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Client Alert

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Revenue Procedure 2010-12 Extends Guidance Allowing Real Estate Investment Trusts to Preserve Cash While Satisfying Distribution Requirements

"By extending the earlier guidance and providing certain clarifying changes, Revenue Procedure 2010-12 will be welcomed by REITs confronting capital-constraints."

On December 23, 2009, the Internal Revenue Service (the IRS) issued Revenue Procedure 2010-12, 2010-3 IRB, 12/23/2009 (Revenue Procedure 2010-12) which amplifies and extends for an additional two years guidance previously issued by the IRS in Revenue Procedure 2009-15, 2009-4 IRB 356, 1/7/2009 (Revenue Procedure 2009-15) regarding the treatment of certain stock distributions by publicly traded real estate investment trusts (REITs).[1] By extending the earlier guidance and providing certain clarifying changes, Revenue Procedure 2010-12 will be welcomed by REITs confronting capital-constraints. This *Alert* is a brief summary of the REIT distribution requirements and the effect of Revenue Procedures 2010-12.

REIT Distribution Requirements

To maintain its qualification as a REIT, a company is required each year to distribute at least 90 percent of its REIT taxable income (excluding any net capital gains) to its shareholders.[2] In addition, to avoid the payment of federal income tax, a REIT generally must distribute at least 100 percent of its REIT taxable income (including any net capital gain).[3] In each case, the amount distributed must not be preferential—*i.e.*, every shareholder of the class of stock to which a distribution is made must be treated the same as every other shareholder of that class, and no class of stock may be treated otherwise than according to its dividend rights as a class.[4] Because market conditions during recent years have, in many cases, strained the ability of REITs to access capital, some REITs have sought to modify their dividend policies to preserve cash while satisfying the REIT distribution requirements in other ways.

Cash Preservation Strategies

One method of deferring the cash outlays required to satisfy the REIT distribution requirements is for a REIT to declare a dividend during, and set the record date in, the last three months of the taxable year while paying the dividend in January of the following year. Such dividends are treated for US federal income tax purposes as paid by the REIT and received by the REIT's shareholders on December 31 of the year in which they are declared.[5] Another method that REITs may employ to preserve cash on their balance sheets while satisfying the REIT distribution requirements in the current taxable year is to declare a dividend before the due date of the current year's tax return (including extensions) and pay the dividend on or before the date of the first regular dividend payment after such declaration, provided such payment is made during the 12-month period following the close of such year.[6] Such distributions are taxable to the REIT's taxable shareholders in the year paid, even though the distributions relate to the prior year for purposes of the REIT distribution requirements.[7] Of course, both of these alternatives merely defer required cash distributions by the REIT for a limited period of time, but do not eliminate the need to distribute cash to the REIT's shareholders.

Revenue Procedure 2010-12

A third cash-saving dividend strategy was initially approved by the IRS in several private letter rulings and later expanded and confirmed in Revenue Procedures 2008-68, 2009-15 and 2010-12. Under these rulings, a REIT permitted its shareholders to elect to receive a distribution in cash *or* in common stock of equivalent value, and the IRS permitted the REIT to treat the entire amount of the dividend (*i.e.*, both the cash and the stock) as satisfying the REIT distribution requirements. The rulings also allowed the REIT to put an overall limit on the amount of cash it was willing to pay (irrespective of the shareholders' elections). Prior to the issuance of Revenue Procedure 2008-68, the cash limit in the rulings was not less than 20 percent of the total dividend. Because private letter rulings may be relied upon only by the taxpayers who received them, the National Association of Real Estate Investment Trusts (NAREIT) requested that the IRS issue guidance formalizing and liberalizing the conclusions reached in these rulings, which the IRS did in Revenue Procedures 2008-68, 2009-15 and 2010-12.

Revenue Procedure 2010-12 provides that a distribution of stock by a REIT will be treated as a dividend equal to the amount of money that could have been received, and will not be treated as a preferential dividend, even if a shareholder receives a different combination of stock and money from other shareholders, and even if the value of the stock on the date of distribution is different from the amount of money that could have been received by the shareholder, provided that:

1. The distribution is made by the REIT to its shareholders with respect to its stock;
2. The REIT's stock is publicly traded on an established securities market in the United States;
3. The distribution is declared on or before December 31, 2012 with respect to a taxable year ending on or before December 31, 2011;[8]
4. Each shareholder may elect to receive its dividend in either cash or stock of equivalent value subject to a limitation on the amount of money to be distributed in the aggregate to all shareholders, provided that:
   a) the amount of cash to be distributed in the aggregate to all shareholders 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 the shareholder's respective entitlement under the dividend, but in no event will any shareholder electing to receive cash receive less than 10 percent of the shareholder's entire entitlement under the dividend declaration in cash;
5. The calculation of the number of shares to be received by any shareholder is determined over a period of up to two weeks ending 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;[9] and

6. With respect to any shareholder participating in a dividend reinvestment plan (a DRIP), the DRIP applies only to the extent that, in the absence of the DRIP, the shareholder would have received the distribution in cash as described in (4).

Revenue Procedure 2010-12 thus provides temporary relief to publicly traded REITs seeking to limit the amount of cash required to satisfy the REIT distribution requirements. It is worth noting, however, that despite urging by NAREIT, the IRS did not address certain potential disguised sale concerns relating to limited partners in a REIT's operating partnership that receive distributions of REIT stock or extend the relief provided by the revenue procedure to non-listed REITs.[10]

The foregoing is only a summary of the guidance provided in Revenue Procedure 2010-12, and does not address all aspects of this Revenue Procedure or its possible effects on a REIT, its shareholders or its employees. In particular, REITs making use of the UPREIT or DOWNREIT structure should consider the effect of a REIT stock distribution on the limited partners or other investors in the operating partnership.

Endnotes

1. Revenue Procedure 2009-15 amplified and superseded the guidance set forth in Revenue Procedure 2008-68, by making the temporary guidance applicable not only to publicly traded REITs, but also to publicly traded regulated investment companies (*e.g.*, mutual funds). Revenue Procedure 2008-68, which is substantially similar to Revenue Procedure 2010-12, was discussed in Latham & Watkins' Client Alert No. 773.
2. Section 857(a).
3. Section 857(b).
4. Section 562(c).
5. Section 857(b)(9).
6. Section 858(a).
7. Section 858(b).
8. The earlier revenue procedures stated that they were effective for distributions which related to taxable years ending on or before December 31, 2009, and did not provide an outside declaration date.
9. The earlier revenue procedures stated that the calculation would be determined "as close as practicable to the payment date," without any guidance as to the period over which the calculation was to be made. *See* Rev. Proc. 2009-15 at Section 3.02(5).
10. *See* NAREIT Compendium Memo. 2009-27, Dec. 28, 2009.

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

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

David O. Kahn
+1.213.891.8675
david.kahn@lw.com
Los Angeles

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

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

Eric J. Matuszak
+1.213.891.7974
eric.matuszak@lw.com
Los Angeles

David S. Raab
+1.212.906.1344
david.raab@lw.com
New York

Lisa G. Watts
+1.212.906.1883
lisa.watts@lw.com
New York

Abu Dhabi
Bryant B. Edwards
+971.2.672.5002

Barcelona
Jordi Domínguez
+34.93.545.5000

Brussels
Howard Rosenblatt
+32.2.788.60.00

Chicago
Diana S. Doyle
+1.312.876.7700

Doha
Bryant B. Edwards
+974.452.8322

Dubai
Bryant B. Edwards
+971.4.704.6300

Frankfurt
Hans-Jürgen Lütt
Anders Kraft
+49.69.6062.6000

Hamburg
Tobias Klass
Götz T. Wiese
+49.40.4140.30

Hong Kong
Joseph A. Bevash
+852.2522.7886

London
Daniel Friel
+44.20.7710.1000

Los Angeles
Laurence J. Stein
Michael J. Brody
Samuel R. Weiner
+1.213.485.1234

Madrid
Jordi Domínguez
+34.91.791.5000

Milan
Fabio Coppola
+39.02.3046.2000

Moscow
Mark M. Banovich
+7.495.785.1234

Munich
Thomas Fox
Stefan Süss
+49.89.2080.3.8000

New Jersey
David S. Raab
+1.212.906.1200

New York
David S. Raab
+1.212.906.1200

Orange County
David W. Barby
+1.714.540.1235

Paris
Christian Nouel
+33.1.40.62.20.00

Rome
Fabio Coppola
+39.06.9895.6700

San Diego
David O. Kahn
+1.619.236.1234

San Francisco
Kirt Switzer
+1.415.391.0600

Shanghai
Rowland Cheng
+86.21.6101.6000

Silicon Valley
Kirt Switzer
+1.650.328.4600

Singapore
Mark A. Nelson
+65.6536.1161

Tokyo
Hisao Hirose
+81.3.6212.7800

Washington, D.C.
Joseph D. Sullivan
Cheryl M. Coe
+1.202.637.2200