Dechert LLP

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Reduced Cash Requirement in Part Stock and Part Cash Dividends: New IRS Guidance on RIC and REIT Distributions

On May 4, 2020, the U.S. Internal Revenue Service issued Revenue Procedure 2020-19,[1] temporarily allowing publicly offered regulated investment companies (RICs), including certain business development companies and certain closed-end investment companies, as well as publicly offered real estate investment trusts (REITs) to limit the cash component of their dividends to a maximum of 10% cash if certain procedures are followed. The intent of this IRS initiative is to allow RICs and REITs to conserve capital and enhance their cash liquidity during the current COVID-19 coronavirus pandemic. This IRS release was in response to a recent specific Dechert request to the U.S. Treasury Department recommending guidance allowing all RICs to use a 90 percent/10 percent combination of stock and cash for this purpose.

Revenue Procedure 2020-19 applies to distributions declared by publicly offered RICs and REITs on or after April 1, 2020 and on or before December 31, 2020.

Generally, in order to avoid corporate-level income tax and to remain qualified to pass-through the character of certain items of a RIC's or REIT's investment income and realized capital gains tax-free to its shareholders under the Internal Revenue Code, the RIC or REIT must satisfy an annual requirement to distribute all of its net taxable income as dividends (Distribution Requirement). Many BDCs and closed-end investment companies are taxed as RICs. However, the distribution by a RIC or REIT paid solely in its own shares of stock, without shareholders being able to receive cash instead, generally does not count as a dividend for this purpose unless certain exceptions apply. One existing exception is IRS Revenue Procedure 2017-45,[2] which sets forth requirements whereby a distribution by a "publicly offered" (as defined below) RIC or REIT that is made at least 20% in cash and the rest in stock, at the election of the shareholder, will be included as the RIC's or REIT's dividend.

While keeping the other requirements of Revenue Procedure 2017-45 the same, Revenue Procedure 2020-19 lowers the cash limitation percentage (as defined below) to 10 percent, for distributions declared by publicly offered RICs and REITs on or after April 1, 2020 and on or before December 31, 2020.

The IRS guidance is limited to RICs and REITs that are publicly offered. Publicly offered RICs are those whose shares: are continuously offered pursuant to a public offering within the meaning of section 4 of the Securities Act of 1933; are U.S. exchange-traded; or are held by at least 500 persons for all days of the taxable year. A publicly offered REIT means a REIT required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

To take advantage of this dividend cash limitation IRS procedure, a publicly offered RIC (or REIT) would need to satisfy all of the following, with respect to an upcoming distribution:

- The RIC (or REIT) must provide each shareholder an election to receive part or all of the distribution in cash or stock;

- The RIC (or REIT) may limit the total amount of cash to be distributed to all shareholders (cash limitation amount) to a specified fraction of the total value of the distribution;

- The amount of cash allowed to be distributed (cash limitation percentage) may not be less than 10% of the total distribution;

- If the total amount of cash elected to be received by all shareholders exceeds the cash limitation amount, then each shareholder electing to receive a percentage of cash that exceeds the cash limitation percentage will receive cash in excess of the cash limitation percentage on a pro rata basis, in accordance with the formula provided in the Revenue Procedure 2017-45;

- Each shareholder electing to receive an equal or lower percentage of cash than the cash limitation percentage must receive the full amount of cash elected to be received by such shareholder;

- If the total amount of cash elected to be received by all shareholders does not exceed the cash limitation amount, then shareholders will receive the amount of cash elected to be received by them;

- The number of shares of stock to be received by each shareholder as part of this distribution is calculated in accordance with a formula that: utilizes the market price of the shares; 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 related dividend declaration; and uses data from a period of no more than two weeks ending as close as practicable to the payment date;

- 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 is substituted as discussed above; and

- If a shareholder is participating in a dividend reinvestment plan (DRIP), the stock received by that shareholder pursuant to the DRIP will be treated as received in exchange for cash received in the distribution.

A related important consideration in the current market is whether a RIC required to pay a dividend to satisfy its Distribution Requirement may do so in compliance with applicable provisions of the Investment Company Act of 1940. Under such provisions, while any indebtedness and other senior securities of a registered closed-end investment company (including a BDC) remain outstanding, such investment company (or BDC) generally is not permitted to declare a cash distribution unless the investment company (or BDC) meets the applicable asset coverage ratios at the time of the declaration and would continue to satisfy such ratios after the payment of the cash dividend.[3]

In 2009, the SEC Division of Investment Management issued a no-action letter (ACAS Letter) permitting a BDC to rely on then-applicable IRS guidance (Revenue Procedure 2009-15) which, similar to Revenue Procedure 2020-19, temporarily allowed a BDC to limit the cash component of its dividend to a maximum of 10% cash if certain procedures were followed.[4] Under the ACAS Letter, the BDC was permitted to pay up to 10% of its distribution in cash, even if the payment of such cash dividend would otherwise not be permitted under the 1940 Act because the BDC would be out of compliance with applicable asset coverage ratios.

As the specific IRS guidance referenced in the ACAS Letter has expired,[5] there has been some uncertainty as to whether BDCs and other RICs seeking to pay a maximum of 10% of their distributions in cash under Revenue Procedure 2020-19 may rely on the ACAS Letter. In a helpful clarification, Dechert has been advised by the SEC staff that such RICs may rely on the ACAS Letter. Thus, for RICs that may fall out of compliance with applicable asset coverage ratios, payment of cash/stock dividends with a maximum of 10% cash in reliance on Revenue Procedure 2020-19 may be the exclusive way to satisfy the Distribution Requirement without running afoul of the 1940 Act (in the absence of further relief from the SEC).

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Footnotes

1) Revenue Procedure 2020-19.

2) Revenue Procedure 2017-45, 2017-35 I.R.B. 216.

3) Section 18(a)(1)(B) and 61(a)(1) of the 1940 Act.

4) American Capital, Ltd.: No-Action Letter (June 30, 2009).

5) Revenue Procedure 2009-15 was in effect until Dec. 31, 2011, after which it expired.