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CLARION PARTNERS

Understanding taxation of REIT distributions

A REIT has special tax advantages that can help maximize after-tax distributions.

1 REIT income is taxed only once, at the shareholder's marginal tax rate

- REITs are pass-through vehicles that do not pay corporate income tax to the extent they distribute their taxable income.

2 REIT ordinary income distributions may benefit from a maximum 20% tax reduction on the marginal rate

- The Tax Cuts and Jobs Act of 2017 introduced a tax deduction of up to 20% for ordinary income dividends paid by REITs.[1]
- For example, an investor in the 37% tax bracket could reduce the effective tax rate to 29.6%. The net investment income tax of 3.8% may also apply.

3 Return of capital (ROC) reduces the taxes on distributions paid to investors in the current year

- A return of capital occurs when a fund pays out distributions that are greater than its taxable income.
- A REIT may distribute cash flows that are greater than its taxable income due to the depreciation expense on the property and amortization of other fund expenses.
  - — The depreciation and amortization (D&A) expense will reduce the amount of taxable income but not the cash income generated from the underlying properties.
  - — ROC is not taxable in the year distributed, but it reduces the shareholder's tax basis, which increases capital gain or reduces loss when sold.[2]
  - — The portion of the distribution in excess of the taxable income is considered a return of capital.[3]

Tax Rates	Combined Qualified Business Income Deduction	Effective Tax Rate
37%	**20.0%**	**29.6%**
35%		**28.0%**
32%		**25.6%**
24%		**19.2%**

Source: IRS.

Illustrative Example Based on $100,000 Initial Investment and 5% Pre-Tax Annual Distribution Rate[4]

	Taxable Bond	REIT			
ROC (%)	**0%**	**0%**	**50%**	**75%**	**100%**
Distribution paid	$5,000	$5,000	$5,000	$5,000	$5,000
ROC ($)	$0	$0	($2,500)	($3,750)	($5,000)
Taxable portion of distribution	$5,000	$5,000	$2,500	$1,250	$0
Highest ordinary income tax rate	37.0%	29.6%	29.6%	29.6%	29.6%
Tax payable	($1,850)	($1,480)	($740)	($370)	$0
After-tax distribution	**$3,150**	**$3,520**	**$4,260**	**$4,630**	**$5,000**
Effective tax rate	**37.0%**	**29.6%**	**14.8%**	**7.4%**	**0.0%**
After-tax yield	**3.2%**	**3.5%**	**4.3%**	**4.6%**	**5.0%**

The illustration example does not represent an actual investment.

KEY TAKEAWAY

Investing in a REIT may increase after-tax distributions and lower an individual's effective tax rate, compared to an investment in taxable bonds.

See footnotes on Page 2.

DEFINITIONS AND RISKS

Distribution: Usually the value of property (generally money) paid by a fund periodically to its shareholders from cash flows generated from portfolio holdings (such as net capital gains, net income from operations) and which are not in redemption or liquidation of shares.

Depreciation: Allowed deduction for the exhaustion and/or wear and tear of property used in the trade or business or held for the production of income.

Amortization: The spreading out of capital expenses related to intangible assets over a specific duration—usually over the asset's useful life—for accounting and tax purposes.

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1. The 20% deduction is currently set to expire after 2025.
2. Capital gains rates may vary, and other taxes such as surtax, state and local taxes may also apply.
3. Return of capital is not provided to shareholders for tax reporting purposes until after the close of the taxable year.
4. The actual ROC may be larger or smaller than that assumed in the above illustrative scenario. The analysis does not consider 3.8% net investment income tax, tax on capital gains or state and local taxes. After-tax distribution equals the differences between distribution paid and tax payable. The effective tax rate equals tax payable divided by distribution paid.

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