As of 1/1/2018 the taxation of REITs has changed

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How are REIT dividends taxed?

Distributions retain the tax characteristics of what happened in the REIT

By Robert N. Gordon | *October 19, 2014 - 12:01 am EST*

My recent column talked about companies lowering their overall tax burden by spinning off or becoming REITs that pay no corporate level of tax. Readers have asked if these real estate investment trusts pay qualifying dividends or are REIT investors taxed like MLP investors. The answers might surprise you.

REITs are like mutual funds for real estate. They've been around since 1960. Like mutual funds, REITs do not pay a corporate level of tax as long as they distribute at least 90% of their income to their shareholders before the end of their year. REITs paid out approximately $34 billion in “dividends” in 2013. The average REIT yield is over 3.5%.

REITs make distributions to their holders that retain the tax characteristics of what happened in the REIT. In these ways, they are similar to MLPs. REITs; of course, carry their own tax quirks and complications that investors should be aware of.

When a REIT makes a distribution, it is not a dividend from a regular corporation that has paid tax. REIT distributions take many forms, with each carrying different tax characteristics. The distributions from a REIT are usually composed of varying percentages of each of these different kinds of taxable income — each REIT has its own unique combination.

The common wisdom is that REIT distributions are taxed as ordinary income, taxed at the investor's highest rate; this taxable income is from the operating profits of the REIT. In 2013, 69% of REIT payments were taxed as ordinary income. Note that some REITs distributed no taxable ordinary income while others had 100% taxed as ordinary income.

REITs also distribute money from operating profits that are currently tax sheltered by depreciation and other deductions. These payments are considered a return of capital that lowers one's cost basis. If an investor holds the REIT for more than one year, it is fair to assume that the return-of-capital adjustments to basis give rise to long-term gains taxed at a favorable rate. In 2013, return-of-capital distributions constituted 14% of REIT payments.

Distributions can also be paid out of long-term capital gains realized from properties that were sold by the REIT. These distributions keep their tax nature and can be taxed favorably. This is more common in timber REITs.

Sometimes a REIT receives qualifying dividends from a taxpaying company. The REIT also can pass along the qualifying dividends to their shareholders. Both these qualifying dividends and the long-term gain distributions would be taxed at the favorable tax rates offered to long-term capital gains. Seventeen percent of the REIT distributions paid in 2013 came from either long-term gains or qualifying income.

There are also many cases where investors get taxed on un-recaptured Section 1250 gains, although the percentage of the distributions taxed this way is usually small. This income is taxed at 28%.
It is a rare instance when a REIT retains the gain it realized and doesn't distribute it to shareholders. In this case, the REIT would pay a corporate tax on the gain and pass a tax credit on to the investors with a Form 2439 (this is much more common in closed-end funds). I saw none of these in 2013, but they do happen.

Of the 352 REIT 2013 distributions reported on REIT.com, 45 were distributions that would be taxed entirely as long-term gains, given the above scenario. At the other end of the spectrum, 124 were distributions that were 95% or more ordinary income. The rest all had some amount of both. It can pay to visit REIT.com and see how your REIT distributions are being taxed.

It seems that, with careful selection, REIT distributions could be tax free for those with capital losses. What the REITs invest in seems to drive the difference.

Ironically, non-U.S. REIT distributions can be taxed more favorably than payments from domestic REITs. If a U.S. taxpayer invests in a REIT domiciled in a foreign country that has a tax treaty with the U.S., then dividends on that REIT can be taxed as qualifying dividends. This is because they are foreign companies operating in a treaty country. Thirty countries besides the U.S. have REIT-like structures, and 24 are treaty countries.

There are tax twists to REITs, but most can be turned to the investor's advantage once the rules are known.

Robert N. Gordon (bob@twenty-first.com) is the chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business.