



Neighborhood Profit Sharing With Real Investment Trusts (REITs)



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Neighborhood Profit Venturing through Real Estate Investment Trusts (REITs)

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Can Real Estate Investment Trusts (REITs) change the way both residents and investors better their neighborhood and portfolios? As a neighborhood redevelopment tool, we investigate such a concept. Furthermore, this profit-making concept is extended to key constituents who know the community best: policy makers, stakeholders, and residents of the neighborhood. Through neighborhood REITs, residents accrue wealth and ownership for themselves and their neighborhood.

The economic and political platform of REITs has been in existence since the 1960s. So, why have we not heard about REITs as a method of community redevelopment before? Traditionally, REITs have focused on making an economic impact as they relate to the stock, real-estate, and financial markets. Until now, the potential social value of REITs as a community development tool has been overshadowed by their political and economic benefits to wealthier investors who probably don't live anywhere near the site of their investment.

Although REITs offer plenty of information for monitoring economic trends, their social impact has yet to be realized. One may contend that the legislation's original intent had social goals with a more modest investor pool in mind. In 1960, REIT legislation was signed by President Dwight D. Eisenhower as The Real Estate Investment Trust Act. The President's intent was to

allow the everyday investor an opportunity to invest in large scale portfolios of real estate (“REIT”, n.d.). See appendix A for a view of REIT legislation.

This proposal focuses on local real estate, where residents can participate with a large scale investment that is in their own community. We highlight four critical points about a neighborhood-focused REIT and conclude with a deliberation of threats and opportunities. First, what is a Real Estate Investment Trust (REIT)? The second point delves through the political and economic trends as they relate to REIT start-up and performance. The third point discusses the payout of REITs. And finally, the fourth point lays out management control of a REIT. Although, this is the first documented attempt to realize the social implications of REITs, the outcomes have potential to be replicated among other neighborhoods and regions throughout the United States.

First, what exactly is a Real Estate Investment Trust (REIT)? A REIT is modeled after a mutual fund in which investors pool their money to purchase a collection of assets. Particular to REITs, the assets are real estate. The REIT owns and operates its own income producing property and/or real estate asset (sec.gov). Unique to this proposal, the REIT is comprised of properties specific to the neighborhood (i.e. vacant, city owned properties) and the resident becomes an owner of their neighborhood through purchase of REIT shares. Likewise, the REIT is treated the same way as a domestic corporation and is regulated by the Internal Revenue Service (IRS). Most domestic REITs are registered with the U.S. Securities and Exchange Commission (SEC). See appendix B for organizational and operational rules for REITs and appendix C for different types of REITs.

Defining REITs allows for an opportunity to consider its feasibility as a viable profit venture for neighborhoods. In doing so, our second critical point looks at REIT trends over the last 50 years. Incidentally, the number of REITs has increased as regulations have changed over time. Most notably, the Tax Reform Act of 1986 allows REITs to manage their own real estate (Borden, 2015). Prior to TRA, the REIT served as a real estate holding and was restricted to retain advisors and property managers resulting in fees hindering REIT performance (Ambrose & Linneman, 2001).

Policy changes such as clarification of REIT terms and the increased flexibility for property management have allowed investors to become more comfortable with REITs. Although political and economic trends have influenced the creation of REITs, they have not served as a predictor for REIT dividends. Moreover, REITs are not affected by the stock market or economic trends like their mutual fund counterparts. Thus, investors look to REITs as a source of diversification for their investments. Another distinction between a mutual fund and the proposed neighborhood REIT is that the shareholders live, work, and are familiar with the neighborhood in which they are investing. See appendix A, for more information regarding the political and economic trends.

As shareholders are keen to their neighborhood investment through a REIT, knowing how

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dividends are paid out is important. The third critical point relates to the payout distributed to REIT shareholders. Financially, REIT dividends are paid and taxed the same way as mutual funds. Meanwhile, the difference between a REIT and a mutual fund is how the asset is taxed. REITs do not incur corporate income tax, eliminating double taxation (Wunder, 2016). Tax is only paid on the ordinary income portion of the shareholder's dividend.

Equal importance to payout is how the neighborhood REIT is structured and traded. REITs can either be publicly or privately held. Public REITs are traded on major stock exchanges such as NYSE. Private REITs are not publically traded. The unique characteristics of a neighborhood REIT will call for deliberation by the North Central Neighborhood Association and its residents to determine public or private structure. See appendix C for REIT categories and types and figure 2 for public and private REIT comparison.

Income generated by a REIT could be from rents, mortgage interest, and mortgage-backed securities. Likewise, the type of income is indicative of the type of REIT. Academic and professional literature identifies three major types of REITs: mortgage, equity, and hybrid REITs. See appendix C for more information on types of REITs. The REIT is exempt from paying income taxes on the profits earned, although they are required to payout 90% of their dividends. The result of this distribution requirement allows for a higher dividend payout to its shareholder.

In addition to REIT payout, the fourth point recognizes how REITs are controlled and managed. There are two ownership requirements for a REIT. First, the REIT must have at least 100 shareholders. Second, the five or fewer rule protects the minority interest of the shareholder by not allowing five or less individuals to own 50% or more of the stock (NARIET.com, n.d.; Howard, Pancak & Shackelford, 2016). The five or fewer rule prevents a few really wealthy persons from having control of the REIT. See appendix B for REIT rules.

Indeed, prohibiting unitary control allows for a wider distribution of dividends to the neighborhood shareholders. Additionally, the SEC requires a board of directors for management of the REIT (SEC.gov). The Tennessee Business Law Journal recommends having a staggered board term. Staggering board terms keeps true to the majority interest of its shareholders. (McCall, 2011).

In consideration of payouts along with the economic and political trends, we attempt to forecast the social implications of REITs. First, we explore the threats and opportunities for the neighborhood profit-making venture. The preliminary gathering of threats and opportunities allow us to move forward with the neighborhood REIT venture.

Threats of neighborhood REITs are to be considered and guarded against. One such threat is the concept of REITs being lumped together as another form of neighborhood redevelopment. REITs are unlike previous interventions, but they could easily be grouped as such. It is anticipated that residents and investors will relate REITs to Tax Increment Financing (TIFs) as

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they both are affected by assessed property values. In response to such a claim, TIFs are a form of public financing used to subsidize redevelopment and are based on property value and revenue. REITs are not structured the same way. Unlike TIFs, REITs are managed like a mutual fund where shareholders own the real estate investment.

What differentiates REITs from previous redevelopment efforts is that the shareholder has a financial and vested interest in their neighborhood. Furthermore, collective control from its minority shareholders promotes civic engagement within the community.

In addition to education and community acceptance of REITs, we must acknowledge the challenge of access to capital. Acquiring wealth is not exactly easy. Homeownership is one way to create wealth. Another way is through the dividends received from a neighborhood REIT. Purchase of shares will allow an individual build capital and credit. This creates an opportunity towards homeownership if they choose. Since shares are not as expensive as a down payment on a home, the REIT provides a chance to create wealth on a smaller scale.

Other concerns involve the cost of starting and operating a REIT and REIT management. The start-up and operational costs include legal counsel, insurance, asset valuation, property management, and administrative and financial compliance. Such costs will affect the price of shares and the feasibility in forming a REIT. Inasmuch as a neighborhood REIT's assets are properties that have been ceded to it by the city, there are no costs associated with the purchase and taxing of the assets for which investment funds will be sought. Effective management is a much bigger concern, given that neighborhood groups rarely have expertise in financing and managing real estate projects. The North Central Neighborhood Association (NCNA) has partners that include a commercial bank, two major universities, a successful development firm and a well-regarded technical institute whose graduates can build and rehab properties.

The "owners" and "investors" in the REIT will include these institutions but also people from the neighborhood. Indeed, it is possible to stipulate that neighborhood people have the right to invest in projects first. These larger entities with deep pockets and wealthy individuals with an interest in community development will be invited to invest in projects only after community people have had a chance to invest in them. Local people will not be cut out.

It doesn't even matter that neighborhood investors are not especially well-to-do. Individuals establishing credit for the first time and those needing to remedy their credit can do so by investing in and receiving dividend income through a REIT. An example might be a military individual who could build credit through investment of a REIT, while dually serving as a stepping-stone for a future mortgage loan.

In every case, a new stream of income is received by the shareholder through REIT dividends, and those funds can be used to improve the holder's credit and loan worthiness. Tax exempt investors, such as the two universities, can leverage their investments through the REIT structure without being subject to unrelated business tax income (UBTI). See appendix E for more information regarding the payout of REITs. Another windfall for neighborhood REITs is

realized by reclaiming dilapidated city owned properties and converting them into revenue generating parcels. As such, the cleanup for this profit-making venture has the potential to attract new residents as community builders.

One such target for community building is the neighborhood integration of transitioning military individuals. See appendix D for Veterans as Community Builders. Such individuals are conditioned and are successful in rebuilding distressed communities. Furthermore, REIT investment allows residents to access to affordable quality housing in a metropolitan area, while receiving a profit through REIT dividends.

To be sure, there are threats and opportunities that could affect a neighborhood-based REIT. However, we hope to build one as a profit-making venture for neighborhood investment, improvement, and stabilization that can appeal to a variety of current and potential renters and owners. As one resident stated during a 2016 symposium hosted at the Pulitzer Foundation, “this proposal has rippling effects” (October 6th, 2016). The REIT has the potential build upon and contribute to the political, economic, and social realm of overall neighborhood wellness and development.

There are two potential drawbacks to using REITs in the way we have outlined above. First, the persons who invest in this kind of financial tool typically have to be “qualified investors.” That is, they have sufficient wealth and/or income to cover the loss of their principal investment should the project fail. Many “community people” and perhaps most of them probably do not have that kind of money.

The aforementioned limitation on the sale of shares in a REIT applies to a “Public REIT.” It does not apply to a “Private REIT.” Private REITs are exempted from the strict limits imposed by the SEC that shares goes only to “Qualified Investors.” A person who is not wealthy can buy shares in a Private REIT of the sort we propose to use in St. Louis.

See: <https://www.reit.com/investing/reit-basics/guide-private-reits> for a discussion of this exemption. The exemption for a Private REIT is under regulation D (Form D with SEC): <https://www.sec.gov/fast-answers/answers-regdhtm.html>.

Of course, there are trade-offs with the exemption. The SEC cautions investments with Private REITs/Securities. There is less accountability from the REIT directors in a Private REIT. On the one hand, this can create more uncertainty for the investor. On the other hand, if the private REIT decides to sell stock to a less qualified investor, its directors, too, are taking a risk. Private investment requires "trust" from both sides. In our case, the proposed REIT will have non-qualified investors from the community on the Board of Directors and the REIT will be run through Enterprise Bank, which also has a seat on the REIT's Board of Directors.

The second potential drawback of using a Private REIT is that some time and expense may have to go toward obtaining a waiver for smaller, community-based investors, even though the engagement of these persons is allowed. Assuming one can move past that hurdle, state regulators may require more oversight of the management team, if only because of the novelty of

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using this particular kind of investment tool in community-based development. Thus, this kind of REIT may be more expensive to manage until such time as state regulators become comfortable with its operation and management.

We expect that promised investments by much wealthier individuals and corporations will go some distance to blunting concern about the involvement of persons of modest wealth. The engagement of a local banking institution to manage the REITs dedicated to a neighborhood's redevelopment, as we just observed, also should help reassure regulators that the money of all investors is being managed well.

If prospective investors become convinced that the creation of one or more REITs is not feasible, there is another option available to the principal investors: the creation of a for-profit or non-profit "umbrella" development group that can solicit funds from both wealthier and not-so-wealthy or even not-at-all-wealthy people and organizations. This approach lacks both the expense and protections afforded by a REIT. It also would have to be organized so that its profits and dividends would be dispersed the same way REITs are required to disperse the money they make. No private developer would be allowed to make excessive profits from its work in the neighborhood being redeveloped.

The properties being redeveloped are imagined to be both a private resource and a community resource. As such, both investors and would-be developers are willing to take smaller profits in order to promote projects that serve the well-being of everyone living or working in the area, even if they invest nothing in proposed projects.

APPENDIX A

Pivotal REIT Policy

President Dwight D. Eisenhower signed The Real Estate Investment Trust Act as a side piece contained in the Cigar Excise Tax Extension of 1960 (Brounen & Koning, 2014; Graff, 2001). The intent of this act was to allow the everyday investor to invest in large portfolios of real estate, the same way investors would invest in similar class assets (“REIT”, n.d.). Although REITs have been around for decades, they have not gained much popularity until recently. Part of the reason why is due to the ambiguity of the IRS definition and regulations behind the initial signing of the REIT Act. Specifically, a REIT would have to engage in a third-party contractor to manage the property. This made it difficult for an investor to favor this type of passive investment (Borden, 2015).

Several REIT amendments were adopted and rolled into the Real Estate Investment Trust Modernization Act of 1999. The REIT Modernization Act (RMA) of 1999 allows a REIT to own 100% of a taxable REIT subsidiary and lowers the distribution requirement from 95% to 90% (Implications and Opportunities of the REIT Modernization Act, n.d.). REITs can now own and operate income-producing properties. The loosening of restrictions is what led to the REIT boom of the 1990s, which contributed to REITs becoming the third most important asset class next to stocks and bonds (Brounen & Koning, 2014).

Recent media coverage clarifies the definition of “real property” as it relates to REIT policy. On August 31, 2016, The IRS and U.S. Dept. of Treasury issued final regulations to clarify the definition of “real property”. The final regulation is not modifying the previous definition. Rather, it offers clarification for the original three categories: 1) land; 2) inherent and permanent structures; and 3) structural components (Final regulations on the definition of real property for REITs, 2016). The real property clarification mitigates uncertainty as to what qualifies as an asset under the asset test for a REIT.

Regulatory policy has increased the number of listed REITs, and their performance has offered stability in unstable financial markets. Investment advisors state that in an unstable financial market diversification should include real estate investment. The reason why is that REITs are less sensitive to the macro-economic environment than traditional classes of assets (Dubreuville, Cherif and Bellalah, 2016; Simon & Ng, 2009). Other policies also have affected REIT investment trends. Examples include the Wall Street Reform and Consumer Protection Act of 2010 and Economic Stabilization act of 2008 and the Housing and Economic Recovery Act of 2008. These policy changes affected REIT participation by changing investors’ access to credit.

Significant Legislation for REITs 1960-2016

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|---------|---|
| 1960 | Cigar Excise Tax Extension |
| 1969-75 | IRS rulings between 69' and 75' addressing what assets qualify as a REIT |
| 1976 | Tax Reform Act of 1976 |
| 1986 | Tax Reform Act; The Modern REIT Era |
| 1997 | REIT Simplification Act |
| 1999 | REIT Modernization Act, ability for formation of Taxable REIT Subsidiaries (TRS) |
| 2004 | REIT Simplification Act |
| 2008 | REIT Investment Diversification and Empowerment Act |
| 2015 | House Approval to end Tax Free Real Estate Spinoffs |
| 2015 | Federal Regulations 26 CFR part 1, Sec 856. Defines what is considered as “real property” |
| 2016 | IRS release of REIT guidance on regulations and asset test(s) |
| 2016 | IRS & US Treasury issue final regulations, Sec 856-859 clarifying the definition of “real property” |

APPENDIX B

REIT Rules

REITs' original legislative intent has remained true as enacted by President Eisenhower. During a U.S. Congressional meeting, a statement by U.S. Senator Jonny Isakson (R-GA) is made regarding the 50th anniversary of REITs.

“While the REIT model has evolved, the original legislative intent of making large-scale, income-producing commercial real estate investment available to all types of investors remains at its core.” Congressional Record Volume 156, Number 123.

The regulatory body for REITs is the Internal Revenue Service (IRS) and its formal structure is treated the same way a domestic corporation is. The National Association for Real Estate Investment Trusts (NARIET) outlines four compliance requirements in establishing a REIT (NARIET.com, n.d.; Howard, Pancak & Shackelford, 2016):

(1) **Organizational**- two ownership tests

- (a) Beginning its second taxable year a REIT must have at least 100 shareholders
- (b) Five or fewer rule. No more than five individuals can own 50% of the value for the REIT stock during the last half of its taxable year

To ensure that these test(s) are met they can be included in the organizational documents (by-laws).

(2) **Operational**- two annual income tests and a number of quarterly asset tests to ensure that the majority of the REITs income and assets are derived from real estate sources.

Annual requirements:

- (a) At least 75% of a REITs annual gross income must be from real estate related income such as rents, mortgage interest, or gains from the the sale of property.
- (b) No more than 5% of a REITs income can be from non-qualifying sources such as service fees.

Quarterly requirements:

- (c) At least 75% of a REITs assets must consist of real estate assets such as real property, loans, or cash.
- (d) A REIT cannot indirectly or directly own more than 10% of the voting securities of any corporation other than another REIT, a taxable REIT subsidiary (TRS), or a qualified REIT subsidiary (QRS).
- (e) A REIT is prohibited to own stock in a corporation other than another REIT, TRS or QRS in which the value of the stock comprises more than 5% of the REITs assets.
- (f) The value of the stock from the other REITs, TRS or QRS cannot comprise more than 25% of the value of REITs assets.

(3) **Distribution-** A REIT must distribute at least 90% of the sum of its taxable income. The REIT pays taxes on such just like another corporation.

(4) **Compliance and Filing-** 1) A REIT files an income tax return, 1120-REIT. A REIT does not have to make its election until after the end of its first year. The REIT election forms are due in March. The REIT tests as described above must be met if wanting to qualify as a REIT. 2) The REIT is obligated to annually notify its shareholders requesting details of beneficial ownership of shares.

Most REITS (except for private REITs) are registered with the U.S. Securities and Exchange Commission (SEC), and are regulated by Internal Revenue Service (IRS) (“Understanding the Basics of REITs”, n.d.).

SEC requirements, in addition to the above-

- (a) Managed by a board of directors or trustees
- (b) Shares are fully transferable

An example of REIT governance reported by the Tennessee Journal of Business law offers a practical method for staggering their board for a two to three year term. Moreover, this approach guards against issuance of preferred stock above the current market price. In addition to staggered boards, another good practice is to have the board not be internally affiliated with or employed by the REIT. This approach helps with the REIT to be more aligned with its shareholder interests (McCall, 2011).

APPENDIX C

Types of REITs

Investment Categories

For investment purposes, there are three types of REITs: 1) Public, stock exchange listed REITs; 2) Public, non-listed REITs; and 3) Private REITs (reit.com; Noguera, 2015). **Publicly-listed** REITs are registered with the Securities and Exchange Commission (SEC). These public shares are listed and traded on major stock exchanges. Public REITs are liquid. Liquidity refers to how easy an asset is sold. The volume of shares equates to liquidity. A larger volume of shares is more liquid. The second type of REIT is **public non-listed**, which means the REIT is publicly registered with the SEC. These public shares are not traded on major stock exchanges. Public non-listed REITs are generally not liquid (reit.com). The third type of REIT is **private**, which means that the REIT is not listed with the SEC. These private shares are not traded with major stock exchanges (reit.com, n.d.). Private REITs are illiquid. This means that a redemption program will need to be in place for liquidation and redemption of shares (sec.gov). Although the term “private REIT” is common in literature, the preferred term is “unlisted REIT”, because they follow SEC rules but do not list shares on exchanges (Corgel & Gibson, 2007).

The performance of the unlisted REITs is nearly on par with public REITs. In 2003, the unlisted REIT group raised \$7 billion through broker-dealer channels, and publicly-traded REITs raised \$8.1 billion (Corgel & Gibson, 2007).

A criticism of private/unlisted REITs is their aggressive fees (often 10% to 15%) that are deducted from the investor’s contribution and paid to the financial planner or sponsor. Selling, service, and acquisition fees are higher for private REITs. A \$10,000 investment in an unlisted REIT might generate up to \$1,500 in fees. A comparable investment in a publicly traded REIT would generate less than \$100 in fees. Despite the disparity in fees, the dividend payout for private REITs out performs publicly traded REITs (Corgel & Gibson, 2007). Literature on private REITs is limited. Only one publication was found that references privately held REITs. A neighborhood REIT’s fee structure might differ from the aforementioned examples. A comparison of public and private REITs is offered in figure 2.

Investment categories tell us how the investment is listed and traded. Furthermore, each category is regulated and traded differently. Likewise, each category seizes a different level of shareholder risk and return. In consideration investment categories, investment type is a factor too. The investment category deals with how the investment is traded and investment type deals with type of asset held by the REIT.

Investment Types

Real estate covers a broad spectrum of asset types. Assets can be realized as vacant land, commercial and residential property, mortgage interest and equity. The reason why the asset type matters is because each asset has its own set of risks. After the three main investment types

are outlined, we will illustrate how asset type contributes to risk level.

There are three primary REIT investment types: mortgage, equity, and hybrid (Nogurea, 2015). **Mortgage REITs** are residential or commercial properties and earn revenue through mortgage interest or mortgage backed securities. Mortgage REITs are affected by interest rates. As interest rates increase the income for the mortgage REITs decreases (Ambrose, power point, n.d.). **Equity REITs** are residential and commercial properties and earn revenues through rents received (reit.com, n.d.; Wikipedia, n.d.). Equity REITs are affected by property management and rent collection. **Hybrid REITs** are residential and commercial properties and are a combination of equity and mortgage REITs (2015 Cotter & Roll, 2015). These REITs are affected by both mortgages and property management.

An alternative to the three primary REIT categories is the industry-specific REIT. These fall under the equity REIT category and collect rent. They include retail, residential, healthcare, and offices. A well-noted retail REIT is Taubman Centers, Inc. (NYSE: TCO). The major shopping center developer was noted as the first REIT to offer an IPO in 1992 (Borden, 2015; Investopedia.com, n.d.). Residential REITs is an equity-based investment that relies on rents from multi-family, apartment or manufactured homes. Investopedia.com notes that the largest amount of rental REITs are found in large urban centers where the high cost of single family homes cause individuals to rent (n.d.). Another type of equity REIT is a healthcare REIT (Raudszus, Olliges, & Mueller, 2012; Investopedia.com, n.d.). Medical office building transactions accounted for 25 percent of the total transaction activity for medical office buildings in 2010 (Health Care Sector is RX for REITs, 2011). An office REITs is another equity type which receive rental income and typically have long-term leases (Raudszus, Olliges, & Mueller, 2012; Investopedia.com, n.d.).

For equity REITs, rents are received and contribute to dividend payout. Asset management can make a difference for equity REITs through vacancy and property management. Moreover, the quality of those factors can make a difference in net income (Investopedia.com, n.d.). Let's say that the neighborhood REIT develops a multi-family housing complex. Vacancy rates, maintenance, and management make a difference in how the property (the asset) makes a profit for the REIT.

Different risk factors apply to mortgage REITs. The asset's payout is based on interest earned from mortgages. The Federal Reserve and U.S. Treasury affect REIT performance and dividends through interest rates. Mortgage assets align by federal funds and securities.

For this proposal, the neighborhood REIT is considered an equity REIT. This is because the asset is real estate and the income is from rent received. Furthermore, the assets are exclusive to a specific location (the North Central Neighborhood). Moreover, is undetermined whether the REIT is best categorized as a public or private REIT. Considerations such as shareholder size and liquidity will need to be deliberated between the North Central Neighborhood and its partners.

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APPENDIX D

*Veterans as Community Builders:
Discrimination Mitigation and Inner-City Redevelopment in Urban Areas*

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Introduction

There are a number of ways to acquire wealth, inheriting it being the easiest. For those of us unlikely to have much wealth passed on to us by our parents, however, homeownership is one of the main ways most Americans will use to acquire a measure of wealth over the course of their life.

The longer one owns a house or remains among those persons who do the better off he or she is likely to be in the long run. The robustness of this finding extends to all social classes and races.ⁱ But the wealth-building advantage that accrues to homeownership does not extend to all races and classes equally. It also tends to be concentrated in certain communities more than others.

In general and for a long time, low-income and minority persons have had more difficulty acquiring wealth through homeownership. Homeownership also has tended to be lower in places where lower-income and minority persons reside.

This is why the federal government has tried to make it easier for lower and moderate-income people to buy a house and to increase homeownership in places that have comparatively less of it. It also is why federal regulatory and law enforcement agencies try to identify and counteract practices that discourage homeownership among minority and lower-income persons and in the kinds of places where these persons live.

One can question the wisdom and success of federally-inspired homeownership initiatives, but not their persistence. Nor can one deny the zeal with which officials criticize practices and institutions that are thought to limit the chances of lower-income and minority persons to buy a house. Their efforts, effective or not, are intended to reduce the effect of practices thought to discriminate against lower-income and minority persons who want to buy a house.

All their efforts notwithstanding, lower-income and minority persons still find it hard to buy and keep a house long enough so that they might acquire wealth this way. Residential areas where more persons like this live tend to have lower rates of homeownership, less valuable houses, and

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more vacant, abandoned, or rundown properties. These conditions have shown little sign of abating in the last half-century. So, too, have the practical difficulties attendant to filling so many of the holes left in communities that have been subjected to much economic disinvestment and population loss.

It's time to find another way to address these problems.

Mitigating the Effects of Discrimination

In cases where the environment has been damaged by certain longstanding practices, officials take steps to mitigate the effects of this damage. *Environmental Mitigation*, compensatory mitigation, or mitigation banking, refers to projects or programs intended to offset damage done to an existing historic or natural resource such as a stream, wetland, endangered species, archeological site or historic structure. In areas that have been subjected to environmental degradation, credits are awarded to companies that improve the water, land, and/or air. These credits are issued by a governing public body.

Federal officials do something like this when they believe lending institutions have acted in ways that discouraged lower-income and minority persons from buying a house. In cases of discrimination, however, federal officials *take away* the ability of lenders to do business the same old way by denying them certain credits that make it hard for them to do more business. The denial of a bank's CRA (Community Reinvestment Act) credits effectively stops a bank from pursuing any expansion plans it might have. It can even discourage partners from wanting to work with them or buy them out until such time as the bank stops doing whatever federal regulators say it has been doing wrong.

Proposed here is a strategy to encourage lenders to mitigate the long-term effects of discrimination in the purchase and sale of housing to lower-income and minority persons by promoting the redevelopment and sale of housing in lower-income and minority areas.

Discrimination Mitigation refers to projects or programs that would offset the damage done to residential areas by leaving them racially homogeneous or predominantly low income. In this case, CRA credits would be awarded to lending institutions that either alone or in collaboration with other corporate or non-profit entities engage in activities that either increase racial mixing or homeownership opportunities in low-income and racially-homogeneous areas.

Projects and programs intended to achieve *discrimination mitigation* would combine the investment and lending power of financial institutions working through two kinds of trusts: a *community land trust* and a *real estate investment trust*.

Community Land Trust (CLT)

Residential land trusts emerged in the United States after calls among civil rights leaders in the 1950s and 1960s in the American South for economic reforms to reverse rampant poverty.

The non-profit CLT is intended to achieve one or more of the following goals:

- Gain control over local land use and reduce absentee ownership
- Provide affordable housing for lower income residents in the community
- Promote resident ownership and control of housing
- Keep housing affordable for future residents
- Capture the value of public investment for long-term community benefit
- Build a strong base for community action
- Preventing foreclosure

A 2007 study showed that foreclosure rates of members of housing land trusts in the US were 30 times lower than the national average.ⁱⁱ Foreclosures in 2008 and 2009 destabilized many urban neighborhoods as vacancy and abandonment rose and absentee landlords replaced homeowners.

CLTs work to counter the effects of real estate booms and busts by owning the land and leasing it long-term to the land user who owns the home and other improvements on the land. CLTs usually retain rights to buy buildings from residents who move out of the community. The goal of residential trusts is often to protect housing prices from real estate speculation and gentrification, as well as to allow residents to accrue ownership equity, including sweat equity. In so doing, CLTs can maintain the affordable housing stock in a neighborhood even as it contributes to the area's revitalization.

The land in question here would be parcels and individual housing units owned by cities that are ceded to a private entity rather than a non-profit community group. The ownership vehicle and instrument of revitalization would be a *real estate investment trust*. Unlike a CLT, a real estate investment trust (REIT) is intended to make a profit. But it must disburse its profit to its institutional and individual investors (low or moderate-income individuals).

Real Estate Investment Trust (REIT)

The REIT acts as an investment agent specializing in real estate and real estate mortgages. It is a company that owns, and in most cases, operates income-producing real estate. Most REITs own commercial real estate: office and apartment buildings, warehouses, hospitals, shopping centers, hotels, and even timberlands. They have not typically owned single-family residences.

The REIT in this instance would employ an organization to act as an umbrella developer for the area covered by the CLT. The umbrella developer would be separate from the contributing lending institutions but have representatives from those institutions and the local community

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serve on an oversight board. This umbrella developer would oversee the rehabilitation of existing housing stock for rent or ownership and build new housing on empty parcels.

Because a REIT is entitled to deduct dividends paid to its owners/shareholders, it may avoid incurring all or part of its liabilities for U.S. federal income tax. In return, REITs are required to distribute at least 90% of their taxable income into the hands of investors. In exchange for promoting redevelopment projects that either increase racial mixing or the availability of housing in low-income areas, the participating lenders are awarded CRA credits.

Lenders' shares of the REIT's profits would be plowed back into new CLT-backed projects. Individual investors (presumably low or moderate-income persons) would either pocket their profits or plow them into their personal home-buying fund. They also would realize part of the profit made on their house upon its eventual resale.

To qualify for these credits, the new or rehabilitated housing developed by the REIT must be in areas that would be made more racially-mixed or are predominately low-income. The parcels assembled by the REIT's partner CLT would not be granted by a local governing authority unless the resulting housing satisfied one or both of these criteria.

The people purchasing, renting, or leasing the property with an option to buy it would have to qualify as new or established community members who are in good standing with the CLT.

This latter provision is intended to address one of the lingering social factors that make homeownership and retention so difficult in lower-income and minority areas: keeping and attracting people who are willing to take good care not just of their own property but of their neighbor's property as well.

Homeownership is not a right. It is a privilege for which some persons are better prepared and able to carry out. An effective program of *discrimination mitigation* would pay as much attention to securing a neighborhood as it would good individual tenants and homeowners.

The Military-Community Connection

The downsizing of the armed forces and large number of veterans already waiting to acquire better housing provide would-be developers and community-based organizations with a large, well-trained, and mission-ready population with which to work. This is especially true of metropolitan areas near military bases.

A group of St. Louis institutions: educational, banking, commercial, and at least one community organization is poised to develop a model program that would complement the CLT-REIT initiative outlined above. It would do so by taking on the role of the umbrella developer alluded to above. It will take the lead in integrating armed services personnel into new and existing housing units in inner-city areas where it is working. The nearby presence of the region's VA hospital and Scott Air Force Base are definite plusses. The availability of medical, housing, educational support from the federal government and additional support for small business This activity is financed in part through an allocation of Community Development Block Grant funds from the Department of Housing and Urban Development and the City of St. Louis Community Development Administration.

development among veterans should enhance the chances that veterans will make a smooth transition into the neighborhoods where they are moving.

Democratizing Wealth Building

Urban redevelopment projects have been criticized for improving communities by making them attractive for new and more well-to-do homebuyers while pushing out long-term and less well-to-do residents. The incoming people are often white. The displaced persons are often minorities.

The *Veterans as Community Builders* initiative avoids these problems in novel and important ways:

1. The community is redeveloped around existing homeowners rather than displacing them.
2. Less well-to-do residents are not priced out of the neighborhood as it improves, because Missouri tax laws limit the amount that existing homeowners can be charged in taxes as the value of their property increases.
3. Veterans can become homeowners and business owners, providing both economic resources and social stability to the area.
4. Provisions can be made in all REIT projects for existing residents to buy shares of the proposed residential and commercial development efforts. Indeed, they can be given the first option to invest in projects *before* any large institutional investors or wealthier outsiders are allowed to buy shares of the commercial and residential projects.
5. Existing residents can profit from their neighborhood's redevelopment by money made by each project and from the enhanced value of their own real estate holdings.

¹ http://www.nytimes.com/2014/11/30/opinion/sunday/homeownership-and-wealth-creation.html?_r=0; <http://www.keepingcurrentmatters.com/2014/12/15/new-york-times-homeownership-is-best-way-to-build-wealth/>; <https://www.nahb.org/generic.aspx?genericContentID=215073&channelID=311>; and <http://www.huduser.org/publications/pdf/wealthaccumulationandhomeownership.pdf>.

² See: <http://www.yesmagazine.org/issues/purple-america/community-land-trust-keeps-prices-affordable-for-now-and-forever>.

APPENDIX E

The Payout of REITs

Both public and private REITs distribute at least 90% of their taxable income to shareholders each year (Case, Hardin, & Wu, 2012). Furthermore, any undistributed income will be subject to the federal income tax rate of 35% plus state and local taxes (Grumbacher, Towsner, & Schneider, 2013). With respect to transferability, REITs allow for a tax-free exchange of property for shares of equity REITs (Ambrose, power point, n.d.).

Although REITs have the advantage of tax-free sale of stock, ordinary REIT dividends are treated the same way as non-REIT dividends. For tax-exempt investors, the REIT structure allows for investments to be leveraged without being subject to unrelated business taxable income (UBTI) (Ambrose, power point, n.d.). A reason for the exemption to corporate tax is because the investment is a passive form of income (NPQ, 2011). Dubreuville, Cherif and Bellalah state that real estate is typically perceived a safe-haven when financial markets are unstable (2016).

Another consideration to payout is how the REIT is structured. Public and private REITs differ in levels of liquidity. Inasmuch, a public holding is more liquid than a private holding. If the North Central Neighborhood elects a private REIT structure, they will need to create a redemption program for issuance of shares. Redeeming shares from a private REIT could prolong the payout to its holders.

Figure 1: Threats and Opportunities of REITs

| THREATS | OPPORTUNITIES |
|---|--|
| Meet 100 shareholder requirement (<i>St. Louis City County population, 315,685</i>)* | Residents become entrepreneurs of their own neighborhood |
| Marketing to neighborhood, despite previous redevelopment efforts | Building a sense of legitimacy for the neighborhood |
| Resident access to capital for investment (resulting in more outside investors and less inside investors) | Reclamation of city owned, vacant properties |
| Redevelopment interests of anchor institutions may differ from residents | Community building through existing residents |
| Representation on the Board of Directors | Community building through military families |
| Public policy and changing the rules of REITs | Tax exempt entities can leverage their investments without being subject to income tax from unrelated business taxable income (UBTI) |

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| | |
|---|--|
| Consideration of start-up costs while maintaining an accessible price per share | Neighborhood REIT model to be applied in other communities |
|---|--|

* Population estimate is from St. Louis Census Data Center, State/County Annual Population Change FY 2014-2015. Population decline of -1,537 with a net migration of -3,176.

Figure 2: Public vs. Private REIT comparison and Neighborhood REIT considerations

| | Public REIT | Private REIT |
|---|---|---|
| Overview* | REITs file with the SEC and shares are traded on national stock exchanges | REITs can file with SEC but are not traded on national stock exchanges. |
| Liquidity* | Shares are listed and traded on major stock exchanges. Most are listed on the NYSE. | Shares are not traded on public stock exchanges. Redemption programs for shares vary. Investor exit strategy or becomes listed on national stock exchange after a period of time (often 10 years). |
| Management* | Self-advised and self-managed | Externally advised and managed |
| Performance Measure* | Numerous independent performance benchmarks are available for tracking listed REITs Analyst reports are available to the public. | No independent performance data available |
| Transaction Cost* | Low. Costs are the same as for buying or selling any other publicly traded stock | High. Fees of 10-15% of the investment are charged for broker commissions and other up-front costs. Management fees are also common. Back-end fees may be charged TBD. Neighborhood REITs will have a lower transaction cost due to city ceded asset |
| Investment Amount (Public & Private only)* | One Share | Average \$1,000 to \$2,500 Neighborhood REITs will have a lower investment amount than Private REITs |
| | | Neighborhood REIT |
| Investment Amount | | Undetermined. Less than Private REITs |

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| | | |
|--|---------------------------|-------------------------------|
| (Neighborhood only) | | |
| Asset Type | Equity, Mortgage & Hybrid | Equity |
| Location | International & Domestic | Designated neighborhood |
| Realm: economic, political, or social | Economic & Political | Economic, Political, & Social |

**Source: U.S. National Securities Exchange, National Association of Real Estate Investment Trusts.*

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