NAV REITs: "RETURN OF CAPITAL" FOR TAX PURPOSES

A NAV REIT's "return of capital" for tax purposes is distinguishable from the general economic understanding of a "return of capital."

In the general economic sense, a "return of capital" is the return of a stockholder's own contributions to a fund's capital.

By contrast, a NAV REIT's "return of capital" for tax purposes typically relates to the depreciation expense the NAV REIT has deducted from gross income for U.S. income tax purposes.

A Simplified Example:

Assume a NAV REIT earns $1,000 in rental income and can take a $100 depreciation deduction on its property. The $100 depreciation deduction will reduce the NAV REIT's gross taxable income from $1,000 to $900.

- Depreciation here is a tax accounting concept. It does not necessarily represent an economic reduction in the property's value. Indeed, the property value might have increased over the same period.

If the NAV REIT distributes all of the $1,000 that it has earned to its stockholders, of that $1000, for U.S. federal income tax purposes, the REIT designates $900 as "ordinary income" and $100 as "return of capital."

The stockholder will have to pay ordinary income tax on the $900 but may defer income tax on the $100. (The stockholder must reduce the tax basis in her NAV REIT stock by $100.) The reduction in tax basis will likely cause the stockholder to recognize more taxable gain when she later disposes of her NAV REIT stock, but meanwhile the stockholder defers taxes and can benefit from the time value of money.

The NAV REIT's "return of capital" is thus typically a tax benefit to the stockholder who recognizes only $900 of taxable income on a $1,000 distribution when the distribution is paid out.

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