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Client Alert

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Revenue Procedure 2008-68 Enables Real Estate Investment Trusts to Preserve Cash While Satisfying Distribution Requirements

"... a distribution of stock by a REIT will be treated as a dividend equal to the amount of money which could have been received ..."

On December 10, 2008, the Internal Revenue Service issued Revenue Procedure 2008-68 which provides guidance regarding the treatment of stock distributions under the distribution requirements applicable to real estate investment trusts (REITs). While this guidance provides only temporary relief, Revenue Procedure 2008-68 will be welcomed by many REITs facing capital constraints as a result of recent unprecedented events in the capital markets. The following is a brief summary of the REIT distribution requirements and the effect of Revenue Procedure 2008-68.

REIT Distribution Requirements

To maintain its qualification as a REIT, a REIT must distribute each year at least 90 percent of its REIT taxable income (excluding any net capital gains) to its shareholders.[1] In addition, to avoid the payment of income tax, a REIT generally must distribute at least 100 percent of its REIT taxable income (including any net capital gain).[2] 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.[3] Because current credit market conditions have strained the ability of many REITs to access capital, some REITs have sought to adjust 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 as paid by the REIT and received by the REIT's shareholders on December 31 of the year in which they are declared.[4] 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.[5] 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.[6] Of course, both of these alternatives merely help by delaying cash distributions by the REIT for a limited period of time, not by eliminating the need for the cash distributions.

Revenue Procedure 2008-68

A third cash-saving dividend strategy was approved by the IRS in several earlier private letter rulings. 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 treated 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 a limit on the amount of cash it was willing to pay (irrespective of the shareholders' elections), provided the cash limit was at least 20 percent of the total dividend.[7] However, because private letter rulings may be relied upon only by the taxpayers who received them, the National Association of Real Estate Investment Trusts requested that the IRS issue published guidance formalizing and liberalizing the conclusions reached in these rulings.

The IRS has done so in Revenue Procedure 2008-68, which provides that a distribution of stock by a REIT will be treated as a dividend equal to the amount of money which could have been received if:

1) the distribution is made by the REIT to its shareholders with respect to its stock;
2) 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 its respective entitlement under the dividend, but in no event will any shareholder electing to receive cash receive less than 10 percent of its entire entitlement under the dividend declaration in cash;
3) the calculation of the number of shares to be received by any shareholder is 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;
4) 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) above; and
5) the REIT's stock is publicly traded on an established securities market in the United States.

Revenue Procedure 2008-68 thus provides temporary relief to publicly traded REITs that want to satisfy the REIT distribution requirements without distributing the entire amount of a required dividend in cash, and it expands the previously issued private letter rulings by permitting the cash portion of the dividend to be capped at 10 percent (rather than 20 percent) of the total dividend amount.

Effective Date

Revenue Procedure 2008-68 is effective with respect to distributions declared on or after January 1, 2008 and relating to taxable years ending on or before December 31, 2009.

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The foregoing is only a brief summary of the guidance provided in Revenue Procedure 2008-68 and does not address all aspects of the Revenue Procedure or all of its possible effects on a REIT or its shareholders. 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 members of the operating partnership.

If you have any questions about this *Client Alert* or would like additional information regarding the legislation described herein, please contact Michael Brody, David Kahn, Ana O'Brien, Pardis Zomorodi or Eric Matuszak in our Los Angeles office or David Raab in our New York office.

Endnotes

[1] Section 857(a).

[2] Section 857(b).

[3] Section 562(c).

[4] Section 857(b)(9).

[5] Section 858(a).

[6] Section 858(b).

[7] *See, e.g.*, PLR 200832009 (August 8, 2008); PLR 200817031 (April 25, 2008); PLR 200618009 (May 5, 2006).

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