

Real Estate Investment Trusts (**REITs**) are an efficient way for many investors to invest in commercial and residential real estate businesses. As an investment, REITs combine the best features of real estate and stocks. They give an investor a practical and effective means to include professionally-managed real estate in a diversified investment portfolio.

The **REIT** industry began its fifth decade in 2000. Because of the industry's overall maturity and performance over the last four decades, **REITs** can be viewed as "all-weather" investments.

Here are answers to fundamental questions about **REITs** for investors, financial planners, stock brokers, the media and the general public.

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## Frequently Asked Questions About REITs

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## **1. What is a REIT?**

A REIT is a company that 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 freely traded, usually on a major stock exchange.

To qualify as a REIT, a company 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.

## **2. Why were REITs Created?**

Congress created REITs in 1960 to make investments in large-scale, income-producing real estate accessible to smaller 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 as 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: greater diversification through investing in a portfolio of properties rather than a single building and management by experienced real estate professionals.

## **3. 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 estate property or interest on mortgages on 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

#### **4. How Many REITs are There?**

There are about 180 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. Total assets of these listed REITs exceed \$400 billion.

About 20 REITs are registered with the SEC but are not publicly traded. Approximately 800 REITs are not registered with the SEC and are not traded on a stock exchange

#### **5. What Types of REITs are There?**

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

##### **Equity REITs**

Equity REITs own and operate income-producing real estate. Equity REITs increasingly have become primarily real estate operating companies that engage in a wide range of real estate activities, including leasing, 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.

##### **Mortgage REITs**

Mortgage REITs 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 modern mortgage REITs also manage their interest rate risk using securitized mortgage investments and dynamic hedging techniques.

##### **Hybrid REITs**

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

#### **6. How are REITs Structured?**

REITs are typically structured in one of three ways: Traditional, UPREIT and DownREIT. A traditional REIT is one that owns its assets directly rather than through an operating partnership.

In the typical UPREIT, the partners of an Existing Partnership 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. The REIT typically is the general partner and the majority owner of the Operating Partnership Units.

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. 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 partnership that owns and operates separate properties.

## **7. What Types of Properties do REITs Invest in?**

REITs invest in 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, self-storage facilities or factory outlet stores. Health care REITs specialize in health care facilities, including acute care, rehabilitation and psychiatric hospitals, medical office buildings, nursing homes and assisted living centers.

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

## **8. Who Determines a REIT's Investments?**

A REIT's investments are determined by its board of directors or trustees. Like other publicly traded companies, a REIT's directors are elected by, and responsible to, the shareholders. In turn, the directors appoint the management personnel. As with other corporations, REIT directors are typically well-known and respected members of the real estate, business and professional communities.

## **9. How are REITs Managed?**

Like other public companies, the corporate officers and professionals that manage REITs are accountable to both their boards of directors as well as their shareholders and creditors. Many REITs became public companies within the past 10 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 rolled their ownership positions into shares of the new public companies. Thus, the senior management teams of many REITs have ownership interests which are aligned with the interests of shareholders.

## **10. How do REITs Measure Financial Performance?**

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 for real estate companies.

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 depreciation 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.

Many 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.

## **11. How do Shareholders Treat REIT Distributions for Tax Purposes?**

REITs are required by law to distribute each year to their shareholders at least 90 percent of their taxable income. Thus, as investments, 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. Since rental rates tend to rise during periods of inflation, REIT dividends tend to be protected from the long-term corrosive effect of rising prices.

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 to provide their shareholders early in the year 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 at NAREIT's web site, [www.nareit.com](http://www.nareit.com). A return of capital distribution is defined as that part of the dividend that exceeds the REIT's taxable income. Because real estate depreciation is such a large non-cash expense that may overstate any decline in property values, the dividend rate divided by Funds From Operations (FFO) or Adjusted Funds From Operations (AFFO) is used by many as a measure of the REIT's ability to pay dividends.

A return of capital distribution 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 especially attractive to investors in higher tax brackets.

## **12. Are REIT Dividends Subject to the new 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 at the maximum new rate of 35 percent (down from 38.6 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);
- 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 one-third of REIT dividends qualified for the lower 15 percent capital gains rate in 2003. Of this amount, 54 percent represented capital gain distributions and 46 percent represented return of capital, which is taxed at a capital gain rate when the stock is sold.

## **13. 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 Internet sites, while information on local and regional real estate markets is available in the financial press or at research sites on the Internet such as [www.lendlease.com](http://www.lendlease.com) or [www.tortowheatonresearch.com](http://www.tortowheatonresearch.com).

#### **14. How has Real Estate Financing Changed Over Time?**

Historically, income-producing commercial real estate often was financed with high levels of debt. Properties provided tangible security for mortgage financing, and the rental income from those properties was a clear source of revenue to pay the interest expense on the loan. Property markets often were dominated by developers or entrepreneurial businessmen who were attempting to build personal fortunes and who were willing to take on huge risks to do so. Prior to the real estate recession of the early 1990s, it was not uncommon for individual properties to carry mortgages that represented over 90 percent of the properties' estimated market value or cost of construction. Occasionally, loan-to-value ratios went even higher. The severe real estate recession of the early 1990s forced many real estate lenders, developers and owners to reconsider the appropriate use of debt financing on real estate projects.

Today, properties owned by REITs are financed on a much more conservative basis. On average, REITs are financing their projects with about half debt and half equity, which significantly reduces interest rate exposure and creates a much stronger and less volatile business operation. Two-thirds of the REITs with senior unsecured debt ratings are investment grade.

#### **15. How are REIT Stocks Valued?**

Like all companies whose stocks are publicly traded, REIT shares are priced every day in the market and give investors an opportunity to value their portfolios daily. To assess the investment value of REIT shares, typical analysis involves one or more of the following criteria:

- Management quality and corporate structure
- 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
- Anticipated growth in earnings per share
- Underlying asset values of the real estate and/or mortgages, and other assets.

Stock 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.

## **16. 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. Low occupancy 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 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 cutting-edge services provided by other landlords. The RMA allows REITs to create subsidiaries that can provide the competitive services that many of today’s tenants desire.

## **17. Who Invests in REITs?**

Tens of thousands of individual investors, both U.S. and non-U.S., own shares of REITs. Other typical buyers of REITs are pension funds, endowment funds and foundations, insurance companies, bank trust departments and mutual funds.

Investors typically are attracted to REITs for their high levels of current income and the opportunity for moderate long-term growth. These are the basic characteristics of real estate. In addition, investors looking for ways to diversify their investment portfolios beyond other common stocks as well as bonds are attracted to the unique characteristics of REITs.

Today, a broad range of investors are using REITs to help achieve their investment goals, from large pension funds seeking diversification to the retired school teacher seeking a high-quality income investment.

Listed REIT shares may be purchased on the open market, with no minimum purchase required. Many investors also are choosing to own REITs through mutual funds or exchange traded funds that specialize in public real estate companies.

## **18. 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. Because most REITs also have a small-to-medium equity market capitalization, their returns should be comparable to other small to mid-sized companies.

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

**REITs offer investors:**

- 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
- Portfolio diversification, which reduces risk
- Oversight: Independent directors of the REIT, independent analysts, independent auditors, and the business and financial media monitor a public REIT's financial reporting on a regular basis. This scrutiny provides an investor 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.

**19. What Role do REITs Play in 401(k) Plans?**

Most 401(k) plans offer a variety of stock and bond investment options. However, real estate is largely not accessible in most of today's defined contribution 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. Participants and sponsors should make sure that their 401(k) plans include real estate one of the strongest sources of portfolio diversification among their investment choices. Historically, institutional investors have invested in broadly diversified portfolios of multiple investments, meeting their plan liabilities while controlling the risk of catastrophic losses in any one year. Individual investors may not understand the importance of this investment concept.

NAREIT commissioned Ibbotson Associates—a leading authority on asset allocation to examine the historical investment performance of the publicly traded equities of REITs to determine if REITs provide meaningful diversification benefits in diversified portfolios. Ibbotson found that, historically, REITs have earned competitive returns and exhibited lower volatility than other types of stocks. Ibbotson also 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 your portfolio to REITs each year from 1972 to 2003 would have boosted the average annual return from 10.9 percent to 11.2 percent while reducing portfolio risk from 10.8 percent to 10.4 percent. Allocating 20 percentage points to REITs would have boosted the average annual return to 11.5 percent while reducing portfolio risk to 10.1 percent. For more information on Ibbotson's study, visit their web site at [www.ibbotson.com](http://www.ibbotson.com).

## **20. If I Own a Home, do I Still Need to Invest in REITs?**

REIT investing complements homeownership. While owning a home can be a good investment, the investment benefits are enhanced when combined with REIT stocks.

Importantly, homeownership differs from other investments in some significant ways. A house is an expenditure as much as it is 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.

A widely-used index of single-family house prices nationwide gained 5.8 percent compounded on average from 1976 to 2003. Equity REITs, meanwhile, produced a 6.5 percent compound annual return on a price-only basis, but with dividends reinvested, REITs' compound annual total return for the span was 15.5 percent.

The low correlation between REIT returns and changes in house prices, combined with the historically attractive total return and moderate volatility of REITs, make it no surprise that REITs show up in the optimal portfolios estimated for both homeowners and renters.

In the final analysis, investors may be able to build greater long-term financial wealth when they combine homeownership and REIT stocks as part of a diversified investment portfolio.

## **21. 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 under the REIT Modernization Act.
- Strong operating characteristics, including effective corporate governance procedures, conservative leverage, widely accepted accounting practices, strong tenant relationships and a clearly defined operating strategy for succeeding in competitive markets.

## **22. 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 stockbroker. 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 NAREIT web site, [www.nareit.com](http://www.nareit.com), also lists all publicly traded REITs with their exchange symbols. Many local libraries offer a wide range of publications which provide investment research and information on public companies such as REITs.

Another alternative is to diversify your investment further by buying shares in a mutual fund that specializes in investing in real estate securities. A list of such mutual funds is available at the NAREIT web site. Investors can compare and evaluate the performance of mutual funds through public information sources such as Morningstar, Inc., which can also be found in many local libraries. These sources can offer detailed information on past performance, current portfolio holdings and information dealing with the various costs of investing in funds. There are also a number of real estate and REIT exchange traded funds and closed end funds.

## **23. How are REITs Different from Limited Partnerships?**

REITs are not partnerships, although, as is the case with other corporations, REITs use partnerships to engage in joint ventures. There are important organizational and operational differences between REITs and limited partnerships.

One of the major differences between REITs and limited partnerships is how annual tax information is reported to investors. Each year, an investor in a REIT receives a traditional IRS Form 1099 from the REIT, indicating the amount and type of income received during the prior tax year. However, an investor in a partnership receives a more complicated IRS Schedule K-1

which must be furnished to taxpayers later in the year than a 1099. Also, a REIT investor must file fewer state tax returns than required by a partnership investment.

Many believe the corporate governance features of a REIT are superior to those of a partnership.

Other important differences between REITs and limited partnerships are summarized in the "REIT's vs. Partnerships" [chart](#) (included in this document).

#### **24. Can I Exchange Real Estate for REIT Stock as Part of a "Section 1031 Like Kind Exchange?"**

By way of background, 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 exchanged property. Non-simultaneous exchanges are also 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. 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 and 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.

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# Important Differences: REITs vs. Partnerships

	<b>REITs</b>	<b>Partnerships</b>
Liquidity	Yes; most REITs are listed 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. 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