

IRS Blesses Stock Dividends from Certain RICs and REITs

*Paul D. Carman, Craig Cohen, Melanie J. Gnazzo, and Christie R. Galinski**

The authors of this article examine a recent guidance issued by the Internal Revenue Service that allows publicly offered real estate investment trusts and regulated investment companies to make stock distributions that qualify for the dividends-paid deduction.

The Internal Revenue Service (“IRS”) recently issued Rev. Proc. 2017-45, which allows publicly offered real estate investment trusts (“REITs”) and regulated investment companies (“RICs”) to make stock distributions that will qualify for the dividends-paid deduction, if certain requirements are met, and therefore enable a RIC or REIT to meet its minimum annual dividend distribution tests.

Among other requirements to make a stock dividend deductible, the distribution must provide shareholders with the option to receive a minimum cash component of at least 20 percent. Under this guidance, RICs and REITs are better able to preserve cash while still paying the dividends that are required under the tax law.

The new revenue procedure makes permanent guidance that has historically been

provided privately in letter rulings and is similar to previous public guidance that was issued during the financial crisis to help RICs and REITs save cash but which has now expired.

REITs, RICs, and Stock Distributions

REITs and RICs both have a distribution requirement. In order to keep their tax advantaged status, RICs must distribute at least 90 percent of their investment company taxable income, while REITs must distribute 90 percent of their real estate investment trust taxable income.

In addition, RICs must make a distribution of at least 98.2 percent of their ordinary income and capital gain net income to avoid excise taxes.

REITs are also required to make a distribu-

*Paul Carman (carman@chapman.com) is a partner and the Practice Group Leader of Chapman and Cutler LLP’s Tax Department. His practice focuses primarily on structuring the tax consequences of finance and investment transactions and investment vehicles. Craig Cohen (ccohen@chapman.com), a partner in the firm’s Tax Department, advises clients on a broad range of substantive U.S. tax issues, such as the taxation of capital markets transactions (including securitizations, structured finance and derivatives); cross-border financing; the formation and operation of private equity, real estate and hedge funds; and FATCA. Melanie J. Gnazzo (mgnazzo@chapman.com) is a partner in the firm’s Asset Securitization Department and Tax Department and a member of the Lease Finance Group. She also serves on the firm’s strategic planning committee and as the San Francisco Office Leader. Christie R. Galinski (galinski@chapman.com) is an associate in the firm’s Tax Department.

tion of 85 percent of their ordinary income and 95 percent of their capital gain net income to avoid excise taxes. If a REIT or a RIC merely credits shareholders with a dividend rather than actually distributing the dividend, ordinarily no deduction is allowed.

However, certain kinds of distributions of stock do not qualify as a dividend for purposes of calculating the distribution amount for the percentage tests above. For example, normally, a pro rata distribution that is solely of stock to existing shareholders is not treated as a distribution of property that qualifies as a dividend for tax purposes, and thus would not be included for purposes of measuring compliance with the minimum annual distribution tests above.

Also, except in the case of publicly offered REITs and RICs, a distribution is not included for purposes of the distribution tests unless it is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class.

In other words, according to the regulations, “every shareholder of the class of stock with respect to which the distribution is made must be treated the same as every other shareholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class.”

Many believe that so long as all shareholders are offered the same choice, the distribution should meet the pro-rata requirement. However, the IRS has not always agreed. Thus, even if a REIT or RIC makes a distribution that allows the shareholders to elect to receive stock or cash or a combination of the two, if the distribution is not treated as pro rata

it would not be a qualifying distribution for purposes of meeting the minimum distribution tests.

For REITs and RICs with significant non-cash taxable income or other liquidity issues, meeting the annual minimum distribution requirement can become a stumbling block for maintaining status as a REIT or RIC. However, Rev. Proc. 2017-45 allows a publicly offered REIT or a publicly offered RIC to make a distribution of stock that will qualify for purposes of the distribution requirements when certain requirements are met.

Qualifications for Stock Distributions

If a distribution of stock meets the following requirements, the IRS will treat the distribution as a dividend that qualifies for purposes of the distribution requirements.

First, the REIT or RIC must make the distribution to its shareholders with respect to its stock.

Second, under the declaration of the distribution, each shareholder must receive a cash-or-stock election with respect to all or part of the distribution.

Third, the distribution must offer at least 20 percent cash to shareholders.

Fourth, each shareholder, other than those that request a cash percentage exceeding the cash limitation provided in the declaration, must receive cash equal to the amount that such shareholder elected to receive.

Fifth, if the aggregate of all the shareholders' elected cash amounts does not exceed the cash limitation amount provided in the declaration, then each shareholder that requested

a cash percentage exceeding the limit must receive cash equal to their elected cash amounts.

Sixth, if the aggregate of all the shareholders' elected cash amounts does exceed the cash limitation amount provided in the declaration, then each shareholder that elected to receive a cash percentage exceeding the limit must receive an amount that is calculated based on a formula in the guidance (which generally scales back the cash distributed to those that elected more than the minimum percentage of cash so as to provide a pro rata reduction for all excess cash claimants based on *each excess cash claimant's share of the total excess claims of all shareholders.*)

Seventh, the calculation of the number of shares to be received by a shareholder is determined based on a formula that:

- (1) Utilizes the market share of prices;
- (2) Is designed so that the value of the number of shares to be received in lieu of cash corresponds to the amount of cash to be received with respect to that share; and
- (3) Uses data from a period of not more than two weeks ending as close as practicable to the payment date.

Additional Items

The ruling also provides two other important items.

First, the value of stock received by any shareholder in lieu of cash will be considered equal to the amount of cash for which the stock was substituted.

Second, if a shareholder participates in a dividend reinvestment plan, the stock received by that shareholder pursuant to the dividend reinvestment plan is treated as received in exchange for cash received in the distribution.

Previous Guidance

Rev. Proc. 2017-45 is similar to previous guidance (Rev. Proc. 2008-68, Rev. Proc. 2009-15, Rev. Proc. 2010-12) that was introduced during the financial crisis to help RICs and REITs that did not have sufficient cash to make the required distributions. That guidance was introduced in 2008 and eventually extended to cover distributions made before December 31, 2011. Rev. Proc. 2017-45 has no expiration date.

Definitions

A publicly offered REIT is a REIT which is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

A publicly offered RIC is a RIC the shares of which are continuously offered pursuant to a public offering, regularly traded on an established securities market, or held by or for no fewer than 500 persons at all times during the taxable year.

REITs and RICs Other Than Publicly Offered REITs and RICs

Rev. Proc. 2017-45 does not reach REITs and RICs other than publicly offered REITs and RICs, so the uncertainty for private REITs and RICs created by the current Code and Regulations continues.