New Flexibility Comes To REIT Earnings Distribution

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Law360, New York (September 1, 2017, 11:31 AM EDT) -- On Aug. 11, 2017, the Internal Revenue Service released guidance allowing publicly offered real estate investment trusts and regulated investment companies to distribute earnings in a combination of cash and stock as long as shareholders are able to elect to receive cash or stock and the aggregate amount of cash available is at least 20 percent of the total dividend. To the extent shareholders elect to receive more cash than is available, each shareholder who elects to receive all cash must receive a pro rata share of the cash and the rest of the distribution in stock. The number of shares to be issued is calculated using market trading prices from some period within the two weeks prior to the dividend payment date. Because the entire amount of the distribution is taxable to shareholders regardless of the amount of stock they receive, both the cash and the stock amounts count toward satisfying the REIT and RIC distribution requirements for U.S. federal income tax purposes.

The new revenue procedure is based on long-standing provisions of the Internal Revenue Code and consistent with more than 50 private letter rulings that the IRS has routinely issued to REITs and RICs. Stock/cash dividends are most commonly used by companies when converting to REIT status, an event that requires a fully taxable dividend purge of all historic C corporation earnings and profits. Companies that have operated as C corporations for years before their REIT conversion often have a substantial E&P purge requirement. Some REITs also use the stock/cash dividend method to distribute the accumulated earnings and profits of an acquired C corporation, while others find the method helpful in satisfying the annual REIT distribution requirement. The latter is often in connection with the receipt of phantom income, including original issue discount and market discount on certain real estate mortgages and income or gain recognized in connection with the restructuring of real estate mortgages. The new guidance will allow REITs and RICs that would like to issue 80/20 stock/cash dividends to avoid the filing fee, drafting expense and approximately six-month delay associated with obtaining a private letter ruling.

The guidance applies to REITs that are required to file annual and periodic reports with the U.S. Securities and Exchange Commission and RICs whose shares are continuously offered pursuant to a public offering, regularly traded on an established securities market, or held by at least 500 persons throughout the taxable year. This limited scope means that some private REITs and RICs, which often use a consent dividend election to make taxable noncash dividends (a method that is unavailable to public companies), would still need to obtain a private letter ruling to use a stock/cash dividend to satisfy their distribution requirements.

Historically, the IRS has issued three similar revenue procedures allowing REITs and RICs to use the stock/cash dividend method for meeting their distribution requirements. This guidance was in effect for the 2008 through 2011 taxable years and allowed up to 90 percent of the dividend to be made in stock (as long as the shareholder election mechanism was used), which provided REITs and RICs with relief during the financial crisis. The new revenue procedure has no sunset on its applicability and should alleviate IRS resource constraints (i.e., avoiding the allocation of resources to issuing what has become a very routine private letter ruling).

The language of the revenue procedure is very different from that used in the prior private letter rulings and revenue procedures on this topic. The new text is complex, using a host of defined terms and formulas to reach a result consistent with the prior rulings and revenue procedures. The revenue procedure is silent on some points, such as how to treat a shareholder who does not return an election form. REITs and RICs should carefully consider the terms of the shareholder election process, including whether to treat a shareholder who fails to timely return a valid election form as having elected to receive cash or stock. Private letter rulings on the topic explicitly left this decision to the distributing company’s discretion, and, in practice, companies take varying approaches. In addition, REITs and RICs desiring significant additional flexibility in their dividend declaration mechanics might consider seeking a private letter ruling notwithstanding the existence of this revenue procedure.

In light of the additional flexibility afforded under this guidance, a publicly offered REIT or RIC should consider whether to update its disclosure to indicate if it intends to continue to pay cash dividends or to take advantage of the ability to distribute earnings in a combination of cash and stock. Any intended payment of stock/cash dividends will also likely require an update of existing disclosure of the tax implications of investing in the applicable REIT or RIC. In addition, payment of stock/cash dividends will require coordination with the applicable exchange on which the respective REIT or RIC shares are traded.

Key Takeaways

- New IRS guidance provides REITs and RICs with greater flexibility for distributing their earnings partially in stock to save cash while satisfying their distribution requirements and avoiding the expense and delay of seeking a PLR

- Changes to public disclosure should be considered, especially for REITs and RICs that are considering taking advantage of the increased flexibility

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