Elective Stock Dividends:
Tax Consequences for REITs and Shareholders

Questions and Answers

Q: THE IRS RECENTLY ISSUED GUIDANCE TO REITS ABOUT THE USE OF ELECTIVE STOCK DIVIDENDS. WHAT DOES IT MEAN?

A: In December 2008, the IRS issued Revenue Procedure 2008-68, which permits listed REITs to pay “elective stock dividends” through 2009 if the company elects to do so. Elective stock dividends are dividends comprised of a combination of cash and stock. Under this IRS guidance, so long as a REIT provides its shareholders with a choice between cash or stock (and so long as at least 10 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, 15 percent. “Earnings and profits” (E&P) is a specific amount calculated for tax purposes that generally (but not completely) conforms to taxable income.

Revenue Procedure 2008-68 was modeled after a 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 only significant substantive difference between Revenue Procedure 2008-68 and the private letter rulings is that under the private rulings a REIT was required to make available to shareholders a cash floor of 20 percent cash.

This IRS guidance provides listed REITs with the ability to use this election to retain and conserve cash in the midst of a financial environment in which credit is severely constrained and at a time when the future availability of credit is highly uncertain.

In January 2009, the IRS issued Revenue Procedure 2009-15 to extend Revenue Procedure 2008-68 to mutual funds to dividends paid for tax years 2008 and 2009. In December 2009, the IRS issued Revenue Procedure 2010-12, authorizing listed REITs to distribute elective stock dividends through the 2011 tax year.

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.

Revenue Procedure 2010-12 confirms that the amount of the elective stock dividend paid in stock will be equal to the amount of cash that could have been received instead of the 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 OF 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). Also, Revenue Procedure 2010-12 confirmed that elective stock dividends are not considered preferential and therefore qualify for the dividends paid deduction.

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 (currently at 15 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 2009 by virtue of an elective stock dividend and in 2010 generated taxable income and E&P of $1.5 million. If the REIT in 2010 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.