

REIT and MLP Taxation Under the New Tax Law

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Under the Tax Cuts and Jobs Act of 2017, real estate investment trusts, master limited partnerships, and private equity managers operating as publicly traded partnerships were granted the favorable treatment of flow-through entities. Sounds good, but note there are a few surprises.

The Tax Cuts and Jobs Act of 2017 granted a tax break to owners of flow-through entities. The law generally allows a 20 percent deduction for income coming from a flow-through entity.¹ For ordinary income flowing from someone's business, that equates to a tax of 29.6 percent.² Real estate investment trusts (REITs) and publicly traded partnerships (PTPs) like master limited partnerships (MLPs) or private equity managers (such as KKR) were granted the same benefit. However, flow-through income received by investors from these vehicles would also be subject to the 3.8 percent Medicare tax on investment income.³ Oddly, the 3.8 percent tax is on the full dollar amount of the flow-through income received, not on just the 80 percent that is taxable. This anomaly creates a net tax of 33.4 percent.⁴

Asset Location

Historically, the majority of REIT distributions were taxed at the highest rate. Because of this, REITs were well suited to be held in a tax deferred/exempt account. But with this 20 percent tax break, REITs change from being one of the most tax inefficient investments that should have been held in a tax sheltered account, into becoming an investment now best held in taxable accounts.

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¹ IRC § 199A, as added by P.L. 115-97 (popularly called the Tax Cuts and Jobs Act of 2017).

² That is, $\$80 \times 37\%$.

³ See IRC § 1411(a)(1).

⁴ That is, $(\$100 \times 3.8\%) + (\$80 \times 37\%)$.

An MLP's taxable income will enjoy the reduced 33.4 percent tax rate, even on amounts recaptured on MLP sales. MLPs should only have been held in taxable accounts,⁵ and that fact has not changed with the change in law.

MLP Funds Got Better and REIT Funds Got Worse

The 20 percent deduction for flow-through income is not available to corporations. MLP funds and REIT funds are corporations.

REIT Funds. REIT funds are corporations that are not subject to tax as long as they distribute their income each year because they are allowed a dividends-paid deduction.⁶ Unfortunately, the 20 percent deduction for flow-through income is not available to the REIT fund and therefore also is not available to the investor. REIT income that flows through to the investor retains the nature of the income as it is received by the REIT. Thus the REIT funds will pass through 100 percent taxable income to the investor, rather than 80 percent taxable income. Directly held REIT income will be taxed at 33.4 percent while REIT fund distributions will now be taxed at 40.8 percent.

It is also interesting to note that mortgage REITs gain an advantage over directly held mortgage securities because the interest income from a mortgage held directly will be taxed at the maximum of 40.8 percent while income coming from a mortgage REIT would be taxed at only 33.4 percent as income distributed by a flow-through entity.

MLP Funds. Because MLP funds hold more than 25 percent of their assets in MLPs, they flunk the test to be non-tax-paying regulated investment companies (RICs) and instead are tax-paying corporations. As it has been, an MLP fund first pays a corporate tax on its income and then distributes what is left to its holders as qualified dividend income taxed at 23.8 percent.

Until now, however, after the MLP fund paid the 35 percent corporate tax, the total tax drag equaled 50.47 percent.⁷ Now the MLP fund will pay only a 21 percent tax before it sends the rest to shareholders as qualified dividend income. The new total tax drag is a much lower 39.8 percent.⁸ Although this is more than the 33.4 percent that would apply if one held the MLP directly, the funds do not issue the dreaded K-1s that have given so many headaches to investors.

⁵ Many MLPs threw off debt-financed income, which would subject a tax-exempt entity like an IRA to taxation as unrelated business taxable income. See IRC § 514.

⁶ IRC § 857(b)(2)(B).

⁷ That is, $(\$100 \times 35\%) + (\$100 \times (1 - 35\%)) \times 23.8\%$.

⁸ That is, $(\$100 \times 21\%) + (\$100 \times (1 - 21\%)) \times 23.8\%$.

Planning Point. For those preferring 1099s to K-1s, I suggest that investors utilize exchange traded options on MLPs. Holders of these options also do not receive a K-1 and are taxed annually at a favorable 30.6 percent rate,⁹ lower than any of the possibilities explored above.

Conclusion

Now, more than ever, it is incumbent on taxable investors to investigate what investment tool they are using to get their desired asset exposure.

⁹ As non-equity options taxed under IRC § 1256, all gains are treated as 60 percent long-term and 40 percent short-term.



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