Taxation of Investment Funds: 2009

Tax Planning International: Special Report

Taxation of Investment Funds 2009

The financial crisis which began in late 2008 put investment funds under intense pressure and scrutiny, however, they remain a central feature of the modern investment landscape. They are active in every major financial market in the world, trading all varieties of assets and instruments and act as leaders in innovation on numerous fronts. Despite their importance and long history, investment funds remain little understood by many investors, policy makers and financial professionals.

This Special Report takes a broad look at investment funds around the globe looking at the lessons to be learnt from the current financial crisis and the changes that will impact on Investment Funds in 2009 and beyond. The Report includes detailed sections looking at the main types of investment funds, both private (hedge funds and private equity) and public (pension funds and Real Estate Investment Trusts).

Tax, legal and regulatory issues are analysed in detail, and developments in hedge funds, pension funds, REITs and private equity are examined in a number of onshore and offshore jurisdictions including: United Kingdom, United States, Belgium, Bermuda, Cayman Islands, Germany, Ireland, Australia, India, Hong Kong and Singapore. Finally, the appendices give a round of recent events to give a broad picture of where the investment fund industry has come from over recent years, and where it may be heading.

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Cash conservation strategies for US REITs

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Real estate investment trusts, or REITs, achieve their tax advantaged status and effectively avoid corporate level income taxation because they are allowed to take a deduction against their taxable income in the amount of dividends they pay to their shareholders. As a result, REITs are required to distribute a significant portion of their earnings to their shareholders each year, which limits the amount of cash they can retain to fund growth or future operations. Today, however, 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 REITs, the annual distribution requirement presents an additional challenge. Accordingly, many REITs are looking for ways to retain cash without jeopardising their REIT qualification and at a minimum tax cost to the REIT.

This article provides a summary of REIT qualification requirements that pertain to distributions and outlines certain strategies a REIT can deploy in its efforts to conserve 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. Note, however, that this article does not address ways for a REIT to minimise its taxable income for a particular taxable year through deferral of income or acceleration of expenses, which also would reduce the amount of necessary dividend distributions.

I. Minimum required distributions

The REIT rules require minimum annual distributions of only 90 percent 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 of 1986, as amended (the "Code"). As a result, a REIT generally may chose to retain all or part of its long-term capital gains and as much as 10 percent 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 percent). In the case of undistributed long-term capital gains, the REIT can elect to attribute to its shareholders the gains and the REIT-level taxes paid, possibly resulting in a shareholder-level refund and allowing each shareholder to increase its basis in REIT shares by the difference between such shareholder's share of the gain and taxes paid.

II. 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, the REIT is able to defer the dividend payment up to a month beyond the taxable year end. However, 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 non-deductible 4 percent 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) described 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.

III. 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 shareholders have the option to elect to receive cash in lieu of stock; (ii) the distribution results in the receipt of property by some shareholders and an increase in the proportionate earnings and profits of the corporation by other shareholders; (iii) the distribution results in some common shareholders 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 shareholders can elect to receive in cash or common stock of equivalent value. On December 10, 2008 the Internal Revenue Service (the "IRS") issued Revenue Procedure 2008-68 announcing that the IRS will treat a cash option stock dividend as a taxable stock dividend so long as shareholders can elect to take at least 10 percent of the dividend in cash. Revenue Procedure 2008-68 was later amplified and superseded by Revenue Procedure 2009-15 that extended the cash option stock dividend guidance to publicly traded regulated investment companies. With respect to REITs, Revenue Procedure 2009-15 is substantively identical to Revenue Procedure 2008-68 (together, the "Revenue Procedure").

The Revenue Procedure provides that the IRS will treat a capped cash option stock dividend by a public REIT as a taxable dividend, and will consider the amount of stock distributed to be equal to the amount of cash which could have been received instead, if:

- the dividend is made by the REIT to its shareholders with respect to its stock;
- the terms of the dividend allow each shareholder the right to elect to receive its entire distribution in either cash or stock of the REIT of equivalent value, provided that the REIT may impose a limitation on the amount of cash to be distributed in the aggregate to all shareholders of not less than 10 percent of the aggregate distribution; and
- the number of shares to be distributed is determined as close as practicable to the payment date based upon a formula utilising market prices.

The Revenue Procedure does not mandate any particular valuation formula, providing some flexibility to address concerns raised by the current market volatility. The formula employed, however, must be designed to equate in value the number of shares to be received by a shareholder with the amount of money that the shareholder could have elected to receive in lieu of the shares. Accordingly, if the REIT declares a cash option stock dividend of $0.50 per share with a 10 percent cash cap, and each shareholder elects to receive all cash, the cash component of the dividend to each shareholder would be $0.05, and the per share stock component would be determined by dividing 0.45 by the share price determined under the valuation formula.

The Revenue Procedure further provides that, to the extent the REIT maintains a dividend reinvestment plan, such plan would apply only to the cash portion of the dividend. It should be noted that this guidance applies only to REITs whose stock is publicly traded on an established securities market in the United States and to distributions with respect to taxable years ending on or before December 31, 2009.

The IRS had previously issued several private letter rulings allowing REITs to cap the cash portion of the dividend at 20 percent of the total dividend amount; otherwise the private letter rulings are substantially similar in facts and legal conclusions to the Revenue Procedure. While a private letter ruling does not have precedential value and can be relied upon only by the taxpayer to whom it was issued, a Revenue Procedure constitutes official IRS guidance. Importantly, because public REITs typically cannot tolerate any uncertainty with respect to their REIT compliance, before the Revenue Procedure, market practice had been to obtain a private letter ruling from the IRS. Now, public REITs can rely on the Revenue Procedure without any need to obtain their own private letter ruling as long as they stay within the parameters of the Revenue Procedure. Notably, the IRS chose to issue its guidance on cash option stock dividends in the form of a Revenue Procedure and not a Revenue Ruling. Generally, Revenue Rulings are statements of substantive law, while Revenue Procedures set out IRS practice and procedures. Thus, it is not clear what deviations from the requirements of the Revenue Procedure may be viewed as permissible by the IRS and the practitioners; however, public REITs would be well advised to continue the practice of obtaining a private letter ruling from the IRS in advance of any capped cash option stock dividend that deviates from the Revenue Procedure.

A. Withholding Tax

Any stock distribution made to a non-U.S. shareholder generally will be subject to withholding at a rate of 30 percent (or a lower treaty rate, if applicable) or 35 percent in the case of a capital gain dividend paid to a greater than 5 percent non-U.S. shareholder 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 10 percent of the distribution in cash notwithstanding the 10 percent 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.

B. Corporate and Securities Law Requirements

The mechanics, frequency and scope of shareholder' 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 option stock dividend. In addition, once the structure of a 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 shareholders 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.

IV. 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 shareholders 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.

V. Corporate Governance and Disclosure Considerations

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.

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