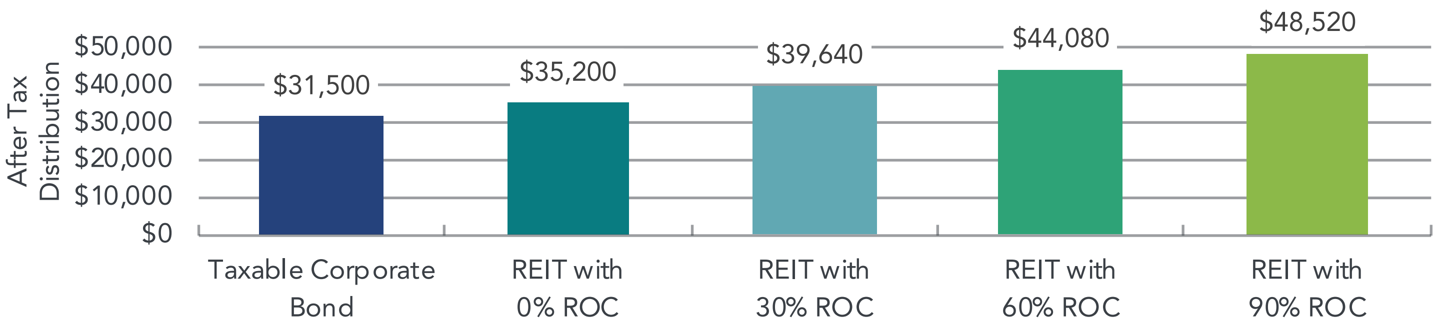
New Tax Law Benefits REIT Ordinary Income Distributions

LEAVES HISTORIC BENEFITS IN PLACE

- Under the "Tax Cuts & Jobs Act", REIT ordinary income distributions now benefit from a 20 percent tax deduction[1] which effectively reduces the tax rate from 37 percent to 29.6 percent for individuals in the highest tax bracket.
- Other tax benefits for REIT distributions remain unchanged:
  - REIT pass-through treatment of earnings remains unchanged
  - Favorable tax treatment for Return of Capital ("ROC")[2] remains unchanged. ROC generally resulting from depreciation and amortization may decrease the taxable portion of REIT income in the current year.[3] The depreciation and amortization may later be recaptured upon sale as capital gain, which is currently taxed at a lower rate than ordinary income.[4]
  - The chart below represents the tax deferral benefit from ROC distributions. It depicts that when a REIT earns rental income, for example, but is entitled to depreciation deductions, the REIT's distributions to shareholders are received as a tax-free ROC (to the extent of the shareholders' tax basis in their shares) to the extent that REIT income is offset by deductions. As noted above, this results in a deferral benefit and can also result in a tax rate benefit.



Example of Tax Benefit After the Tax Cuts & Jobs Act[5]

$100,000 investment; 5 percent annualized rate (pre-tax); highest tax bracket of 37 percent

	Distribution	Taxable Portion	Tax Payable[6]	After Tax Distribution	Effective Tax Rate	After Tax Distribution Rate	Tax Equivalent Distribution Rate
Taxable Corporate Bond	$5,000	$5,000	$1,850	$3,150	37.0%	3.2%	5.0%
REIT with 0% ROC	$5,000	$5,000	$1,480	$3,520	29.6%	3.5%	5.6%
REIT with 30% ROC	$5,000	$3,500	$1,036	$3,964	20.7%	4.0%	6.3%
REIT with 60% ROC	$5,000	$2,000	$592	$4,408	11.8%	4.4%	7.0%
REIT with 90% ROC	$5,000	$500	$148	$4,852	3.0%	4.9%	7.7%

Source: Ernst & Young LLP.

WHAT ARE REITS?

A REIT is a company that owns, operates, or finances income-producing real estate or real estate related-assets. A REIT can be likened to a mutual fund for real property investments because REITs generally allow individual investors to invest in a portfolio of commercial/residential real estate properties or mortgages. REITs own, for example, apartment complexes, hospitals, office buildings, timber land, warehouses, hotels, shopping malls, and various real estate-related mortgages and debt securities. Generally speaking, there are two types of REITs: equity REITs and mortgage REITs. Equity REITs acquire real property and derive profits from rents and capital appreciation. Mortgage REIT invests in real estate mortgages or mortgage-backed securities.[7]

To qualify as a REIT, a company must satisfy various ownership tests, assets tests, and income tests. Among other requirements, a REIT must: distribute at least 90 percent of its taxable income to its shareholders each year; invest at least 75 percent of its total assets in real property or cash; receive at least 75 percent of its gross income from rents from real property, interest on mortgages, or from sales of real estate; have a minimum 100 shareholders; and have no more than 50 percent of its shares held by five or fewer individuals. With certain exceptions, REITs are generally required to act as passive investors in real property and are prohibited from acting as dealers or operating active businesses.

REITs are tax advantaged investment vehicles in that, unlike U.S. corporations, are generally not subject to "double taxation." Generally, the income of U.S. corporations is subject to double taxation because corporate income is subject to tax at the time that it is earned (21 percent maximum rate) and is taxed again when it is distributed to individual shareholders (20 percent maximum rate for certain dividends and 37 percent maximum for others). REITs, however, are entitled to a dividend paid deduction and a REIT's shareholders are generally entitled to a pass-throughs deduction. This means that the REIT itself is not subject to tax to the extent that it distributes its taxable income and gain to its shareholders. Only the REIT's shareholders are taxed (for individual shareholders, the maximum rate is 20 percent, with respect to a REIT's capital gains and 29.6 percent with respect to all other dividends, taking into account the pass-throughs deduction).

REITs allow individual investors to invest in large-scale professionally managed real estate portfolios and are attractive to investors seeking steady cash flow (because of the strong incentives for REITs to distribute all taxable profits to shareholders). In this way, REIT investors are able to benefit from appreciation in a real property portfolio's value and also to receive regular cash flow from the income generated by the portfolio.

However, there are risks in investing in REITs. The real estate market can be cyclical, and its performance can be affected by various factors such as general economic conditions, availability of financing, local economic conditions, and interest rates. Additionally, real property investments are generally illiquid and may be subject to various regulatory restrictions (such as zoning, building codes, municipal codes, etc.). Additionally, REITs must adhere to the strict requirements imposed by the Internal Revenue Code, and the regulations thereunder, or risk the loss of REIT status or other penalties that could affect an investor's return from an investment in a REIT.

WHAT OTHER FACTORS SHOULD BE CONSIDERED WHEN DECIDING WHETHER TO INVEST IN A REIT?

Above, we describe some of the incentives under the tax law that promote investment in real property, generally, and in REITs, in particular. To illustrate these incentives, we draw a comparison between an investment in REIT equity and an investment in corporate bonds.

However, it is important to keep in mind that there are numerous non-tax related considerations that an investor should consider when deciding whether to invest in REIT equity or in corporate bonds.

As noted above, 75 percent of a REIT's total assets must be real property assets. On the other hand, corporate bonds offer a fixed rate of return regardless of the assets, businesses, or investments held by the corporations.

Investors in REIT common equity become shareholders of the REIT and enjoy voting rights. Corporate bonds are debt instruments and do not have voting rights. Common REIT shares do not have a fixed maturity date and the price investors receive when they sell or redeem their shares varies according to the value of the REIT's assets. Corporate bonds, on the other hand, must be repaid in full at maturity. REITs pay dividends on common shares that increase or decrease based on the REIT's profits and on the value of its assets. Corporate bonds pay a fixed amount of interest for their entire terms. Some REITs offer preferred equity that resembles bonds in a number of respects. For example, some features of preferred REIT equity may include a fixed maturity/redemption date and entitlement to fixed dividends. Preferred equity may also lack voting rights.

Corporate bonds generally have priority with respect to payment over preferred or common equity, which can result in a lower risk profile, depending on the corporation's financial security. A bond investment in a company is less risky than an equity investment in the same company. However, an equity investment in a financially secure REIT generally would be less risky than that a bond investment in a financially distressed corporation.

ENDNOTES

1. Enacted on December 22, 2017, effective for tax years beginning after December 31, 2017 but does not apply to tax years beginning after December 31, 2025.
2. An ROC, for tax purposes, should be distinguished from an economic return of capital, where an investor is repaid out of its own contributions rather than from the economic profits of the investment. As a tax law concept, an ROC is not tied to an investment's financial performance. ROC distributions are distributions to a REIT shareholder that exceed the earnings and profits ("E&P") of the REIT but that do not exceed the shareholder's adjusted tax basis in its REIT shares. ROC distributions are not gross income to a shareholder and, thus, are not subject to income tax. A shareholder is required to reduce its adjusted tax basis in its REIT shares to the extent of ROC distributions received. Distributions that exceed both the REIT's E&P and the shareholder's adjusted tax basis in its REIT stock are not ROC distributions and are treated as capital gain to the shareholder.
3. From a tax perspective, amortization and depreciation create an income deferral benefit because a taxpayer is entitled to amortization and depreciation deductions without regard to whether an asset actually amortizes or depreciates. Especially in the context of real property investments, an asset can increase in value and, nevertheless, its owner generally will be entitled to depreciation deductions with respect to the asset. This creates a deferral benefit because the depreciation deductions reduce taxable income from an asset, on a current basis. The trade off is that the tax basis in the asset is reduced. Thus, when an asset does not actually depreciate in value and the asset is later sold, the income deferred via depreciation deductions is recognized as gain. In this manner, income from the asset (up the amount of the depreciation deductions taken) is deferred until the disposition of the asset.
4. Generally, depreciation and amortization reduce a REIT's net taxable income and its E&P. Depreciation and amortization are non-cash items, so they generally do not reduce a REIT's ability to make distributions. Thus, when a REIT distributes its operating income to its shareholders, such distributions may be treated as ROC distributions when gross income from operations (that increases E&P) is offset by depreciation and amortization deductions (that decrease E&P).
5. As noted, tax-free ROC distributions received by a shareholder reduce the shareholder's adjusted tax basis in its REIT shares. As a result, when a shareholder disposes of REIT shares (assuming no increase or decrease in the value

of the shares), generally, the shareholder will recognize gain to the extent of ROC distributions received. When the holder of a taxable corporate bond disposes of the bond (assuming no increase or decrease in the value of the bond), generally, the holder will not recognize gain (because interest payments received by a bond holder do not reduce the holder's adjusted tax basis in the bond). However, please note that (in the above scenario) the REIT shareholder has taxable gain only to the extent that the shareholder had received tax-free ROC distributions (i.e., gain is recognized only to the extent of the deferral benefit), whereas, the bond holder would have been required to recognize taxable income on all interest payments (i.e., the bond holder recognizes no gain because the bond holder was never entitled to a deferral benefit). Thus, in sum, a non-corporate bond holder has no deferral benefit and pays a higher (37 percent) ordinary income rate on all interest payments, whereas, a REIT shareholder generally receives a deferral benefit (in the manner depicted below) and, non-corporate REIT shareholders generally will be subject to lower capital gains rates (20 percent) when the deferred income is eventually recognized.

6. Assumes all distributions are ordinary distributions and not capital gain distributions.
7. The tax advantages described above mostly relate to investments in equity REITs.

This material is provided solely for the purpose of enhancing knowledge on tax matters. It does not provide tax advice to any taxpayer because it does not take into account any specific taxpayer's facts and circumstances.

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