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The Use of Elective Stock Dividends by a Publicly Offered REIT – What to Consider

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Should a widely held real estate investment trust (“REIT”) use elective stock dividends in an effort to build up cash reserves? Before engaging in this form of tax planning, REITs would benefit from a high-level summary of the process and an evaluation of the underlying considerations.

A REIT is required to distribute at least 90 percent of its “ordinary” taxable income (subject to adjustments for certain “non-cash” items) and is then subject to a corporate level tax on any undistributed taxable income, which may include net capital gain. Ordinarily, this minimum distribution requirement is satisfied via a cash dividend declared and paid by the REIT. Because of this distribution requirement, investors looking for current yields as well as capital appreciation choose the REIT structure; and, publicly traded REIT stock tends to trade at a higher multiple than a real estate company structured as a C corporation, which is not obligated to make cash distributions. In fact, many publicly traded REITs promote increases in their dividend rates; provided that a good portion of those cash distributions are supported by taxable earnings (and are not merely depleting capital).

In light of the immediate effects of the current coronavirus (COVID-19) pandemic on REIT tenants, many publicly traded REITs are exploring ways to build up cash reserves, either in response to their own liquidity issues or in preparation for investment opportunities. Some might have preliminarily

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concluded that because the effects of the coronavirus on their operations are so severe (including temporary closures, voluntarily or involuntarily), they likely would have little or no taxable income for 2020. Because of the projected reduction in taxable income and the availability of other tax planning, some REITs may not have the need to maintain the same dividend policy. Accordingly, some publicly traded REITs have already announced a suspension or reduction of future dividends on their common stock. At the same time, at least one REIT has announced that it intends to use elective stock dividends (as described below) to satisfy the distribution requirement and generate a dividends paid deduction to retain capital and enhance financial flexibility.¹

Note: The intent of this article is not to advocate whether a widely held REIT should or should not use the elective stock dividends; rather, it merely summarizes how it works at a high level and certain other considerations we address in our typical discussions with clients that are evaluating this form of tax planning.

Generally speaking, distributing shares of a corporation's common stock proportionately to all shareholders does not cause shareholders to realize dividend income and, thus, does not give a REIT a deduction for dividends paid for U.S. federal income tax purposes. However, among other exceptions, this general rule does not apply to a distribution that is, at the election of any shareholder, payable either in stock or property (including money). These elective stock dividends provide a means for REITs to make dividends partially in stock, permitting them to retain cash while still meeting their 90 percent distribution requirement and generating a deduction for dividends paid.

The elective stock dividend exception is broad enough to allow a REIT to take into account cash dividends reinvested into shares for purposes of the distribution requirement.² C corporations that have converted to REITs have also used this approach to purge earnings and profits ("E&P") accumulated during non-REIT years. Because the effectiveness of elective stock dividends at purging non-REIT E&P affects an entity's ability to qualify as a REIT, several C corporations requested rulings from the IRS, which as a policy has required the cash component to be no less than 20 percent of the entire distribution.³ Some publicly traded REITs also requested letter rulings confirming that the use of elective stock dividends would not result in preferential dividends, which were applicable to them before 2015. In these situations, the minimum cash component remained at 20 percent of the total distribution.⁴

In response to the 2008 financial crisis, the IRS published revenue procedures both clarifying the process by which a publicly traded REIT would undertake an elective stock dividend and temporarily reducing the minimum cash component to 10 percent.⁵

¹ Press release: <https://www.sec.gov/Archives/edgar/data/912242/000119312520074958/d890877dex991.htm>.

² See PLR 9731007; PLR 199837008; PLR 200052031.

³ See PLR 201320007; PLR 201431020; PLR 201537020.

⁴ See PLR 200122001; PLR 201503010.

⁵ See Rev. Proc. 2010-12, *amplifying and superseding* Rev. Proc. 2009-15 (extended by two years the elective stock dividends by publicly traded REITs (i.e., distribution being declared on or before December 31, 2012, with respect to a tax year ending on or before December 31, 2011)).

On August 11, 2017, the IRS issued Revenue Procedure 2017-45 providing a safe harbor regarding the use of elective stock dividends by “publicly offered” REITs and “publicly offered” regulated investment companies (“RICs”). For this purpose, 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 (including both listed and non-listed REITs). Revenue Procedure 2017-45 continues the administrative policy of the IRS for issuing private letter rulings by requiring a distribution of cash at not less than 20 percent of the aggregate declared distribution, under which shareholders may elect to receive the distribution in stock or cash. Revenue Procedure 2017-45 also requires the calculation of the number of shares to be received by any shareholder in connection with the cash/stock distribution to be determined over a period of up to two weeks ending as close as practicable to the payment date.

Pursuant to Revenue Procedure 2017-45, if the conditions are satisfied, the IRS will treat the distribution of stock as a distribution of property to which section 301 applies by reason of section 305(b) (i.e., a taxable distribution).⁶ Further, 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. As neither a publicly offered REIT nor a publicly offered RIC is subject to the preferential dividend rule of section 562(c) after 2014, Revenue Procedure 2017-45 does not cover this situation.⁷ Recently, Nareit submitted a letter to Congress lobbying for a temporary reduction of the minimum cash component of an elective stock dividend to 10 percent similar to the temporary guidance following the 2008 financial crisis. In response to the request and in recognition of the need for enhanced liquidity, the IRS on May 4, 2020, released Revenue Procedure 2020-19 modifying the safe harbor provided in Revenue Procedure 2017-45 by temporarily reducing the minimum cash component to not less than 10 percent. This temporary relief is effective only with regard to distributions declared by a publicly offered REIT or publicly offered RIC on or after April 1, 2020, and on or before December 31, 2020.

One consequence of an elective stock dividend that may not be apparent: If a REIT wants to maintain the same dividend rate per share following the dividend, it will likely have greater dividend distributions in the future because there will be more shares outstanding. This dilutive effect could be sizable considering that the stock prices of most publicly traded REITs have declined significantly over the past two weeks. In fact, one publicly traded REIT recently suspended its dividend reinvestment and stock purchase plan “to reduce dilution of stockholder value given prevailing market prices,” and, at the same time, announced a stock repurchase plan for up to \$200 million.⁸ To this end, it is worth noting that in

⁶ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

⁷ In comparison, in PLR 201516047 issued prior to the PATH Act, which exempts publicly offered REITs from the preferential dividend rule, the IRS determined, among other things, “if, under those terms, a shareholder receives a combination of stock and money that differs from the combination received by another shareholder and if the fair market value of the stock on the date of distribution differs from the amount of money which could have been received instead, those differences will not cause the distribution to be considered preferential under section 562(c).”

⁸ Press release: <https://www.sec.gov/Archives/edgar/data/888491/000088849120000015/ohi-20200320ex991d74732.htm>.

early 2019 one publicly traded REIT followed an elective stock dividend with a reverse stock split “to neutralize the dilutive impact of the stock to be issued in the special dividend that was announced.”⁹

Another issue to be considered is the effects on REIT shareholders. The purpose of an elective stock dividend is to enable a publicly offered REIT to preserve cash (i.e., 80 percent or potentially up to 90 percent) for liquidity and investment purposes. However, depending on the tax bracket of an individual shareholder, the shareholder may actually need cash from elsewhere to cover tax liabilities on the elective stock dividend even if the dividend is eligible for a 20 percent deduction under section 199A. A similar issue exists for a foreign shareholder that is subject to fixed, determinable, annual or periodic (FDAP) withholding. In the event the minimum total cash component of an elective stock dividend is reduced to 10 percent, even foreign shareholders that benefit from a reduced withholding rate of 15 percent under a relevant income tax treaty will need to tap other sources to satisfy the tax burden incident to the elective stock dividend. Finally, to the extent the shareholder is a RIC, the RIC itself also faces a minimum distribution requirement; thus, an earlier announcement of a planned elective stock dividend would be helpful.

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⁹ Press release: https://www.sec.gov/Archives/edgar/data/922864/000092286419000005/press_releasexforxreversex.htm.