STRATEGIC TAX CONSULTANTS

REITs

Enhanced Agility Through Strategic Distribution Management

Prepared by:

John J. Gail, Project Manager
CSG Strategic Tax Consultants

150 W. Main Street
Suite 1200
Norfolk, VA 23510
1.844.4CSGTAX
csgtax.com

STRATEGIC TAX CONSULTANTS

Abstract:

As most of us know, Real Estate Investment Trusts (REITs) are bound by rules and regulations that often hinder their ability to retain, and thus, reinvest earnings. Many REITs are eligible to implement a tax strategy known as cost segregation. Unfortunately, misinformation has left many REITs believing that their organization isn't eligible. The most common type that can implement this strategy and realize a substantial benefit are Equity REITs. This is especially true for those that have privatized and those that are positioning to privatize. Let's explore a strategy for using cost segregation with a focus on what's important to the managers of these entities.

Cost Segregation:

I'll explain cost segregation at a glance, and then provide a link with more detailed information for those whose curiosity is peaked. When a building is purchased, typically the sale price is divided into two buckets: land and building. This is inefficient, since the cost of the building is recovered over either 27.5 or 39 years (depending on the type of property), and the cost of the land is never recovered for tax purposes. When a proper cost segregation study is performed, the first thing that happens is an expert visits the subject property. While on site, all of the assets that were included in the sale are identified, and a portion of the purchase price is allocated to them. Instead of just building and land assets, cost segregation identifies land improvements, personal property, and even building components. Some of the building components that will receive an allocation are the roof, floor, walls, windows, and doors. Examples of the 5 and 15 year property that may be identified include carpet, decorative lighting, asphalt, and signage. The person that performs the study is an expert in both engineering techniques and MACRS depreciation, and will assign the appropriate depreciable life to each component and asset. Besides the peace of mind that comes along with knowing that these allocations are done efficiently and correctly, the portion of the sale that is moved to a shorter life increases non-cash expense through depreciation. This means lower distribution requirements and enhanced flexibility for REIT managers. That's not all though, shareholders benefit as well as you will see in the following paragraphs. To learn more about cost segregation, please click here.

Cost Segregation - REIT Case Study:

Example: Last year, Joe Investo purchased 20 shares of HIGH YIELD REIT (HYR) for $30 per share ($30 * 20 shares = $600 Basis). Assume that HYR has had taxable earnings of $2.50 per share every year that it has been in business. Additionally, it has only ever paid the required 90% distribution of $2.25 per share. This year, however, HYR had a cost segregation performed on several of its real estate properties. The resulting increase in depreciation reduced taxable income to $1.50 per share. HYR is only required to make a 90% distribution, which in this case is $1.35 per share. Instead, it decides to pay the regular dividend of $2.25. This means that $0.90 per share must be reclassified as return of capital (because this amount is above the required distribution). Joe Investo will not pay any taxes on the return of capital this year, but will eventually pay the lower capital gains rate on this portion. The lower capital gains rate is deferred until he sells his shares. The result is a permanent tax arbitrage on the dividend! This is also the reason so many investors prefer dividends with a high percentage of return of capital dividends. Joe's reduction in basis will be ($0.90 * 20 shares = $18), leaving him with a basis of $582.

Note: All ordinary dividend's that a REIT distributes count as Qualified Business Income per IRC 199A. Interestingly, REIT shareholders are not subject to wage or basis limitations per IRC 199A. In other words, cost segregation will never reduce shareholders ability to take the 20% qualified business income deduction, even if return of capital distributions have eliminated the shareholder's basis!

Why This Matters For Your REIT:

1. Dividend Management

- REITs are required to distribute 90% of taxable income. Typically, REIT distributions are taxed at ordinary income rates which can be as high as 37%. The exception is that any time a REIT pays dividends above the 90% requirement, those dividends are reclassified as return of capital. Investors benefit by excluding that portion of the dividend from income until shares are sold. Investors will only pay the capital gains rate on this portion of the dividend (0-20%).

2. Cash Management

- The increase in depreciation from the previous example can also be used for cash management. As we saw, the non-cash expense reduces a REITs distribution requirement. This provides management with the option to use this retained cash for long or short term strategic goals. This may include reinvestment in additional properties, improvements to existing real estate, or reduction of debt.
- Gain from real property sales increases the dividend requirement for REITs. By increasing depreciation, cost segregation can be used to reduce this liability at a time when cash from a sale needs to be reinvested.

Note: REITs are generally exempt from tax. The exception is when a REIT distributes less than 100% of taxable income. When a 90% distribution is made, REITs do not pay tax on that portion. The 10% that is retained however, is subject to taxation. Therefore, a REIT can use cost segregation the same way it was used in the first example to eliminate this tax burden. Since more than 100% of taxable earnings are distributed, the REIT has no liability!

3. Financial Statement Impact

- Cost segregation does not affect financial reporting or depreciation of tangible assets for financial accounting. The only exception is the impact it has on taxes.

4. Funds From Operations (FFO)

- Many investors consider FFO the most important measure for valuing REITs. Fortunately, because depreciation is added back to net income in this equation, cost segregation has no impact.

5. Insurance

- Property investors often overpay for insurance by having to purchase specialty insurance for assets not covered in a standard package. An added benefit of cost segregation is that it provides the REIT with an exact value for these assets. This allows management to buy only the amount of insurance that the company needs.

6. Disposition

- This is easiest to illustrate with an example. Let's assume that a roof on an investment property is destroyed in a storm. Determining the value of the roof for disposition can be difficult. Compounding this problem, is the fact that dispositions are often scrutinized by the IRS. Cost segregation provides a proven, defensible tax basis that satisfies IRS requirements. That's peace of mind for your company and your CPA.

Conclusion:

Cost segregation can be applied to new construction, purchases of used property, and even property purchased up to 20 years ago. While many CPA's do identify some assets on their client's purchase, it is typically a fraction of the value that can be realized. This is because a good cost segregation study incorporates both accounting and engineering expertise. The team at CSG: Strategic Tax Consultants, has been performing cost segregation for 20 years and employs CPA's, engineers, and construction professionals. This is how we are able to get our clients the highest quality and most accurate cost segregation study possible. Whether your firm chooses to work with us or another company, your REIT should consider the benefits of having a cost segregation study performed. The value and flexibility that cost segregation provides to REIT's stakeholders is difficult to balk at.

For more information please visit our website:

CSG: Strategic Tax Consultants

STRATEGIC TAX CONSULTANTS

About CSG Strategic Tax Consultants

Founded in 1999, as a national provider of services geared towards assisting business owners with Research & Development Tax Credits, Cost Segregation Studies, 179D Energy Tax Deductions, 45L Energy Tax Credits, Fixed Asset Depreciation Review and additional tax strategies, CSG has steadily grown to take the worry out of navigating America's tax laws for the businesses we represent. In fact, we literally wrote the book on cost segregation for Commerce Clearing House, the world's largest provider of tax content, called the 'Practical Guide to Cost Segregation.'

We know that keeping-up with industry standards and ever-changing tax accounting practices can be a full-time job. That's why our clients trust and rely on us to adeptly handle their tax-accounting needs. We'll save you money while you take care of your day-to-day operations and your own clients.

CSG is a wholly-owned subsidiary of Wall, Einhorn & Chernitzer L.P. (WEC) a Norfolk, Virginia-based accounting firm. And, because we work alongside WEC, a firm that employs not only engineers, but 80-plus CPAs and tax professionals with an average of 20+ years in the public practice; CSG will always have a breadth of expertise at our fingertips, every day. We are dedicated to providing valuable solutions to our clients in a professional and timely matter.

WEC is an independently owned and operated member firm of CPAmerica International, one of the largest associations of CPA firms in the United States. Through our affiliation, we have instant access to the expertise and resources of more than 2,500 professionals across America. As a client of our firm, you will benefit from the resources, experience and professional knowledge base of a national firm while still receiving the personalized service and attention that only a locally-owned, independent accounting firm can offer.

Visit www.csgtax.com for more information.