

Earn Tax-Advantaged Income and Grow Your Principal with Non-Traded REITs

by Chris Miller

Today, real estate investors are still looking for tax-sheltered income and solid appreciation potential – while maintaining a diversified portfolio. An increasing number are finding this in non-traded REITs – particularly since this is an investment that is eligible for IRAs as well. I have long advocated buying institutional-grade properties with credit tenants for stability and security of income, as well as excellent growth potential. Tenant-in-common investments are available in this arena with a minimum investment of \$200,000, but is there a solution for investors looking to place \$20,000 to \$200,000 at a time? Are options available that will allow for periodic investments, say \$20,000 per quarter?

Yes, there are – the non-traded REIT. Such an entity raises money to buy properties, manages those buildings to produce income for investors, then looks to sell the portfolio in the future at a favorable price – with the intention of providing partially tax-deferred income and capital appreciation to investors. A non-traded REIT has a business plan that looks very similar to the one we put together (or should be doing) for our own investment properties. The REIT's sponsor will seek out and buy quality properties, manage them to distribute good tax-sheltered cash flow to investors and sell these properties in the future under favorable market conditions. A non-traded REIT has several exit options – all the properties can be sold in a portfolio (to a pension fund, or another REIT), the properties can be sold off one at a time, or the REIT can be listed on a public stock exchange – giving investors immediate liquidity. The REIT's managers will pick the liquidity option that will produce the best price for investors.

As with its cousin, the traded REIT, non-traded REITs come in many different sizes and specialties. There are hotel REITs, office REITs, and even ones that focus on a “sub-sub-market,” like a medical office REIT. Two of my favorite non-traded opportunities now are a self-storage REIT and an apartment REIT. I like the self-storage program because it offers investors a way to invest in this growing market without the large capital outlay usually required for success. I like the apartment one because, like many of us, I see good things ahead for the apartment market.

What Are the Risks?

What risks do non-traded REITs pose to investors? The same risks that we face with traditional real estate investments – tenants may move out, resulting in decreased cash flow and/or a short-term drop in property values. These risks are moderated by buying good-quality assets with credit tenants in growing markets. Also important is spreading those assets among dozens of properties in different geographic locations. A REIT raising \$2 billion of equity can, using conservative leverage, buy hundreds of properties nationwide and decrease risk through diversification. Of course, the REIT's sponsor is very important to evaluating risk – how long have they been doing this, and what is their *track record*?

How do REITs Compare With Bonds or Trust Deeds?

Non-traded REITs beat bonds and trust deeds due to the tax benefits and the growth potential they offer. Bonds and trust deeds offer good income, but it is taxable at current ordinary income

rates. (35% if you're in the highest bracket, *PLUS* 9.3% from California.) Additionally, if I buy a 10-year bond or note for \$100,000, I will earn income over the years, and get my \$100,000 at the end. However, due to inflation, it is no longer worth as much. Assuming a 4% annual inflation number, my \$100,000 would turn into \$66,483 in "2008 dollars." That represents declining purchasing power, and is why CD's are sometimes referred to as "Certificates of Depletion."

The REITs I prefer currently pay a 7% distribution – with tax benefits. The tax benefits are that 40-70% of that income is tax-deferred. This means that, to earn the same amount of income with a fully-taxable investment, I need to seek out higher returns – and take more risk. With non-traded REITs, I can achieve the same after-tax result while having both growth potential and less risk.

What's the Difference Between a Traded REIT and a Non-Traded One?

The most obvious difference between these two vehicles is that one trades on a stock exchange, while one does not. One's value will go up and down with the fortunes of the stock market, while the others' (the non-traded ones) will remain more stable – a value that is tied to their underlying property value. Also, a non-traded REIT has a business plan with a defined exit strategy – the offering sponsor picks properties with the goal of selling them for a profit within a given time-frame (anywhere from 3-10 years, depending on the program). Traded REITs tend to buy with an eye on income only – as I have heard one real estate expert say, "To best sell properties at a profit, you need to buy them that way."

Lastly, a non-traded REIT can offer better tax efficiency. All REITs see their income sheltered by depreciation. Traded REITs, due to their indefinite business plan, may own assets that have been on the books for 10 years, or even longer. Long time owners of investment property know that the longer they hold a property, the less of a tax break they get from depreciation. An investor buying a share of that REIT inherits a share of the lower basis from those longer-term assets. The result – less shelter for income, more taxes paid, and less money in your pocket. Since non-traded REITs are buying properties today, investors get more "bang for their buck" in terms of tax-deferred income. This means more spendable income for non-traded REIT owners – more money in their pockets means smarter investing.

Why I Buy Non-Traded REITs

Non-traded REITs offer tax-deferred income and growth potential with less volatility than the stock market. This is why I personally invest in these REITs. These investments work great for IRAs as well. For these investments in my IRA, I take advantage of the *dividend reinvestment program*, which allows me to reinvest my income in more shares of the REIT, at a discounted price. By doing so, I am raising my overall effective yield – for more income and more growth potential.

Since non-traded REIT investments can be made starting at \$20,000, they make sense for smaller investments – rather than keep extra cash on hand in the bank at 5% interest, one can invest in a non-traded REIT to earn, perhaps, 7% annual - partially tax-deferred - income, and see growth of

principal as well. If these benefits sound attractive to you, then perhaps non-traded REITs are worth a look.

Christopher Miller is a Senior Consultant with Midpoint Financial Services in Tustin, California and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator and as an advisor helping clients through over two hundred 1031 exchanges. Call him toll-free at (877) 313-1868.