REITs 101

Chances are good that if you are reading this article, you either lost money in a REIT or have questions about REITs. The purpose of this post is to provide a basic description of REITs. Subsequent posts talk about the many REIT frauds and scams in the marketplace.

Interest rates have been quite low for the last several years. Take a look at Treasury bills and certificates of deposit rates and you will see what we mean. When rates stay low for extended periods, investors seek products offering better yields. One such popular product is a REIT – short for Real Estate Investment Trust.

Investopedia defines REIT as follows:

"A security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate."

Congress created REITs in 1960 to provide greater investment opportunities for ordinary Americans. REITs allow numerous investors to pool their resources and invest in large properties or portfolios of properties including malls, medical facilities, cell towers, office building, warehouses, apartment complexes and hotels. Individually, few investors could afford to purchase such a property.

REITs are also popular because they pay dividends and receive special tax treatment. The IRS requires REITs to distribute at least 90% of their income back to investors. Unlike ordinary companies, however, a qualified REIT can deduct distributions paid to investors thus avoiding double taxation.

Stockbrokers like REITs because they usually pay commissions far above normal market rates. Discount online brokerage services have driven down commissions on ordinary stock transactions, not so for certain REITs, however.

So what isn't to like?

There are *two types* of REITs. The first type trades on national securities exchanges just like a stock. These offer good liquidity and often pay dividends as well.

The second type of REITs are publicly registered non-exchange traded REITs. These are the source of most investor complaints. Often called "non-traded REITs," these investments are usually very illiquid meaning there is no ready secondary market for shares. Invest in one of these and you may be forced to hold it for 8 years or longer!

The Financial Industry Regulatory Authority, the SEC and several states have warned investors to be very careful before investing in a non-traded REIT. Unfortunately, these are the REITs that normally pay the highest commissions to brokers and carry the highest fees.

Although stockbrokers tout these as "publicly registered," that doesn't mean they are publicly traded.

Although not very common, there is a third type of REIT known as a private REIT or private placement REIT. These can be extremely risky and should only be sold to accredited and sophisticated investors. Because they are neither publicly traded nor registered, it is hard to determine their actual worth and they too can be nearly impossible to sell.

Non-traded REITs and private REITs are generally not suitable for investors who may need access to their money in the short or medium term. We have seen instances of unscrupulous brokers recommending these investments to people nearing retirement, often with disastrous results.

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This post was written by attorney Brian Mahany, author of the Due Diligence blog.