

Rev. Rul. 2002- [Ruling that discount is not a dividend]

REIT; DIVIDENDS PAID DEDUCTION; REINVESTMENT PLAN

ISSUE

What are the Federal income tax consequences arising from the issuance of shares of a publicly-traded widely-held real estate investment trust (“REIT”) pursuant to a dividend reinvestment plan (“DRIP”) and cash option purchase plan (“COPP”) under the facts described below?

FACTS

Situation 1 (DRIP)

Company, a widely-held REIT that is publicly-traded on an established securities exchange (“Exchange”), created a DRIP for its shareholders. Under the DRIP, which is available to all existing Company shareholders of record, shareholders can elect to have the cash dividends that would otherwise be distributed to them automatically reinvested in shares of Company common stock newly issued by Company. A shareholder may elect to become a participant in the DRIP and may change such election at any time by completing an enrollment card and returning it to the plan’s administrator (“Administrator”). Administrator, which is unrelated to Company, will purchase shares of Company common stock directly from Company and hold them as agent for DRIP participants.

The purchase date for shares acquired through the DRIP is the date the dividends are paid by Company. Company regularly pays dividends quarterly. The purchase price of shares of Company stock acquired under the DRIP is determined by an objective multi-day pricing formula. Under the formula, the purchase price is calculated by multiplying the average daily high and low trading prices (the “Average Price”) of Company’s stock reported by the Exchange (for a period from I to J business days preceding the applicable Purchase Date (“Pricing Period”)) less a discount of 5 percent which Company’s board of directors has determined to be reasonable. Company’s board of directors can adjust the discount applied to the Average Price in its sole discretion, provided that it cannot alter the discount for a particular Pricing Period after that period has begun. If a day’s average high and low trading price of Company’s shares falls below a threshold price on any day of the Pricing Period, that day is ignored for purposes of the multi-day pricing formula. The multi-day pricing period is intended to minimize unwanted volatility in the purchase price of Company’s shares that might otherwise arise if a fixed-date pricing mechanism were used. Because the pricing formula is based primarily upon an average price that is determined over the multi-day Pricing Period, it is possible that on any given Purchase Date the purchase price of common shares under the DRIP may be less than the average high and low trading prices of Company’s shares on such date by more than 5 percent.

Conversely, on any given Purchase Date the purchase price of common shares under the DRIP may exceed the average high and low trading prices of Company's shares on such date.

Participants in the DRIP may terminate their participation at any time. Participants are aware of the fixed percentage discount determined by Company before they agree to participate in the DRIP. Company pays all administrative costs of the DRIP. These administrative costs include printing and distributing the DRIP prospectus and reports, legal fees incurred in connection with the DRIP's preparation, registration fees, and transfer agency fees. Administrative costs do not include brokerage fees on common stock purchases because all purchases under the DRIP are made directly from Company.

Situation 2 (DRIP and COPP)

The facts are the same as in Situation 1 except that in addition to a DRIP Company also establishes a COPP for both existing Company shareholders of record and nonshareholders. Participants enroll in the COPP by completing an enrollment card and returning it to the Administrator. Participants may make an initial investment of at least G to a maximum of F in the COPP. Cash purchases in excess of the maximum F may be made by a participant only upon acceptance by Company of a written request for a waiver of the maximum investment limitation. Participants may also enroll in an automatic cash investment feature of the plan whereby Administrator automatically draws funds from a participant's bank account on a regular basis for stock purchases. Administrator acquires from Company newly issued shares of Company common stock with money received for investment through the COPP monthly.

The purchase date for shares acquired through the COPP is the last business day of the month ("Purchase Date"). The purchase price of shares of Company stock acquired under the plan is determined by the same objective multi-day pricing formula described in Situation 1, which applies equally to both participants in the DRIP and COPP. A DRIP participant does not have to participate in the COPP, and COPP participants do not have to participate in the DRIP.

The DRIP in Situation 1 and the DRIP and COPP in Situation 2 are each designed to enable Company to raise capital in a cost-efficient manner on a regular, recurrent basis directly from participants in the plan. By issuing shares through the DRIP and COPP, Company is able to avoid investment banking, brokerage, distribution and other costs typically associated with a traditional underwritten equity offering. The DRIP and COPP also diversifies Company's shareholder base by enabling retail investors to invest directly alongside Company's large, institutional investors on a cost-efficient basis. Further, Company believes that raising capital through the DRIP and COPP is advantageous as compared to a traditional underwritten equity offering because traditional underwritten equity offerings may be perceived by the market as an

indication of Company's belief that its shares are overvalued, whereas DRIPs and COPPs, because of their continuing, regular nature, minimize any such inference.

LAW

Section 857(a)(1) provides, in part, that the provisions of part II of Subchapter M of Chapter 1 (except sections 856(g) and 857(d)) shall not apply to a REIT for a tax year unless the deduction for dividends paid during the year (as defined in section 561, but determined without regard to capital gains dividends) equals or exceeds 90 percent of its real estate investment trust taxable income.

Section 857(b)(2)(B) provides that in determining real estate investment trust taxable income, the taxable income of the REIT will be adjusted by, among other things, the deduction for dividends paid (as defined in section 561) computed without regard to that portion of such deduction that is attributable to the net income from foreclosure property.

Section 561(a) provides, in part, that the deduction for dividends paid shall be the sum of (1) the dividends paid during the taxable year, and (2) the consent dividends for the taxable year (determined under section 565). Section 1.561-2(a)(1) provides that a dividend will be considered paid when the shareholder receives it.

Section 562(a) provides that the term "dividend" shall, except as otherwise provided in that section, include only dividends described in section 316 (relating to the definition of dividends for purposes of corporate distributions).

Section 562(c) provides that the amount of any distribution shall not be considered as a dividend for purposes of computing the dividends paid deduction, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared to another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference.

Section 1.562-2(a) provides, in part, that a corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated. The

disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution.

Section 301(a) generally provides that a distribution of property made to a shareholder shall be treated in the manner provided in section 301(c). Section 301(c)(1) provides that in the case of a distribution to which section 301(a) applies, that portion of the distribution that is a “dividend” (as defined in section 316) shall be included in gross income. The term “dividend” is defined in section 316(a) as any distribution of property made by a corporation to its shareholders out of current or accumulated earnings and profits. The term “dividend” used in sections 561 and 562 refers generally to dividends described in section 316.

Section 305(a) provides that, with certain exceptions, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock. Section 305(d)(1) provides that for purposes of the foregoing the term “stock” includes rights to acquire stock.

Section 305(b)(1) provides that section 305(a) will not apply, and the distribution will be treated as a distribution to which section 301 applies, if the distribution is, at the election of any shareholder (whether exercised before or after the declaration), payable either in the stock of the distributing corporation or in property.

Section 1.305-2(a) provides that if any shareholder has the right to an election or option with respect to whether a distribution shall be made either in money or any other property, or in stock or rights to acquire stock of the distributing corporation, then, with respect to all shareholders, the distribution of stock or rights to acquire stock is treated as a distribution of property to which section 301 applies regardless of (1) whether the distribution is actually made in whole or in part in stock or in stock rights; (2) whether the election or option is exercised or exercisable before or after the declaration of the distribution; (3) whether the declaration of the distribution provides that the distribution will be made in one medium unless the shareholder specifically requests payment in another; (4) whether the election governing the nature of the distribution is provided in the declaration of the distribution or in the corporate charter or arises from the circumstances of the distribution; or (5) whether all or part of the shareholders have the election.

Section 1.305-1(b)(1) provides that where a distribution of stock or rights to acquire stock of a corporation is treated as a distribution of property to which section 301 applies by reason of section 305(b), the amount of the distribution, in accordance with section 301(b) and section 1.301-1 is the fair market value of such stock or rights on the date of the distribution.

Section 1.305-1(b)(2) provides that where a corporation that regularly distributes its earnings and profits, such as a regulated investment company, declares a dividend pursuant to which the shareholders may elect to receive either money or stock of the distributing corporation of equivalent value, the amount of the distribution of the stock received by any shareholder electing to receive stock will be considered to equal the amount of the money that could have been received instead.

In Rev. Rul. 76-53, 1976-1 C.B. 87, a widely-held corporation that regularly distributed its earnings and profits adopted a DRIP pursuant to which shareholders could acquire shares of the company's stock at a price equal to 95 percent of the fair market value of such stock on the dividend payment date. The ruling held that the distributions made by the corporation while the plan is in effect will be treated as payable either in stock or in cash at the election of the shareholder within the meaning of section 305(b)(1). The ruling also concludes that section 1.305-1(b)(2) does not apply to determine the amount of the distribution for shareholders electing to participate in the DRIP because the stock acquired through the DRIP was not of equivalent value with the cash distributed to fund such acquisition.

Rev. Rul. 78-375, 1978-2 C.B. 130 addresses the treatment of shareholders who participate in a DRIP and COPP, which provides shareholders with the right to purchase a company's shares at 95 percent of the fair market value of such shares on the purchase date. The ruling held that participants in the DRIP and COPP are treated as having received a distribution to which section 301 applies by reason of section 305(b)(1). The ruling also concluded that the amount of such distribution to DRIP participants is equal to the fair market value of the company's shares on the dividend distribution date and the amount of such distribution to COPP participants is the difference between the fair market value of the shares purchased on the purchase date and the amount of the actual payment made by the participant to purchase such shares.

Rev. Rul. 79-42, 1979-1 C.B. 30, also concerned participants in a DRIP. In that ruling, the company distributed cash to an agent acting on behalf of plan participants, and the agent purchased shares at a discount to the day's trading price from the company. The ruling concludes that participating shareholders are treated as having received a distribution to which section 301 applies by reason of section 305(b)(1) and, under section 1.305-1(b), the amount of the distribution to participating shareholders is the fair market value of the stock on the dividend payment date.

Rev. Rul. 83-117, 1983-2 C.B. 98, considers two situations in which a DRIP affects a REIT's dividends paid deduction. Under the first situation ("Scenario 1"), the REIT's shareholders may elect to have cash dividends that would otherwise be distributed to them reinvested in newly issued shares of the REIT's stock. The stock acquired by shareholders under this plan is priced at

95 percent of its fair market value on the distribution date. The ruling assumed that the 5 percent discount approximates the costs that the REIT would otherwise incur in issuing new shares. The second situation (“Scenario 2”) is identical to the first, except that the stock acquired is priced at less than 95 percent of its fair market value on the distribution date. Thus, the discount exceeds 5 percent.

In Scenario 1, Rev. Rul. 83-117 holds that the REIT is entitled to a dividends paid deduction for the amount of any distribution made in both cash and discounted stock. The plan treats the shareholders impartially by giving them an equal opportunity to reinvest. Moreover, the ruling concluded that the plan’s discount is relatively small, resulting in relatively minor differences in the amounts received by shareholders of the same class.

In Scenario 2 of Rev. Rul. 83-117, the ruling concluded that the plan’s discount is no longer relatively minor, causing more than relatively minor differences in the amounts received by shareholders of the same class. Accordingly, Rev. Rul. 83-117 held that the dividend in Scenario 2 is preferential and the REIT is not entitled to any dividends paid deduction.

Rev. Rul. 75-468, 1975-2 C.B. 115 addresses whether preferred stock issued to target shareholders in a statutory merger will be treated as having been issued with an unreasonable redemption premium within the meaning of section 305(c) and section 1.305-5(b), where the target’s stock declines in value between the date that the exchange ratio is determined and the date the acquirer’s preferred stock is issued in exchange therefor, resulting in an increase in the redemption premium from 5 percent to 16 percent, which is in excess of the 10 percent limitation of section 1.305-5(b)(2) then in effect. The ruling concludes that because a redemption premium in excess of 10 percent arose solely as a result of market conditions and was not bargained for or intended by the parties, it was a reasonable redemption premium within the meaning of section 305(c) and section 1.305-5(b).

In determining whether payment by a corporation of certain expenses such as administrative fees constitutes a constructive dividend to shareholders, the Service and courts have examined whether the expense is for the primary benefit of the corporation or the shareholder. In Osrow v. Commissioner, 49 T.C. 333 (1968), acq. 1969-1 C.B. 21, the court held that a corporation’s payment of underwriting expenses on behalf of shareholders constitutes a dividend to those shareholders. See also Crosby v. United States, 496 F.2d 1384 (5th Cir. 1974).

ANALYSIS

The Service has reconsidered its holding in Rev. Rul. 76-53 that section 1.305-1(b)(1) rather than section 1.305-1(b)(2) applies to determine the amount of the distribution that participating

shareholders in a DRIP are treated as having received where the purchase price for the stock acquired through the DRIP is less than the price of such stock on an exchange on the date of the distribution. Rev. Rul. 76-53 assumes that stock acquired through the DRIP is not of “equivalent value” with the cash distribution that is used to fund such acquisition because the purchase price for the shares acquired through the DRIP differs from the price of such shares on the exchange on the date of the distribution. That ruling assumes without analysis that the exchange traded price of the shares on the distribution date represents the fair market value of the shares acquired through the DRIP.

After reconsidering the matter, the Service now believes section 1.305-1(b)(2) applies to the purchase of stock through a DRIP that is established by a publicly-traded, widely-held corporation that regularly distributes its earnings and profits, when participation in the DRIP is open to all shareholders on an equal basis. The term “equivalent value” as used in section 1.305-1(b)(2) should be interpreted to mean “equivalent fair market value.” The fair market value of property is generally defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. United States v. Cartwright, 411 U.S. 546, 551 (1973); Treas. Reg. § 1.170A-1(c)(2); Treas. Reg. § 20.2031-1(b). While the trading price of stock on an exchange is indicative of fair market value in most cases, it should not be used to determine the fair market value of stock that is purchased in a transaction between independent parties negotiating at arm’s-length. If parties negotiate at arm’s-length to arrive at a price for stock that differs from its market trading price, that arm’s-length negotiated price should be respected as determinative of the fair market value of such stock to the parties.

Company and the participants in the DRIP (and possibly in the COPP) stand in a corporation-shareholder relationship which could under other circumstances indicate that the formula for Company's shares under the plan was not one that would be arrived at by independent parties acting at arm’s-length. In these circumstances, however, there is no indication that the formula price is other than an arm’s-length price or intended by Company to confer a benefit to its shareholders, particularly in light of the fact that the pricing formula, which relies on a multi-day average, could result in a purchase price for shares acquired through the DRIP or COPP that is less than, equal to or greater than the price of the shares on the Exchange on the Purchase Date. Furthermore, in situation 2, there is evidence of arm’s-length pricing from the fact that Company is willing to sell its shares using the same formula price to non-shareholders under the COPP. Although this additional factor is not present in situation 1 because Company has implemented only a DRIP, a discount of up to 5 percent is relatively minor and accordingly will be treated as *per se* an arm’s-length price. See, e.g., Rev. Rul. 83-117, 1983-2 C.B. 98. Whether a Purchase Price that results from a discount in excess of 5 percent applied to the Average Price in situation 1 would be treated as an arm’s-length price will depend on an evaluation of the particular facts

and circumstances at the time the discount is established. Accordingly, since the price at which Company's shares are sold to participants in the plans in situation 1 and situation 2 represents a price arrived at between parties negotiating at arms'-length, such price is therefore dispositive of the fair market value of such shares to participants in the plans.

HOLDINGS

Under Situation 1 and Situation 2 described above, it is held as follows:

1. In Situation 1 (DRIP only), a discount of up to 5 percent that is applied to the Average Price is deemed to be reasonable, is not intended to confer a benefit on Company's shareholders, and results in an arm's-length purchase price. Accordingly, such a discount will not give rise to a distribution to participants in the DRIP under section 301. A discount in excess of 5 percent in situation 1 may also result in an arm's-length Purchase Price depending on the facts and circumstances.
2. In Situation 2 (DRIP and COPP), any discount (including a discount in excess of 5 percent) that is applied to the Average Price is deemed to be reasonable, is not intended to confer a benefit on Company's shareholders, and results in an arm's-length purchase price. Such a discount reflects Company's pricing advantage of offering shares through the plans and is not intended to confer a benefit on Company's shareholders. Accordingly, such a discount will not give rise to a distribution to participants in the plans under section 301.
3. A shareholder of Company that participates in the DRIP will be treated as having received a distribution to which section 301 applies by reason of the application of section 305(b)(1). Pursuant to section 1.305-1(b)(2), the amount of the distribution to the participating shareholder will be the amount of the cash distribution that is used to fund the acquisition of shares through the DRIP.
4. A shareholder of Company that purchases shares through the COPP will not be treated as having received a distribution to which section 301 by reason of section 305(b)(2) with respect to such purchase.
5. The basis of the shares acquired by a participating shareholder through the DRIP will equal the amount of the amount of the dividend distribution to such shareholder under section 301. The basis of the shares acquired by a participant in the COPP will equal the amount paid for such shares.

6. Company will be entitled to a dividends paid deduction for the amount of any distribution under the DRIP in cash under section 561.

7. Company's payment of the administrative costs of the Plan will not constitute a distribution of property to which section 301 applies. The amount of any discount shall not be considered an administrative cost.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 76-53, 1976-1 C.B. 97, is modified to the extent inconsistent with this ruling.

Rev. Rul. 78-375, 1978-2 C.B. 130, is modified to the extent inconsistent with this ruling.

Rev. Rul. 83-117, 1983-2 C.B. 98, is superseded.