Earn Tax-Deferred Income Without Contributing to an RRSP

Description

For most investors, it makes sense to invest in a TFSA because whatever is earned inside, whether it's interest, dividends, or capital gains, is entirely tax free. If you used up your TFSA contribution room, you could invest in an RRSP or a non-registered account.

If you're in a high tax bracket, it's logical for you to contribute to an RRSP to reduce your tax bracket. You have until February 29 to contribute to an RRSP for the 2015 tax year. What you put in an RRSP is tax deferred until you take it out in retirement, at which time it's taxed at your marginal tax rate.

However, did you know you can receive tax-deferred income from real estate investment trusts (REITs) in your non-registered account?

Tax-deferred income: return of capital

Some REITs yield as high as 9-14%. Their distributions can consist of other income, capital gains, foreign non-business income, and return of capital (ROC). The ROC portion is tax deferred.

The ROC reduces your adjusted cost basis (ACB). Simultaneously, the ROC portion of the distribution is tax deferred until you sell your shares or until your ACB turns negative.

If you buy REITs in a non-registered account, you'll need to track the change in the ACB. The T3 that you'll receive will help you figure out the new ACB.

A concrete example

Here's a concrete example with **Northwest Healthcare Properties REIT** (TSX:NWH.UN). If you had bought 1,000 shares at the start of 2015 for $9.28 per share, and the transaction fee was $10, the ACB would have been $9,290. You would have received $800 income for the whole year (a yield of 8.6%).

The REIT has yet to announce if 100% of its distributions were tax deferred in 2015 as it was in 2014. If it were, your ACB would be reduced to $8,490. And you pay no taxes on that income!

Since 2010 Northwest Healthcare has paid out distributions that were tax deferred by 94% or more. If it keeps that up, unitholders will have paid little to no tax on the shares for over a decade.

If you hold your shares, somewhere down the line your ACB will turn negative. Let's say it turns -$800, implying a capital gain of $800. Half of that capital gain ($400) would be taxable and the ACB would be updated to zero. At that point, if you sell the shares for $10,000, the full amount is viewed as capital gain, and $5,000 is taxable.

Today, Northwest Healthcare yields 9.4% at $8.53 per unit.

Other REITs with a high portion of ROC in their distributions include the following:

- **Dream Office REIT** (TSX:D.UN) yields 14.4% at $15.55 per unit
- **Dream Industrial Real Estate Invest Trst** (TSX:DIR.UN) yields 10.2% at $6.89 per unit
- **Dream Global REIT** (TSX:DRG.UN) yields 9.7% at $8.24 per unit

In 2014 the ROC portion made up 72.5%, 77.4%, and 50.3% of their distributions, respectively.

Word of caution

The percentages of each type of income can change every year, so the historical ROC percentages can only be used as a reference. Additionally, the record keeping and tax effects of ROC can be tricky for some investors. So, it's always better to consult a tax advisor before investing.

In conclusion

Some REITs have a large portion of their distributions as return of capital, which are tax-deferred investments. The return of capital portion of the distribution is not taxed until you sell the shares or if the adjusted cost basis turns negative.

Income investors should consider holding REITs with a big percentage of ROC in a non-registered account to get tax-deferred income. Then they can save RRSP room for other investments, such as high-yield U.S. dividend stocks. However, if you hate math you should invest REITs in an RRSP or TFSA.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:D.UN (Dream Office Real Estate Investment Trust)
2. TSX:DIR.UN (Dream Industrial REIT)
3. TSX:NWH.UN (NorthWest Healthcare Properties Real Estate Investment Trust)

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