14 Real Estate Syndicates and Investment Trusts

REAL ESTATE SYNDICATION

Real estate syndication offers the opportunity to channel private savings into real estate investments for which other financing is not available. It has been a popular method of financing the purchase and sale of properties in the higher price ranges.

The term "syndication" has no precise legal significance. It is a descriptive term for an organization or combination of investors pooling capital for investment in real estate. The responsibility, obligation and relationship of the syndicator to the investment group and the investors to each other are determined principally by the form of organization.

Real estate licensees have been active in real estate syndication for years. This follows naturally from licensees' involvement as agents in purchase and sale transactions. When confronted with a listing or other opportunity to sell property requiring financing that could not be handled by a single purchaser, a real estate broker might turn to others for pooling of capital necessary to consummate the purchase.

In General

A typical real estate syndication combines the money of individual investors with the management of a sponsor, and has a three-phase cycle: origination (planning, acquiring property, satisfying registration and disclosure rules, and marketing); operation (sponsor usually manages both the syndicate and the real property); and liquidation or completion (resale of the property).

Benefits

Often real estate brokers or developers have been at some time in a controlling position with respect to an expensive piece of property that appears to offer extremely favorable opportunities for profit to the purchaser. All too often the investment outlay on such a purchase is more than any single client can manage. The real estate licensee who understands the methods of syndication can turn what would otherwise have been a frustrating and unrewarding situation into a possible profitable transaction for both the licensee and the investors.

By pooling limited financial resources with others who are similarly situated, a small-scale investor may participate in ownership and operation of a piece of property that is too much to handle singly or in a joint venture with one or two others.

Syndication also offers professional management which might not otherwise be economically feasible for the small investor. Professional management, the basic commodity that the syndicator has to offer, is crucial to successful syndication.

Syndicate Forms

Selecting the form of organization involves practical as well as legal and tax considerations. Each of the available entities has advantages and disadvantages. The corporate form insures centralized management as well as limited liability for the investors but is seldom utilized in modern syndicates because of its negative tax features. The general partnership (joint venture) avoids the double taxation normally involved in a corporate entity but the unlimited liability provision and lack of centralized management militate against its use. The limited partnership combines many of the advantages of the corporate and partnership forms. It has some of the corporate advantages of limited liability and centralized management and the tax advantages of the partnership.

Limited Liability Corporations

A limited liability company (LLC) is a hybrid business entity that essentially combines aspects of a corporation with a partnership. This entity form permits active participation in management and control by the members along with limited liability similar but with certain exceptions to corporate shareholders. Properly created and operated, a LLC may be taxed similar to a partnership and avoid some of the taxation problems of a corporation. It should be noted that LLCs as an entity can not hold a real estate license.

Limited Partnership

Under the California Revised Limited Partnership Act, a limited partner is not liable as a general partner unless the limited partner is also named as a general partner in the certificate of limited partnership or the limited partner participates in control of the business (Corporations Code Section 15632). If the limited partnership agreement otherwise satisfies certain tax requirements, the limited partnership is taxed as a partnership rather than as an association taxable as a corporation.

Regulatory Control of Real Estate Syndicate Offerings

The increasing use of syndicates to invest in real estate in California led to the enactment of the Real Estate Syndicate Act (Business and Professions Code Sections 10250, et seq.) in 1969. Operative January 2, 1970, this law was applicable only to noncorporate syndicates owned beneficially by 100 persons or less which were formed for the sole purpose of investing in real property. Jurisdiction over these offerings was transferred from the Department of Corporations to the Department of Real Estate. Jurisdiction over other syndicate offerings (e.g., oil and gas syndicates) remained with the Department of Corporations.

Effective January 1, 1978, the Real Estate Syndicate Act was repealed and the regulation of offerings of all real estate syndicate interests was again vested in the Department of Corporations.

A given form of business for pooling investment money may constitute a securities offering for which the organizers must seek a permit or exemption from the Department of Corporations.

The 1977 legislation also added Section 25206 to the Corporations Code, enabling real estate brokers to engage in the sale of certain types of security interests without having to obtain a broker-dealer license from the Department of Corporations. The legislation also added a provision to the Real Estate Law making it the basis for disciplinary action against a real estate broker if he/she violates certain provisions of the Corporations Code or the regulations of the Corporations Commissioner in transactions involving the sale, exchange or trade of real estate syndicate interests in which the broker is permitted to engage under the Corporations Code. Real Estate Brokers seeking to engage in the sale of security interests in real estate syndicates should also consult Department of Corporations Release No. 62-C (July 2, 1980).

Persons desiring detailed information concerning the offer and sale of interests in real estate syndicates should seek such information from the Department of Corporations.

REAL ESTATE INVESTMENT TRUSTS

In 1960, the Real Estate Investment Trust Act provided for a similar investment structure in real estate as mutual funds provide for investing in stocks.

If a REIT distributes 90% or more of its income annually to shareholders, and otherwise qualifies under IRS rules, the REIT is permitted to be taxed at corporate rates on only the retained earnings. The shareholders may be taxed for the dividends received from the REIT and any capital gains.

Real Estate Investment Trusts or REITs are entities that own and in most cases operate different types of income producing real estate or related real estate assets, typically consisting of shopping centers, office buildings, hotels, apartments and mortgages secured by real estate. Some REITs will concentrate their holdings specifically in one type of real estate, such as shopping centers, while others may concentrate in one region of the country.

Some advantages of a REIT include:

1. Pooling of funds to take advantage of large investment opportunities.
2. Diversification with interests in a number of different properties .
3. REITs traded publically on the major stock exchanges can be readily traded or sold for cash.
4. Although not held true with the recent financial crisis, over time REIT's stock returns have historically had a low correlation with the returns of other equities or from bonds.
5. Publically traded REITs must make detailed disclosures to investors along with submitting regular financial reports to the Securities Exchange Commission offering greater transparency for the investor.

REIT's do come with some disadvantages especially in the area of taxation. Dividends received from a REIT are currently taxed at a higher rate than other stock dividends. An investment in a REIT can not be used to defer capital gains tax as may be permitted by the IRS "Section 1031 Like-Kind Exchange" rules. In addition, a REIT can not pass tax losses through to its investors as may be possible in certain other real estate investments.
A REIT is accorded special tax treatment because most of its income is received from real estate and distributed to the shareholders. Along with this tax advantage, REITs are subject to qualifications and limitations, including:

1. Be structured as a corporation, trust or association and be managed by a board of director or trustees.
2. Have transferable shares or certificates of interest.
3. Be an entity taxable as a corporation.
4. Can not be a financial institution or an insurance company.
5. Be jointly owned by at least 100 persons.
6. Pay to the shareholders dividends annually of at least 90% of the REIT's taxable income.
7. Have no more than 50% of it's shares held by 5 or fewer individuals during the last half of each taxable year (5/50 rule).
8. At least 75% of total investment assets must be in real estate.
9. Generate at least 75% of gross income from rents on real property or mortgage interest.
10. No more than 25% of its assets may consist of stock in taxable REIT subsidiaries.

Because the usual penalty for not meeting the qualifications is the loss of REIT status, it is suggested that licensees contact the IRS for the most current tax law involving REITs.

Types of REITs
REITs are categorized as equity trusts, mortgage trusts (short-term or long-term) or hybrid trusts.

An ***equity REIT*** is the most common and make most of their money for investors from rents collected on its real estate properties. Unlike other real estate companies, a REIT must acquire and develop its properties primarily to operate them rather than to resell them after they are developed. The REIT may buy or construct buildings, develop real estate projects, lease properties for rental income and place mortgages on its holdings.

An equity trust's internal sources of growth capital are refinancing of its mortgage debt and retaining of capital gains when property is sold. External sources are the public sale of its securities, acquisition of properties in exchange for its securities, and short-term bank loans.

A ***mortgage REIT*** lends money directly to real estate owners and may invest in existing mortgages secured by real property. Income is essentially derived from interest on these mortgages. From the investors viewpoint, this type of REIT is similar to bond mutual funds.

A ***hybrid REIT*** combines both of the above types by owning and operating income producing real estate along with investing their assets in mortgages.

REITs can further be broken down into publically traded and non-exchanged traded REITs. Both of these types are filed with SEC, however only publically traded REITs have shares traded on national stock exchanges. Separate from these two types, some REITs are private and are not freely traded as they are not registered with the SEC. An investor pays a fixed price for each unit in a private REIT and anticipates receiving regular dividends from income produced from rents or mortgage interest. Typically private REITs only trade during certain windows of time when the investor can redeem units back to the issuer on terms set by the private REIT. Many private REITs have at times suspended redemptions. These types of private REITs do not have the disclosure requirements of other REITs and typically there is no public or independent source of performance data available for the investor.

Like other investments, REITs carry the risk of loss of investment and can be a complicated investment product. There are many other technical and involved provisions spelled out in federal law, Internal Revenue Service rulings, and the California Corporations Commissioner's regulations. In addition, tax rules can be complex requiring contacting the IRS for the most current tax laws involving REITs. To be properly informed beyond the general picture presented here, licensees should contact all these sources.