

# REITs (Real Estate Investment Trusts)--Still a Good Source for Dividend Income

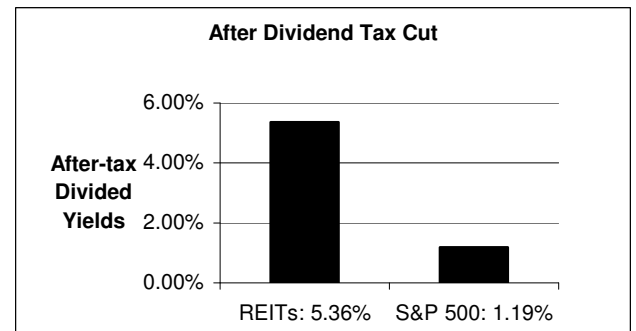
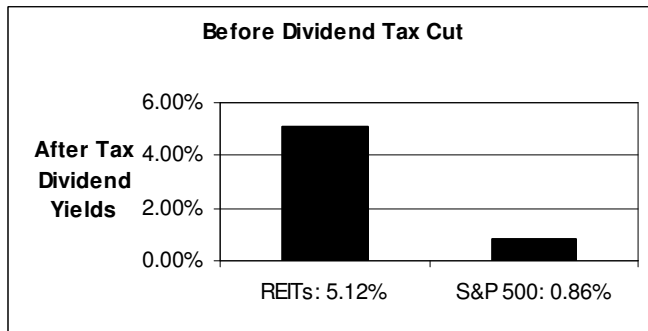
By Gary Case

Following President Bush's signing of the new tax-cut bill at the end of May, many investors with REIT stocks may wonder how their REIT dividends will stack up next to corporate stock dividends that will benefit from a lower tax rate. After all, the Bush Administration's most recent tax cut did shrink the maximum tax rate, so that now dividends and capital gains are taxed at the same 15% rate but REIT dividends aren't eligible for the tax cut on the whole, because REITs don't pay corporate taxes on their income.

But that's not the whole story. REIT dividends can still beat corporate stock dividends substantially, in terms of total yield, even after the tax cut on dividends. Here's why: There is still a huge differential between the after-tax dividend yield from REIT stocks and the after-tax dividend yield from corporate stocks.

Because REITs are *required* by law to pass through 90% of income to avoid corporate taxation, over the five-year period from 1997 to 2002, the average annual composite REIT yield, according to the National Association of Real Estate Investment Trusts, was nearly 7.5%, which is equivalent to 5.12% (before dividend tax cut), and 5.36% (after dividend tax cut). In comparison, the average yield of the S&P 500 (which represents a wide selection of corporate stocks) for those same five years was only 1.4%, which is equivalent to .86% (before dividend tax cut), and 1.19% (after dividend tax cut--See chart)

## 1997-2002 After Tax Dividend Yields



Source: Market Composite Index: S&P data: courtesy of Bloomberg

Keeping this wide differential in mind, many investors might begin to question how logical it is to switch their team allegiance from REIT stocks to corporate stocks for the sake of the 2003 tax cut on dividends. There's even the possibility that Congress may hold to the sunset provisions and let this tax break disappear in 2009. But that's not all there are a few other points that investors need to remember about corporate stock dividends:

1. Even though future trends cannot be divined from past history, corporate stocks historically have not provided yields nearly as strong as REIT stocks.
2. The majority of investors won't benefit from the tax break on dividends, because most investors' money is in IRAs and 401 (k)s, which aren't taxed. According to a *Wall Street Journal* report<sup>1</sup> earlier this year,

<sup>1</sup> The Wall Street Journal, "In Translation: Tax-Free Dividends Wouldn't Benefit All", January 12, 2003.

“Internal Revenue Service data show that only a small percentage of investors own a large amount of dividend-paying stock outside a retirement account.”

3. Not every corporate stock pays a dividend. According to Multex, a New York research firm, less than 25% of corporations currently pay dividends on their stocks<sup>2</sup>.

So, although the recently signed tax-cut legislation will benefit the small subset of investors who own corporate stocks that pay dividends, it won't benefit every investor. Nor does the tax cut even come close to eliminating the wide differential between the after-tax dividend yield of REIT stocks and corporate stocks. This favorable differential probably means that REIT stocks may continue to be a winning strategy for many investors.

In fact, to be sure that your portfolio is wisely allocated, it's still a good idea to leave a portion of your investments in REITs. As a recent *Money* magazine article concluded about REITs and the new tax plan: "... REITs will still offer a compelling after-tax payout. And history shows that a dose of real estate stocks can add stability to your overall portfolio. Once again, a tax-law change alone shouldn't dictate your investment strategy.”

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<sup>2</sup> Ibid.