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Memorandum

IRS Temporarily Reduces the Cash Limitation Percentage Applicable to Certain Part Stock, Part Cash Distributions by Publicly Offered REITs and Publicly Offered RICs

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Summary

On May 4, 2020, the Internal Revenue Service (the "IRS") released Rev. Proc. 2020-19, which provides temporary guidance on the minimum amount of cash that publicly offered real estate investment trusts ("REITs") and publicly offered regulated investment companies ("RICs") must be prepared to distribute to their shareholders in order for certain elective part stock, part cash distributions to qualify for the dividends-paid deduction. Specifically, the new guidance temporarily modifies the safe harbor previously provided under Rev. Proc. 2017-45 by reducing the "Cash Limitation Percentage" from 20 percent to 10 percent in order to alleviate current liquidity constraints on such REITs and RICs caused by the economic impact of the coronavirus. This means that in order for certain distributions paid in REIT or RIC stock to qualify as dividends for purposes of the dividends-paid deduction available to REITs and RICs, at least 10 percent of those distributions must be potentially payable in cash, at the election of the shareholders.

This temporary modification applies solely with respect to dividends declared on or after April 1, 2020 and on or before December 31, 2020.

Background

DISTRIBUTIONS ELIGIBLE FOR THE DIVIDENDS-PAID DEDUCTION

Both REITs and RICs are generally required to distribute at least 90 percent of their taxable income each year in order to maintain their tax status as a REIT or RIC and may generally eliminate their corporate-level income tax liability by distributing 100 percent of their taxable income each year; however, the distributions must qualify for the dividends-paid deduction under Section 562(a) of the Internal Revenue Code of 1986, as amended (the "Code"). A distribution by a REIT or a RIC to its shareholders will qualify for the dividends-paid deduction under Section 562(a) of the Code if the distribution is treated as a taxable dividend at the shareholder-level under Section 301(c)(1) of the Code. Section 301(c)(1) of the Code will generally treat distributions as taxable dividends if the distributions are paid out of the REIT's or RIC's earnings and profits. While cash distributions paid out of earnings and profits (not in redemption of a shareholder's interest) will readily qualify as dividends under Section 301 of the Code, distributions by a REIT or a RIC of its own stock do not generally qualify as dividends under

Section 301 of the Code and thus would not generally be eligible for the deduction. However, Section 305(b)(1) of the Code provides that distributions by a REIT or a RIC of its own stock will be treated as dividends under Section 301 of the Code if the distributions are, at the election of the shareholders, payable in either stock or property. As a result of this exception, REITs and RICs are able make certain stock distributions to their shareholders (*e.g.*, pursuant to a dividend reinvestment plan) that qualify for the dividends-paid deduction, provided shareholders have the option to elect that such distributions be paid in cash.

SAFE HARBOR RULE FOR ELECTIVE CASH/STOCK DISTRIBUTIONS

Rev. Proc. 2017-45 established a safe harbor for elective cash/stock distributions, providing that a distribution by a REIT or RIC of its own stock will qualify as a dividend under Section 301 of the Code if the following conditions are satisfied:

- A REIT or RIC makes a distribution to its shareholders with respect to its stock.
- Pursuant to the declaration of the distribution, each shareholder is entitled to elect to receive cash or stock with respect to part or all of the distribution.
- The Cash Limitation Percentage, *i.e.*, the portion of the entire distribution potentially payable in the form of cash, must equal at least 20 percent.
- Shareholders electing to receive a cash percentage that is less than or equal to the Cash Limitation Percentage must receive cash equal to their elected amount.
- If the aggregate amount of cash elected by all shareholders does not exceed the Cash Limitation Amount (*i.e.*, maximum aggregate amount of cash to be distributed to all shareholders as limited by the declaration of the distribution), then all shareholders must receive cash equal to their elected amount.
- If the aggregate amount of cash elected by all shareholders exceeds the Cash Limitation Amount, each shareholder that has elected to receive more than the Cash Limitation Percentage will receive a pro rata amount of cash that approximates their relative entitlement.
- The number of shares received by a shareholder must be based upon a formula that (1) utilizes the market value of the shares, (2) is designed so that the value of the shares received corresponds as closely as practicable to the amount of cash to be received under the declaration with respect to that share, and (3) uses data from a period of no more than two weeks ending as close as practicable to the payment date.

Rev. Proc. 2020-19 modifies the above by reducing the Cash Limitation Percentage from 20 percent to 10 percent. This temporary modification applies solely with respect to dividends declared by a REIT or a RIC on or after April 1, 2020 and on or before December 31, 2020.

Conclusion

By reducing the Cash Limitation Percentage described above from 20 percent to 10 percent, Rev. Proc. 2020-19 enables publicly offered REITs and RICs to satisfy the distribution requirements necessary to maintain their tax status as a REIT or a RIC and eliminate their corporate-level income tax liability without having to sacrifice as much liquidity.

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