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REIT Investors Receive Another Tax Advantage that Increases Net Income.

by Burland B. East III, CFA | March 2019

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Introduction

Real estate investment trust (REIT) investors, which already experience significant tax benefits, **now qualify for another tax advantage**, due to the passage of the Tax Cuts and Jobs Act (TCJA) in late 2017. With TCJA now in effect, up to 45% of a REIT's dividend is further advantaged, regarding taxation.

Before we get started, it's important to clarify certain assumptions made in this paper. First, taxes are discussed at the federal level, but additional taxes may apply depending on the investor's state residence, which could drive after-tax yield lower. Second, the analysis in this paper assumes that investors have a long-term investment timeline (greater than one year) for the purposes of calculating long-term capital gains.

Tax Efficiency for Long-term Investors

Currently, REITs generally **do not** pay taxes at the company level, as the REIT legal structure is basically a pass-through entity. This structuring mandates that REITs distribute at least 90% of their earnings to investors in the form of dividends, in order to avoid corporate tax. This is different than most other common equity market structures—such as C Corporations—which must pay taxes at the company level, and where shareholders pay again at their level. REIT investors, however, generally **do** pay taxes. The IRS classifies REIT distributions as follows:

- **Ordinary Income**: The maximum Federal rate on ordinary income is 37%, but individual rates vary between 10% and 37%.

- **Return of Capital**: Although not immediately taxable, capital from this category reduces the tax cost basis of the REIT shares based on their original purchase date. Therefore, if shares are sold, the cost basis is lower (and tax liability larger), but returned capital would be taxed as capital gains.

- **Capital Gains**: The maximum Federal rate on long-term capital gains is 20%, but can drop as low as 15% in certain cases.

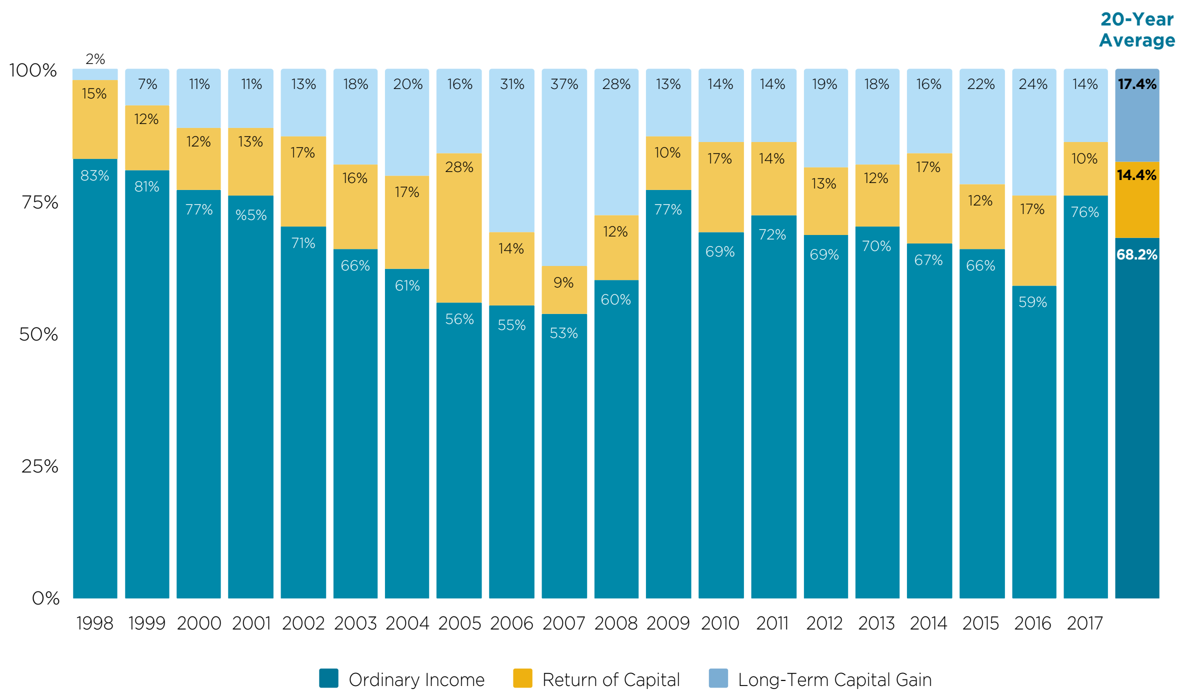
For the 20-years ended December 31, 2017, (see Figure 1 below), approximately 31.8% of REIT dividends, on average, have been tax-advantaged, identified as either:

- Return of capital: 14.4% (yellow) or capital gains: 17.4% (blue)
- The remaining amount has been taxed as ordinary income: 68.2% (purple), a rate typically higher than the capital gains rate.

Figure 1.

REIT Dividend Taxation Varies Year-to-Year— But has Consistently Been Advantageous

REIT Dividend Tax Treatment % | 1998 – 2017, including Cumulative 20-Year Average



Source: NAREIT.

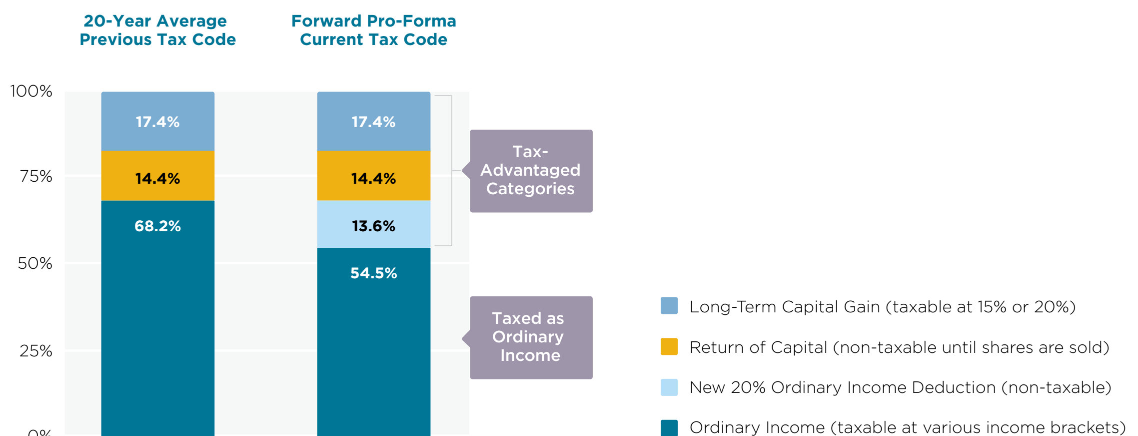
Beginning in 2019, REIT investors received another tax advantage through legislation, due to the Tax Cuts and Jobs Act (TCJA). They include:

1. **A deduction of up to 20%**, applicable to the ordinary income portion of a REIT distribution.

2. **Lower individual tax rates**. For example, the highest federal tax rate now stands at 37.0% for the highest U.S. tax bracket (over $500K filing separately and over $600K filing jointly). This federal rate was dropped 2.6% down from the 39.6% rate in place prior to TCJA' s passage.

Although the second point above applies to all taxable income, whether derived from a REIT or any other income source, the first point is **exclusive to REIT investors**. If we use the 20-year average as a hypothetical example on a go-forward or "pro forma" basis, the taxable percentage of a REIT dividend is reduced. The recent tax code change decreases taxable ordinary income by 20%—from 68.2% to 54.5%. The remaining 13.6% is non-taxable. Figure 2 (shown below) provides REIT investors with a graphical comparison, of the old tax code versus the new. The ordinary income category (represented in purple), which is typically taxed at the highest rate, is reduced as compared to the previous tax code.

Figure 2. **New TJCA Tax Code Increases the Tax-Advantaged Categories for REIT Dividends**



Sources: U.S. Treasury/Internal Revenue Service and NAREIT.

We have next provided Figure 3 below to further outline the implications of the new tax code. In Figure 3, we compare income derived from REIT dividends to traditional stock and bond dividend income. Because the total amount of an investor's income can significantly impact outputs, we have provided two hypothetical examples: 1) A single filer earning $100,000 annually; and 2) A single-filer earning $500,000 per annum. **The difference in effective tax rates between the two asset classes is highly significant, as shown in both examples**.

Figure 3. **On Average, Income from REITs are Likely Taxed at a Lower Rate than Non-REIT Income, Regardless of Tax Bracket**

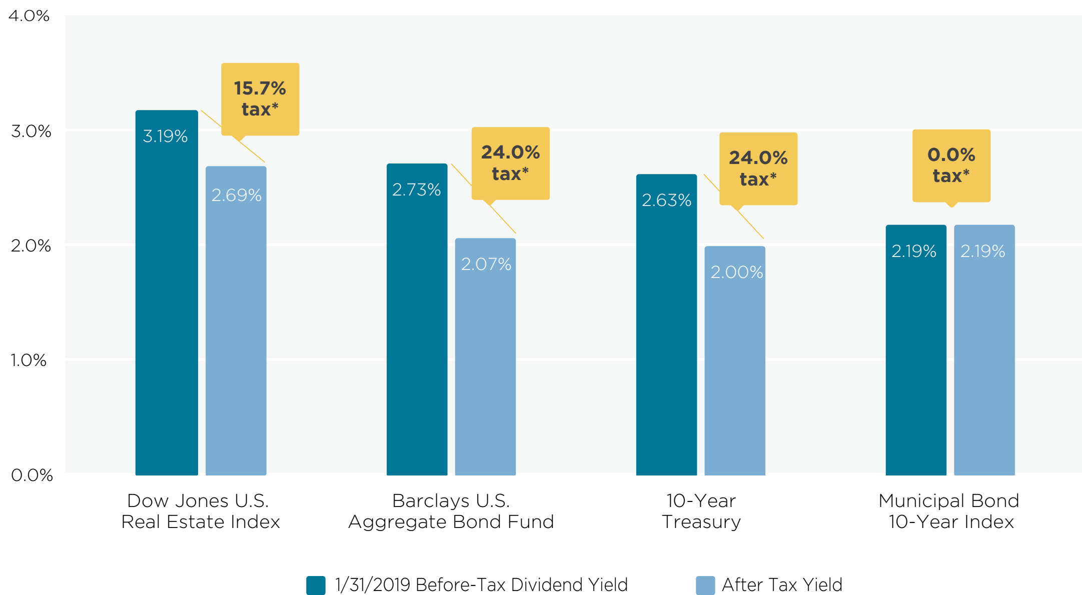
	Current REIT Dividend and Tax Breakdown		Current Non-REIT Stock/ Bond Dividend and Tax Breakdown	
Dividend Classification	**Pro Forma Weight**	**Tax Rate**	**Weight**	**Tax Rate**
Hypothetical Example #1: **SINGLE-FILER: $100,000 annual income**				
Ordinary Income At marginal 2018 individual bracket	54.5%	24.0%	100.0%	24.0%
20% Ordinary Income Deduction	13.6%	0.0%	0.0%	0.0%
Long-Term Capital Gain	17.4%	15.0%	0.0%	15.0%
Return of Capital	14.4%	0.0%*	0.0%	0.0%
Effective Tax Rate		**15.7%**		**24.0%**
Hypothetical Example #2: **SINGLE-FILER: $500,000 annual income**				
Ordinary Income At highest 2018 individual bracket	54.5%	37.0%	100.0%	37.0%
20% Ordinary Income Deduction	13.6%	0.0%	0.0%	0.0%
Long-Term Capital Gain	17.4%	20.0%	0.0%	20.0%
Return of Capital	14.4%	0.0%*	0.0%	0.0%
Effective Tax Rate		**23.7%**		**37.0%**

* Is not subject to potental capital gains tax until REIT shares are sold.
Source: American Assets Capital Advisers.

Although the examples in Figure 3 apply to common stock REITs, REIT preferred stocks also derive significant benefits from tax-code changes. Preferred REIT stocks are now solely subject to a 20% ordinary income deduction—translating to 80% of the dividend being taxed. All else being equal, there is an advantage to investing in REIT preferred stocks over non-REIT stocks or bonds.

If we compare REITs to asset classes where the new REIT tax advantage does not apply—REITs' after-tax yields are even more attractive. Figure 4 below compares REIT yields to other asset-class yields on a pre- and post-tax basis. Even municipal bonds, renowned for their tax status and income generation potential, generate 18% less income than REITs after tax. (Please be advised, taxation is complex. The sample calculation below is provided for illustrative purposes only. It should not be construed as tax advice. Please consult your tax professional.)

Figure 4. **Pre- and Post-Tax Yields: REITs Top Out Munis and More**

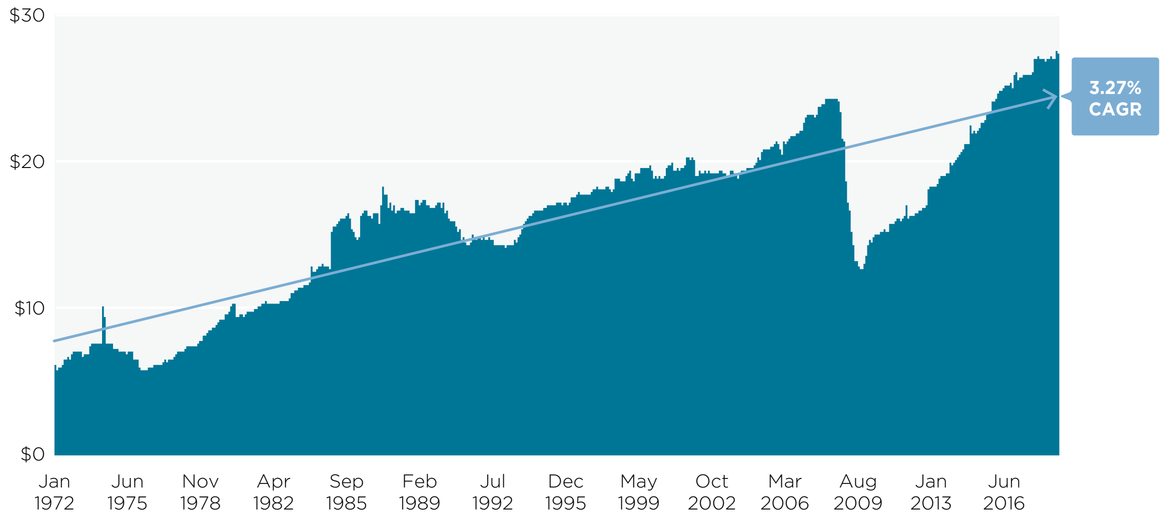


* Assumes single-filer with income of $100,000 per year, no applicable state income tax.
Source: Bloomberg Markets.

Lastly, unlike fixed income dividends, **REIT dividends tend to grow over time**. Since the inception of their structure (1972), REITs have grown their dividend at an annual compounded rate of 3.27% per year, as shown in Figure 5 below.

Figure 5. **Income is Not Fixed: REIT Dividends have Grown Over Time**

December 1971 – February 2018



Source: NAREIT.

In Conclusion

Tax efficiency is highly important to individual investors with taxable accounts— especially those that are seeking efficient ways to generate income. **The current tax code implemented by the TCJA increases the advantages of owning common stock REITs. Investors would be wise to consider both common stock and preferred stock REIT funds for their income needs**. When compared to other yield-producing asset classes, REITs may be more effective than municipal bonds due to higher after-tax yield and the dividend growth potential.

About Burland B. East III, CFA
Chief Executive Officer, American Assets Capital Advisers (AACA)

Thirty years of experience on Wall Street as a Managing Director and as a NASD Broker-Dealer member-owner. Raised approximately $15 billion in capital (mostly equity) from sophisticated investors globally in 142 large-scale real estate transactions including 26 IPOs, 40 follow-on offerings, and 19 private equity transactions as well as numerous converts, preferred stocks, bond offerings, tenders, mergers, strategic advisory assignments, and mezzanine debt placements.

Burl serves on the Board of Advisors of Comunidad Realty Partners, a dynamic real estate investment firm specializing in multifamily apartment communities in densely-populated Hispanic neighborhoods. Previously, Burl served on the Leadership Council at USC's Lusk Center for Real Estate and the Board of Directors of Excel Trust, Inc., a NYSE listed equity REIT. Prior Board Associate for NAREIT. Burl spoke at over 250 large real estate industry events in the U.S., Europe, and Asia and chaired events like NAREIT's Annual Convention. Mr. East has been interviewed in the financial press and on TV dozens of times and authored numerous articles for major publications like *Barron's*.

Other significant investment experience includes: Dow Jones/Realty Stock Review Outstanding Sell Side Analyst, Honorable Mention, 1996, 1997, and 1998; Lectured at USC Marshall School of Business, Northwestern University, University of San Diego, and University of Wisconsin. Has authored approximately 20,000 pages of widely distributed research; MBA from Loyola University, Baltimore, MD; Chartered Financial Analyst (CFA); Series 24: General Securities Principal; Series 27: Financial Operations Principal; Series 7: Registered Representative; and Series 63: State Blue Sky. (The foregoing are currently in inactive status).

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FTSE NAREIT All REITs Index. The FTSE NAREIT All REITs Index is a free-float adjusted market-capitalization weighted index that includes all tax qualified REITs listed on the NYSE, AMEX, and NASDAQ National Market. The base date of index is December 31, 1999, with the base value of 100.

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