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What are Non-Traded Real Estate Investment Trusts (REITs)?

A non-traded REIT is a company that owns, operates, and/or finances primarily income-producing real estate assets. They are not traded on an open exchange and are available to investors that meet certain state-mandated suitability requirements.[1] Non-traded REITs give investors the ability to invest in private real estate assets that provide tax-advantaged income, while offering periodic liquidity.

WHAT QUALIFIES AS A REIT?

REITs were created in 1960 to provide investors with access to real estate investments. They have several key tax benefits: REITs are exempt from federal corporate level taxes on distributions to shareholders.[2] In addition, under the 2017 Tax Cuts and Jobs Act, REIT shareholders can deduct 20% of the ordinary REIT dividends they receive until the end of 2025.[3] To benefit from these advantages, a company must meet several criteria[4] to qualify as a REIT under U.S. tax law:

- **Ownership Test:** REITs must be owned by at least 100 individuals, and cannot be closely held[5] after the first taxable year.
- **Asset Test:** At least 75% of the REIT's total assets at each quarter end must be in real estate assets, cash, and/or government securities. There are also certain diversification requirements.[6]
- **Income Tests:**
  - At least 75% of the REIT's annual gross income must be from real estate related sources (including rents from real property and interest mortgages on real property).
  - At least 95% of the REIT's annual gross income must be from real estate related sources, or from dividends/interest.
- **Distribution Test:** At least 90% of a REIT's taxable income must be distributed to shareholders each year.

HOW ARE THEY STRUCTURED?

There are three types of REIT structures:

	Publicly Traded REITs	Non-Traded REITs	Private REITs
Registration with SEC	Registered under the Securities Act of 1933	Registered under the Securities Act of 1933	Exempt from registration
Reporting Obligations	Required to file annual and periodic reports with the SEC under the Securities Exchange Act of 1934	Required to file annual and periodic reports with the SEC under the Securities Exchange Act of 1934	Exempt from reporting obligations
Minimum Investment Amount	None	Typically, $1,000-$2,500	Typically, $10,000-$25,000
Investor Eligibility Requirements	None	Investors meeting state-mandated eligibility requirements[1]	Accredited investors or higher
Liquidity	Real time via a public exchange	Periodic share repurchases, typically up to 5% of the net asset value (NAV) of the fund per quarter	Generally, no periodic liquidity
Term	At investor discretion	Typically, perpetual-life vehicle	Pursue an IPO or contemplate wind down (typically after 5-10 years)

WHAT ARE THE DIFFERENT TYPES OF REITS?

There are three main types of REITs:

- **Equity REITs** own and operate real estate properties, which may include commercial (shopping malls, office buildings) or residential (apartment complex) properties. Revenues are generated through rental income from tenants that occupy their real estate properties.
- **Mortgage REITs** provide financing to commercial and/or residential real estate owners and operators, either directly in the form of mortgages or real estate loans, or indirectly through investments in mortgage-backed securities. Revenues are generated through interest payments from the mortgages in their portfolios.
- **Hybrid REITs** use investment strategies of both equity REITs and mortgage REITs.

Typically, publicly traded and private REITs are either equity or mortgage REITs, while non-traded REITs are generally a hybrid, predominantly focused on equity strategies.

WHAT ARE THE DIFFERENT STRATEGIES OF NON-TRADED REITS?

There are four types of investment strategies that a non-traded REIT can deploy. These strategies are differentiated by the asset's current stage of development and the level of work needed to get it to a position where it is generating consistent income or returns. Most non-traded REITs focus on core and/or core plus strategies.

Level of Risk/ Return Potential

Strategy Type	Current State	Level of Risk	Primary Investment Goal
Core	Good condition	Low – Medium	Income
Core Plus	Needs some improvement	Medium	Income and Capital Appreciation
Value-Add	Requires renovation	Medium – High	Capital Appreciation
Opportunistic	Ground-up development or major overhaul	High	Capital Appreciation

BENEFITS

- **Income Potential:** Income is a core part of the overall return of most non-traded REITs, which must distribute 90% of their annual taxable income to investors to qualify as a REIT and avoid federal corporate income taxes. In addition, non-traded REIT shareholders can deduct 20% of the ordinary REIT dividends they receive until 2025.
- **Diversification:** Non-traded REITs can reduce volatility in a portfolio given their low levels of correlation with other asset classes. Non-traded REITs can offer diversification by asset class, geography, and type of tenant.
- **Lower Volatility:** Non-traded REITs typically value their assets on a monthly basis and tend to be less volatile than publicly traded REITs, which are subject to daily market fluctuations.
- **Access at Low Investment Minimums:** Non-traded REITs offer exposure to real estate properties, with investment minimums as low as $1,000-$2,500.
- **Periodic Liquidity:** Generally, non-traded REITs offer investors quarterly share repurchases at NAV (typically up to 5% of the NAV of the fund).[7]
- **Transparency:** A prospectus is available and periodic reports are filed with the SEC (e.g., Form 10-K, 10-Q, and 8-K), giving investors a transparent view of the holdings and the ability to review the operations of the non-traded REIT, including expenses.
- **Simplified Tax Reporting:** Non-traded REITs issue a Form 1099 instead of a Schedule K-1, which is typically provided in private limited partnership structures.

KEY RISK CONSIDERATIONS

Key risk considerations may include, but are not limited to, the following:

- **Real Estate Risk:** Due to the nature of the underlying real estate properties, investors may be exposed to a wider range of potential risks including market, location, leverage, vacancy, and tenant risk. Investors should understand the risks associated with the type of real estate properties in a non-traded REIT before investing.
- **Interest Rate Risk:** Non-traded REITs can be sensitive to interest rates. An increase in interest rates may erode the relative attractiveness of the income generated, and may lower the value of the underlying property.
- **Income Risk:** While non-traded REITs must distribute 90% of their annual taxable income, dividends are not guaranteed. In addition, non-traded REITs may use offering proceeds and borrowings to pay distributions, which reduces the value of investors' shares and capital available to invest in real estate assets.
- **Liquidity:** While non-traded REITs may offer quarterly share repurchases, the number of shares eligible for repurchase may be limited and subject to fees and/or other restrictions. In addition, private REITs are considered longer-term investments, with investment terms ranging from 5-10 years (or longer).
- **Fees:** Most non-traded REITs charge an annual management fee of 0.75-1.25% of net assets. Fund managers also collect a performance participation allocation, which can be as high as 12.5%, subject to a hurdle rate (generally ranging from 5-7%).
- **Leverage:** Non-traded REITs often use leverage, which offers the potential for higher yields, but also increases the downside risk.
- **Manager Selection:** Not all fund managers are the same. The experience, skill level, size of team, assets under management, and track records of managers are all key factors to consider when investing in a non-traded REIT.

Please contact your financial professional or a fund manager to learn more.

ENDNOTES

1. Suitability standards may vary by state, but generally require an investor to have: 1) a net worth of at least $250,000; or 2) a gross annual income of at least $70,000 and a net worth of at least $70,000.
2. A REIT is able to pass through taxes for capital gains, dividends, or interest earned to individual investors avoiding double taxation (at both the fund and investor level).
3. Tax Cuts and Jobs Act, Provision 11011 Section 199A – Qualified Business Income Deduction FAQs, as of Sept. 6, 2023.
4. For specific requirements, please see Internal Revenue Code Section 856.
5. A company will be disqualified as a REIT if, after the first taxable year, more than 50% of its shares is owned directly or indirectly by five or fewer individuals. For specific requirements, please see Internal Revenue Code Section 856(h).
6. For specific requirements, please see Internal Revenue Code Section 856(c).
7. The Board can decide to suspend share repurchases at any time. Redemption programs also may require that shares be redeemed at a discount, meaning investors lose part of their investment if they redeem their shares.

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