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How Hidden Commissions Can Damage Non-traded REITs and DSTs

Depending on how you got into a passive real estate investment, such as a private real estate investment trust or a Delaware Statutory Trust, you may be paying some charges you didn't realize. And they can add up.

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Over the past few years, the financial services industry has come under criticism regarding fees charged, hidden fees, commissions, 12b-1 fees, and a host of other reductions in the value of their client investments. Much of this criticism is warranted, in my opinion.

A huge topic of conversation in recent years has been around the up-front commission charged by broker/dealers (B/D), who are not held to the fiduciary standard, when they place clients into front-end-load mutual funds. Many savvy investors have discovered how these commissions can take a huge chunk out of their portfolios, and have turned to advisers covered by the fiduciary standard, such as Registered Investment Advisers (RIA), or have decided to self-manage accounts to avoid these up-front commissions.

The investing fees people aren't talking about

Little has been written or discussed regarding commissions related to passive real estate investments, however. The passive real estate investments I wish to focus on here are private non-traded Real Estate Investment Trusts (REITs) and Delaware Statutory Trusts (DSTs). In a previous Kiplinger article, "**I'm a Landlord: Can I Ever Truly Retire?**" I examined how active real estate investors could use this little-known strategy to sell their investment real estate, re-invest with passive real estate sponsors, incur no current income tax, and continue receiving the benefits of rental income and appreciation. All of this while preserving the ability to pass these assets onto heirs while permanently excluding income tax on all gains.

In the case of non-traded REITs (which are different from the publicly traded REITs investors may be more familiar with), you can invest in specifically targeted passive real estate. This approach may offer superior cash flow in this low interest rate environment, as well as appreciation, in some instances. In most cases, individual investors cannot simply go into their online brokerage accounts and invest in these type of REITs, nor can they instruct their 1031 exchange facilitator to invest directly into a DST. These investments typically require going through a Broker/Dealer or a Registered Investment Adviser.

The B/D model charges an up-front commission, often ranging from 5% to 8% of the investment amount. Unfortunately, the investment fees are not spelled out on most

brokerage statements. Instead the statements show the gross amount, not the net amount available to invest in the underlying real estate. As such, I've known B/Ds to make the false claim that they aren't charging the client a commission at all, saying it is being paid by the sponsor of the investment. Baloney. If an investor puts $400,000 into a DST, and only $370,000 is available to be invested into real estate because a commission of $30,000 was paid to a salesperson, I have news for this investor: They WERE charged a commission. Their confusion is understandable, given the investment is still stated as $400,000 on their statement and the commission is never mentioned.

Investing with an RIA (instead of a broker) could pay off

Investors choosing to use an RIA will not pay a sales commission charged on their investment. Instead, an asset management fee, stated as a percentage of assets under management, will be charged monthly, quarterly or annually. Using this same example, when the investor puts in $400,000, the sponsor, otherwise known as the property manager, of the DST or REIT grosses up the stated investment amount. So, if you invested $400,000 through an RIA, all $400,000 is available for investment because the $30,000 commission was never paid out of your investment.

In addition, rent is paid based upon the higher grossed up amount when using an RIA. If rents were 5%, the B/D client would receive $20,000 per year. The RIA client would expect to receive this plus an additional 5% on the $30,000 commission that was never paid out, for a total of $21,500. When the investment is sold or otherwise liquidated, the grossed-up commission that was never paid in the first place can be paid to the investor.

A dollars and cents example

To answer your likely thought; yes, this is confusing. To help explain this concept, I took a look at a real-life situation where an investor sold a rental house, netting $400,000. He decided to invest $100,000 each into DSTs offered by the four largest sponsors in the country. I used the estimated rental income stated by the four sponsors, current commission rates for each, an annual appreciation rate on the underlying real estate of 2%, and an average RIA fee of 0.8% per year.

Most DST investments are held between four years and 10 years. Using the assumptions listed, the following is the cumulative increase in overall investment percentages and overall dollars returned using an RIA rather than using a B/D.

- Sale after Year 4 +6.1%, over $24,000 more
- Sale after Year 6 +5.7%, over $22,000 more
- Sale after Year 8 +5.28%, over $21,000 more
- Sale after Year 10 +4.89%, over $19,000 more

It does matter who you use to help purchase non-traded REITs and DSTs. If you agree using an RIA makes more sense than using a B/D, you will also want to consider an RIA who will be there to service your account year after year and is extremely knowledgeable about the various sponsors, products and outlook for real estate sectors in the coming years.

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To be an accredited investor, an individual must have had earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years and "reasonably expects the same for the current year," according to the SEC. Or, the individual must have a net worth of more than $1 million, either alone or together with a spouse. With the passage of the Dodd-Frank Act, this now excludes a primary residence as being eligible as part of an investor's net worth (investors who had existing accredited investments but who now fail the net-worth test without their residence being valued were grandfathered).

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