The Tax Plan and Commercial Real Estate

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The final version of the revised taxation rules has significantly positive implications for REIT investors. In short, after-tax dividend distributions could increase by more than 17% relative to the old rules, increasing after-tax yields by as much as approximately 50 basis points. Key drivers of the approved legislation include a reduction to an effective maximum federal tax rate of 29.6% on the portion of REIT distributions that are taxable as ordinary income. This is 7.4% lower than the 37.0% maximum federal ordinary income rate applicable to taxable fixed income distributions.

To illustrate, a hypothetical investment of $100,000 in a REIT under the new rules would have an after-federal tax distribution yield that is 37 bps higher than a taxable bond assuming both have a 5% pre-federal tax distribution yield and 100% of all distributions are taxed as ordinary income:

	Taxable Bonds[1]	REITs[2]
Annual cash distribution	$5,000	$5,000
Ordinary income %	100%	100%
Ordinary Income Tax (at maximum federal tax rate of 37.0% for bonds and 29.6% for REITs)	$1,850	$1,480
After-federal tax net income	$3,150	$3,520
After-federal tax yield	**3.15%**	**3.52%**

Further, factoring in that a portion of REIT distributions have historically been and are likely to continue to be characterized as either long-term capital gain or non-taxable distributions, the after-tax return of REITs may be further enhanced:

	Taxable Bonds[1]	REITs[2]
Annual cash distribution	$5,000	$5,000
Ordinary income %[3]	100%	59%
Capital Gain %[3]	0%	24%
Non-taxable distribution[3,4]	0%	17%
Ordinary Income Tax on the portion of the distribution properly taxed at ordinary income rates (at maximum federal tax rate of 37% for fixed income and 29.6% for REITs)	$1,850	$873
Long-term federal capital gains tax on the portion of the distribution properly taxed at capital gains rates (at max rate of 20% applicable to REITs)	$0	$240
Total federal tax paid	$1,850	$1,113
After-federal tax net income	$3,150	$3,887
After-federal tax yield	**3.15%**	**3.87%**

As a result, we expect to see increased interest in REITs as a means to access direct real estate investments as well as a tax-advantaged alternative to taxable fixed income.

[1] Bonds are debt instruments and are classified by the type of issuer — for example, government, corporate, municipal, foreign, mortgage; maturity — short, medium, long; and quality — high, medium, low. Bonds pay a fixed amount of interest semiannually; the interest is fixed for the life of the bond. At maturity, a bond is repaid in full. Risks associated with bonds include credit risk, interest rate risk and market risk. In addition, some corporate bonds can be called for redemption by the issuer and have their principal repaid prior to the maturity date.

[2] Real Estate Investment Trusts (REITs) are companies that invest in real estate: when you buy a REIT stock you become a shareholder in the business. REITs allow individuals to invest in large-scale, income-producing real estate. This may include office buildings, shopping malls, apartments, hotels, resorts, self-storage facilities, warehouses and mortgages or loans. Unlike other real estate companies, a REIT does not develop real estate properties to resell them. Instead, a REIT buys and develops properties primarily to operate them as part of its own investment portfolio. Risks associated with REITs include weakness in real estate prices, distributions are not guaranteed and may exceed operating cash flow, distributions and REIT status carry tax consequences and diversification can be limited. REITs also have the potential to produce negative total returns during the times when interest rates are elevated or rising.

[3] Hypothetical tax character of REIT distributions based on total tax character of 2016 REIT distributions as determined by NAREIT. While NAREIT represents publicly traded REITs, generally speaking, REIT distributions – whether listed, non-listed or private – characterize the taxation of their distributions as either ordinary income, capital gains or non-taxable distributions. In this example, discussing how the tax reform may impact REIT distributions in general, a representative allocation has been selected as represented by NAREIT. The allocation percentage was derived by NAREIT surveying the reported results of the REITs in its database and creating an average.
Many REITs do not produce income but still pay distributions. These distributions may represent a return of capital. There is no guarantee that shareholders will receive distributions or that an investment in the REITs sponsored by Black Creek Group LLC will be profitable or that the REITs will realize growth in the value of their assets. A REIT's distributions may be paid from sources other than cash flows from operating activities, such as cash flows from financing activities, which may include net proceeds from primary shares sold and borrowings (including borrowings secured by a REIT's assets). A REIT's future distributions may be paid from these sources as well as proceeds from the sales of assets, proceeds from the issuance of shares pursuant to the REIT's distribution reinvestment plan cash resulting from a waiver or deferral of fees, and interest income from its cash balances. There is no limit on distributions that may be made from these sources. To the extent a REIT pays distributions from sources other than cash flows from operating activities, it may have less funds available for the acquisition of properties, and stockholders' overall return may be reduced.

[4] Non-taxable distributions — also known as "return of capital" — occur when the REIT distributes more than its taxable income. There is no guarantee a REIT will have non-taxable distributions.