated superior long-term risk-adjusted returns, as well as the liquidity and transparency of public capital markets. Here are answers to fundamental questions about **REITs**.



National Association of Real Estate Investment Trusts®  
*REITs: Building Dividends and Diversification®*

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# The Basics of REITS



### What is a REIT?

A REIT is a company that mainly owns, and in most cases, operates income-producing real estate such as apartments, shopping centers, offices, hotels and warehouses. Some REITs also engage in financing real estate. The shares of many REITs are traded on major stock exchanges.

To qualify as a REIT, a company must have most of its assets and income tied to real estate investment and must distribute at least 90 percent of its taxable income to its shareholders annually. A company that qualifies as a REIT is permitted to deduct dividends paid to its shareholders from its corporate taxable income. As a result, most REITs remit at least 100 percent of their taxable income to their shareholders and therefore owe no corporate tax. Taxes are paid by shareholders on the dividends received and any capital gains. Most states honor this federal treatment and also do not require REITs to pay state income tax. Like other businesses, but unlike partnerships, a REIT cannot pass any tax losses through to its investors.

### Why were REITs Created?

Congress created REITs in 1960 to make investments in large-scale, income-producing real estate accessible to average investors. Congress decided that a way for average investors to invest in large scale commercial properties was the same way they invest in other industries — through the purchase of equity. In the same way shareholders benefit by owning stocks of other corporations, the stockholders of a REIT earn a pro-rata share of the economic benefits that are derived from the production of income through commercial real estate ownership. REITs offer distinct advantages for investors: portfolio diversification, strong and reliable dividends, liquidity, solid long-term performance and transparency.

### How Does a Company Qualify as a REIT?

In order for a company to qualify as a REIT, it must comply with certain provisions within the Internal Revenue Code. As required by the Tax Code, a REIT must:

- Be an entity that is taxable as a corporation
- Be managed by a board of directors or trustees
- Have shares that are fully transferable
- 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 the taxable year
- Invest at least 75 percent of its total assets in real estate assets
- Derive at least 75 percent of its gross income from rents from real property or interest on mortgages financing real property
- Have no more than 20 percent of its assets consist of stocks in taxable REIT subsidiaries
- Pay annually at least 90 percent of its taxable income in the form of shareholder dividends

### How Many REITs are There?

There are about 170 REITs registered with the Securities and Exchange Commission in the United States that trade on one of the major stock exchanges — the majority on the New York Stock Exchange. These REITs have a combined equity market capitalization of nearly \$350 billion.

Additionally, there are REITs that are registered with the SEC but are not publicly traded, and REITs that are not registered with the SEC or traded on a stock exchange.

## Characteristics of Publicly Traded REITs, Non-Exchange Traded REITs and Private REITs

	<b>PUBLICLY TRADED REITS</b>	<b>NON-EXCHANGE TRADED REITS</b>	<b>PRIVATE REITS</b>
<b>Overview</b>	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.
<b>Liquidity</b>	Shares are listed and traded, like any other publicly-traded stock, on major stock exchanges. Most are NYSE listed.	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 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.
<b>Transaction Costs</b>	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. Ongoing management fees and expenses also are typical. Back-end fees may be charged.	Varies by company.
<b>Management</b>	Typically self advised and self managed.	Typically externally advised and managed.	Typically externally advised and managed.
<b>Minimum Investment Amount</b>	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.
<b>Independent Directors</b>	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.
<b>Investor Control</b>	Investors re-elect directors.	Investors re-elect directors.	Investors re-elect directors.
<b>Corporate Governance</b>	Specific stock exchange rules on corporate governance.	Subject to state and NASAA regulations.	Not required.
<b>Disclosure Obligation</b>	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.
<b>Performance Measurement</b>	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.

### What Types of REITs are There?

The REIT industry has a diverse profile, which offers many investment opportunities. REITs often are classified in one of three categories: equity, mortgage or hybrid.

#### 1. Equity REITs

Equity REITs mostly own and operate income-producing real estate. They increasingly have become real estate operating companies engaged in a wide range of real estate activities, including leasing, maintenance and development of real property and tenant services. One major distinction between REITs and other real estate companies is that a REIT must acquire and develop its properties primarily to operate them as part of its own portfolio rather than to resell them once they are developed.

#### 2. Mortgage REITs

Mortgage REITs mostly lend money directly to real estate owners and operators or extend credit indirectly through the acquisition of loans or mortgage-backed securities. Today's mortgage REITs generally extend mortgage credit only on existing properties. Many mortgage REITs also manage their interest rate and credit risks using securitized mortgage investments, dynamic hedging techniques and other accepted derivative strategies.

#### 3. Hybrid REITs

As the name suggests, a hybrid REIT both owns properties and makes loans to real estate owners and operators.

### Who Manages a REIT?

Like other publicly traded companies, a REIT's executive management team operates the company, deciding what properties it will own and manage. Management's decisions are overseen by a board of directors that is responsible to the shareholders. As with other corporations, REIT directors are typically well-known and respected members of the real estate, business and professional communities. Many of today's REITs became public companies within the past 15 years, often transforming to public ownership what previously had been private enterprises. In many cases, the majority owners of these private enterprises became the senior officers of the REIT and contributed their ownership positions to the REIT.

### What Types of Properties Do REITs Own and Manage?

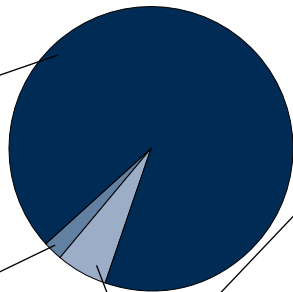
REITs own and manage a variety of property types: shopping centers, apartments, warehouses, office buildings, hotels, and others. Most REITs specialize in one property type only, such as shopping malls or self-storage facilities.

Some REITs invest throughout the country or in certain other countries. Others specialize in one region only, or even in a single

### Types Of REITs

**91% Equity REITs**  
Own Real Estate Assets  
Revenues Come Principally from Rents

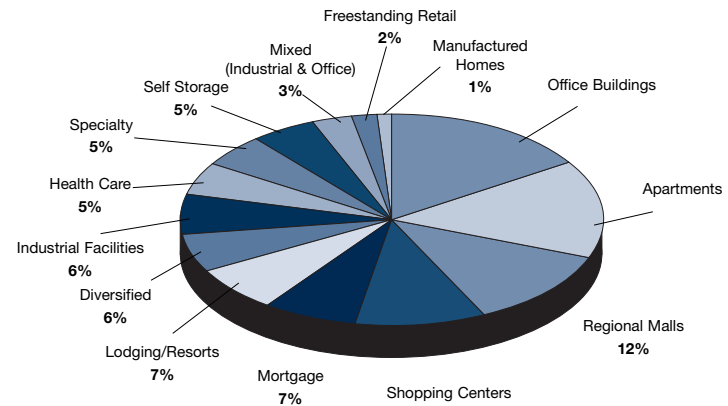
**2% Hybrid REITs**  
Combine the  
Investment Strategies  
of Equity and  
Mortgage REITs



**7% Mortgage REITs**  
Loan Money to Real Estate Owners or Invest in Existing Mortgages or Mortgage-Backed Securities  
Revenues Come Principally from Interest on Mortgages

Listed REITs as of June 30, 2007  
Source: NAREIT\*

### Listed REITs Invest In All Property Types



Listed REITs as of June 30, 2007  
Source: NAREIT\*

metropolitan area.

**How are REITs Different from Partnerships?**

REITs are not partnerships. Most publicly-traded REITs are vertically-integrated real estate companies that develop, own and actively manage commercial real estate. Shares in these companies are traded, the same as other stocks, on major exchanges, providing complete liquidity and market pricing. Publicly-traded REITs are subject to the same financial disclosure requirements as other publicly-traded companies. Independent corporate governance consultants have rated the REIT industry's governance among the best of all U.S. industry groups.

**Important Differences: REITs vs. Partnerships**

	<b>REITs</b>	<b>Partnerships</b>
Liquidity	Yes; publicly traded REITs are listed on stock exchanges and trade throughout the day	No. When liquidity exists, generally much less than listed 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. In most cases this makes REITs suitable for individual IRAs, 401(k), and other pension plans	No
Investor Control	Yes, investors re-elect directors	No, controlled by general partner who cannot be easily removed by limited partners
Independent Directors	Yes, stock exchange rules or state law typically requires 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	Schedule K-1
Subjects Investors to State Taxes	Only in state where investor resides	Yes, for all states in which it owns properties

**How do REITs use Partnerships?**

Like other industries, the real estate industry, including REITs, often uses partnerships to co-venture with others. In addition, REITs are typically structured in one of three ways: the traditional REIT, the umbrella partnership REIT (UPREIT) and the downREIT.

A traditional REIT is one that owns its assets directly rather than through an operating partnership.

In the typical UPREIT, a REIT partners with others, and the partnership is termed the Operating Partnership. In return for their respective contributions, the REIT as well as the other partners receive interests in the operating partnership called operating partnership units (OP units). The REIT typically is the general partner and the majority owner of the OP units. For the partners contributing property to the operating partnership, any capital gain tax liability is deferred until such time as the OP units are converted into common shares of the REIT.

After a period of time (often one year), the non-REIT partners may enjoy the same liquidity of the REIT shareholders by tendering their units for either cash or REIT shares (at the option of the REIT or Operating Partnership). This conversion may result in the partners incurring the tax liability that had been deferred at the UPREIT's formation. However, the unitholders may tender their units over a period of time, thereby spreading out such tax. In addition, when a partner holds the units until death, the estate tax rules operate in such a way as to provide that the beneficiaries may tender the units for cash or REIT shares without paying income taxes.

A DownREIT is structured much like an UPREIT, but the REIT owns and operates properties other than its interest in a controlled partner-

# Why Invest in REITs?

ship that owns and operates separate properties.

## Who Invests in REITs?

Individual investors of all ages, both in the U.S. and worldwide, invest in REITs directly or through REIT mutual funds. Other typical buyers of REITs are exchange traded funds, pension funds, endowments, foundations, insurance companies and bank trust departments.

Investors typically are attracted to REITs for their high levels of continuing current income and the opportunity for long-term growth. These are the basic characteristics of commercial real estate investment.

Today, a broad range of investors are using REITs to help achieve the investment goals of diversification, dividends, liquidity, performance and transparency.

## Why Should I Invest in REITs?

REITs are total return investments. They typically provide high dividends plus the potential for moderate, long-term capital appreciation. Long-term total returns of REIT stocks are likely to be somewhat less than the returns of higher risk, high-growth stocks and somewhat more than the returns of lower risk bonds.

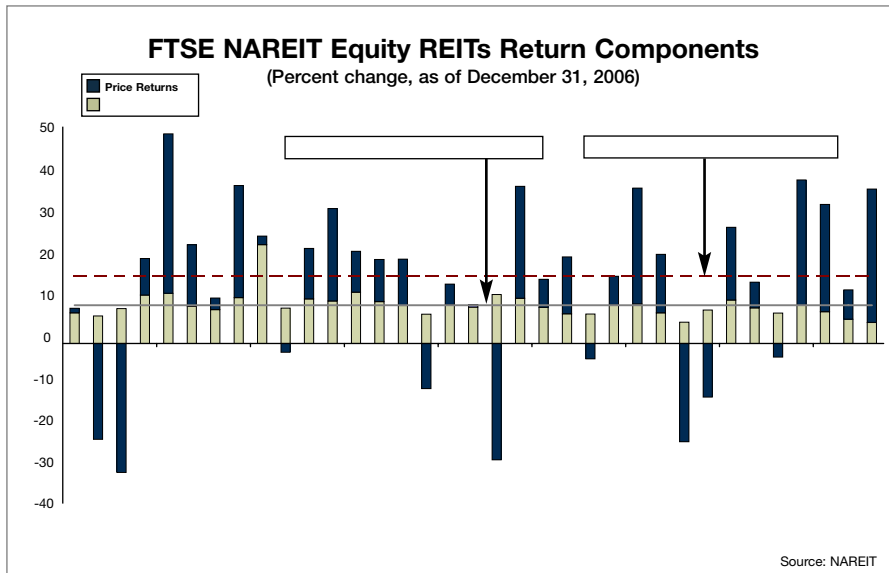
REITs are required by law to distribute each year to their shareholders at least 90 percent of their taxable income. Thus, REITs tend to be among those companies paying the highest dividends. The dividends come primarily from the relatively stable and predictable stream of contractual rents paid by the tenants who occupy the REIT's properties. Because rental rates tend to rise during periods of inflation, REIT dividends tend to be protected from the long-term corrosive effect of rising prices.

There is a relatively low correlation between listed REIT stock returns and the returns of other equities and fixed income investments. Thus, including listed REITs in your investment program helps build a diversified portfolio.

REITs offer investors:

- Portfolio diversification, which reduces risk
- Current, stable dividend income
- High dividend yields

- Dividend growth that has consistently exceeded the rate of consumer price inflation
- Liquidity: shares of publicly traded REITs are readily converted into cash because they are traded on the major stock exchanges
- Professional management: REIT managers are skilled, experienced real estate professionals
- Oversight: Independent directors of the REIT, independent analysts, independent auditors, and the business and financial media monitor a publicly traded REIT's financial reporting on a regular basis. This scrutiny provides investors with a measure of protection and more than one barometer of the REIT's financial condition.
- Disclosure obligations: REITs whose securities are registered with the SEC are required to make regular SEC disclosures, including quarterly and yearly financial reports.



### Is Homeownership a Substitute for Investing in REITs?

A house is an expenditure, not an investment, particularly when financed with a sizeable mortgage. It does not produce current income, but rather requires regular mortgage interest, real estate tax and insurance payments, plus other occasional expenditures, to be properly maintained.

In contrast, REITs represent investment in commercial real estate, which generates continuing income flow from rents.

A widely-used index of single-family house prices nationwide gained 6.2 percent compounded on average from 1976 to 2006. Equity REITs, meanwhile, produced a 7.7 percent compound annual return on a price-only basis, but with dividends reinvested, REITs' compound annual total return for the same period was 15.57 percent.

Additionally, an investment in a REIT represents an investment that is diversified across a range of real estate properties in a variety of geographic locations. By comparison, a home's investment risk is not diversified, but rather highly concentrated in a single location.

The low correlation between percent changes in REIT returns and house prices, combined with the historically attractive total returns and moderate volatility of REITs, make it no surprise that REITs show

## How to Invest in REITs

up in the optimal portfolios designed for both homeowners and renters.

### **How do I Invest in a REIT?**

An individual may invest in a publicly traded REIT, which is listed on a major stock exchange, by purchasing shares through a securities dealer. As with other publicly traded securities, investors may purchase common stock, preferred stock or debt securities. An investor can enlist the services of a broker, investment advisor or financial planner to help analyze his or her financial objectives. These professionals may be able to recommend appropriate REIT investments for the investor. An investor may also contact a REIT directly for a copy of the company's annual report, prospectus and other financial information. Much of this information is available on a company's web site. The web site [www.investinreits.com](http://www.investinreits.com) also lists all publicly traded REITs with their exchange symbols. Many financial web sites and local libraries offer a wide range of investment research and information on REITs.

Another alternative is to diversify your investment further by buying shares in a REIT mutual fund or exchange traded fund. A list of such funds is available at [www.investinreits.com](http://www.investinreits.com). Investors can compare and evaluate the performance of funds through information sources such as Morningstar, Inc. These sources can offer detailed

information on funds' past performance, current portfolio holdings and costs of investing.

### **What Should I Look for When Investing in a REIT?**

The market usually rewards companies that demonstrate consistent earnings and dividend growth with higher price-earnings multiples. Thus, investors should look for REITs and publicly traded real estate companies with the following characteristics:

- A demonstrated ability to increase earnings in a reliable manner. For example, look for companies with properties in which rents are below current market levels. Such properties provide upside potential in equilibrium markets and downside protection when economic growth slows.
- Management teams able to quickly and effectively reinvest available cash flow. The ability to consistently complete new projects on time and within budget. Creative management teams with sound strategies for developing new revenue opportunities.
- Strong operating characteristics, including effective corporate governance procedures, conservative leverage, accepted accounting practices, strong tenant relationships and a clearly defined operating strategy for succeeding in competitive markets.

### **How do REITs Measure Earnings?**

Like the rest of corporate America, the REIT industry uses net income as defined under Generally Accepted Accounting Principles (GAAP) as the primary operating performance measure.

The REIT industry also uses Funds From Operations (FFO) as a supplemental measure of a REIT's operating performance. NAREIT defines FFO as net income (computed in accordance with GAAP) excluding gains or losses from sales of most property and deprecia-

tion of real estate. When real estate companies use FFO in public releases or SEC filings, the law requires them to reconcile FFO to GAAP net income.

Most real estate professionals as well as investors believe that commercial real estate maintains residual value to a much greater extent than machinery, computers or other personal property. Therefore, they view the depreciation measure used to arrive at GAAP net income as generally overstating the economic depreciation of REIT property assets and the actual cost to maintain and replace these assets over time, which may in fact be appreciating. Thus, FFO excludes real estate depreciation charges from periodic operating performance. Many securities analysts judge a REIT's performance according to its Adjusted FFO (AFFO), thereby deducting certain recurring capital expenses from FFO.

NAREIT's April 2002 "White Paper" on FFO discusses the definition in detail, advises REITs to adopt certain computational and disclosure practices and recommends that REITs disclose additional information about other financial calculations such as details on capital expenditures. The White Paper is available at NAREIT's Web site, [www.nareit.com](http://www.nareit.com).

### **How do Investors Gauge a REIT's Ability to Pay Dividends?**

Many investors often look at the payout ratio as the measure of a REIT's ability to pay its current dividends. Because real estate depreciation is a large non-cash expense that likely overstates any decline in property values, dividend per share divided by net income per share likewise understates a REIT's ability to sustain dividend payments. Therefore, the payout ratio, calculated as dividend per share divided by Funds From Operations (FFO) per share, or as

dividend per share divided by Adjusted Funds From Operations (AFFO) per share, is used by many as a more accurate measure of the REIT's ability to pay dividends.

### What Factors Contribute to REIT Earnings?

Growth in earnings typically comes from several sources, including higher revenues, lower costs and new business opportunities. The most immediate sources of revenue growth are higher rates of building occupancy and increasing rents. As long as the demand for new properties remains well balanced with the available supply, market rents tend to rise as the economy expands and increases demand for space. Low occupancy rates in underutilized buildings can be increased when skilled owners upgrade facilities, enhance building services and more effectively market properties to new types of tenants. Property acquisition and development programs also create growth opportunities, provided the economic returns from these investments exceed the cost of financing. Like other public companies, REITs and publicly traded real estate companies also increase earnings by improving operating efficiency and taking advantage of new business opportunities.

The REIT Modernization Act (RMA), which took effect on January 1, 2001, provides REITs with other opportunities to increase earnings. Prior to the enactment of the RMA, REITs were limited to providing only those services that were long accepted as being "usual and customary" landlord services, and were restricted from offering more

advanced services provided by other landlords. The RMA allows REITs to own taxable subsidiaries that can provide the competitive services that many of today's tenants desire, as well as to provide services like real estate asset management for other investors.

### How are REIT Stocks Valued?

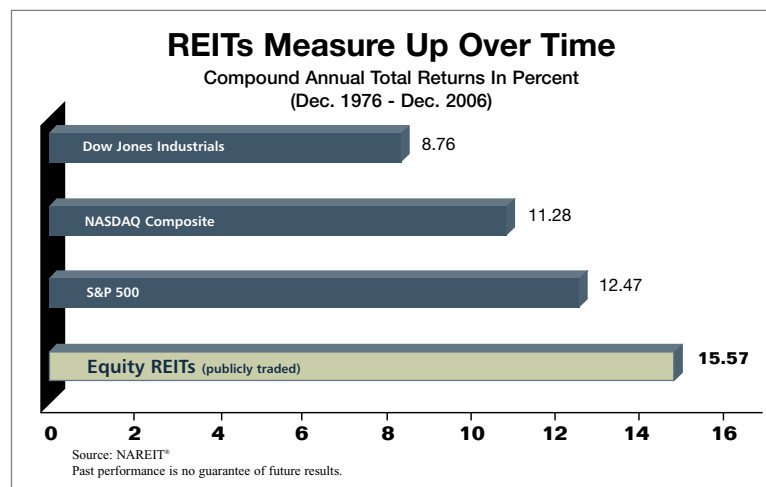
Like all companies whose stocks are publicly traded, REIT shares are priced by the market throughout the trading day. To assess the investment value of REIT shares, typical analysis involves one or more of the following criteria:

- Anticipated growth in earnings per share
- Anticipated total return from the stock, estimated from the expected price change and the prevailing dividend yield
- Current dividend yields relative to other yield-oriented investments (e.g. bonds, utility stocks and other high-income investments)
- Dividend payout ratios as a percent of REIT FFO (see pages 16-17 for discussion of FFO and payout ratios)
- Management quality and corporate structure
- Underlying asset values of the real estate and/or mortgages, and other assets.

Stocks of REITs that are registered with the SEC but not publicly traded on an exchange should be valued in consultation with a qualified financial advisor.

### What Real Estate Fundamentals Should I Consider Before Investing?

REIT investors often compare current stock prices to the net asset value (NAV) of a company's assets. NAV is the per share measure of the market value of a company's net assets. At times, the stock price of a REIT may be more or less than its NAV. Investors should understand some of the fundamental factors that influence the value of a REIT's real estate holdings. One critical factor is how well balanced the supply of new buildings is with the demand for new space. When construction adds new space into a market more rapidly than it can be absorbed, building vacancy rates increase, rents can weaken and



property values decline, thereby depressing net asset values.

In a strong economy, growth in employment, capital investment and household spending increase the demand for new office buildings, apartments, industrial facilities and retail stores. Population growth also boosts the demand for apartments. However, the economy is not always equally strong in all geographic regions, and economic growth may not increase the demand for all property types at the same time. Thus, investors should compare the locations of properties of different companies with the relative strength or weakness of real estate markets in those locations.

Information on company properties is available at their web sites, and links to these sites are available at [www.investinreits.com](http://www.investinreits.com). Information on local and regional real estate markets is available in the financial press or at research sites on the Internet such as [www.ppr.info](http://www.ppr.info) or [www.tortowheatonresearch.com](http://www.tortowheatonresearch.com).

### **What Role do REITs Play in 401(k) Retirement Savings Plans?**

The number of 401(k) plans offering a real estate option has more than tripled in the past five years to almost one in five plans. Real estate stocks' competitive rates of return, stable levels of risk, and low correlation with the investment returns of other stocks and bonds offer significant diversification benefits to a multi-asset portfolio. Plan participants and sponsors should make sure that their 401(k) plans include real estate—one of the strongest sources of portfolio diversification—among their core investment choices or within target date and lifecycle funds. Pension plans, historically, have invested directly in commercial real estate to provide these benefits, which now are available to individual investors through REITs.

NAREIT commissioned Ibbotson Associates—a leading authority on asset allocation—to examine the investment performance of publicly traded REIT stocks to determine if REITs provide meaningful diversification benefits in diversified portfolios. Ibbotson found that REIT returns are relatively uncorrelated with those of other stocks and bonds. In fact, as the total equity market capitalization of REITs increased and the companies achieved wider analytical coverage

from Wall Street analysts and a broader base of investors, the correlation of REIT returns with those of other investments declined appreciably. As a result of these investment characteristics, the Ibbotson analysis demonstrates that REITs are a strong source of portfolio diversification, raising returns and lowering risk in a wide range of diversified portfolios.

For example, the analysis by Ibbotson found that allocating 10 percent of an optimized portfolio to REITs each year from 1972 to 2006 would have boosted the average annual return from 10.7 percent to 11.1 percent while reducing portfolio risk from 10.9 percent to 10.6 percent. Allocating 20 percentage points to REITs would have boosted the average annual return to 11.5 percent while reducing portfolio risk to 10.5 percent.

# Taxes and REIT Investment

## **How do Shareholders Treat REIT Dividends for Tax Purposes?**

For REITs, dividend distributions for tax purposes are allocated to ordinary income, capital gains and return of capital, each of which may be taxed at a different rate. All public companies, including REITs, are required early in the year to provide their shareholders with information clarifying how the prior year's dividends should be allocated for tax purposes. This information is distributed by each company to its list of shareholders on IRS Form 1099-DIV. An historical record of the allocation of REIT distributions between ordinary income, return of capital and capital gains can be found on NAREIT's web site at [www.investinreits.com](http://www.investinreits.com).

A return of capital distribution is defined as that part of the dividend that exceeds the REIT's taxable income. A return of capital distribu-

tion is not taxed as ordinary income. Rather, the investor's cost basis in the stock is reduced by the amount of the distribution. When shares are sold, the excess of the net sales price over the reduced tax basis is treated as a capital gain for tax purposes. So long as the appropriate capital gains rate is less than the investor's marginal ordinary income tax rate, a high return of capital distribution may be attractive.

### **Are REIT Dividends Subject to the 15 Percent Maximum Tax Rate?**

In May 2003, the U.S. Congress passed the Jobs and Growth Tax Relief Reconciliation Act, which cut income tax rates on most dividends and capital gains to a 15 percent maximum. Because REITs do not generally pay corporate taxes, the majority of REIT dividends continue to be taxed as ordinary income up to the maximum rate of 35 percent.

However, REIT dividends will qualify for a lower tax rate in the following instances:

- When the individual taxpayer is subject to a lower scheduled income tax rate;
- When a REIT makes a capital gains distribution (15 percent maximum tax rate), or a return of capital distribution, as described on page 23;
- When a REIT distributes dividends received from a taxable REIT subsidiary or other corporation (15 percent maximum tax rate); and
- When permitted, a REIT pays corporate taxes and retains earnings (15 percent maximum tax rate).

In addition, the maximum 15 percent capital gains rate applies generally to the sale of REIT stock.

Available data indicate that about 45 percent of REIT dividends qualified for the lower 15 percent capital gains rate in 2006. Of this amount, 69 percent represented capital gain distributions and 31 percent represented return of capital, which is taxed at a capital gain rate when the stock is sold.

### **How do the "Section 1031 Like Kind Exchange" Rules Affect REITs?**

Section 1031 of the Internal Revenue Code generally permits tax deferral when investment property or property used in a trade or business is exchanged for "like kind" property as long as the exchange is completed within 180 days of the transfer of the taxpayer's exchanged property. Non-simultaneous exchanges also are permissible under section 1031 if certain criteria are met. These exchanges are known as "like kind exchanges." An example of a like kind exchange would be an exchange of an apartment building in Baltimore for an apartment building in San Diego. Consequently, REITs routinely use section 1031 in conducting their own investment operations.

However, REIT stock does not qualify as investment property, and accordingly, it is not possible to effect a like kind exchange of real estate for REIT stock. Although REIT stock cannot qualify for like kind exchange treatment, another provision of U.S. tax law (Section 721 of the Internal Revenue Code) does permit owners of real property to exchange their property for partnership interests on a tax-deferred basis if certain conditions are met. Relying on this provision, many REITs own the majority, if not all, of their properties through an operating partnership ("OP") in which they hold the majority interests. The operating partnership most often pertains to an "umbrella partnership REIT" or "UPREIT," but also may pertain to a "DownREIT."

From time to time, real estate owners may transfer properties on a

tax-deferred basis to an OP in exchange for OP units. The OP units ultimately are exchangeable into REIT stock or cash in a taxable transaction, and they allow their owners to receive partnership distributions typically similar to the REIT distributions they would receive had they converted the OP units into REIT stock. The web sites of many REITs contain information about transfers of properties in exchange for OP units.

**What is “Unrelated Business Taxable Income” (UBTI) and can REIT Dividends Constitute UBTI?**

In very general terms, “unrelated business taxable income” or UBTI is income earned by an otherwise tax-exempt entity that is considered taxable income to the entity, typically because it is derived from a business activity unrelated to the tax-exempt purpose of the entity. For example, an “individual retirement account” or IRA is typically considered tax-exempt, but if it earns UBTI, it must pay tax on that income.

In general, REIT dividends do not generate UBTI (at least no more than dividends from non-REIT stocks). See Revenue Ruling 66-106, in which the IRS specifically held that dividends from a REIT generally do not generate UBTI; and Revenue Ruling 2006-58, which held that a charitable remainder trust is not subject to unrelated business taxable income as a result of being allocated excess inclusion income

## Global Real Estate Investment

from a REIT. Nevertheless, there are exceptions to the general rule, such as when a pension plan owns more than 25 percent of a REIT's stock and in the case of certain mortgage REITs that use financings considered to be "taxable mortgage pools."

Because the answers to these questions are complex, it is important to consult with a competent tax advisor for answers applicable to your specific situation.

### **How is the Global Listed Property Market Configured?**

While many of the world's REITs and listed property companies are based and traded in the United States, the listed real estate market is rapidly becoming global. The growth is being driven, importantly, by the appeal of REITs. More than 20 countries now have REIT legislation, and more are exploring it.

The most comprehensive index for the REIT and global listed property market is the FTSE EPRA/NAREIT Global Real Estate Index, which was created jointly by the index provider FTSE Group, NAREIT and EPRA, the European Public Real Estate Association. The index is used by a variety of institutional investors, money managers and funds to manage real estate investment on a global basis. It contains both REITs and non-REIT listed property companies.

As of May 31, 2007, the FTSE EPRA/NAREIT Global Real Estate Index included more than 300 listed real estate companies in more than 20 countries around the globe. On an equity market capitalization basis, approximately 42 percent of the index's value was in North America; approximately 36 percent was in Asia; and approximately 22 percent was in Europe.

### **What Benefit Does a Global Listed Real Estate Allocation Provide in a Global Investment Portfolio?**

Research done by the investment consulting firm Ibbotson Associates showed that an allocation to global listed real estate improves the returns of a global investment portfolio.

Ibbotson charted risks and returns for various asset classes (stocks, bonds, real estate and cash) for the period 1990-2005 and constructed optimized portfolios of these assets – with and without an allocation

to global listed real estate – at a variety of levels of portfolio risk (volatility). The firm's research showed that the addition of global real estate boosted the returns of portfolios throughout the risk spectrum. For example, an optimized portfolio of moderate risk (defined by a 10 percent standard deviation) produced an average annual return of 9.87 percent without a global real estate allocation, and 10.98 percent with a 20 percent global real estate allocation – an increase of 111 basis points.

Both the historical and forward-looking analyses concluded that U.S. real estate should be between one-third and two-thirds of the real estate allocation in an optimized global portfolio.

### **How Can I Add a Global Listed Real Estate Allocation to My Portfolio?**

The easiest and most cost-efficient way to add a global listed real estate allocation to a portfolio is purchasing an investment in a mutual fund or exchange traded fund of these securities. A list of such funds can be found at [www.investinreits.com](http://www.investinreits.com).

# Glossary of REIT Terms

**Adjusted Funds From Operations (AFFO)** — This is a measure of a real estate company’s cash flow generated by operations. AFFO is usually calculated by subtracting from Funds from Operations (FFO) certain “non cash” revenues and expenses and normalized recurring expenditures that are capitalized by the REIT and then amortized, but which are necessary to maintain a REIT’s properties and its revenue stream (*e.g.*, new carpeting and drapes in apartment units, leasing expenses and tenant improvement allowances). This calculation also is called Cash Available for Distribution (CAD) or Funds Available for Distribution (FAD).

**Capitalization Rate** — The capitalization rate (or “cap” rate) for a property is determined by dividing the property’s net operating income by its market value (or purchase price). Generally, high cap rates indicate higher returns on investment.

**Cost of Capital** — The cost to a company, such as a REIT, of raising capital in the form of equity (common or preferred stock) or debt. The cost of equity capital generally is considered to include both the dividend yield as well as the expected equity growth either by higher dividends or growth in stock prices. The cost of debt capital generally is the after-tax interest expense on the debt incurred.

**DownREIT** — A DownREIT is structured much like an UPREIT, but the REIT also owns and operates properties other than its interest in a controlled partnership that owns and operates separate properties.

**EBITDA** — Earnings before interest, taxes, depreciation and amortization. This measure is sometimes referred to as Net Operating Income (NOI).

**Equitization** — The process by which the economic benefits of ownership of a tangible asset, such as real estate, are divided among numerous investors and represented in the form of publicly traded securities.

**Equity Market Cap** — The market value of all outstanding common stock of a company.

**Equity REIT** — A REIT which owns, or has an “equity interest” in, income-producing real estate (rather than making loans secured by real estate collateral).

**Funds From Operations (FFO)** — The most commonly accepted and reported supplemental measure of REIT operating performance. Equal generally to a REIT’s net income, excluding gains or losses from sales of property or debt restructuring, and real estate depreciation charges.

**Hybrid REIT** — A REIT that combines the investment strategies of both equity REITs and mortgage REITs.

**Implied Equity Market Cap** — The market value of all outstanding common stock of a company plus the value of all UPREIT partnership units as if they were converted into the REIT’s stock. It excludes convertible preferred stock, convertible debentures and warrants even though these securities have similar conversion features.

**Leverage** — The amount of debt in relation to either equity capital or total capital.

**Mortgage REIT** — A REIT that makes or owns loans and other obligations that are secured by real estate collateral.

**Net Asset Value (NAV)** — The net “market value” of all a company’s assets, including but not limited to its properties, after subtracting all its liabilities and other obligations.

**Positive Spread Investing (PSI)** — The ability to raise funds (both equity and debt) at a cost significantly less than the initial returns that can be obtained on real estate acquisitions.

**Real Estate Investment Trust Act of 1960** — The federal law that authorized REITs. Its purpose was to allow small investors to pool their investments in real estate in order to get the same benefits as might be obtained by direct ownership, while also diversifying their risks and obtaining professional management.

# Glossary of REIT Terms

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**Real Estate Investment Trust (REIT)**

— A REIT is a company dedicated to owning and, in most cases, operating income-producing real estate, such as apartments, shopping centers, offices and warehouses. Some REITs also are engaged in financing real estate.

**Securitization** — Securitization is the process of financing a pool of similar but unrelated financial assets (usually loans or other debt instruments) by issuing to investors security interests representing claims against the cash flow and other economic benefits generated by the pool of assets.


**Straight-lining** — Real estate companies such as REITs “straight-line” rents because generally accepted accounting principles require it. Straight-lining averages the tenant’s fixed rent payments over the life of the lease.

**Total Market Cap** — The total market value of a REIT’s (or other company’s) outstanding equity securities and indebtedness.

**Total Return** — A stock’s dividend income plus capital appreciation, before taxes and commissions.

**UPREIT** — In the typical umbrella partnership REIT or UPREIT, the partners of the Existing Partnerships and a REIT become partners in a new partnership termed the Operating Partnership. For their respective interests in the Operating Partnership (“Units”), the partners contribute the properties from the Existing Partnership and the REIT contributes the cash proceeds from its public offering. The REIT typically is the general partner and the majority owner of the Operating Partnership.

After a period of time (often one year), the partners may enjoy the same liquidity of the REIT shareholders by tendering their Units for either cash or REIT shares (at the option of the REIT or Operating Partnership). This conversion may result in the partners incurring the tax deferred at the UPREIT’s formation.



NAREIT is the worldwide representative voice for REITs and listed real estate companies with an interest in U.S. real estate and capital markets. Members are REITs and other businesses that own, operate and manage income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

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[www.investinreits.com](http://www.investinreits.com)



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