National Association of Real Estate Investment Trusts®
REITs: Building Dividends and Diversification®

September 2017

All About Elective Stock Dividends and REITs

Questions and Answers

In August 2017, the IRS issued a revenue procedure ([Rev. Proc. 2017-45]) that allows SEC-registered REITs to offer shareholders elective stock dividends, which are dividends paid in a mixture of stock and cash (with at least 20 percent of the total distribution being cash), to satisfy their dividend distribution requirements. This revenue procedure is effective for distributions declared on or after Aug. 11, 2017 and formalizes long-standing IRS private letter ruling policy. However, a REIT now no longer has to obtain a private letter ruling to issue an elective stock dividend within the scope of the revenue procedure.

In December 2008, during the financial crisis, the IRS had issued a similar revenue procedure ([Rev. Proc. 2008-68]) limited to listed REITs that allowed them to offer shareholders elective stock dividends to satisfy their distribution requirements through 2009 (with a 10% cash distribution threshold). This revenue procedure was extended to mutual funds by Rev. Proc. 2009- 15, and only applied to dividends for tax years 2008 and 2009. In December 2009, the IRS issued another revenue procedure ([Rev. Proc. 2010-12]), extending this guidance for two years, for dividends in tax years 2010 and 2011.

To illustrate these dividend arrangements, one REIT declared a regular quarterly dividend of $.95 per share to be paid in a combination of cash, not to exceed 40 percent in the aggregate, and common shares. Shareholders will be asked to make an election to receive this dividend all in cash or all in shares. To the extent that more than 40 percent cash in the aggregate is elected, the cash portion will be prorated. Shareholders who do not make an election will receive 40 percent in cash and 60 percent in common shares.

This document outlines how these distributions will impact performance measures, taxes and financial reporting issues.

Financial Reporting Issues

Q. HOW ARE ELECTIVE STOCK DIVIDENDS ACCOUNTED FOR IN THE FINANCIAL STATEMENTS?

A: In December 2009, the Financial Accounting Stan-dards Board (FASB) deter-mined that the stock portion of an elective stock/cash dividend will be accounted for as a stock issuance. Companies are required to report the stock portion of the dividends prospectively in per share amounts under the FASB's current earnings per share

guidance. This requirement is effective for interim and annual periods ending on or after December 15, 2009 and applied on a retrospective basis.

The official FASB guidance for elective stock dividends, issued in January 2010, is provided in Accounting Standards Update No. 2010-01, Accounting for Distributions to Shareholders with Components of Stock and Cash. This Update is available on the FASB web site, and may be accessed by [clicking here].

Performance Issues

Q: HOW ARE ELECTIVE STOCK DIVIDENDS TREATED IN CALCULATIONS TIED TO THE FTSE NAREIT U.S. REAL ESTATE INDEX SERIES?

A: Elective stock dividends affect the performance measures of the FTSE NAREIT U.S. REIT Index in the following manner: Price Return Index: The price return index is calculated as the weighted average of the price returns of each company included in the FTSE NAREIT U.S. Real Estate Index Series. The relative weight applied to each company's price return equals the company's equity market capitalization multiplied by its free float weight divided by the total equity maket capitalization of all companies in the index portfolio, subject to Paragraph 3.0 (Algorithm and Calculation Methodology) of the Ground Rules for the Management of the FTSE NAREIT U.S. Real Estate Index Series. Each company's equity market capitalization for any day equals the product of the total number of common shares

outstanding and the closing price of those shares at the end of the preceding day. The stock component of an elective stock dividend increases the number of common shares outstanding used in the calculation of the price return effective on the exdividend date. In theory, the increase in common shares outstanding would be offset by a proportionate decrease in share price, all else equal, thereby having no effect on the overall price return calculation. In practice, actual market prices used in index

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Tax Issues

Q: HOW ARE REIT ELECTIVE STOCK DIVIDENDS TREATED FOR TAX PURPOSES?

A: Under this 2017 IRS guidance, so long as a REIT provides its shareholders with a choice between cash or stock (and so long as at least 20 percent of the total dividend is available in cash), the entire dividend distribution is treated as a distribution of cash for purposes of the tax rules to qualify as a REIT. If a REIT chooses to pay an elective stock dividend, the entire distribution is taxable to a shareholder as a dividend to the extent of the REIT's current and accumulated earnings and profits, and then treated as a return of the shareholder's tax basis in the stock (otherwise known as a "return of capital" distribution), with any excess then treated as received in exchange for stock. If the stock has been held for more than one year and is a capital asset, this excess amount typically is eligible for the maximum rate applicable to long-term capital gains, 20 percent. "Earnings and profits" (E&P) is a specific amount calculated for tax purposes that generally (but not completely) conforms to taxable income. The 2011 and earlier revenue procedures were modeled after a

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Tax Issues (continued)

series of private letter rulings that the IRS issued to individual REITs from 2001-2008 that also concluded that these elective stock dividends were eligible for a REIT's dividends paid deduction and produced the same tax consequences to REIT shareholders as described above. The 2017 IRS guidance provides SEC-registered REITs with the ability to use this election to retain and conserve cash when appropriate.

Q: WHAT IS THE TAX TREATMENT OF AN ELECTIVE STOCK DIVIDEND FOR REIT SHAREHOLDERS?

A: In general, for federal income tax purposes, the elective stock dividend is treated as a distribution entirely of cash. Accordingly, each shareholder must include the sum of the value of the shares and the amount of cash received from the elective stock dividend in his or her gross income as dividend income to the extent that the dividend is made out of the portion of the REIT's current and accumulated E&P allocable to the elective stock dividend. (For example, if 90 percent of the total dividend were made out of the REIT's E&P, then 90 percent of the cash and the value of the stock received by a U.S. shareholder must be included in that shareholder's gross income as dividend income). The amount of the distribution in excess of the REIT's current and accumulated E&P then would be treated as a return of a shareholder's tax basis in the stock. Any additional excess then would be treated as an amount realized for the sale or exchange of the stock for a shareholder that holds the stock as a capital asset. The revenue procedures confirmed that the amount of the elective stock dividend paid in common stock will be equal to the amount of cash that could have been received instead of the common stock. A shareholder that receives shares of a REIT's common stock pursuant to the elective dividend would have a tax basis in such stock equal to the amount of cash that could have been received instead of such shares, as described above, and the holding period in such stock would begin on the day following the distribution date for the elective stock dividend. Accordingly, a shareholder that sells the stock he or she receives immediately after receipt from the elective stock dividend would have no further taxable gain because the amount received from such sale would equal the tax basis of such stock.

Q: WHAT IS THE TAX TREATMENT FOR A REIT IN CONNECTION WITH ITS DISTRIBUTION OF AN ELECTIVE STOCK DIVIDEND?

A: To the extent that an elective stock dividend is attributable to a REIT's current and accumulated E&P, it is viewed as a dividend paid by the REIT. Thus, the entire amount of the dividend (the cash plus the amount of cash that could have been received instead of the common stock) is counted for purposes of the requirement that a REIT distribute a dividend equal or exceeding 90 percent of its REIT taxable income yearly. Further, the REIT receives a dividends paid deduction for the amount of the distribution equal to its E&P so that a REIT has no corporate tax liability if its dividends paid deduction equals its taxable income (a payout of 100 percent of its taxable income).

Q: WILL A SHAREHOLDER BE TAXED AGAIN IN THE FUTURE WHEN THE REIT DISTRIBUTES THE CASH IT RETAINS?

A: As noted above, a REIT distribution (like that of any other corporation) is treated, first, as a dividend to the extent of the REIT's E&P, then as a return of capital to the extent of a particular shareholder's tax basis in the REIT stock, and then as an amount received for the sale or exchange of the stock. If the stock were held as a capital asset for at least one year, this latter amount would be taxed at the maximum long-term capital gains rate of 20 percent. Typically, the distribution of both the cash and stock portions of an elective stock dividend would reduce a REIT's current and accumulated E&P. Thus, any subsequent distribution of cash by the REIT again would be analyzed in this three-part manner. Any distributions first would be taxable to the extent that the REIT had any accumulated earnings and profits not eliminated by the elective stock dividend and/or current earnings and profits attributable to earnings in the current tax year. Any additional distribution beyond the current and accumulated E&P would be treated first as a tax-free return of capital and thereafter as proceeds from the sale of a capital asset, which would be eligible for tax treatment as a long-term capital gain if the stock was held for more than one year. For example, assume a REIT retained $1 million in 2017 by virtue of an elective stock dividend and in 2018 generated taxable income and E&P of $1.5 million. If the REIT in 2018 distributes $2.5 million in dividends, $1.5 million would be treated as ordinary income and $1 million would be treated first as a return of capital, which would reduce a shareholder's tax basis, and thereafter as proceeds from the sale of a capital asset, which would be eligible for tax treatment as a long-term capital gain if held for more than one year.

Performance Issues (continued)

calculations may or may not conform to such theory.

Total Return Index:
The elective stock dividend also will have a neutral effect on the total return index. Similar to the price return index, the stock component of the elective stock dividend distribution is captured in the total return index calculation as an increase in the common shares outstanding, or float. However, the cash component of the elective stock dividend for each company is treated as a regular dividend and added to the total return index on the ex-dividend date.

Dividend Yield:
The dividend yield calculation recognizes only the cash portion of the total elective stock dividend distribution. The dividend yield equals the company's annualized cash dividend rate divided by the company's most recent closing stock price. The dividend yield calculation includes only regular cash dividend distributions and does not factor in special cash dividends or stock dividends distributed by companies.

NAREIT calculates an alternative dividend yield series that includes the entire dividend distribution, including the stock portion, in the dividend yield calculation. The alternative dividend yield series is calculated daily and posted to the Industry Data & Performance section of the NAREIT web site, REIT.com.

Q: ARE OTHER LEADING INDEXES TAKING THE SAME OR A SIMILAR APPROACH?

A: Yes.