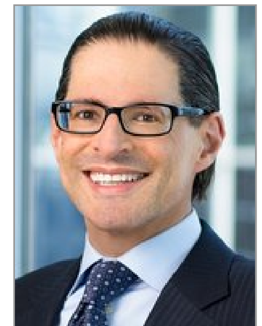
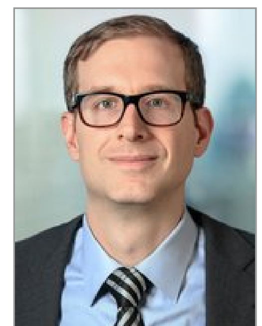
Cash Management For REITs And Funds In Uncertain Times

By **David Levy, Nickolas Gianou and Sarah Beth Rizzo** (March 25, 2020, 4:32 PM EDT)


David Levy


Nickolas Gianou

Sarah Beth Rizzo

Although we are only at the beginning stages of what is shaping up to be a significant downturn, capital market conditions have already made it challenging, and in some cases impossible, for healthy companies to raise equity capital.

The current choppiness in equity capital markets highlights one of the largest drawbacks to real estate investment trust and regulated investment company status: the requirement to distribute at least 90% of ordinary income and short-term capital gains[1] each year.

Given their inability to retain earnings, REITs rely on frequent equity offerings to acquire and develop assets and to operate, with at-the-market programs providing nearly instantaneous execution of equity offerings. Similarly, RICs — which include most mutual funds and business development companies, many of which function as commercial lenders — often rely on equity offerings to make new investments, and in the case of RICs that have incurred indebtedness or issued preferred equity, strict asset coverage requirements under the Investment Company Act obligate such RICs to closely manage their capital.

Based on developments in the equity capital markets as of this writing, now is a good time for many REITs and RICs to consider options to preserve liquidity.

Deferring Monthly or Quarterly Distributions

Although publicly traded REITs and RICs generally pay dividends on a monthly or quarterly basis, the tax law permits REITs and RICs to make distributions on an annual basis, and specifically allows a REIT or RIC to pay a dividend in January and use that dividend to satisfy the prior year's distribution requirement with no excise tax consequences. Depending on how the current situation develops, deferring any remaining 2020 dividends until January 2021 may be a sufficient cash management strategy for some REITs and RICs.

Cash/Stock Dividends

The IRS has for decades issued private letter rulings to REITs and RICs that permitted them to pay a dividend partly in cash and partly in shares of stock, so long as at least 20% of the total distribution was payable in cash. Because the entire amount of a dividend is taxable regardless of the amount of stock a shareholder receives, both the cash and the stock components of the dividend count toward satisfying the REIT and RIC distribution requirements.

During the 2008 financial crisis, the IRS issued guidance that temporarily allowed REITs to make such cash/stock dividends with a lower cash cap of 10% in tax years 2008 through 2011. The ability to satisfy up to 90% of the distribution requirement by issuing shares of stock proved to be a significant lifeline for a number of publicly traded REITs and RICs. Given the current environment, the

National Association of Real Estate Investment Trusts has proposed that the IRS consider a similar relief measure.

Under generally applicable guidance issued by the IRS, any publicly traded REIT or RIC may satisfy its annual distribution requirements, including those relating to capital gains, through cash/stock dividends without having to obtain a private letter ruling. Under the guidance, the cash/stock dividend is effected as follows:

- The REIT or RIC declares a dividend that is payable at the election of each shareholder in cash or stock (sometimes with an option to receive a combination of the two), subject to an aggregate cash cap that is not less than 20% of the entire distribution.[2]
- Each shareholder who chooses to receive all stock generally receives the full amount of its entitlement in stock.
- If shareholders in the aggregate elect to receive an amount of cash less than or equal to the cash cap, then each shareholder who elects cash will receive the amount of cash elected.
- If shareholders in the aggregate elect to receive an amount of cash that exceeds the cash cap, then the cap kicks in such that each shareholder who elected to receive cash would receive a pro rata share of the cash and the rest of the distribution in stock.

The structure is generally intended to provide all shareholders the same per-share dividend, on a value basis, whether they receive cash, stock or a combination of the two.

Stock issued in connection with a cash/stock dividend is generally valued based on a trailing average price formula. While market volatility does not affect the ability of a REIT or RIC to execute a cash/stock dividend, the accompanying disclosure materials, among other things, should focus investors' attention on the impact of volatility on their decisions to choose to receive their distribution in the form of REIT or RIC stock or cash.

In our experience, the vast majority of investors who submit election forms choose to receive their dividends entirely in cash. In situations where all investors submit cash election forms, the dividend payout formula will result in all shareholders receiving their distribution as 20% cash and 80% stock, which means that the cash/stock dividend strategy functions analogously to a pro rata cash dividend coupled with a pro rata stock split.

Two other aspects of the cash/stock dividend strategy are interesting in light of the current situation. First, during the 2008 crisis, a number of REITs and RICs considered converting to taxable C-corporation status to retain earnings, albeit at the expense of losing certain aspects of analyst coverage and inclusion in stock indices that are limited to REITs and RICs.

Given that the IRS' minimum cash cap on a cash/stock dividend is 20% and the corporate tax rate is 21%, an entity can use the cash/stock dividend approach to place itself in an analogous situation without sacrificing analyst coverage or inclusion in these indices.

Additionally, if the U.S. Department of the Treasury responds favorably to National Association of Real Estate Investment Trusts' request to temporarily reduce the cash cap from 20% to 10%, the cash/stock dividend strategy will be far more favorable for REITs and RICs than would be converting to C-corporation status. Moreover, the cash/stock dividend approach enables an entity to avoid the potentially significant state income tax liability that it would incur if it converted to a C corporation.

Second, an entity can manage cash by combining the cash/stock dividend strategy with the January dividend strategy described above to reduce the frequency with which it needs to issue a cash/stock dividend. If a REIT or RIC were to pursue this approach, it would declare a cash/stock dividend in the fourth quarter of 2020 and issue the cash and stock in January of 2021.

In that circumstance, if the amount of the January 2021 distribution exceeds the remaining undistributed 2020 taxable income, the excess is treated as a distribution that counts towards the

2021 distribution requirement. For a REIT or RIC desiring maximum flexibility going forward, one sufficiently large cash/stock dividend paid in January of 2021 can enable the entity to retain 80% of its 2020 and 2021 taxable income.

Asset Dispositions

REITs and RICs that require more cash than their operations produce can consider both taxable and tax-deferred asset dispositions as a capital-raising strategy. In the case of a taxable asset disposition, an entity can satisfy the distribution requirement attributable to recognized gains by using the cash/stock dividend strategy described above. Tax-deferred dispositions, by their nature, do not implicate the distribution requirement, which is tied to taxable income and gains. Due to the prevalence of real estate joint venture transactions, tax-deferred transactions are more commonly effected by REITs than RICs.

In analyzing whether to structure an asset disposition as a taxable or tax-deferred transaction, decision makers should consider the 100% prohibited transition tax imposed on gain recognized by a REIT on a sale of dealer property.[3] The status of an asset as dealer property is determined under an inherently uncertain facts-and-circumstances analysis.

To provide REITs with certainty on the application of the prohibited transaction tax, the rules contain several safe harbors, which generally allow a REIT to sell an asset without incurring the prohibited transition tax if the asset has been held for at least two years for the production of rental income and certain other requirements are satisfied, including requirements relating to the annual number of sales made by the REIT and the magnitude of the sales relative to the REIT's entire portfolio.

Even in situations where an asset is not eligible for a safe harbor, the REIT may be able to assert that the asset is not dealer property if the REIT can establish that it intended to hold the property for rental income at the time the property was acquired and that its decision to sell the property was driven by changes in market conditions brought about by the current crisis.

Depending on the situation, a REIT that desires to raise money through taxable asset sales while retaining control over its assets may pursue one of the following options.

Sale-Leaseback: Land and Building

A REIT could sell both a building and the land beneath it to a buyer and then lease the property back. The REIT can then redeploy the sales proceeds as it sees fit while retaining occupancy of the building. Rental payments made by the REIT under the lease will behave in a similar way to a long-term amortizing mortgage.

Sale-Leaseback — Land Only

If a REIT encounters difficulty in executing a sale/leaseback as described above — e.g., due to issues with an existing tenant — it may be able to retain ownership of the building while executing a sale/leaseback of the land beneath a building. In this arrangement, the REIT would sell the land beneath the building to a capital provider and lease the land back from the capital provider with 99 years representing a market ground lease term.

The REIT thereby obtains immediate cash equal to the value of the land beneath the building, and the ground lease payments made by the REIT to the capital provider function similarly to a long-term senior mortgage. This structure works best in situations where the building is either not subject to indebtedness or subject to indebtedness that can be repaid without a significant prepayment penalty.

The transactions described above are taxable, meaning that any gain recognized by the REIT on the sale transaction will be factored into the REIT's annual distribution requirement. If a REIT wants to raise capital while avoiding the distribution requirement altogether, it may pursue a leveraged joint venture, whereby the REIT contributes an asset to a joint venture while a third-party capital provider contributes cash to be used by the joint venture for development, operations or debt service/repayment.

The joint venture would then borrow money from a third-party lender and make a non-pro rata cash

distribution to the REIT, and the REIT would guarantee the underlying indebtedness. In this arrangement, the REIT is eligible for rollover treatment on the property contribution and deferral treatment on the cash distribution, meaning that the structure operates as an immediate cash-raising transaction without a related distribution requirement.

Conclusion

Current conditions will present publicly traded REITs or RICs with the same types of cash management challenges as the 2008 crisis. The strategies outlined above and their variations can begin a cash management conversation that better position REITs and RICs for the immediate future.

David Levy and Nickolas Gianou are partners, and Sarah Beth Rizzo is counsel at Skadden Arps Slate Meagher & Flom LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] In addition, REITs and RICs generally attempt to distribute 100% of their income and capital gains because any retained amounts are subject to corporate-level tax.

[2] Although the cash cap may be any number larger than 20%, REITs typically set the limit at 20% to preserve as much cash as possible.

[3] This penalty tax does not apply to RICs.