Real Estate Investment Trusts will have a tax advantage in 2011

BY ROSS D. FREEMAN, SPECIAL TO THE SUN DECEMBER 2, 2010

Four years ago the federal government announced that publicly traded income trusts, which provide big tax advantages over traditional corporations, would lose that edge by the end of 2010.

Photograph by: Archive, Calgary Herald

Four years ago the federal government announced that publicly traded income trusts, which provide big tax advantages over traditional corporations, would lose that edge by the end of 2010.

The market reaction was swift and terrible, erasing $25 billion from the market value of income trusts and raising a cacophony of anger from investors who had put many of their eggs in the income trust basket.

But one type of income trust was mostly spared by Ottawa: the Real Estate Investment Trust, or REIT. With the approach of the Dec. 31 deadline for other income trusts to lose their tax advantage, REITs are poised to become a popular investment option, especially for aging baby boomers looking for high-yield investments to fund their retirement.

The government's reason for striking down income trusts, despite an earlier promise to leave them alone, was twofold.

Income trusts were felt to be a drain on the federal treasury since they paid no tax. The perception was that they were also bad for the economy because these businesses distributed most of their profits rather than reinvesting them and growing their businesses.

No policy reason was given for the preferential treatment of REITs except that other jurisdictions -most notably the United States -had a similar exclusion.

The REIT tax advantage works like this: REITs, like all income trusts, distribute their profits to unitholders. When a REIT makes a distribution to its unitholders, it is allowed to deduct that distribution when calculating the tax it would owe. So, as long as the REIT distributes at least as much as its taxable income, it pays no tax. Corporations get no deduction whatsoever for paying dividends.

This is a big part of the reason that income trusts were so popular in the first place. Some large corporations pay dividends, but they are normally low-yield such as two or three per cent.

They can't afford to pay much more because they would then not have the cash to pay their taxes. A REIT can pay five or six per cent in distributions because it will have no tax to pay.

What would-be investors need to understand, however, is that after Dec. 31, only REITs that earn income strictly from passive real estate activities such as earning rent or mortgage interest are entitled to the tax advantage; they can't have land development profits. Hotels and nursing homes also don't qualify. For this reason, several Canadian REITs are spinning out their non-qualifying business lines so as to fit within the exemption.

REIT units are eligible investments for tax-deferred plans such as RRSPs and RRIFs and for tax-free plans like TSFAs. Where REIT units are held in such plans, there is no tax payable on the REIT income at either the entity level or the unitholder level until the funds are pulled out of the RRSP or RRIF.

It may well be that REITs will trade at a premium to other investment vehicles in 2011 due to their ability to pay high distributions.

This will allow them to raise more capital without diluting the existing holders, which will in turn allow them to grow their business, their profitability and their ability to make distributions. Other investment vehicles will only be able to look on with envy.

Ross Freeman is a nationally recognized tax consultant and partner at Borden Ladner Gervais LLP.

© Copyright (c) The Vancouver Sun