Real Estate Tax Alert

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PLR 201444022: REIT Preferential Dividends and Management Fee Structures

Background

Open and closed-end real estate investment funds offer opportunities for investors of all types and sizes to invest in various real estate strategies around the world. To attract large amounts of capital, these investment funds often offer certain investors alternative fee structures based upon the size of their capital commitments. For a fund structured as a real estate investment trust ("REIT"), such alternative fee arrangements may be offered only to certain classes of shares. The IRS has recently ruled in PLR 201444022 that separate classes of shares of a REIT would not be recognized as separate where the separate classes were offered solely to implement a tiered investment advisory fee structure in which the amount of the fees effectively borne by the shareholders would vary based on the amount invested by the shareholders. Treating the two classes as a single class, the IRS concluded that the varying distributions to the shareholders constituted a preferential dividend. A preferential dividend is not considered to be distributed for purposes of the dividends paid deduction and the REIT distribution requirement and may cause a taxpayer to fail to qualify as a REIT.

Distribution requirements & preferential dividends

While REITs are taxed as corporations for US income tax purposes, REITs often pay no tax as they are generally allowed a deduction for dividends paid.[1] To qualify as a REIT, a corporation, association or trust must satisfy a number of asset, income, distribution and ownership requirements. One such requirement is that the deduction for dividends paid during the taxable year equals or exceeds 90 percent of the REIT's taxable income for such taxable year (determined without regard to the deduction for dividends paid and by excluding any net capital gain).[2]

In general, a dividend by a REIT is not eligible for the dividends paid deduction if it is a "preferential dividend."[3] A distribution will be considered a preferential dividend if such distribution provides a preference to any share of stock as compared with other shares of the same class, or a preference to one class of stock as compared with another class except to the extent the class receiving the preference is entitled (without reference to waivers of their rights by shareholders) to such preference.[4] Thus, if a REIT is determined to have made a preferential dividend during a taxable year, such dividend is disallowed for purposes of determining the dividends paid deduction and the taxpayer may fail to qualify as a REIT for the taxable year as a result.

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1 Section 857(b)(2)(B). All "Section" and "§" references are to the provisions of the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" or "Treas. Reg. Section" references are to regulations promulgated thereunder.
2 Section 857(a)(1).
3 Section 562(c),
4 Id.

Where any preference in fact exists, it extends to the entire amount of the distribution and not merely the preferential part of such distribution.[5]

Permissible differences in prior rulings

On numerous occasions, the Service has ruled that REITs and RICs may offer investors different classes of shares which, due to differences in administrative expenses and fees associated with each class, result in different amounts of distributions being paid to each class without creating a preferential dividend. These have typically involved cases in which the REIT or RIC offered investors different classes which had differing percentages of front and deferred sales "loads" or commissions.

In Rev. Proc. 99-40, the Service provided guidelines by which distributions made to shareholders of RICs may vary in certain cases but still be deductible. Specifically, Rev. Proc. 99-40 provides that different classes of shares of a RIC may pay a different share of fees and expenses, not including advisory or custodial fees or other fees and expenses related to the management of the RIC's assets, if these expenses are actually incurred in a different amount by such class. The Rev. Proc. provided that advisory and other management fees must be allocated based on the net asset value ("NAV") of each class in relation to the NAV of the RIC, although, different classes may be allocated and pay a different advisory fee to the extent that any differences in such amounts are the result of the application of the same performance provisions in the advisory contract to the different investment performance of each class of shares.

While Rev. Proc. 99-40 does not specifically apply to REITs, the Service has applied the guidelines set forth in Rev. Proc. 99-40 in the REIT context. For example, the IRS has ruled that distributions paid by a REIT that issued two classes of shares where only one class was subject to a distribution fee, would nevertheless, qualify as dividends for purposes of the dividends paid deduction.[6] The Service has also ruled that the class-specific allocation of expenses and performance fees, consistent with the requirements for RICs in Rev. Proc. 99-40, would not, in itself, result in dividends paid by the taxpayer being preferential dividends.[7]

PLR 201444022

Background

In PLR 201444022, the taxpayer, an externally managed and privately held limited liability company (the "Taxpayer"), proposed issuing two classes of shares, Class A Shares and Class B Shares (collectively, the "Shares"). The Taxpayer proposed that the quarterly management fee ("Base Fee") paid to its external manager (the "Advisor") would be determined only by reference to the portion of the NAV attributable to the Class A Shares. Any performance based "Incentive Fee" would accrue on the Taxpayer's NAV attributable to the Class A Shares and Class B Shares separately but on otherwise identical terms. Investors purchasing at least a certain threshold of Shares would be entitled to purchase a set percentage of the Class B Shares, which would not be subject to the Base Fee. On each quarterly dividend date, after each preferred share has received its preferred dividend in accordance with its terms, each Class B Share would be entitled to receive on a pro rata basis any accumulated but unpaid "Special Dividends" which would initially be equal to the reduction in the amount of the Base Fee formerly charged by the Advisor with respect to the portion of the aggregate NAV of the Class B Shares, effectively creating a "tiered investment advisory fee structure" whereby each Class B shareholder would not pay a Base Fee. If, in the future, the Base Fee was charged on a different basis, the Special Dividend would not be automatically adjusted without a vote by the shareholders holding Class A Shares approving any increase in the amount of Special Dividends or by the shareholders holding Class B Shares in the case of a proposed decrease in

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5 Treas. Reg. § 1.562-2(a).
6 PLR 201109030 (March 4, 2011).
7 PLR 201119025 (May 13, 2011).

the amount of Special Dividends. For purposes of determining the NAV of each class of Shares, the Special Dividend would be treated as an amount similar to an expense that is borne pro rata by each class of Shares and will, therefore, reduce the NAV of each class on a pro rata basis. Aside from the right of each Class B shareholder to the Special Dividend, the rights of each class of Shares were expected to be identical.

Holding

The Service ruled that "the proposed arrangement would exist to implement a tiered investment advisory fee structure based on the amount invested for shareholders whose shares otherwise confer substantially the same rights and obligations" and that "[u]nder the circumstances, the Class A and Class B [S]hares are not appropriately recognized as separate classes for purposes of section 562(c)." The fact that, in the event the calculation of the Base Fee changed, the amount of the Special Dividend would not be adjusted in the absence of a shareholder vote approving the adjustment did not change the substance of the proposed dividend, which was, in the view of the Service, to permit a difference in investment advisory fees between shareholders with otherwise substantially identical rights. Thus, the Service ruled that the payment of a Special Dividend on the Class B Shares would cause the Taxpayer's entire distribution made to the Class A and Class B Shares to be a preferential dividend under Section 562(c) and cause the distribution to be ineligible for the dividends paid deduction. In turn, the preferential dividend could result in the Taxpayer failing to distribute 90% of its REIT taxable income and, therefore, failing to qualify as a REIT.

Combination of multiple classes

In arriving at its decision, the Service noted that the Class A and Class B Shares would not be respected as separate classes of shares, despite the different classes of shares being authorized and issued under a state statute. This is in contrast to a number of previous rulings in which the Service has allowed REITs to issue different classes of shares with different fees and administrative expenses allocated to each class (consistent with Rev. Proc. 99-40) and concluded that the distributions would not be treated as a single class resulting in preferential dividends.[8] As discussed above, in each of the cases where the IRS has ruled that there was no preferential dividend, any fixed and performance based advisory fees were generally applicable to each class of shares based on a percentage the respective NAV of each class. Such percentage was consistent across all classes and any differences in fees paid would be a result of differences in the NAV of each class of shares. In PLR 201444022, the IRS concluded that the difference between the Class A Shares and Class B Shares did result in a different management fee being effectively borne by each class of Shares.

In ruling that the Class A and Class B Shares would not be respected as separate classes of shares, the Service believed that "[t]o accept Taxpayer's argument on the facts presented here would significantly undermine the preferential dividend rules." Distinguishing the facts in the ruling from those in other rulings where the IRS concluded that there was no preferential dividend, the Service's view is largely premised on its belief that Congress' intent was that, while differences associated with administrative expenses are permissible and should not cause distributions to be preferential dividends, differences due to a reduction in investment advisory or management fees for a particular class are not permissible. This view appears to be based primarily on the legislative history of Section 562(c). In 1986, Congress amended Section 562(c) to provide that "differences in the rate of dividends paid to shareholders are not treated as preferential dividends (within the meaning of Section 562(c)), where the differences reflect savings in administrative costs (but not differences in management fees), provided that such dividends are paid by a RIC to shareholders who have made initial investments of at least $10 million."[9]

8 PLR 2011190225 (May 13, 2011); See also PLR 201205004 (February 3, 2012), PLR 201244012 (November 2, 2012), PLR 201316013 (April 19, 2013), PLR 201327006 (July 4, 2013).
9 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., 246 (1986).

Application

While a private letter ruling may not be cited as precedent, it provides insight into the Service's application of the rules in determining whether (1) different classes of REIT shares will be respected and, (2) if the classes of shares are respected, whether differences in distributions made by a REIT to each class of shares would result in the entire distribution being treated as a preferential dividend. While, in certain situations, the Service has extended the rules set forth in Rev. Proc. 99-40 to allow differences in distributions relating to administrative or sales costs, such differences have not been allowed due to differences in investment advisory or management fees. In light of PLR 201444022, funds which offer such alternative investment advisory or management fee arrangements and that utilize REITs in their structures should consider the potential impact of the IRS's view on their current and future structures.

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