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FROM THE ARCHIVES: June 4, 2003

Tax Law Offers Benefits To Real-Estate Investors

By RAY A. SMITH
Staff Reporter of THE WALL STREET JOURNAL

How does the new tax law affect real-estate investors? Here are three areas worth noting.

Faster Depreciation. One benefit is an increase in the amount owners can depreciate on tenant improvements made in their buildings and on certain equipment, including security measures.

The so-called bonus depreciation provision affords owners the opportunity to take a tax deduction for depreciation at an increased rate of the total cost of the qualified property, which typically includes equipment or improvements. This means a landlord that spends $1,000 on qualified property will get a first-year deduction of $500 and depreciate the balance over 39 years, which is the current depreciation schedule for improvements, says Fred Witt, national director, Real Estate Tax Services at Deloitte & Touche LLP in Phoenix. "A real-estate owner investing $1,000 in new improvements will claim a deduction of $512.82, or a write-off of 51%, in the first year." The 51% reflects the bonus 50% plus 1/39th of the balance.

The benefit applies to qualified property purchased after May 5, 2003, and placed in service before Jan. 1, 2005.

Lower Tax Rate. Under the new law, investors in commercial properties, including apartment buildings, shopping centers and motels, will pay a lower tax on the capital gains from the sale of their property. The reduced rate is effective for transactions occurring on or after May 6, 2003, through Dec. 31, 2008.

While many in the real-estate industry welcome the lower tax rate on gains, some think the reduction will only marginally influence owners' behavior. "For people who are looking for the best way to monetize their [real-estate] assets, a sale may become marginally more attractive but not as attractive as refinancing" especially with currently low interest rates, says Robert L. Freedman, vice chairman of GVA, an international commercial real-estate services provider, in Chicago.

Mixed Bag for REITs. Real-estate investment trusts don't qualify for the new law's reduction of corporate-dividend taxes because they generally don't pay corporate taxes. So investors in

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REALTY CHECK

Here are some things contained in the tax law signed by President Bush last week that real-estate investors in particular should take note of

Capital Gains Tax Rates

- Taxes on gains from the sale of properties were cut to 15% from 20% on properties held a year or longer
- They were cut to 5% from 10% for taxpayers in the 10% and 15% brackets
- The new rates are effective on or after May 6, 2003 through Dec. 31, 2008

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REIT stocks will continue to have to pay a maximum tax of 35% on a majority of REIT dividends, as opposed to the lower 15% tax rate investors in other sectors will pay under the new law. But REIT dividends will qualify for the lower 15% maximum rate under certain circumstances. (See righthand column for exceptions.)

William Schaff, co-portfolio manager of the Undiscovered Managers REIT Fund in Dallas, which is an investment fund managed by Bay Isle Financial LLC of Oakland, Calif., concedes that the law's exclusion of REITs "makes broader equities a little more competitive on an after-tax basis." But he points out that on an absolute basis, REIT yields are still hovering, on average, around 7%, compared with lower yields for 10-year and 30-year Treasury notes and the Standard & Poor's 500-stock index.

Even with all that, he says, "the fact is people should own REITs just because they are a good portfolio diversifier," since the stocks tend to move in the opposite direction of the broader market and swing less wildly than stocks and bonds. He adds that one way for investors to reduce the tax impact is to put REIT stocks into a tax-deferred pension plan such as an IRA.

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- REIT dividends may qualify for capital gains rates subject to certain limitations

Bonus Depreciation

- The 30% bonus depreciation for qualified property increases to 50% for property acquired after May 5, 2003 and before Jan. 1, 2005
- Property includes equipment with a recovery period of less than 20 years or tenant improvements
- Property wouldn't qualify for the 50% bonus depreciation if there was a written binding contract for its acquisition before May 6, 2003, though the 30% bonus depreciation may still apply

REIT Dividends

The majority of REIT dividends will continue to be taxed as ordinary income at a maximum new rate of 35%. However, REIT dividends will qualify for the lower 15% maximum rate when:

- The individual taxpayer is subject to a lower scheduled income tax rate
- A REIT makes a capital gains distribution
- A REIT distributes dividends received from a taxable REIT subsidiary or other corporation
- As permitted, a REIT pays corporate taxes and retains earnings

In recent years, about one quarter of REIT dividends on average would have qualified for the maximum 15% rate.

Sources: Gary C. Pokrant, CPA, tax principal, Reznick Fedder & Silverman, CPAs, P.C., the National Association of Real Estate Investment Trusts

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