"Dividend Reinvestment Plans and Direct Purchase Plans for Real Estate Investment Trusts"

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Introduction

Real estate investment trusts ("REITs") are a popular tax vehicle to hold real estate in a publicly owned manner.1 REITs often are in the market for new capital for several reasons. Many REITs need to attract new capital because their business plans include acquisitions of new property or because they must or desire to repay debt. Because a REIT must distribute at least 95 percent of its REIT taxable income2 each year to maintain its REIT status for tax purposes,3 a REIT cannot reinvest its income and, hence, new capital is required for acquisitions and repayment of debt.

As a result of their continual need for new capital, many REITs have adopted dividend reinvestment plans ("DRIPs") and direct purchase plans ("DPPs").4 In a DRIP, shareholders can elect to have their dividend distributions5 reinvested in the REIT's stock automatically under a plan adopted by the REIT. A DPP allows shareholders and often non-shareholders to acquire shares of REIT stock directly from the REIT for cash. In each case the REIT receives the benefit of new capital6 and the shareholders have the benefit of a convenient and low cost method of acquiring additional REIT shares on an automatic and regular basis. Often the costs to the REIT of raising capital through a DRIP or DPP are much less than an underwritten offering of stock.7

This article describes how a typical combined DRIP and DPP is organized and the principal federal income tax aspects of the operation of such plans for the REIT and its shareholders. Surprisingly, the federal income tax aspects of these plans are not completely settled and, to the extent settled, are in certain respects at odds with the expressed desires of the REIT industry.8

A Typical Plan Combining a DRIP and DPP

Frequently a REIT will adopt a DRIP and a DPP as a part of one plan. The following is a summary of a hypothetical plan.9 Some typical variations between plans are noted.

The plan is administered by a bank, trust company, brokerage firm or similar entity. The plan administrator collects the dividends, purchases and holds shares of stock acquired under the plan, keeps records, sends statements of account activity to participants, and performs other duties related to the plan. Participation in the dividend reinvestment portion of the plan is open to any shareholder of the REIT10 provided the shareholder enrolls with the plan administrator. Some REITs do not allow a shareholder to participate in the plan if the shareholder's shares are registered in the name of a nominee (for example, where shares are held in the name of a broker or bank), whereas other REITs do allow such participation provided the shareholder coordinates its participation with its nominee. Usually, if participation is not allowed through a nominee a shareholder can participate by having its shares re-registered in the shareholder's name. Participation in the direct purchase portion of the plan is usually open to any person, whether or not a shareholder. However, many plans have limits on the amount of periodic investments, *e.g.*, no optional cash investment under the plan may exceed $20,000 per month. Even plans that have a limit may provide that the limit may be waived by the REIT.

Under the plan, a participant may select one of three investment methods: (1) full dividend distribution reinvestment and optional cash purchases, under which all cash dividend distributions paid on all common shares then or subsequently registered in the participant's name are automatically reinvested in additional common shares and, in addition, a participant may make optional cash purchases of additional common shares pursuant to the plan; (2) partial dividend distribution reinvestment and optional cash purchases, under which cash dividend distributions are automatically reinvested with respect to a specified number of common shares and a participant may also make optional cash purchases of additional common shares; and (3) optional cash purchases only, under which a participant may make optional cash purchases of additional common shares in accordance with the plan without reinvestment of cash dividend distributions.11 A participant may change its choice of investment method at any time by notifying the plan administrator in writing in the manner provided under the plan.

Participants may discontinue the reinvestment of dividend distributions under the plan by a written notice to the plan administrator. To halt the reinvestment of dividend distributions, a notice of discontinuance must be received and effected by the plan administrator at least a specified number of days before the next dividend payment date ("Investment Date")12 or such notice will not be effective until after the Investment Date. A participant may discontinue the automatic reinvestment of dividend distributions and continue the optional cash investment portion of the plan.

A participant may, at any time, withdraw all or a portion of the shares credited to its plan account by notifying the plan administrator and specifying the number of whole shares to be withdrawn. A participant may also sell all or a portion of the shares in its plan account by notifying the plan administrator and specifying the whole number of shares to be sold. The plan administrator will make such sales on a regular basis. The plan administrator will make cash payments to participants for any fractional shares for which withdrawal or sale is requested equal to the net proceeds per share from the next sale of shares by the plan administrator multiplied by such fraction. To fulfill plan requirements, shares of stock may be purchased in the open market or directly from the REIT. Usually, shares are purchased from the REIT if the market price per share of the stock is greater than the book value per share of stock. Shares are purchased on the open market if the market price per share of the stock is less than the book value per share of stock. Under some DRIPs, the plan administrator acquires stock only from the REIT. Shares purchased directly from the REIT under the plan (whether in connection with optional cash investments or reinvestment of dividend distributions) may be issued at a discount of 0 percent to 5 percent of the market price, which is subject to change from time to time at the REIT's discretion.13 Any such change is typically made by the REIT after a review of current market conditions, the level of participation in the plan and the REIT's current and projected capital needs and can be made without prior notice to the participants. Some plans, particularly older plans, have fixed discounts. Some plans may provide different discounts for the DRIP portion and the DPP portion. Usually, no discount is offered on shares purchased under the plan in the open market instead of directly from the REIT because the REIT would have to make up any difference between the market price and any such discounted price.

The market price of stock acquired under a plan may be determined under various methods. Some of these methods are:

1. The average of the high and low sales prices of the shares, as quoted under the applicable stock exchange composite transactions, on the Investment Date.
2. The closing sales price of the shares, as quoted under the applicable stock exchange composite transactions, on the Investment Date.
3. The average of the high and low sales prices of the shares under the applicable stock exchange composite transactions, for a specified number of trading days immediately preceding the Investment Date.
4. The average of the closing sales prices of the shares under the applicable stock exchange composite transactions, for a specified number of trading days immediately preceding the Investment Date.
5. The highest of the following series of prices: (i) the average of the high and low sales prices of the shares, as quoted under the applicable stock exchange compositetransactions, on the date that the dividend distribution is declared; (ii) the average of the daily closing prices of the shares, as so quoted, for a specified number of trading days immediately before the Investment Date; and (iii) the average of the high and low sales prices of the shares, as so quoted, on the Investment Date.

If no shares are traded on the relevant date or dates for purposes of calculating the market price, the prices will typically be determined on the basis of the most recent prior date on which such shares were traded.

The method of computation is important, as we will see, because of the Internal Revenue Service's position that, for several purposes, the only relevant market value is the market value on the Investment Date. For example, under the formula in item 5 above for calculating the market price for shares purchased under the plan, if the discount under the plan is 5 percent the actual discount may be less than 5 percent of the actual fair market value of shares on the Investment Date and, in some cases, the discount price could even exceed the actual fair market value on the Investment Date. However, the discount can never exceed 5 percent of the actual fair market value of the shares under this formula on either the declaration date or Investment Date.14

Federal Income Tax Issues

For federal income tax purposes, several issues arise from the operation of DRIPs and DPPs for both the REIT and its shareholders. The principal issue for the REIT is whether the operation of the plans affects the deductibility of dividends,15 both as to those reinvested and those not reinvested. Also, the REIT is concerned about the amount of the dividends paid deduction. Shareholders are principally concerned about the amount and timing of the dividends but are also concerned about the treatment of expenses related to the operation of the plan that are paid by the REIT. These and other issues are analyzed in the remainder of this article.

Development and Summary of Law and Administrative Pronouncements and Positions

Preferential Dividends. Section 857(a)(1) provides, in part, that the provisions of part II of Subchapter M of Chapter 116 will not apply to a REIT for a tax year unless the "deduction for dividends paid" during the year (determined without regard to capital gains dividends) equals or exceeds 95 percent of its REIT taxable income (determined without regard to the deduction for dividends paid and by excluding any net capital gain).

Section 857(b)(2)(B) provides that in determining REIT taxable income, the taxable income of the REIT will be reduced 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.

The "deduction for dividends paid" is the sum of (1) the dividends paid during the taxable year and (2) the consent dividends for the taxable year (determined under section 565).17

Only REIT distributions that constitute "dividends" may be included in the deduction for dividends paid and the term "dividend" means only dividends described in section 316 (relating to the definition of dividends for purposes of corporate distributions) with certain exceptions.18 One of these exceptions is in section 562(c) which provides that the amount of any distribution will 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; *i.e.*, it must not constitute a "preferential dividend." 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.19 Thus it is of paramount importance to a REIT that none of its dividends constitutes preferential dividends. Numerous REITs have requested rulings that their DRIPs or DPPs, or certain aspects of their plans, do not cause the related dividend distributions to constitute preferential dividends.20The first provision dealing with preferential dividends appeared in the Revenue Act of 1936 in conjunction with the accumulated earnings tax provisions.21 Congress wanted to penalize individuals who attempted to defer personal income taxes by leaving earnings in corporations without a valid business purpose. At that time the tax rate on individuals was higher than on corporations. Congress also did not want the corporation to pay "preferential dividends" to shareholders having lower marginal tax rates than other shareholders. Congress was primarily concerned with corporate distributions which were a part of a tax avoidance scheme, as opposed to distributions or deemed distributions which derive from non-tax motivated transactions. This concern is made clear in the

legislative history for the Revenue Act of 1938 which provided: Subsection (h) of the bill, relating to "preferential dividends" has the same purpose as section 27(g) of the existing law which disallows a dividends-paid credit for a distribution which is preferential. No dividends-paid credit should be allowed in the case of a distribution not in conformity with the rights of shareholders generally inherent in their stock holdings, whether the preferential distribution reflects an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance. The preference which prevents the allowance of a dividends-paid credit may be one in favor of one class of stock as well as one in favor of some shares of stock within one class. The provision has been expanded in this bill so as to leave no uncertainty as to its purpose in this respect. On the other hand, the words "equal in amount," being regarded by the committee as surplusage in existing law and apparently being productive of some confusion have been eliminated in the new provision in the interest of clarity. The committee believes that *no distribution which treats shareholders with substantial impartiality* and in a manner consistent with their rights under their stockholding interest, should be regarded as preferential by reason of minor difference in valuations of property distributed.22

The Internal Revenue Service initially took a very strict position with respect to interpretation of the preferential dividend provision.23 The courts initially supported the Internal Revenue Service24 but later adopted a more flexible, factually oriented analysis that found no preferential dividend if shareholders were treated with "substantial impartiality."25With respect to the application of the preferential dividend provisions to DRIPs, the Internal Revenue Service's published position is in Rev. Rul. 83-117.26 Rev. Rul. 83-117 considers two situations in which DRIPs affect a REIT's dividends paid deduction. Under the first plan (Situation 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. According to the ruling, the 5 percent discount approximates the costs that the REIT would otherwise incur in issuing new shares. Under the second plan (Situation 2), the REIT's shareholders may also have their cash dividends reinvested, but 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 Situation 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 concludes that the plan's discount is relatively small, resulting in relatively minor differences in the amounts received by shareholders of the same class.

In Situation 2, Rev. Rul. 83-117 concludes 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. Based on this conclusion, the ruling held that the dividend in Situation 2 is preferential and the REIT is not entitled to any dividends paid deduction for the preferential dividend.

Accordingly, under the Internal Revenue Service's interpretation, the fact that a plan is impartial between shareholders with respect to the size of the discount allowable on price of the REIT stock is not enough. The discount must also be "relatively small resulting in relatively minor differences in distributions to similarly situated taxpayers."27 The Internal Revenue Service concluded in Rev. Rul. 83-117 that any discount exceeding 5 percent is not "relatively small" and, thus, will cause a preferential dividend. Because the ruling states that the 5 percent discount approximates the costs that the REIT would otherwise incur in issuing new shares, one argument to rebut this holding would be based upon the actual costs the REIT would have to pay to issue similar amounts of stock in an underwritten offering, if greater than 5 percent. This argument has the shortcoming that it is very factually oriented and would unlikely result in all REITs being treated equal as to the permissible percent of discount. Another argument is that the price is *per se* arm's length because in a typical publicly traded REIT no one shareholder controls the REIT sufficiently to control the sales price of stock under the plan.

The Amount of the Dividend. To understand the reasoning the Internal Revenue Service uses to determine the amount of the dividend deductible by the REIT and reportable by its shareholders, particularly when a discounted price is involved, one must have a general understanding of the operation of section 305.

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(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 301 states that, except as otherwise provided, a distribution of property made by a corporation to a shareholder with respect to its stock will be included in the gross income of the shareholder to the extent the amount distributed is a dividend as defined in section 316.

If any shareholder has the right to an election or option with respect to whether a distribution will 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 thedeclaration 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.28

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 Treas. Reg. § 1.301-1, is the fair market value of such stock or rights on the date of the distribution.29

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.30

Based primarily upon the foregoing provisions, the Internal Revenue Service has issued a series of revenue rulings that analyze the amount of the dividend paid in a plan undervarious circumstances. While these rulings are helpful, they do not cover all situations. Additional factual situations have been analyzed in private letter rulings.

Rev. Rul. 76-5331 concerns a DRIP and DPP for a non-REIT corporation. The corporation adopted a plan permitting the shareholders of the corporation to choose to have all of the cash dividends otherwise payable on the common shares owned by the shareholder automatically invested to purchase additional shares of the corporation's common stock. The shareholders who elect to participate in the plan acquire the corporation's stock at a price equal to 95 percent of the fair market value of such stock on the dividend payment date. In addition, shareholders participating in the plan, as well as other common shareholders, can make optional cash payments up to a specified amount for the purchase of additional common stock. The shares so acquired with optional cash payments are purchased at 100 percent of fair market value of the corporation's stock on the dividend payment date. Based on the facts, the ruling concluded that the distributions made by the corporation while the plan is in effect "are properly treated as payable either in the corporation's stock or in cash at the election of the corporation's common shareholders within the meaning of section 305(b)(1) of the Code and the regulations thereunder."32 Furthermore, the ruling concluded that the special rule of Treas. Reg. § 1.305-1(b)(2) that provides that the amount of the distribution of the stock received by any shareholder electing to receive stock of the distributing corporation of *equivalent value* is considered to equal the amount of money that could have been received instead, is not deemed applicable to the distributions made by the corporation while the plan is effective "because the common stock acquired by the participants under the plan at a discount of five percent has a greater fair market value than the cash dividend that could have been received in lieu thereof."33

The ruling held that (i) a shareholder of the corporation who participates in the plan will be treated as having received a distribution to which section 301 applies by reason of the application of section 305(b)(1); (ii) the amount of the distribution to the participating shareholders will be the fair market value of the corporation's stock received on the date of the

distribution34; and (iii) the amount of the distribution to the nonparticipating shareholders under section 301 will be the amount of the cash received by such shareholders.35

Rev. Rul. 77-14936 concerns a DRIP for a non-REIT corporation. Under the plan, an agent for the shareholders receives cash dividends otherwise receivable by shareholders participating in the plan and purchases stock of the corporation on the open market at 100 percent of fair market value, plus brokerage commissions. The ruling held that the amount of the dividend received by a participating shareholder is equal to the amount of the cash dividend otherwise payable. Rev. Rul. 76-53 was distinguished. The Internal Revenue Service concluded that here section 305 does not apply because the distribution is payable by the corporation only in cash and "shareholders of [the corporation] do not have the election of receiving their dividend distribution in either stock or cash."37

Rev. Rul. 78-37538 concerns a DRIP and a DPP for a non-REIT corporation. An independent agent for the shareholders administers the plan and acquires shares of the corporation's stock from the corporation. The shareholders can elect to have all their cash dividends (less a quarterly service charge of 3x dollars that is paid to the agent) otherwise payable automatically reinvested in shares of the corporation's common stock. The service charge is paid to the agent for administering the plan and maintaining the stock certificates for the shareholders. The shareholders who elect to participate in the plan acquire the corporation's stock at a price equal to 95 percent of the fair market value of such stock on the dividend payment date. A shareholder who participates in the dividend reinvestment aspect of the plan has the option to invest additional amounts to purchase shares of the corporation's common stock at a price equal to 95 percent of the fair market value of such stock on the dividend payment date.

The Internal Revenue Service concluded that this situation was similar to the one in Rev. Rul. 76-53; *i.e.*, the distributions are properly treated as payable either in the corporation's stock or in cash at the election of the shareholders within the meaning of section 305(b)(1). The ruling concluded (i) a shareholder who participates in the dividend reinvestment aspect of the plan will be treated as having received a distribution to which section 301 applies by reason of the application of section 305(b)(1) and the amount of the distribution will be the fair market value of the corporation's stock received on the date of the distribution, plus, pursuant to section 301, 3x dollars, the service charge subtracted from the amount of the shareholder's distribution; and (ii) a shareholder who participates in the optional payment aspect of the plan will also be treated as having received a distribution to which section 301 applies by reason of the application of section 305(b)(2), and the amount of the distribution will be the difference between the fair market value on the dividend payment date of the shares purchased with the optional payment and the amount of the optional payment.39

As noted above, these revenue rulings do not address many factual situations. Some additional circumstances are considered below.

Brokerage Commissions and Administrative Expenses. In determining whether payment by a corporation of certain expenses constitutes a constructive dividend to shareholders, the Internal Revenue Service and the courts have often examined whether the expenses are for the primary benefit of the corporation or the shareholder. For example, in *Osrow v. Commissioner,*40 the court held that a corporation's payment of underwriting expenses on behalf of shareholders constitutes a dividend to those shareholders.41 The Internal Revenue Service has analyzed in detail the issue of whether payment of brokerage commissions and administrative expenses by a corporation in connection with a plan constitutes dividend distributions to the affected shareholders. General Counsel Memorandum 3948242 concluded that payment of brokerage commissions by a corporation constitutes a dividend distribution subject to section 301.43 General Counsel Memorandum 3957944 concluded that payment of administrative expenses by a corporation does not constitute a dividend distribution.45

These conclusions have corollary effects. If a REIT pays brokerage commissions on the purchase of stock, then the amount of the brokerage commissions must be added to the discount, if any, to determine if such amount exceeds 5 percent of the related cash dividend.46 The amount of the administrative expenses should have no affect on this computation.47 However, in 1995 the Internal Revenue Service issued a private letter ruling48 that indirectly questions this conclusion with respect to administrative expenses. In Private Letter Ruling 9552038 the taxpayer represented (presumably at the behest of the

Internal Revenue Service) that “at no time will the sum of the total discount on Company’s common stock for any given quarter, plus all administrative costs paid by Company on behalf of the participants in the Plan, exceed five percent of the closing price of the common stock.”49 The National Association of Real Estate Investment Trusts, Inc. (“NAREIT”), the national, not-for-profit trade organization representing the REIT industry, submitted a letter to the Internal Revenue Service supporting the position that administrative expenses of plans represent a cost “primarily benefitting” the related REIT and, hence, are not a deemed distribution.50,51 that “the administrative fees... are not included in computing the discount,”52 it is likely that the inference in Private Letter Ruling 9552038 was either unintended or has been abandoned.

Effect of Withholding Taxes. If some distributions are subject to withholding of taxes by a REIT, should this somehow cause dividends under a plan to be preferential? The Internal Revenue Service has properly concluded that it does not in two private letter rulings, one in respect of a regulated investment company53 and one in respect of a REIT.54

Effects of Market Price Valuation Date Selection. As noted above,55 REITs have adopted various methods to determine the market price of stock acquired under a plan. This raises the question of whether a preferential dividend can result from market fluctuations between the pricing dates and the dividend distribution date. The Internal Revenue Service would apparently conclude that it can.56 For example, suppose the market price of the stock is determined as the average of the closing prices of the stock on the 5 trading days before the dividend distribution date. Assume this is $10 and a 5 percent discount is offered or $0.50. If the fair market value of the stock on the dividend distribution date is less than $10, then the discount will exceed 5 percent of the price of the stock on the dividend distribution date and the entire dividend paid on that date is a nondeductible preferential dividend. For this reason, many plans provide that, notwithstanding the general market price formula, the discount cannot exceed 5 percent of the closing price (or the average of the high and low sale prices) of the stock on the dividend distribution date.57

It is interesting to note that in the narrow case “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.”58 The Internal Revenue Service applied this rule to a plan of a regulated investment company where the market price used for the stock issued under the plan was “the higher of (1) the net asset value per share or (2) the 95 percent of the closing market value on the *record date*.”59 (Emphasis added). The dividends under the plan were held not to be preferential, even though the fair market value of the stock on the dividend distribution date could be much lower. Note also that the Internal Revenue Service concluded that Treas. Reg. § 1.305-1(b)(2) does not apply where a discount is applied to the market price of the stock in a plan because the discount caused the stock to be received not to be “equivalent value” to the cash dividend.60 Query whether a REIT having a plan offering no discount can determine the market price on the record date or some other date? Based upon the above analysis, it should. However, it seems strange that the application of a 5 percent discount limit which might be considerably less than market fluctuations between the record date and the dividend distribution date should cause a change in a legal conclusion.61

Amount of Income From Discounts in Optional Cash Purchases Under a DPP. One of the more unsettled areas in the taxation of plans is the amount of income to a participant from a discount to market price in the case of cash purchases under a DPP. Consider two possibilities: (1) a participant who participates in only the DPP and (2) a participant who participates in both the DRIP and the DPP. Initially one would think that there should be no difference between the two scenarios, either as to the participants or the REIT. In a Private Letter Ruling 973100762 the Internal Revenue Service held that as to the REIT the amount of the dividends paid deduction for stock purchases under a DPP at a discount (not to exceed 5 percent) equals “the excess of the fair market value of the common shares received by shareholders under the Cash Purchase portion of the Plan over the amount of Cash Purchases made.”63 However, in Private Letter Ruling 975003364 the Internal Revenue Service developed a bifurcated analysis as to the income recognizable by shareholder participants in a DPP:

1. Shareholders who participate *solely* in the DPP will *not* be treated as having received a distribution of the discount amount of the stock to which section 301 applies by reason of the application of section 305(b). These shareholders will realize no income as a result of these purchases.
2. Shareholders who participate in *both* the DRIP and the DPP *will* be treated as having received at the time of purchase a distribution of the discount amount of the stock to which section 301 applies by reason of the application of section 305(b)(2).

These conclusions were published without any analysis of law. Apparently, the Internal Revenue Service reasoned that a participant only in the DPP could not be squeezed into the statutory framework of section 305(b). Note that the conclusion in Rev. Rul. 78-375 discussed above as to the amount of income to a shareholder participating in a DPP is premised on the fact that the shareholder participated in the DRIP. Although the Internal Revenue Service did not so state in Private Letter Ruling 9750033, logic would demand that the dividend paid deduction mirror these conclusions. However, that would be contrary to the conclusions in previously issued rulings discussed above. Furthermore, the record keeping requirements (Forms 1099, etc.) of the plan administrator would be a nightmare. It is unfathomable to believe that many REITs report either their dividends paid deduction or their income to shareholders using this bifurcated analysis.

Another question involving plans combining DRIPs and DPP is the base to be used in applying the 5 percent discount limit. Should the base be (1) the amount actually paid by the REIT as a cash dividend or (2) the aggregate fair market value of all shares purchased through the DRIP and the DPP?65

Example: A REIT shareholder reinvests $100 of dividends and due to the discount acquires $104 of stock from the REIT. At the same time the shareholder invests $300 of cash and due to the discount acquires $312 of stock. If the first alternative is used the total discount of $16 is divided by $100 (the amount of the cash dividend) so that the fraction is 16 divided by 100 or 16 percent, clearly in excess of the 5 percent limit. The second alternative produces a fraction of 16 divided by 400 or 4 percent, easily within the 5 percent limit.

However, under Treas. Reg. § 1.562-2 a preferential dividend is defined with respect to "*a* distribution." Therefore, each distribution should be tested separately in determining whether there has been a preferential dividend. There apparently is no authority on this point. As a result, a method to preserve the dividends paid deduction for the actual cash dividend is to have the Investment Date for cash purchases under the DPP to be a different date than the dividend payment date. This should isolate the issue described in the above example to only the deemed dividend from discounts on the cash purchases.

Summary of Rules

Based upon the above analysis, the present state of the federal income tax law66 applicable to the operation of DRIPs and DPPs to a REIT can be summarized as follows. This summary assumes that some discount is offered so that the rules under section 305 apply and the result of Rev. Rul. 77-149 does not apply.

1. Provided any discount, including brokerage commissions *paid by the REIT,* in the price of stock acquired from a REIT with reinvested dividends does not exceed 5 percent of the fair market value of the stock on the *dividend payment date,* the dividends paid on such date are not considered preferential for purposes of section 562 and the dividends may be deducted under section 857.
2. Administrative expenses (as opposed to brokerage commissions) incurred and paid by the REIT should have no effect on the deductibility of the dividends by the REIT or the amount of the dividends paid deductions and should not be income to shareholders.
3. A shareholder of the REIT who participates in the DRIP aspect of the plan will be treated as having received a distribution to which section 301 applies by reason of the application of section 305(b)(1). The amount of the distribution to a participating shareholder will be the fair market value of the REIT stock received on the date of the distribution.67

4. The basis of the shares credited to the account of a participating shareholder pursuant to the DRIP aspect of the plan will equal the amount of the dividend distribution, as provided in section 301(c), measured by the fair market value of the REIT stock as of the date of the distribution, pursuant to section 301(d).[68]
5. A shareholder of the REIT who participates in the DPP aspect of the plan will be treated as having received a distribution to which section 301 applies by reason of the application of section 305(b)(2). The amount of the distribution to a participating shareholder will be the difference between the fair market value on the dividend payment date of the shares purchased with the optional payment and the amount of the optional payment.[69]
6. The basis of the shares to the shareholder who participates in the DPP aspect of the plan is the excess of fair market value of the shares purchased with the optional payment over the optional payment (provided that this deemed distribution is taxable as a dividend under section 301(c)(1)) plus the amount of the optional payment.[70]
7. A participant in the plan will not realize any taxable income upon receipt of certificates for whole shares that were credited to the participant's account pursuant to the plan.[71] Any cash received by the REIT shareholder in lieu of a fractional share interest will be treated as a redemption of that fractional share interest, subject to the provisions and limitations of section 302 of the Code.[72]
8. A participant will recognize gain or loss when shares are sold or exchanged on behalf of the participant upon the participant's withdrawal from the plan or when the participant sells the shares after its withdrawal from the plan. The amount of such gain or loss will be the difference between the amount that the participant receives for the whole shares and the participant's tax basis. Any cash received by the participants who withdraw from the plan, in lieu of their fractional share interests, will be treated as a redemption of that fractional share interest, subject to the provisions and limitations of section 302.

1 REITs are subject to the special tax rules set forth in sections 856 through 860 of the Internal Revenue of Code of 1986 (the "Code"). All section references are to the Code, unless otherwise indicated. For a summary of the real estate investment trust provisions of the Code see Thomas R. Popplewell & Muriel C. Brown, Special Forms of Holding Real Estate in FEDERAL TAXES AFFECTING REAL ESTATE, 16-1 (Matthew Bender & Co., Inc., 1997). For a more detailed analysis of the REIT provisions see Steven F. Mount, Real Estate Investment Trusts, 742 Tax Mgmt. (1996) and THEODORE S. LYNN & MICAH BLOOMFIELD, REAL ESTATE INVESTMENT TRUSTS (1996).

2 I.R.C. § 857(b)(2).

3 I.R.C. § 857(a).

4 Some REITs refer to DPPs as stock investment plans, cash option purchase plans or share purchase plans. Sometimes a combination of a DRIP and DPP is called a dividend reinvestment and share purchase plan.

5 The term "dividend distribution" as used herein generally refers to a distribution constituting dividends under state law whether or not such distribution constitutes a "dividend" within the meaning of section 316(a).

6 However, a REIT will not receive any capital from reinvested dividend distributions if the REIT stock purchased pursuant to the plan is acquired on the open market.

7 No underwriting fee is required and the registration requirements with the Securities and Exchange Commission ("SEC") are relatively streamlined.

8 See infra text accompanying notes 50 and 65.

9 The mechanics to adopt a DRIP and/or DPP are generally as follows: The officers of the REIT, working in conjunction with their legal and accounting advisers, formulate the plan. The plan is adopted by the board of directors. For publicly held REITs, a registration statement is filed with the SEC. A plan administrator is engaged to operate the plan. After the registration statement is declared effective by the SEC and any required state securities filings or registrations are completed, the REIT may issue stock under the plan.

10 This requirement is important for tax purposes, particularly if the stock is offered at a discounted price. See discussion infra "Development and Summary of Law and Administrative Pronouncements and Positions —Preferential Dividends."

11 If a REIT has more than one class of stock it is not necessary that each class be eligible for participation in the DRIP. See Priv. Ltr. Rul. 8548014 (Aug. 28, 1985). Although under section 6110(j)(3), written determinations of the Internal Revenue Service may not be used or cited as precedent, they illustrate the thinking of the Internal Revenue Service. Also, the Internal Revenue Manual provides that "[e]xisting files of private letter rulings and memorandums (including . . . General Counsel Memorandum) . . . may be used as a guide with other research material in formulating a district office position on an issue." I.R.M. 424(14).3. In addition, private letter rulings and technical advice memoranda issued after October 31, 1976, and actions on decisions and general counsel memoranda issued after March 12, 1981, may be relied upon in determining whether there is substantial authority to avoid a penalty for understatement of tax with respect to the tax treatment of an item on a taxpayer's return. Treas. Reg. § 1.6662-4(d)(3)(iii).

12 As used herein, the term Investment Date with respect to a DRIP refers to the date on which a dividend distribution is payable to shareholders and with respect to a DPP refers to the date on which shares are purchased. Within a plan the Investment Date for the DRIP portion may not be the same as the Investment Date for the DPP portion.

13 The maximum 5 percent discount has tax significance. See discussion infra "Development and Summary of Law and Administrative Pronouncements and Positions—Preferential Dividends."

14 The reason many REITs have gone to a market price formula using an average of prices from several days is to discourage arbitrageur's from participating in a plan solely to make a profit from differences between trading prices during the Investment Date. Placing a limit on the amount of periodic cash purchases is also intended, in part, to limit arbitrage activity.

15 Pursuant to section 857(b)(2)(B), in computing its taxable income a REIT is entitled to deduct "dividends paid" as defined in section 561.

16 Except section 856(g) dealing with termination of REIT elections and section 857(d) dealing with special earnings and profits provisions.

17 I.R.C. § 561(a).

18 I.R.C. § 562(a). 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. Section 857(d) provides special rules to determine the earnings and profits of a REIT.

19 Treas. Reg. § 1.562-2(a). Such regulation also 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.

Id.

20 *See e.g.*, Priv. Ltr. Rul. 9731007 (Apr. 29, 1997), Priv. Ltr. Rul. 9634024 (May 28, 1996), Priv. Ltr. Rul. 9552038 (Sept. 29, 1995), Priv. Ltr. Rul. 9132056 (May 14, 1991), Priv. Ltr. Rul. 9038025 (June 25, 1990), Priv. Ltr. Rul. 9035016 (May 30, 1990), Priv. Ltr. Rul. 8812062 (Dec. 28, 1987), Priv. Ltr. Rul. 8722060 (Mar. 2, 1987), Priv. Ltr. Rul. 8708005 (Nov. 21, 1986), Priv. Ltr. Rul. 8548014 (Aug. 28, 1985), Priv. Ltr. Rul. 8348007 (Aug. 26, 1983), 8111066 (Dec. 17, 1980), Priv. Ltr. Rul.7920041 (Feb. 15, 1979), Priv. Ltr. Rul. 7102250630A (Feb. 25, 1971). Private letter rulings 9035016, 8708005 and

8548014 concern plans involving regulated investment companies, but such entities are subject to the same restrictions on preferential dividends as REITs. *See* I.R.C. § 852(b)(2)(D).

21 Revenue Act of 1936, H.R. 12395, 74th Cong. § 27(g), 49 Stat. 1648 (1936).

22 H.R. Rep. No. 1860, 75th Cong. (3d Sess.), 23 (1938), 1939-1 (Part 2) C.B. 728, 744 (emphasis added).

23 *See* I.T. 3244, 1939-1 C.B. 181, *declared obsolete b*y Rev. Rul. 71-498, 1971-2 C.B. 434.

24 Generally, anything other than equal per share distributions was considered preferential. *See, e.g., Mary Hosiery Mills, Inc. v. Commissioner*, 42 B.T.A. 646 (1940), *aff'd* 123 F. 2d 858 (4th Cir. 1941); *Monte Glove Co. v. Commissioner*, 44 B.T.A. 539 (1941); *Forstner Chain Corp. v. Commissione*r, 45 B.T.A. 19 (1941); *New York Stock, Inc. v. Commissione*r, 8 T.C. 322 (1947), *rev'd,* 164 F. 2d 75 (2d Cir. 1947).

25 *New York Stock, Inc. v. Commissione*r, 164 F. 2d 75 (2d Cir. 1947); *National Securities Series - Industrial Stock Series v. Commissioner*, 13 T.C. 884 (1950), *acq.* 1950-1 C.B. 4.

26 1983-2 C.B. 98.

27 *Id.*

28 Treas. Reg. § 1.305-2(a).

29 Treas. Reg. § 1.305-1(b)(1)

30 Treas. Reg. § 1.305-1(b)(2)

31 1976-1 C.B. 87.

32 Id. at 89.

33 *Id.*

34 Treas. Reg. §§ 1.305-1(b), 1.301-1(b) and (d).

35 Treas. Reg. § 1.305-2(b), Ex. (1).

36 1977-1 C.B. 82.

37 *Id.* at 83.

38 1978-2 C.B. 130.

39 See also Priv. Ltr. Rul. 8812062 (Dec. 28, 1987) and Priv. Ltr. Rul. 8722060 (Mar. 2, 1987).

40 49 T.C. 333 (1968), *acq.* 1969-1 C.B. 21.

41 *See also, Crosby v. U.S.,* 496 F.2d 1384 (5th Cir. 1974).

42 (Mar. 5, 1986).

43 *See also*, Priv. Ltr. Rul. 9132056 (May 14, 1991). The amount of the constructive dividend distribution to a participating shareholder as a result of the corporation's payment of brokerage commissions on the purchase of stock under the plan is equal to its *pro rata* share of the brokerage commissions actually paid by the taxpayer. Brokerage commissions on the sale of stock by a participant are deducted from the sales proceeds.

44 (Nov. 24, 1986).

45 *See also*, Priv. Ltr. Rul. 9038025 (Jun. 25, 1990) and Priv. Ltr. Rul. 9731007 (Apr. 29, 1997).

46 Priv. Ltr. Rul. 9132056 (May 14, 1991). Generally, this does not present a problem, because no brokerage commissions should arise on purchases from a REIT and open market purchases are usually not discounted.

47 Priv. Ltr. Rul. 9731007 (Apr. 29, 1997); Priv. Ltr. Rul. 9634024 (May 28, 1996); Priv. Ltr. Rul. 9038025 (June 25, 1990).

48 Priv. Ltr. Rul. 9552038 (Sept. 29, 1995).

49 *Id.*

50 Tony M. Edwards & Thayne T. Needles, "*Let it DRIP, but Watch for Puddles",* NAREIT ONLINE (visited July 21, 1998).

51 (Apr. 29, 1997).

52 *Id.*

53 Priv. Ltr. Rul. 8548014 (Aug. 28, 1985).

54 Priv. Ltr. Rul. 8348007 (Aug. 26, 1983).

55 *See supra* text in the first paragraph following note 13.

56 Rev. Rul. 83-117, 1983-2 C.B. 98; Priv. Ltr. Rul. 9731007 (Apr. 29, 1997).

57 There does not appear to be any clear guidance as to whether the average of the high and low sales prices of the stock (*see, e.g.*, Priv. Ltr. Rul. 9750033 (Sept. 10, 1997), Priv. Ltr. Rul. 9035016 (May 30, 1990), Priv. Ltr. Rul. 8722060 (Mar. 2, 1987) and Priv. Ltr. Rul. 8111066 (Dec. 17, 1980)) or the closing price of the stock (*see, e.g.*, Priv. Ltr. Rul. 9634024 (May 28, 1996), Priv. Ltr. Rul. 9552038 (Sept. 29, 1995)) or some other method of determining the price of the stock is the appropriate measure of fair market value. Presumably, the Internal Revenue Service will not object to either an average or the closing price as long as it is used consistently. Note that Treas. Reg. § 20.2031-2(b)(1) provides that for estate tax purposes, fair market value is to be determined by the average method.

58 Treas. Reg. § 1.305-1(b)(2).

59 Priv. Ltr. Rul. 8708005 (Nov. 21, 1986).

60 Rev. Rul. 76-53, 1976-1 C.B. 87, 89.

61 In a letter to the Commissioner of Internal Revenue, the Investment Company Institute requested that a Revenue Ruling be issued and the rule bethat set forth in PLR 8708005, which held that (1) as long as the stock alternative is set at a value not less than 95 percent of the fair market value of the stock, the distribution will not be considered preferential and (2) the amount of the dividend paid deduction, as well as the amount of the dividend to the shareholder, will be the amount of the cash alternative. We also respectfully request that the ruling state that the valuation of the stock for the purpose of the stock alternative can be made as of the declaration date or any other date on or before the distribution date.

Letter from Edwin S. Cohen, Senior Counsel, Covington & Burling, to Commissioner of Internal Revenue, Internal Revenue Service 17-18 (Nov. 23, 1988) (on file with the Investment Company Institute).

62 (Apr. 29, 1997).

63 *Id. Accord* Priv. Ltr. Rul. 9634024 (May 28, 1996); Priv. Ltr. Rul. 8812062 (Dec. 28, 1987), Priv. Ltr. Rul. 8722060 (Mar. 2, 1987).

64 (Sept. 10, 1997).

65 *See* Edward & Needles, *supra* note 47.

66 Note that to the extent one or more of the following conclusions are based upon the conclusions set forth in private letter rulings, they may not technically be based on “law.” *See supra* note 11.

67 Treas. Reg. §§ 1.301-1(b) and (d) and 1.305-1(b).

68 Treas. Reg. § 1.301-1(h)(1) and (2)(i).

69 Treas. Reg. § 1.305-1(b)(1); *but see* text accompanying note 64.

70 I.R.C. §§ 301(d) and 1012 and Treas. Reg. § 1.301-1(h)(1) and 2(i).

71 Rev. Rul. 76-53, 1976-1 C.B. 87.

72 *See* Rev. Rul. 66-365, 1966-2 C.B. 116.