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IRS Extends Favorable Stock Dividends Guidance to RICs

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In December 2008, the Internal Revenue Service (the ***"IRS"***) issued Revenue Procedure 2008-68, providing temporary guidance regarding certain stock distributions by publicly traded real estate investment trusts (***"REITs"***). The taxpayer-favorable guidance gave publicly traded REITs greater flexibility to satisfy their tax-related distribution requirements while conserving cash in an illiquid market. On January 7, 2009, the IRS issued Revenue Procedure 2009-15 (the ***"Procedure"***), extending its prior guidance to publicly traded regulated investment companies (***"RICs"***). Effective January 1, 2008 and for taxable years ending on or before December 31, 2009, the IRS will treat a distribution of stock by a publicly traded REIT or RIC pursuant to certain elections to receive stock or cash as a taxable distribution of property. The Procedure only applies to a REIT or RIC publicly traded on an established U.S. securities market. The amount of the stock distribution will be treated as equal to the amount of cash that could have been received instead. Under the Procedure, REITs and RICs can limit the aggregate amount of cash available to shareholders pursuant to the election to 10 percent of the aggregate distribution of cash and stock taken together. Given the requirement that a REIT or RIC be publicly traded on an established securities market, the Procedure generally will not apply to open-end mutual funds, and will only apply to ETFs and closed-end funds that are traded on a U.S. exchange rather than in the over-the-counter market.

Under the Internal Revenue Code (the ***"Code"***), REITs and RICs must distribute to their shareholders each year their taxable income to minimize the imposition of taxes. Only taxable distributions of property satisfy this distribution requirement. Although a REIT or RIC might normally distribute cash to its shareholders, given current market conditions and liquidity constraints, REITs and RICs can conserve capital through taxable distributions of stock. While *pro rata* distributions of stock to shareholders often are nontaxable, under Section 305(b)(1) of the Code such distributions become taxable when shareholders have the option to elect between receiving stock or cash. REITs and RICs have sometimes relied on this Code provision to issue taxable stock distributions intended to count favorably toward satisfaction of the tax-related distribution requirements. In some instances, the aggregate amount of cash available pursuant to such an election has been limited, for example, so that the maximum cash payable could not exceed 20 percent of the aggregate distribution of cash and stock taken together.

Among other things, limiting the amount of cash available pursuant to a cash-or-stock election casts some doubt on the application of Section 305(b)(1), particularly when the limit is low. The IRS has issued a number of favorable private letter rulings to REITs addressing 20 percent cash limitations. Provided the distribution falls within its strictures, the Procedure temporarily obviates the need to seek such rulings and allows a more generous 10 percent cash limitation.

In pertinent part, the Procedure provides a distribution of stock by a publicly traded REIT or RIC to its shareholders will be considered a taxable distribution of property in an amount equal to the amount of cash that could have been received instead if:

- Each shareholder may elect to receive its distribution in cash or stock of equivalent value subject to a limitation on the aggregate amount of cash to be distributed to all shareholders (the ***"Cash Limitation"***), provided (a) such Cash Limitation is not less than 10 percent of the aggregate declared distribution and (b) if too many shareholders elect to receive cash, each shareholder electing to receive cash will receive a *pro rata* amount of cash corresponding to its respective entitlement under the declaration, but in no event will any shareholder electing to receive cash receive less than 10 percent of its entire entitlement in cash.

- The calculation of the number of shares to be received by any shareholder will be determined, as close as practicable to the payment date, based upon a formula utilizing market prices designed to equate in value the number of shares to be received with the amount of cash that could be received instead.

With respect to any shareholder participating in a dividend reinvestment plan (**"*DRIP*"**), the DRIP applies only to the extent that, in the absence of the DRIP, the shareholder would have received the distribution in cash.

REITs and RICs should note the Procedure does not address the "preferential dividend" rules of the Code, which must be considered prior to relying on taxable stock distributions to meet their distribution requirements. Furthermore, restrictions under the Investment Company Act of 1940 may apply to the issuance of any stock distributions by a RIC.