

# REIT Alert

An informational newsletter from Goodwin Procter's Real Estate & RE Capital Markets Group

## Cash Preservation Strategies for REITs

Not long ago, corporate coffers were flush with cash and activist shareholders were insisting that companies distribute cash rather than retain it to fund growth or future operations. Today, cash is precious. Many companies, including REITs, are facing unprecedented liquidity and capital resource constraints. Keeping internally generated cash on the balance sheet has become a priority even for companies with adequate liquidity because the current financial market environment has limited their options for raising new capital. For example, in recent weeks, REITs with corporate bonds have experienced historically wide spreads at the same time that the value of their equity securities have fallen sharply. It is not expected that the credit markets for corporate debt in or out of the REIT industry will improve significantly over the near term, and REIT executives who have the option not to issue equity at these depressed prices are unlikely to do so until the REIT equity markets become more stable. Accordingly, many REITs are adopting cash preservation strategies, and in some cases those strategies have included suspending cash dividends (e.g., AMB Property, Strategic Hotel & Resorts, Maguire Properties and CapLease Inc.) or reducing them significantly (e.g., Brandywine Realty Trust, Liberty Property, Prologis and Developers Diversified Realty).

With this background, we thought it would be helpful to summarize the REIT qualification requirements that pertain to distributions, and to outline certain strategies a REIT can deploy in its efforts to preserve cash. These strategies include: (i) decreasing the amount of dividend distributions; (ii) deferring the timing of dividend payments; and (iii) replacing all or a part of a cash dividend with a non-cash dividend.

### Minimum Required Distributions

The REIT rules require minimum annual distributions of only 90% of the REIT's taxable income (excluding net capital gains and certain non-cash income) in order to maintain REIT status under the Internal Revenue Code (the "Code"). As a result, a REIT generally may choose to retain all *or part* of its long-term capital gains and as much as 10% of its ordinary income and short-term capital gains. However, a REIT that chooses to retain any capital gains or operating income would be subject to tax on the undistributed amounts at regular corporate tax rates (currently, the maximum federal corporate rate is 35%).

### Deferral of Dividend Distributions

The Code provides two options for REITs to defer dividends of the current year's earnings until the subsequent taxable year. Under Code section 857(b)(9), dividends declared by a REIT in October, November or December and payable to

shareholders of record on a specified date in any such month are deemed to have been paid by the REIT and received by the shareholders on December 31 of that year, so long as the dividends are actually paid during January of the following year. Accordingly, taxable shareholders of record who are entitled to receive the dividend when paid in January are taxed in the year of the declaration and accrual of the dividend, and not in the year of payment.

Code section 858 allows a REIT to further defer dividends of the current year's earnings, but the Code imposes a nondeductible 4% excise tax to the extent the deferred amounts exceed certain thresholds. To use this option the REIT must: (i) declare the dividend before the due date of the REIT's tax return (including extensions) for the taxable year (generally September 15 of the following year); (ii) distribute the dividend in the 12-month period following the close of the taxable year, but not later than the date of the first regular dividend payment for the subsequent year made after such declaration; and (iii) elect in its tax return to have a specified dollar amount of such dividend treated as if paid in the prior taxable year. Such subsequent year dividend relates back to the prior year and is treated as paid in the prior year for purposes of the REIT distribution requirement and also for purposes of calculating REIT taxable income. Unlike dividends distributed pursuant to section 857(b)(9) noted above, shareholders include section 858 dividend distributions in income in the year received. Thus, under this option, the declaration and payment of the dividend can be deferred until well into the subsequent taxable year.

### **Taxable Stock Dividend**

A REIT also can satisfy its distribution requirement by paying all or a part of the amount of the desired distribution in the form of a *taxable* stock dividend. Although many stock dividends, such as a pro-rata dividend of common on common, are not taxable, a stock dividend can be taxable if one of the following conditions is met: (i) the stockholders have the option to elect to receive cash in lieu of stock; (ii) the distribution results in the receipt of property by some stockholders and an increase in the proportionate earnings and profits of the corporation by other stockholders; (iii) the distribution results in some common stockholders receiving preferred stock and other common stockholders receiving common stock; *or* (iv) the distribution consists of convertible preferred stock meeting certain requirements.

Although REITs have employed a variety of taxable stock dividend options, many recent taxable stock dividends paid by public REITs have been structured as dividends that the stockholders can elect to receive in cash or common stock of equivalent value. Importantly, the Internal Revenue Service ("IRS") has issued several private rulings allowing REITs to cap the cash portion of the dividend at 20% of the total dividend and still treat the entire stock dividend as a taxable stock dividend. As a result, those companies were able to pay a substantial portion of the dividend in common stock and preserve cash while avoiding the other more complex taxable stock dividend alternatives.

Although not addressed in any of the private letter rulings, we would hope that the IRS also would rule favorably on such a capped cash option dividend that provided

for a discount of up to 5% on the valuation of the stock component, consistent with the IRS's long standing position that such discounts are permissible in a dividend reinvestment plan (which is another form of taxable stock dividend).

Because public REITs typically cannot tolerate any uncertainty as to whether such a capped cash option stock dividend will produce the desired tax result, market practice has been to obtain a private letter ruling from the IRS. While the IRS has been accommodating in issuing such rulings, the need for a ruling inevitably limits the REIT's ability to respond to changing circumstances. In an October 31, 2008 letter to the Department of the Treasury, NAREIT requested formal guidance sanctioning cash option stock dividends that follow the pattern of the existing private letter rulings, so as to avoid the need for individual private rulings on such transactions. NAREIT also requested a temporary allowance for a 5% cap on the cash component of the dividend. To date, no such formal guidance has been forthcoming, although Treasury officials have been quoted in the tax press to the effect that they are working on the issue.

Any stock distribution made to a non-U.S. stockholder generally will be subject to withholding at a rate of 30% (or a lower treaty rate, if applicable) or 35% in the case of a capital gain dividend paid to a greater than 5% non-U.S. stockholder by a public REIT or a capital gain dividend paid by a private REIT. The withholding tax may result in the REIT paying more than 20% of the distribution in cash notwithstanding the 20% cap. Failure to withhold and pay the appropriate amounts to the IRS could subject the REIT, and the responsible corporate officers, to personal liability for the amount not withheld as well as interest and penalties.

### **Cashless Consent Dividend**

Provided the REIT is able to obtain the consent of its shareholders, the REIT may elect at any time up to the filing of its tax return for a taxable year to declare a cashless consent dividend that would allow the REIT to satisfy its distribution requirement and avoid entity level tax without an actual distribution of cash (subject to certain withholding requirements). However, the REIT shareholders must include the amount of the consent dividend in income as dividends. Because a unanimous consent and participation by the common stockholders is required, this is a viable option only for certain private REITs with a limited number of shareholders who appreciate the cash preservation strategy associated with a cashless consent dividend.

### **Corporate Governance and Disclosure Aspects**

Publicly traded REITs need to be mindful that predictable distribution policies, dividend yield and the timing of dividend payments are among the most material issues for investors. The corporate governance, investor relations and disclosure aspects of any decision to conserve cash by reducing, suspending or modifying the form, amount or timing of REIT dividends require careful analysis and planning. Among other things, boards of directors and investor relations officers of publicly traded REITs need to take into account: (i) the effect of the various strategies discussed above on those shareholders who rely on regular cash dividend payments

as part of the total return on their investment; (ii) the dilutive effect (both real and perceived) of stock dividends, particularly if a cash election is offered or the “capped cash option” is selected, in light of currently depressed stock prices; (iii) the impact on reported FFO and earnings per share on a pro forma basis, particularly to assess whether guidance needs to be adjusted to reflect the higher projected number of outstanding shares; and (iv) disclosure requirements, such as Regulation FD and periodic reporting in Forms 10-Q and 10-K.

### **Compliance with Corporate and Securities Law Requirements**

If the REIT is considering a distribution of equity securities in a transaction that involves stockholder elections, particular attention should be given to matters such as: (i) anticipating all potential elements and variables of the distribution structure in the initial private letter ruling request; and (ii) providing adequate time for obtaining the private letter ruling and for distributing and receiving election materials returned by both beneficial and record stockholders. The mechanics, frequency and scope of stockholders’ elections will have to satisfy corporate law requirements with respect to, among others, record and payment dates, in addition to tax requirements. REITs should assume that in most cases separate elections will be necessary for each separate quarterly cash/stock dividend. In addition, once the structure of a stock dividend and related election mechanics are developed, the transaction will have to be documented and executed in compliance with the Securities Act of 1933 and SEC guidance, which may require registration of the shares to be issued and delivery to stockholders of a prospectus in connection with their election to receive stock in lieu of cash dividends. Insofar as the election may constitute an offer of securities, all material information concerning the REIT would need to be disclosed, which may be particularly challenging in light of current highly volatile business, economic and financial conditions.

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