SULLIVAN & CROMWELL LLP

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Cash Election Dividends Paid by Real Estate Investment Trusts and Regulated Investment Companies

IRS Revenue Procedure Eliminates Need for REITs and RICs to Obtain IRS Rulings on Cash Election Dividends

SUMMARY

On August 11, 2017, the Internal Revenue Service (the "IRS") issued Revenue Procedure 2017-45 (the "New Revenue Procedure"), which provides that certain stock distributions made by real estate investment trusts ("REITs") and regulated investment companies ("RICs") will be treated as taxable distributions for the purpose of determining both (1) the dividends-paid deduction of the REIT or RIC and (2) the treatment of the REIT's or RIC's shareholders. The New Revenue Procedure makes permanent similar, temporary guidance previously issued by the IRS that expired after 2012. Unlike the earlier guidance, the New Revenue Procedure requires that a greater minimum amount of cash (at least 20%) be received by shareholders as part of the stock distributions.

BACKGROUND

REITs and RICs are generally required to distribute at least 90% of their taxable income.[1] A REIT or RIC that does not meet the distribution requirement will not be entitled to a dividends-paid deduction and thus may become subject to entity-level taxation. The distribution requirement may make a REIT or RIC dependent on capital markets for the majority of its expansion funding and other cash needs. In certain periods, however, some REITs and/or RICs may experience cash-flow challenges and may seek to fulfill the distribution requirement with a distribution that consists primarily of stock, rather than a distribution made entirely in cash.

While the gross income of a shareholder does not generally include distributions of additional shares made by a corporation to its shareholders, a statutory exception treats a stock distribution as taxable if the distribution may, at the election of any shareholder, be paid in stock or cash.[2] Under applicable regulations published by the IRS and the Treasury Department,[3] if any shareholder may elect whether a distribution is made in cash or, alternatively, in stock or other securities of the corporation, that distribution is treated as a taxable distribution of property and a dividend to the extent the distribution is paid out of the earnings and profits of the corporation.[4]

The IRS previously issued a series of revenue procedures intended to provide relief to REITs and RICs during the economic downturn that began in 2008 (the "Old Revenue Procedures").[5] The Old Revenue Procedures provided that the IRS would treat certain stock distributions made by REITs and RICs as taxable dividends and applied to distributions that were declared in calendar years 2008 through 2012 with respect to taxable years ending on or before December 31, 2011.

Qualification for the benefits of the Old Revenue Procedures required, among other things, that: (1) the REIT or RIC was publicly traded on an established securities market in the United States; (2) the distribution permitted shareholders to elect the receipt of either cash or stock subject to a cap on the cash amount (the "Cash Limitation" and, expressed as a percentage of the aggregate, declared distribution, the "Cash Limitation Percentage"), which could limit the total amount of cash to as little as 10% or more of the declared distribution; (3) the amount of stock distributed to a shareholder that received stock in lieu of cash was determined using a formula that equated the value of the stock received with the amount of cash that would have otherwise been payable; and (4) if the cash option was oversubscribed, each shareholder electing cash would receive an amount of cash based on the shareholder's pro rata share of the total cash entitlement available under the declaration (and thus never less than 10% of the shareholder's entitlement).

Since the expiration of the Old Revenue Procedures, entities seeking to maintain REIT or RIC status or make a REIT or RIC election often sought private letter rulings from the IRS to the effect that an elective distribution of stock or cash, subject to limitation on the amount of cash, will be a taxable distribution.[6] We understand that these rulings generally have provided that the lower limit on cash distributions would be at least 20% of the total dividend.

REVENUE PROCEDURE 2017-45

The New Revenue Procedure generally extends the Old Revenue Procedures to stock distributions declared on or after August 11, 2017. Significantly, the New Revenue Procedure uses a 20% Cash Limitation Percentage when compared to 10% under the Old Revenue Procedures (i.e., the New Revenue Procedure adopts the 20% minimum cash amount reflected in the more recent IRS rulings).

A stock distribution qualifies under the New Revenue Procedure if the following conditions are met:

- The distribution is made by a "Publicly Offered REIT" or a "Publicly Offered RIC," as those terms are defined in the Code, with respect to its stock;[7]
- Pursuant to the declaration of the distribution, each shareholder is entitled to elect to receive part or all of its distribution in either cash or stock;
- The Cash Limitation Percentage is not less than 20%;
- Every shareholder that elects to receive cash in a percentage less than or equal to the Cash Limitation Percentage will receive cash equal to the amount of cash elected by such shareholder;
- If the aggregate cash amount is not limited by the Cash Limitation, each shareholder will receive cash equal to the amount of cash elected by such shareholder;
- If the aggregate cash amount is oversubscribed (i.e., limited by the Cash Limitation), each shareholder electing to receive cash in a percentage more than the Cash Limitation Percentage will receive a pro rata amount of cash that (i) is "as close in amount as practicable" to that shareholder's relative entitlement and (ii) is at least the Cash Limitation Percentage multiplied by that shareholder's total entitlement;
- The number of shares that are received by any shareholder receiving property will be determined based upon a formula that (i) utilizes the market value of the shares, (ii) is designed so that the value of the shares distributed "corresponds as closely as practicable" to the amount of cash that would otherwise be paid and (iii) "uses data from a period of no more than two weeks ending as close as practicable to the payment date"; and
- The distribution is declared on or after August 11, 2017.

Under the New Revenue Procedure, the value of the stock received by any shareholder in lieu of cash will be considered to be equal to the amount of cash for which the stock is substituted, using the formula described above. For purposes of the New Revenue Procedure, 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.

In addition, the New Revenue Procedure provides that the ability of shareholders to elect to receive part of their distributions in either cash or stock does not affect the federal income tax treatment of any portion of the distributions that is not subject to the election.

* * *

ENDNOTES

1 Sections 857(a)(1) and 852(a)(1) of the Internal Revenue Code of 1986, as amended (the "Code"). A REIT must also distribute at least 90% of its net income from foreclosure property, but may reduce the required distribution by excess non-cash income, and a RIC must also distribute at least 90% of its net tax exempt income.

2 Moreover, Code Section 305(b)(2) provides that Code Section 305(a) does not apply to distributions that result in the receipt of property by some shareholders and cause the proportionate interests of other shareholders in the corporation's earnings and profits to increase.

3 Treasury Regulations Section 1.305-2.

4 Code Section 316(a).

5 Rev. Proc. 2010-12, 2010-3 I.R.B. 302; Rev. Proc. 2009-15, 2009-4 I.R.B. 356; Rev. Proc. 2008-68, 2008-52 I.R.B. 1373. Discussions of these revenue procedures can be found in the Sullivan & Cromwell LLP publications entitled "Real Estate Investment Trusts and Regulated Investment Companies: IRS Extends for Two Years Existing Guidance on Stock Distributions by Publicly Traded Real Estate Investment Trusts and Regulated Investment Companies" (December 23, 2009), "Regulated Investment Companies: IRS Extends Guidance on Stock Distributions to Publicly Traded Regulated Investment Companies" (January 12, 2009) and "Real Estate Investment Trusts: IRS Issues Temporary Guidance on Stock Distributions by Real Estate Investment Trusts" (December 10, 2008), each of which can be obtained by following the instructions at the end of this publication.

6 *See, e.g.*, PLR 201631005 (May 2, 2016) (requested by a REIT); PLR 201552011 (Dec. 24, 2015) (requested by a RIC).

7 A "Publicly Offered REIT" means a REIT that is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934. Code Section 562(c)(2). A "Publicly Offered RIC" is generally defined as a RIC the shares of which are continuously offered pursuant to a public offering (within the meaning of section 4 of the Securities Act of 1933, as amended), regularly traded on an established securities market, or held by or for no fewer than 500 persons at all times during the taxable year. *See* Code Section 67(c)(2)(B)(i).

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