Demystifying REIT Income and Where to Hold it

Description

Most real estate investment trusts (REITs) are high yield, with some paying out 8-10% yields! A REITs' distributions aren't the same as dividends. I will demystify what those distributions are made of using some REIT leaders as examples.

Distributions are made of multiple components

Distributions consist of different components, including foreign non-business income, other income, capital gains, and return of capital (ROC).

Both foreign non-business income and other income are taxed at your marginal tax rate, while capital gains are taxed at half your marginal tax rate.

The ROC portion requires a bit more explanation. When you receive it, you don't get taxed right away, but instead it reduces your adjusted cost basis (ACB). When the ACB reaches zero, you'll need to start paying the taxes for the ROC portion. Either that or you'll pay the tax on the ROC portion when you sell your units at the reduced ACB.

Look at distribution breakdowns to decide where to hold a REIT

Initially, I thought it was best to buy REITs with a high portion of distributions as ROC in a non-registered account, but ROC is your money being returned to you. So, unless the security appreciated in price, it may not be worth it to buy such REITs in a non-registered account after all.

It's essential to look at each REIT and where its distribution typically comes from *before* deciding where to buy each.

Here's a distribution breakdown of some REIT leaders.

Canadian REIT (TSX:REF.UN) was the first publicly listed REIT in Canada. It's a leading, diversified REIT with retail, office, and industrial properties. Today it yields 4.2% and its distribution has increased for 14 years in a row. This track record is backed by its business performance and prudent business model.

In 2014 its distribution breakdown is as follows: 7.6% from capital gain, 2.9% from foreign non-business income, 88.9% from other income, and 0.6% from ROC.

Historically, other income makes up the largest slice of its distribution. Since that portion is taxed at a marginal rate in a non-registered account, it makes sense to hold Canadian REIT in a TFSA, or for tax-deferred growth in an RRSP.

RioCan Real Estate Investment Trust (TSX:REI.UN) is a leading retail REIT. It hasn't cut its distribution for over a decade, but has increased it occasionally. Today it yields 5.4%. Typically, 40-50% of its distribution comes from other income, and 40-60% from ROC.

So, it makes sense to hold RioCan shares in a TFSA or RRSP.

Northwest Healthcare Properties REIT (TSX:NWH.UN) is the Canadian healthcare landlord, owning medical office buildings and hospitals. Its properties are located in Canada, Brazil, Australasia, and Germany.

Typically, more than 94% of Northwest Healthcare Properties' distribution comes from ROC. It might make sense to buy it in a non-registered account because most of its distributions are tax deferred, but it'd be even better to hold it in a TFSA, so you don't have to pay taxes at all.

In conclusion

Where to hold a REIT depends on what its distribution is made up of. We can only go by how it has typically broken down in past years. If most of the distribution is taxed at the marginal rate, you should definitely *not* buy it in a non-registered account.

If you're aiming for tax-free income, a TFSA is a good place to hold a REIT. Another place to hold a REIT is in an RRSP if you're aiming for tax-deferred growth, but remember that when you eventually take out the money, it's still taxed at the marginal rate.

If you are in a high tax bracket and expect to be in a lower bracket in retirement, it makes sense to contribute first to an RRSP before a TFSA. By contributing to an RRSP, you reduce your tax bracket and you can possibly get a tax refund for more investments.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:NWH.UN (NorthWest Healthcare Properties Real Estate Investment Trust)
2. TSX:REI.UN (RioCan Real Estate Investment Trust)

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