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Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

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Real Estate Investing With REITs

As the memory of the financial crisis recedes, the real estate market shows signs of recovery. You may believe excellent investment opportunities exist now—and that might be the case. Nevertheless, you may be reluctant to buy investment property. Inexperienced investors can make costly mistakes, property management will be either expensive or time consuming, major commitments of capital might be required, and investment real estate is illiquid.

For any or all of those reasons, you may consider investing in real estate investment trusts (REITs) as an alternative. You can buy and sell many different REITs, just as you'd trade shares of common stocks. A given REIT can be diversified, and REIT funds provide even more diversification. What's more, you can invest in REITs with only a few thousand dollars.

Real differences

Broadly speaking, REITs fall into two categories.

Equity REITs own one or more properties. Often, they specialize in various types of real estate. One REIT might own only office buildings, for example, while another REIT might own shopping centers.

Mortgage REITs own debt instruments. They buy existing mortgages, collect payments from borrowers, and pass the money through to investors.

Some REITs are hybrids, owning both properties and mortgages.

Investment implications

In a way, all REITs are hybrids. Equity REITs, for instance, reflect the performance of both the real estate market and the stock market. In a strong real estate market, property values rise.

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Jumbo Nest Eggs

At year-end 2012, Americans held $5.4 trillion in IRAs, versus $5.1 trillion in defined contribution plans, which include 401(k)s.

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Higher property values, in turn, tend to boost the prices of REIT shares.

On the other hand, a stock market crash can sink equity REITs. From May 2008 to February 2009, for example, the Financial Times Stock Exchange National Association of Real Estate Investment Trusts (FTSE NAREIT) U.S. Equity REIT Index fell by 62%, as the stock market collapsed. The values of the office buildings, shopping centers, and other properties held by REITs may not have dropped to the same degree. (Since that bottom, more than four years ago, this equity REIT index has more than tripled. As of this writing, it is 28% higher than in May 2008.)

While equity REITs are a mix of stocks and real estate, mortgage REITs combine the features of real estate and bonds. The yields paid to investors reflect interest rates on real estate mortgages. These REIT shares, however, tend to trade with the bond market: if interest rates rise in the future, mortgage REIT shares probably will fall along with bond values.

Tax treatment

Under the U.S. tax code, REITs are required to pay investors at least 90% of their taxable income each year. This payout reduces or eliminates a REIT's obligation to pay corporate income tax. By comparison, dividends paid to investors by regular corporations may be taxed twice: both the company and the investor can owe tax on those dollars.

As a result of this tax treatment, REITs generally have relatively high yields. In 2013, equity REITs generally pay around 4% to investors. By comparison, the yield on the Standard & Poor's 500 Index of large company stocks is around 2%. Mortgage REITs currently yield about 7%, versus 3% for U.S. corporate bond indexes.

Besides the high yields, REIT investors may benefit from favorable tax treatment.

Example: Jill Young invests $10,000 to buy 200 shares of ABC Office Building REIT at $50 a share. In 2013, Jill receives a $400 (4%) dividend. On the IRS Form 1099-DIV that ABC sends to Jill, she sees that $100 is a long-term capital gain, $100 is ordinary income, and $200 is a return of capital. Therefore, Jill will owe tax on $100 at favorable capital gain tax rates and $100 at ordinary income rates. She'll owe no tax on her $200 return of capital. (Generally, REIT dividends do not get the special low tax rates on "qualified" dividends.)

Although Jill avoids tax on her $200 return of capital in this example, she must lower her basis by $200—$1 per share—to reflect her $200 return of capital. This reduction drops her basis from $50 to $49 and will increase the tax she will owe in the future on a profitable sale. Nevertheless, the REIT tax treatment works in Jill's favor, because she avoids paying ordinary income tax now and may owe tax on a future sale at lower capital gains rates.

Building out

The REIT universe is broad, covering many varieties of investments. Some REITs do not trade publicly; they might offer higher yields but also restrict your ability to sell for many years. Other REITs have been created outside the U.S. These global REITs may offer profit potential, in fast growing regions, but they also might have specific risks found in local markets.

Altogether, carefully selected REITs may deliver substantial cash flow, portfolio diversification, and participation in real estate growth. Be sure to look closely at any REIT before investing, so you're confident you understand the risks involved. ■

Deferred Income Annuities for Your Future

Low investment yields have robbed many savings vehicles of their appeal. Besides bank CDs and money market funds, fixed annuities also may fail to generate enthusiasm these days. According to Beacon Research, which tracks the annuity industry, fixed annuity sales in the first quarter of 2013 were down 11.7% from the first quarter of 2012.

Yet one type of fixed annuity bucked this trend. Beacon reported that sales of deferred income annuities (DIAs) were nearly 150% higher in the first quarter of 2013, versus the first quarter of 2012. Looking back further, New York Life recently announced that DIAs were a $50 million market in 2011; this year, the market is $1 billion and growing rapidly.

Invest now, collect later

DIAs are sometimes called longevity annuities. That is, you can buy one that will pay out as long as you live. If you're married, you can buy a joint DIA that will pay as long as either you or your spouse is alive. This guaranteed income stream may help prevent you from running short of money if you live well beyond normal life expectancy.

Of course, a traditional income annuity (also known as a payout annuity or an immediate annuity) also can provide guaranteed lifetime income. Why are DIAs so popular now? Because they offer much higher yields for consumers who can wait for the cash to start flowing. Typically, DIAs are purchased by

pre-retirees who want supplemental retirement income.

Example: Ed Larson is single, age 60. He is still working, and plans to retire at age 70. Ed's current health and his family history indicate he has a good chance of living to age 90 and beyond.

By shopping around, Ed learns that he would receive a yield in the 5%–6% range if he were to buy an immediate lifetime annuity now. That is, if he bought this annuity for $100,000, he would receive $5,000–$6,000 a year as long as he is alive.

Alternatively, Ed could wait until he retires at age 70 to buy such an annuity. Currently, a 70 year old male could receive $6,000–$7,000 a year from a $100,000 immediate lifetime annuity. Ten years from now, that immediate annuity might have a higher or a lower yield.

Instead, Ed buys a $100,000, 10-year DIA. Currently, such an annuity could yield around 10%. Thus, Ed pays $100,000 now and doesn't start collecting until 2023. Starting then, Ed can receive $10,000 a year throughout his retirement, no matter how long that might last. (Joint annuities have lower payouts than single life annuities.)

Nothing for something

For today's pre-retirees, the idea of a 10% investment return, guaranteed, with no ending date, may be attractive. You'll be confident that money will keep coming, regardless of what happens in the stock or bond markets. Nevertheless, DIAs come with risks you shouldn't ignore.

Keep in mind that DIAs might be guaranteed, but that guarantee doesn't come from any government agency. DIAs are backed by the assets of the issuing company, so you should check into the insurer's financial health before buying a DIA. If the idea of a DIA interests you, our office can help you evaluate the issuer's financial strength.

Your own physical health also is a major concern. If Ed Larson in our example buys an age 70 DIA when he's 60 and dies at, say, age 68, no one will collect a penny from his $100,000 investment. Also, Ed won't have access to his $100,000 if he needs money before age 70. (Some DIAs have refund options, but you'll have to accept a lower payout if you want this opportunity.) Therefore, you should consider your longevity prospects before deciding to put part of your retirement fund into a DIA. ■

Trusted Advice

Tracking Annuity Taxes

- You must use the "general rule" for determining the taxation of payments from a purchased commercial annuity.
- Under the general rule, you determine the tax-free part of each annuity payment based on the ratio of the annuity's cost to the total expected return.
- The expected return is the total amount you and other eligible annuitants can expect to receive under the contract.
- To figure the expected return, use IRS life expectancy tables found in IRS Publication 939, *General Rule for Pensions and Annuities.*
- Once you have recovered the cost of the annuity, tax-free, any subsequent payments are fully taxable.

Leasing Company Cars

Among consumers, leasing cars is increasingly popular. According to Experian Automotive, a data provider, a record 27.5% of new cars financed in the first quarter of 2013 were leased, compared with 24.4% one year earlier. Thus, if you provide company cars to one or more employees, you might consider leasing rather than the traditional purchase arrangement.

Leasing company cars offers obvious advantages. Assuming that your company leases the cars for two or three years, your employees will always be driving a new or relatively new car on business. Leasing cars for no longer than three years can present a more professional image to clients and prospects and reduce the chance your employees will have major operating problems, which can affect productivity.

Leasing cars can deliver financial advantages, too. Upfront costs may be lower when you lease rather than buy a car. Monthly payments likely will be lower than you'd pay on a car loan. As mentioned, short term leases reduce the chance your employees will need expensive repairs.

The downside, of course, is that your company won't actually own

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Did You Know?

Indexed universal life (IUL) sales, as a percent of total universal life sales, increased from 18% in 2009 to 40% through the first nine months of 2012. With IUL, the policy's cash value increase is fully or partially based on a stock market index. Such policies may offer upside potential and downside protection.

Source: Milliman

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the cars. Leased cars won't deliver the same resale value, and your company won't be able to enjoy the long-term cost savings that come from keeping a car after the purchase price has been fully paid. In addition, when you lease company cars, you'll have to urge employees to observe mileage restrictions and avoid unnecessary wear and tear.

Superior tax savings

Your company also may save tax by leasing its company cars. You'll pay sales tax only on the monthly lease payments, rather than on the full purchase price.

Once your employees are driving their leased company cars, your company can deduct the lease payments as well as all the related costs, from gas and oil to inspections and maintenance. You should make your employees aware that this tax treatment applies only to the business use of their company car. Therefore, they must keep a log or use some other method of substantiating their percentage of business car use, rather than personal use.

For your employees, personal use of their company car is considered a taxable fringe benefit. Thus, each year the company must determine the value of the fringe benefit for their employees with company cars, so those employees can pay the resulting income tax.

Commuting to work counts as taxable personal use, along with driving for vacations and any other nonbusiness reasons. Among several allowable methods to put a value on personal use, most companies use the Annual Lease Value table, found in IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, to determine the value of personal use of leased company cars.

Example: ABC Corp. provides employee Sarah Perkins with a leased car; Sarah gets the car when it's new with a fair market value of $35,000. According to the IRS lease value table, the annual lease value of that car is $9,250.

Sarah's logs show that she drives the leased car a total of 15,000 miles this year, including 3,000 miles (20%) for personal use. Therefore, she has a personal use factor of 20%, so her personal use is valued at $1,850: 20% of $9,250.

Consequently, ABC reports that Sarah had $1,850 of taxable fringe benefits from her used car. Reimbursements for gasoline must be reported, too, at 5.5 cents per personal use mile. ABC must perform similar calculations and reporting for each employee who has personal use of a company car. Our office can help your company create a reporting system that complies with IRS regulations. ■

TAX CALENDAR

SEPTEMBER 2013

September 16

Individuals. If you are not paying your 2013 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2013 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in August if the monthly rule applies.

Corporations. File a 2012 calendar year income tax return (Form 1120), and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic six-month extension.

Deposit the third installment of estimated income tax for 2013. Use the worksheet Form 1120-W to help estimate tax for the year.

S corporations. File a 2012 calendar year income tax return (Form 1120S), and pay any tax due. This due date applies only if you timely requested an automatic six-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

OCTOBER 2013

October 15

Individuals. If you have an automatic six-month extension to file your income tax return for 2012, file Form 1040, 1040A, or 1040EZ, and pay any tax, interest, or penalties due.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in September if the monthly rule applies.

Electing large partnerships. If you were given an additional six-month extension, file a 2012 calendar year tax (Form 1065-B).

October 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2013. Deposit any undeposited tax. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 12 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than $500.

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