Latham & Watkins REIT Practice

August 18, 2017 | Number 2199

IRS Provides Guidance on Stock Distributions for Publicly Offered REITs and RICs

Revenue procedure sets forth requirements for ensuring certain stock distributions are treated as property distributions eligible for dividends paid deduction.

On August 11, 2017, the Internal Revenue Service (IRS) published Revenue Procedure 2017-45, which provides guidance on when it will treat stock distributions by certain real estate investment trusts (REITs) and certain regulated investment companies (RICs) as distributions of property under Section 301 of the Internal Revenue Code (Code). Stock distributions eligible for this treatment may constitute dividends under Section 301 and increase the amount of the REIT's or the RIC's dividends paid deduction.

Background

In order to qualify as a REIT or RIC for US federal income tax purposes, a company must meet a number of requirements, including various tests related to the nature of its organization, assets, and income, and a requirement that its "dividends paid deduction" (*i.e.*, generally, the dividends it pays or is deemed to pay) must equal or exceed 90% of its taxable income for the taxable year, subject to certain adjustments. The dividends paid deduction allows the company to deduct from its taxable income the amount of dividends that it pays (or is treated as paying) to its shareholders. This treatment substantially eliminates the "double taxation" that ordinarily results from investing in a typical C corporation.

The dividends paid deduction equals the sum of all distributions of property that Section 301 of the Code treats as dividends. These dividends are included in the recipient shareholders' gross income in accordance with applicable tax rules. Generally, distributions of stock by a corporation to its shareholders with respect to its stock are not distributions of property under Section 301 of the Code that are treated as dividends, and are not included in the gross income of such shareholders. As a result, such stock distributions do not produce a dividends paid deduction. However, pursuant to Section 305(b) of the Code, a stock distribution *is* treated as a distribution of property pursuant to Section 301 if the shareholders may elect to have the distribution payable either in stock or property (*e.g.*, cash), or if the distribution is disproportionate, such that it results in some shareholders receiving property and others increasing their proportionate interest in the corporation's assets or earnings and profits.

Analytical Framework

A distribution of stock that meets all the requirements of Revenue Procedure 2017-45 (described below) will be treated as a distribution of property to which Section 301 of the Code applies by reason of Section 305(b). As such, the stock distribution will produce a dividends paid deduction equal to the value of the stock. In general, the value of the stock that a shareholder receives in lieu of cash will be treated as equal to the amount of cash that the shareholder would have received in the distribution had it not received stock.

Requirements

- A publicly offered REIT or a publicly offered RIC makes a distribution to its shareholders with respect to its stock.
  - A publicly offered REIT is a REIT that 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 either 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 any time during the taxable year.
- Each shareholder has a cash or stock election with respect to part or all of the stock distribution.
- The maximum aggregate amount of cash that shareholders may elect to receive in the distribution (the Cash Limitation Amount) is no less than 20% of the total distribution (the Cash Limitation Percentage).
- Every shareholder who elects to receive a percentage of their distribution in cash which is not more than the Cash Limitation Percentage receives that amount in cash.
- If the aggregate amount of all shareholders' elections to receive the distribution in cash does not exceed the Cash Limitation Amount, then all shareholders that elect to receive cash receive that amount in cash.
- If the aggregate amount of all shareholders' elections to receive the distribution in cash exceeds the Cash Limitation Amount, then all shareholders who elect to receive a percentage of their distribution in cash that is more than the Cash Limitation Amount receive a proportionate share of the cash based on the formula provided in the revenue procedure (described below).
- The number of shares that a shareholder receives is calculated based upon a formula that:
  - Uses the market price of the shares
  - Is designed so that the value of the number of shares to be received in lieu of cash with respect to a share corresponds as closely as practicable to the amount of cash to be received under the declaration with respect to that share
  - Uses data from a period of no more than two weeks ending as close as practicable to the payment date

Impact

Previously, publicly offered REITs and RICs would frequently request a private letter ruling from the IRS to confirm that a distribution of stock would be treated as dividend eligible for the dividends paid deduction. As a result of this new guidance, publicly offered REITs and RICs will be able to pay stock dividends knowing that, if the requirements of the revenue procedure are met, the company will be entitled to a dividends paid deduction with respect to the distribution without seeking such a ruling, which should reduce the administrative burden on both taxpayers and the IRS.

The revenue procedure is effective for distributions declared on or after August 11, 2017.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Michael J. Brody
michael.brody@lw.com
+1.213.891.8724
Los Angeles

Ana G. O'Brien
ana.obrien@lw.com
+1.213.891.8721
Los Angeles

Pardis Zomorodi
pardis.zomorodi@lw.com
+1.213.891.7805
Los Angeles | Century City

Alan B. Beadle
alan.beadle@lw.com
+1.213.891.8671
Los Angeles

You Might Also Be Interested In

Treasury Department Issues Final Regulations on Real Property Definition for REIT Purposes

US Tax Court Exempts Gain on Sale of a Partnership Interest

US Tax Reform Resource Center
