Canadian REITs vs. U.S. REITs: Which Are Better Buys for Canadians?

Description

Real estate is one of the oldest forms of investing. But over the years, it has become complicated, with various layers of paperwork and taxation. When you buy or sell property, you have to pay taxes, like property tax and capital gains tax. And if you buy a property in a foreign land, there is additional taxation. If you believe that buying a U.S. REIT will save you from double taxation, you should read this.

Before talking about the tax treatment of U.S. REITs in the hands of the investor, let's first understand how REITs are different from stocks.

How are REITs different from stocks?

REITs are income trusts that invest in income-producing real estate and share this income with shareholders. You can buy publicly traded REITs on the TSX through a Tax-Free Savings Account (TFSA), and Registered Retirement Savings Plan (RRSP). While buying and selling a REIT is just like a stock or an ETF, the tax treatment is different.

A REIT gets the preferential tax treatment of an income trust, which means it is not subject to corporate tax. As REIT don't pay tax on the dividend, they tend to offer higher distributions. REITs call monthly payments to investors distributions and not dividends. When you file income tax, you get a T3 form for the REIT distributions and a T5 form for stock dividends.

A REIT's distribution comprises different types of income, and they have different tax treatments:

- Gains from the sale of property (you pay capital gains tax on 50% of the capital gains)
- Return on capital
- Income from rent or interest on the mortgage
- Foreign non-business income (rental income from foreign properties)

The last two income types are added to your taxable income, and the marginal tax rate applies.

Now that you know how REITs and their distributions are taxed, there is a significant difference in the way income from Canadian and U.S. REITs is taxed.

Canadian REITs vs. U.S. REITs

You might want to diversify your portfolio by investing in a foreign REIT. But before you look at the U.S. REIT options, check the tax implications and compare them with a Canadian high-dividend stock. I would suggest you buy a Canadian REIT through a registered savings account to save your investment income from all types of taxes.

However, if you buy a U.S. REIT, U.S. tax laws apply. As per Canadian tax laws, you can claim a foreign tax credit on the income tax you file in Canada if you paid tax in the United States. However, this tax credit doesn't apply to U.S. distributions. The distribution on your U.S. REIT will be subject to a withholding tax whether you invested through a registered or unregistered savings account.

Income from U.S. REITs

U.S.-based REIT **Medical Properties Trust** (NYSE:MPW) has a portfolio of hospitals across the United States, Europe, Australia, and Columbia. It leases hospital properties on a triple net lease, and over 90% of these are on a master lease. It has an annual distribution of 5.73%, which it pays quarterly. It has been paying a regular distribution since 2005 and has grown it annually since 2013.

If you invest $5,000 in this REIT, you can get $286.5 in annual distributions, on which the Internal Revenue Service will impose a withholding tax. The distribution amount after the withholding tax will be subject to Canadian income tax if you haven't invested in the U.S. REIT through an RRSP or TFSA.

Income from Canadian REITs

SmartCentres REIT (TSX:SRU.UN) is a Canadian retail REIT that offers a 5.7% annual distribution paid in monthly installments. The REIT has 283 properties; 63% of properties earn rental income, and 37% earn capital gains. It earns 25% of its rental income from **Walmart** and another significant amount from Walmart-anchored stores. SmartCentres is also expanding into commercial and residential properties.

It has been paying regular dividends since 2003 and has even increased them since 2015. If you invest $5,000 in SmartCentres through a TFSA, you can get $285 in distribution income tax free. If you use an unregistered account, you will have to add distribution income to your taxable income.

Final takeaway

When considering investments, don't just look at the returns. Also, look at the tax implications, as they could significantly reduce your returns.

CATEGORY

1. Investing
2. Stocks for Beginners

TICKERS GLOBAL

1. NYSE:MPW (Medical Properties Trust, Inc.)
2. TSX:SRU.UN (SmartCentres Real Estate Investment Trust)

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