SENTRY

REITs make a comeback

Post-recession, REITs are an excellent source of tax-efficient income.

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The aftermath of the Great Recession has seen the rise of income-generating securities as the investment of choice. Whether it's bonds, convertible debentures, preferreds or high-yield equities, investors are gravitating towards income for safety, stability and returns.

Real estate investment trusts (REITs) have been net beneficiaries of this trend back towards income investing. Bill C-52, the dreaded Trust Tax, specifically carved out and preserved the REIT model and structure for most REIT sectors. So as business, infrastructure, and oil and gas royalty trusts march towards January 2011 and taxation, REITs continue to enjoy preferential tax treatment. The predictable result has been flows into the space from other trust sectors.

Return on capital

REITs have also provided investors with a second benefit – their income streams. According to CIBC World Markets, in 2009, 62% of the distributions from REITs were return of capital (ROC). These ROC distributions are generally not taxed when the investor receives them. Instead, they reduce the investor's adjusted cost base. And when the investor eventually does sell the REIT unit, he or she realizes a greater taxable gain on the investment.

For instance, figure 1 demonstrates the cash flows and returns to an investor holding a REIT unit for three years. The capital gain realized in this case is greater than the sale price minus the original purchase price. The difference is the ROC distributions received during the three-year hold period. The net result of ROC distributions: greater after-tax yields to investors than from dividends or interest income.

Fig. 1: Returns from investing in a REIT

	Year 1	Year 2	Year 3
Purchase Price	10.00		
Starting Cost Base	10.00	9.38	8.76
Distribution	1.00	1.00	1.00
Return of Capital	**0.62**	**0.62**	**0.62**
Dividends	0.18	0.18	0.18
Capital Gains	0.12	0.12	0.12
Business Income	0.08	0.08	0.08
Ending Cost Base	**9.38**	**8.76**	**8.14**
Sale Price			12.00
Capital Gains			**3.86**
Annual Income	1.00	1.00	1.00
Annual Taxable Income	0.38	0.38	0.38

Figure 2 shows the net after-tax yields on various investments available to investors. Even though ROC distributions aren't taxed when received, they'll eventually be taxed as capital gains. Therefore, in the example, the ROC distributions are taxed at the capital gains rate. Despite this, the current low yields offered by competing investments make the after-tax yield from REITs very compelling – whether on a nominal or real basis.

Fig. 2: Canadian after-tax yields

	GICs	Bonds	Preferreds	Common Stocks	REITs
Yield	**3.40%**	**5.16%**	**4.94%**	**2.54%**	**5.61%**
% from Interest Income	100.00%	100.00%	0.00%	0.00%	8.00%
Tax Rate	46.41%	46.41%	46.41%	46.41%	46.41%
% from Dividends	0.00%	0.00%	100.00%	100.00%	18.00%
Tax Rate	26.57%	26.57	26.57%	26.57%	26.57%
% from Capital Gains	0.00%	0.00%	0.00%	0.00%	12.00%
Tax Rate	23.20%	23.20%	23.20%	23.20%	23.20%
% from Return of Capital	0.00%	0.00%	0.00	0.00%	62.00%
Tax Rate	23.20%	23.20%	23.20%	23.20%	23.20%
After-tax Yield	**1.82%**	**2.77%**	**3.63%**	**1.87%**	**4.17%**
Inflation Assumption	2.00%	2.00%	2.00%	2.00%	2.00%
Real After-tax Yield	**-0.18%**	**0.77%**	**1.63%**	**-0.13%**	**2.17%**

Despite this, many investors generally view ROC in a negative light. They point out that ROC means you get your own capital or money back. The Canada Revenue Agency agrees with this assessment, and this is why ROC distributions aren't taxed when you receive them.

In the case of investments, taxes apply to the returns earned on your investment, not the investment itself. Investors point out that since part of the return is your own money, it's not really part of the return on your investment and should be separated out to determine the real return on your investment. Generally, this is all true; however, in the case of REITs it's usually not.

Economic vs. accounting ROC

There are two types of ROC that investors must distinguish between: economic ROC and accounting ROC.

Economic ROC occurs when you actually get your own money back. The most common examples of investments that pay economic ROC are mortgages and bonds. With a mortgage investment, the monthly payments are made up of principal and interest payments. Therefore, part of the monthly cash flow is actually your original investment returned to you.

With a bond, typically the periodic payments are 100% interest. Then when the bond matures, the issuer pays the investor the principal back along with the final interest payment. The principal is the return of capital and not part of the return on the investment. In both cases, the investor receives economic ROC or their own money back.

Accounting ROC, on the other hand, occurs when the cash flow paid out by the investment is classified as ROC but is technically not the investor's initial investment. It sounds confusing, but it's really just the mismatch between accounting and economics that GAAP accounting tries to bridge.

Figure 3 shows the simplified income statement for a typical REIT. You'll notice one of the largest expenses is depreciation, which is a non-cash expenditure. When buildings are purchased, the acquisition cost is not expensed right away. Instead, the cost is depreciated over 40 years, at which point the building is considered to have zero value.

Fig. 3: ROC distribution from a REIT

Property Revenue	$100,000
Operating Costs	– $37,000
Net Operating Income	$63,000
General & Administrative	– $5,000
EBITDA	$58,000
Interest Expense	– $20,000
Depreciation	– $30,000
Net Income	**$8,000**
Depreciation	+ $30,000
Funds from Operations	**$38,000**
Maintenance Capex	– $10,000
Adjusted Funds from Operations	**$28,000**
Distributions	$25,000
AFFO Payout Ratio	89.29%
Distributions	$25,000
Net Income	– $8,000
ROC Component	$17,000
ROC Percentage	68%

In reality, a fraction of the purchase price is spent each year maintaining the asset and its earnings power (elevators, balconies, roofs, paint, flooring, electrical, etc.). The difference (depreciation expense > maintenance CapEx) is usually the amount that can be paid out to investors, and is classified as ROC. It also means that when trying to calculate the actual free cash flow from a REIT, the investor must add back the depreciation expense to net earnings and subtract maintenance capital expenditures.

When this analysis is done, it becomes apparent that the earnings quality of the typical REIT is very poor. That is, there are significant and meaningful differences between REIT earnings and REIT cash flows. When REITs pay out distributions that are greater than their net income, the excess is classified as ROC.

Clearly, the REITs generate sufficient free cash flow to pay the distribution, but because of the poor earnings quality of REITs, some of it is classified as ROC for accounting purposes. This is accounting ROC and doesn't represent an actual return of an investor's capital.

According to the Pension Investment Association of Canada, the top 100 Canadian pension plans have approximately 9.4% of their assets in real estate. They're looking for long-life assets with strong recurring cash flows to match against their long-term liabilities (pension obligations) that must be settled periodically in cash.

Similarly, as Canadian investors look out towards retirement, both saving for it and funding it, it becomes increasingly clear that real estate and REITs can provide the strong, stable after-tax yields those investors will need. And a large part of this is due to the accounting ROC delivered by Canadian REITs.

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