Shares or REITs

By Michael Kemp

In a recent email to my accountant I used the acronym "REITs". An email came straight back: "What are REITs?" Many of you know what they are but, since my accountant had to ask, it's given me good reason to start this article with a definition.

REIT stands for Real Estate Investment Trust. And, as the name implies, REITs pool money from lots of investors to buy real estate – be it offices, shopping centres or industrial estates. There are a multitude of REITs trading on the ASX which means you can invest in blue chip real estate as easily as buying shares in listed companies.

Investors often ask the question: "Should I invest in REITs or ordinary shares?" Clearly there's a lot to consider when answering this question. For starters which REITs or companies are you considering, because there's a wide range on offer within each sector?

To simplify things I'm going to consider just one issue. That is, how the Tax Commissioner treats the returns delivered by each, because they are taxed differently.

Taxing Returns delivered by Ordinary Shares

Shares deliver returns to investors in two forms – income (dividends) and capital gains (hopefully).

Dividends are taxed at the investor's marginal tax rate after franking credits (the tax already paid by the company) has been added back. For a full explanation of how this is calculated see Free Newsletter 131 at http://www.bwts.com.au/index.cfm/resources/newsletter-archive/

Shares also deliver returns by way of capital gains, if sold at a price higher than they were acquired (after accounting for acquisition and disposal costs). Tax is typically paid on this gain and is commonly referred to as capital gain tax (CGT).

The rate of CGT varies depending on whether the asset was held by an individual(s), company or superannuation fund. For example:

- Individuals and small businesses pay tax at their marginal rate but can discount the capital gain by 50 percent if the asset is held for more than one year.
- Companies pay 30 percent tax (the current company tax rate) on their capital gains independent of the period the asset was held.
- Superannuation funds pay 15 percent CGT if the asset was owned less than 12 months, 10 percent if longer and no CGT if the fund is in pension phase.

Taxing Returns delivered by REITs

Like shares, REITs deliver returns to investors both in the form of income and capital gain. However neither are taxed in the same manner as those delivered by ordinary shares. Three big differences exist:

1. The cost base used to calculate the CGT payable on REIT ownership is typically adjusted through time.
2. Unlike dividends delivered by shares, distributions from REITs don't have franking credits attached. That's because income isn't taxed in the REIT's hands. Distributions are therefore paid to investors without franking credits attached.
3. Cash flows from several sources are typically included in the distributions from REITs. That is, distributions don't consist purely of rental income. And the tax treatment of the component parts can vary.

For example, a typical distribution could comprise rental income, a return of capital, a distribution of building allowances, a distribution of unrealized capital gains and distributions from the tax differences reserve (items brought to account in different periods for accounting and income tax purposes).

It all sounds rather complicated but can be simplified from the investor's perspective. Look to the Annual Tax Statement (sent to you by your REIT) for an item referred to as the "tax deferred amount". This amount embodies many of the distribution components mentioned above. The good news is this amount isn't taxed in the period it's received, though there is an exception to this – which is explained below.

The tax deferred amount is effectively a distribution in excess of the security holder's share of the taxable income of the trust. As stated, tax doesn't usually have to be paid on this amount in the current period, however the Tax Commissioner does eventually catch up with you – it has later CGT implications if and when you sell your units.

I stated earlier that CGT is applied to shares when they are sold for a price higher than they were acquired (after accounting for of acquisition and disposal costs). Similar rules apply to REITs however the acquisition cost of REITs (referred to as the cost base), unlike ordinary shares, can change through time. That's because the "tax deferred" components of the distributions referred to above are progressively applied to reduce the cost base of the investment.

A lower cost base means more CGT is payable when you come to sell (that's how the Tax Commissioner eventually catches up with you). But in keeping with the "hold forever principle" if you don't sell you don't pay the tax.

Before I finish up I said I'd mention the circumstances where the Tax Commissioner does ask you to pay tax, in the current period, on the tax deferred part of the distribution. As stated, tax deferred amounts are applied to reduce the cost base of the investment (and so increase the unit holder's CGT liability if and when the units are ultimately sold). It's an unusual event, but if the accumulated tax deferred amounts reduce the cost base to zero, any excess is treated as a capital gain in the current period.

The Most Important Thing

So in posing the question: "Is it better to buy shares (which carry franking credits) or REITs (which carry a "tax free" component)" my answer must be:

"It depends……and it depends……..and it depends".

The comparison involves many variables:

- It depends on the REIT you're considering and the structure of the cash flows that make up its distribution.
- It depends on the dividends and franking credits associated with the company you are comparing it to.
- It depends on the tax structure you are holding your investments in.
- And it depends on when you plan to sell, or in fact whether you plan to sell at all.

That's not to detract from the importance of tax considerations. They are important to investors. Just ask any Australian basking in the tax oasis referred to as superannuation. But comparisons between investments based purely on tax considerations can become complicated by a mine field of variables and specific circumstances.

Which reminds me…….more so than tax considerations the most important thing to ask yourself when investing is: "First and foremost is it a good investment?"

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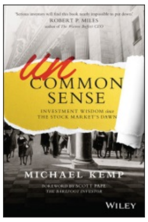

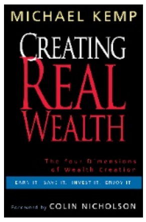

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.