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REIT and MLP Taxation under the New Law

REITs, MLPs and PTPs were granted the favorable treatment of flow thru entities:

There are a few surprises.

The new tax law granted a tax break to owners of flow-thru entities. The law allows a 20% deduction for income coming from a pass-thru entity.[1] For ordinary income flowing from someone's business, that equates to a tax of 29.6%[2]. REITs and PTPs (Publicly Traded Partnerships like MLPs or private equity manager KKR) were granted the same benefit. However, flow-thru income received by investors from these vehicles would also liable for the 3.8% Medicare tax on investment income. Oddly, the 3.8% tax is on the full dollar of income received and not on only on the 80% that is taxable. This creates a net tax of 33.4%[3].

Asset Location

Historically , the majority of REIT's 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

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[1] IRC Sec. 199A
[2] $80 X 37%
[3] ($100 X 3.8%) + ($80 X 37%)=33.4%

20% tax break they move from one of the most tax inefficient investments that should have been held in a tax sheltered account into one now best held in taxable accounts.

An MLPs taxable income will enjoy the same reduced 33.4% tax rate. Even on amounts recaptured on MLP sales. MLPs should only have been held in taxable accounts[4] and that fact has not changed with the change in law.

MLP funds got better and REIT Funds got worse

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

<u>REIT Funds</u>

REIT funds are not subject to tax as long as they distribute their income each year because they are allowed a dividend paid deduction[5]. REIT income that flows through to the investor retains the nature of the income as it is received by the REIT. Unfortunately, the 20% deduction is not available to the REIT and therefore also not available to the investor. Therefore the REIT funds will pass thru 100% taxable income rather than 80% taxable income. Directly held REIT income is taxed at 33.4% while REIT fund distributions will now be taxed at 40.8%.

It is also interesting to note that mortgage REITs could get a boost because the interest income from a mortgage held directly will be taxed at the maximum of 40.8% while income coming from a mortgage REIT would be taxed at 33.4%.

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[4] Many MLP's threw off debt financed income which would subject a tax exempt entity like an IRA to taxation as UBTI– IRC Sec. 514

[5] IRC Sec. 857(b)(2)(B)

MLP Funds

Because MLP funds hold more than 25% of their assets in MLPs, they flunk the test to be non-tax paying Regulated Investment Companies 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 qualifying dividend income taxed at 23.8%.

Until now, after the MLP fund paid a 35% tax, the total tax drag equaled 50.47%[6]. Now the MLP funds will only pay a 21% tax and send the rest to shareholders as qualifying dividend income. The new total tax drag is 39.8%[7]. Although this is more than the 33.4% that would be in place if one held the MLP directly; the funds do not issue the dreaded K-1s that have given so many headaches. For those preferring 1099s to K-1s-we suggest 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% rate[8], lower than any of the possibilities explored above.

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

[6] (\$100 X 35%) + (\$100 x(1- 35%)) X 23.8%
[7] (\$100 X 21%) + (\$100 x(1- 21%)) X 23.8%
[8] As IRC Sec 1256 Contracts all gains are treated as 60% long-term and 40% short term