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Revenue Procedure 2017-45 Provides Open-Ended Guidance for Certain Stock Distributions of RICs

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The IRS recently issued Revenue Procedure 2017-45, which provides guidance for certain stock distributions of a publicly offered regulated investment company ("RIC"). This article describes the requirements of Revenue Procedure 2017-45, highlighting the benefits the guidance provides to publicly offered RICs that find it impossible or impracticable to make cash distributions.

On August 11, 2017, the IRS issued Revenue Procedure 2017-45,[1] which provides guidance permitting certain stock distributions by a publicly offered[2] RIC to be treated as section 301 distributions of property that may be eligible to be included in the RIC's dividends paid deduction.[3] The revenue procedure applies if the RIC distributes at least 20 percent cash and meets other specified requirements as described below. Unlike prior revenue procedures that covered similar stock

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1 2017-35 I.R.B.

2 A publicly offered RIC means a RIC the shares of which are continuously offered pursuant to a public offering, regularly traded on an established securities market, or held by or for no fewer than 500 persons at all times during the tax year. Section 67(c)(2)(B). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

3 Revenue Procedure 2017-45 also applies to publicly offered real estate investment trusts ("REITs"). For purposes of this article, we focus on the application of Revenue Procedure 2017-45 to RICs.

distributions, Revenue Procedure 2017-45 is open-ended, applying to distributions declared on or after August 11, 2017.

Background

A RIC is generally required to make dividend distributions annually with respect to a minimum amount of taxable income in order to qualify to be treated as a RIC. Under section 852(a), a RIC's deduction for dividends paid during the tax year must generally equal or exceed the sum of (1) 90 percent of its investment company taxable income for the tax year and (2) 90 percent of its tax-exempt interest income over certain disallowed deductions.[4] Section 301 includes in gross income only distributions that are dividends as described in section 316—i.e., distributions of a RIC out of its earnings and profits.[5] Thus, only these distributions qualify for the deduction for dividends paid.[6] In addition, except for a publicly offered RIC, the amount of any distribution is not considered as a dividend for purposes of computing the dividends paid deduction unless the distribution is pro rata, with no preference to any share as compared with other shares of the same class, and with no preference to one class of shares as compared with another class except to the extent that the shares are entitled to the preference.[7]

Section 305 governs distributions by a RIC of its own stock. In general, gross income does not include the amount of any distributions by a corporation to its shareholders of its own stock.[8] However, if the distribution is, at the election of any of the shareholders, payable in either stock of the corporation or in property, then the distribution is treated as a distribution to which section 301 applies.[9] In addition, if the distribution has the result of the receipt of property by some shareholders and an increase in the proportionate interest of other shareholders in the assets or earnings and profits of the corporation, then the distribution is also treated as a distribution to which section 301 applies.[10] Thus, these distributions by a RIC may be included in gross income to the extent of the RIC's earnings and profits, and may qualify for the dividends paid deduction.

The regulations under section 305 further clarify that if any shareholder has the right to an election or option with respect to whether a distribution is to be made either in cash 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 the other, (4) whether the election governing the nature of the distribution is provided in the declaration of the distribution or in the

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[4] Section 852(a).

[5] Section 301(c)(1).

[6] Sections 561(b) and 562(a).

[7] Section 562(c)(1).

[8] Section 305(a).

[9] Section 305(b)(1).

[10] Section 305(b)(2).

corporate charter or arises from the circumstances of the distribution, or (5) whether all or part of the shareholders have the election.[11] Moreover, if a corporation that regularly distributes its earnings and profits, such as a RIC, declares a dividend pursuant to which the shareholders may elect to receive either cash 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 cash that could have been received instead.[12]

A series of IRS guidance addressed the ability of a RIC (or REIT) to include distributions of its stock in its dividends paid deduction when shareholders could elect to receive cash in lieu of stock, even though the aggregate amount of cash was limited to a certain percentage of the total distributions. This guidance was issued in response to the financial downturn in 2008, beginning with Revenue Procedure 2008-68,[13] which permitted certain distributions of stock by a publicly traded REIT (whose shareholders could elect to receive cash in lieu of the stock) to be treated as a distribution of property to which section 301 applies if the aggregate cash distributed by the REIT was at least 10 percent of the declared distribution. Revenue Procedure 2008-68 applied to distributions on or after January 1, 2008, with respect to tax years ending on or before December 31, 2009.

Revenue Procedure 2009-15[14] extended the rules of Revenue Procedure 2008-68 to publicly traded RICs as well as publicly traded REITs, also effective for distributions on or after January 1, 2008, with respect to tax years ending on or before December 31, 2009. Finally, Revenue Procedure 2010-12[15] further extended these rules to distributions made by publicly traded RICs or REITs on or after January 1, 2008, and declared on or before December 31, 2012, with respect to tax years ending on or before December 31, 2011.

No further revenue procedures were issued subsequent to Revenue Procedure 2010-12 to cover distributions with respect to tax years on or after 2012—until Revenue Procedure 2017-45.

Requirements under Revenue Procedure 2017-45

Under Revenue Procedure 2017-45, if a publicly offered RIC makes a distribution of stock in a transaction that meets certain requirements, the IRS will treat the distribution of stock as a distribution of property to which section 301 applies by reason of section 305(b). The value of the stock received by any shareholder in lieu of cash will be considered to be equal to the amount of cash for which the stock was substituted.[16]

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[11] Section 1.305-2(a).

[12] Section 1.305-1(b)(2).

[13] 2008-2 C.B. 1373.

[14] 2009-4 C.B. 356.

[15] 2010-3 C.B. 302.

[16] For purposes of Revenue Procedure 2017-45, if a shareholder participates in a dividend reinvestment plan, the stock received by that shareholder pursuant to the dividend reinvestment plan is treated as received in exchange for cash received in the distribution.

For Revenue Procedure 2017-45 to apply to a publicly offered RIC, all the following requirements must be met:

- A publicly offered RIC must make a distribution to its shareholders with respect to its stock.
- Pursuant to the declaration of the distribution, each shareholder has a "cash-or-stock election" with respect to part or all of the distribution.[17]
- The maximum aggregate amount of cash to be distributed to all shareholders (the "Cash Limitation Amount") divided by the amount of cash that would be distributed if every shareholder elected to receive its distribution in cash (such percentage, the "Cash Limitation Percentage") must be at least 20 percent.
- Every shareholder that has not elected to receive a cash amount (the "Elected Cash Amount") in relation to its entire distribution that exceeds the Cash Limitation Percentage (an "Excess Cash Claim") receives cash equal to the shareholder's Elected Cash Amount (other shareholders who have an Excess Cash Claim are "Excess Cash Claimants").
- If the aggregate of all shareholders' Elected Cash Amounts does not exceed the Cash Limitation Amount, then every Excess Cash Claimant receives cash equal to that shareholder's Elected Cash Amount.
- If the aggregate of all shareholders' Elected Cash Amounts exceeds the Cash Limitation Amount, then each Excess Cash Claimant receives an amount of cash that is as close in amount as practicable to the sum of —
    - The product of the Cash Limitation Percentage and that shareholder's entire distribution; and
    - The product of the available cash and the ratio of —
        - That shareholder's Excess Cash Claim to
        - The aggregate of the Excess Cash Claims of all Excess Cash Claimants.
- The calculation of the number of shares to be received by a shareholder is determined based upon a formula that—
    - Utilizes the market price of the shares;

[17] The existence of a cash-or-stock election does not affect the federal income tax treatment of the portion, if any, of the declared dividend that is not subject to the election. For purposes of Revenue Procedure 2017-45, a cash-or-stock election is an election each shareholder may make to receive up to all of the shareholder's entire entitlement under the declaration of the distribution in cash or in stock of the distributing corporation of equivalent value.

- Is designed so that the value of the number of shares to be received in lieu of cash with respect to a share corresponds as closely as practicable to the amount of cash to be received under the declaration with respect to that share; and
- Uses data from a period of no more than two weeks ending as close as practicable to the payment date.

Observations

The open-ended nature of Revenue Procedure 2017-45 is not only welcome news to RICs, but also lightens the IRS's administrative burden. Situations may arise when it is impossible or impracticable for a RIC to make a cash distribution to meet its distribution requirements, especially during periods of economic downturn. The ability to use stock instead to meet their distribution requirements has provided much-needed reprieves in the past to RICs and REITs in need of making dividend distributions but finding themselves low on cash. The prior revenue procedures first permitted REITs, and then RICs as well, to use distributions of stock to meet their respective distribution requirements, but these revenue procedures have been time limited, with the last one covering distributions for tax years ending on or before December 31, 2011. For distributions outside of the timeframes covered by the prior revenue procedures, RICs and REITs have relied on private letter ruling requests to address this issue, a process that is both time consuming and administratively burdensome for both the requesting RIC and the IRS.[18] With the new open-ended process provided by the Revenue Procedure 2017-45, RICs no longer need to rely on private letter rulings to cover distributions of stock on or after August 11, 2017, so long as the requirements of Revenue Procedure 2017-45 are met.

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[18] *See, e.g.*, PLR 200939008 (June 17, 2009), PLR 200935013 (June 3, 2009), PLR 200916021 (Dec. 19, 2008), and PLR 200852007 (Sept. 30, 2008).