Real Estate Tax Alert
Summary of REIT Private Letter Rulings

pwc

Summarized below are significant private letter rulings issued by the IRS to REITs during the last year.

Deemed distribution by REIT treated as actual distribution for preferential dividend purposes

The Internal Revenue Service ("IRS") released private letter ruling 201216031 which provided that dividends payable to a shareholder which are held back by a real estate investment trust ("REIT") to satisfy liabilities of the shareholder to the REIT would not cause its distributions to be treated as preferential and therefore would not cause any of its distributions to fail to qualify for the dividends paid deduction available to the REIT.

Dividend holdback for liabilities due to the REIT

In this case, the taxpayer was a publicly traded REIT. As part of a transaction with the REIT, a third party (the "Shareholder") acquired both publicly traded and non-traded shares of the REIT's common stock. The subscription agreement, under which the shares were acquired, provided for a payment to be made to the REIT if the shares were acquired after the first day of the quarter for which dividends were declared ("Q1"), but prior to or on the day of record for the Q1 distributions. The ruling indicated that the parties agreed that the Shareholder would not be entitled to the portion of the quarterly distribution allocable to the period prior to the date of the acquisition of the shares. The acquisition occurred after the first day of Q1 and before the Q1 date of record. Therefore, the Shareholder was obligated to make a payment to the REIT.

The REIT declared and paid the Q1 distributions to the shareholders of record. However, the REIT held back the dividend payable to the Shareholder with respect to its non-publicly traded shares to offset the amount owed by the Shareholder.

The REIT contended that the held back dividends were constructively paid to the Shareholder because the Shareholder's liability to the REIT was reduced by the amount of the dividend that otherwise would have been paid to the Shareholder. The REIT represented that it would treat the gross dividend payable to the Shareholder as a dividend (to the extent of available earnings and profits) for all federal income tax purposes.

Analysis

REITs generally are required to pay dividends equal to 90 percent of their taxable income each year and are entitled to a dividends paid deduction. However, a distribution is not considered a dividend for these purposes, unless the distribution is pro rata, with no preference to one class of stock as compared with another class, except to the extent that the a particular class is entitled to a preference. The regulations generally provide that a distribution will be preferential if there is a distribution to any shareholders of such class (in proportion to the number of shares held by the shareholder) more or less than the shareholder's pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Although the Shareholder in this case did not actually receive cash in an amount equal to the dividend that it was entitled to receive, the IRS effectively respected the deemed distribution of cash as a distribution that has been made for REIT purposes, and not as a preferential dividend.

The conclusion in PLR 201216031 indicates the IRS is open to treating amounts that are not actually paid to shareholders in the same manner as dividends actually paid as long as the distributions are treated as dividends by both the REIT and the shareholder for all other tax purposes. This taxpayer favorable ruling followed taxpayer favorable rulings related to preferential dividends for class-specific performance, distribution and advisory fees in other recent private rulings (PLR 201109003, PLR 201135002, and PLR 201205004).

For additional information concerning this issue, please contact:

Erica Hanson
213-217-3290
erica.d.hanson@us.pwc.com

Adam Feuerstein
703-918-6802
adam.s.feuerstein@us.pwc.com

Rulings provide insight regarding whether the allocation of certain fees to REIT shares will cause the distributions to be preferential

Background

The IRS issued two PLRs (201205004 and 201135002) that address whether the issuance by REITs of multiple classes of common-stock with class-specific allocations of distribution, management and advisory fees would cause dividends paid by REITs with respect to its shares to be considered preferential dividends for purposes of the REIT distributions requirements. The facts were similar in both rulings, and in both cases the IRS concluded that that the different distributions that would result from fees attributable to a particular class of stock would not cause dividends paid by the REITs to be preferential dividends.

Different fees attributable to different classes of stock

In both rulings, it was noted that different fees were attributable to different classes of stock. The fees noted included selling commissions, distribution fees and dealer manager fees. The reasons noted in the rulings for the different fees attributable to particular classes included that certain pre-existing classes of shares would not be subject to the fees associated with the new issuances of shares and that certain fee structures are not attractive for investors that invest with advisors that are already being paid a fee to manage their account.

The rulings also covered advisory fees. While advisory fees were calculated in the same manner for each class, because the advisory fees were calculated using net asset value (NAV) and also included a performance component, the fees could vary among classes to the extent that a class had a different NAV or experienced different levels of performance.

In order to cover the fees, the REITs planned to allocate class-specific expenses to each class of stock and reduce the distributions payable with respect to each class accordingly (or, in some cases, have the affected shareholder pay the increased fee as part of its purchase price).

Analysis

The REITs sought the rulings to confirm that the differing dividend payments among the classes of shares that resulted from allocating specific expenses attributable to a particular class would not cause the dividends to be treated as preferential for US federal income tax purposes. If the dividends were preferential, then they would not be qualifying dividends for purposes of the dividends paid deduction or the REIT distribution requirement.

The IRS previously issued Rev. Proc. 99-40 which concluded, in part, that variations in distributions to shareholders that exist solely as a result of certain allocations of fees and expenses described in the revenue procedure (and similar to those described above) would not cause distributions by a RIC from being treated as preferential dividends.

While REITs are not within the scope of Rev. Proc. 99-40, the IRS noted in the rulings that Congress and the IRS have acknowledged the similarities between RICs and REITs in many areas and have afforded them similar treatment in many situations. Consequently, the IRS concluded that the rationale underlying Rev. Proc. 99-40 should apply equally to the REITs requesting the rulings. It is important to note that Rev. Proc. 99-40 does not sanction the allocation of all fees and expenses and therefore these PLRs should not be interpreted to mean that all expenses may be allocated to a particular class of shares without raising a preferential dividend issue. For example, Rev. Proc. 99-40 does not cover variations in advisory fees to the extent the variation is not attributable to different performance among the classes.

For additional information concerning this issue, please contact:

Angela Depoy
703-918-3207
angela.m.depoy@us.pwc.com

Adam Feuerstein
703-918-6802
adam.s.feuerstein@us.pwc.com

Recent PLRs regarding billboard sign structures as REIT real estate assets

Introduction

The IRS released two private letter rulings regarding the treatment of structures used to hold billboards and other signs as "real estate assets" for purposes of the REIT income and asset tests. In addition to concluding that certain sign structures and related rights may be treated as "real estate assets," the rulings touch upon other issues including whether license fees for the use of sign structures qualify as rents from real property, whether certain services performed with respect to the sign structures are considered impermissible tenant service income ("ITSI") and the circumstances in which the sign structures and other space rented to a TRS will not be treated as related party rent when there is no comparable space at a property. The two rulings were 201143011 (the "2011 PLR") and 201204006 (the "2012 PLR").

Sign structures treated as real estate assets

In both rulings, the IRS concluded that the sign structures qualified as real estate assets under section 856(c)(5)(B) of the Internal Revenue Code ("Code"). In reaching this conclusion, the IRS focused on the permanency of the structures and the way they were affixed to the real estate. The 2011 PLR noted that the sign structures were substantial structures designed to remain permanently in place and that each of the structural components had never been moved. The sign structures in the 2012 PLR were large, welded steel frames bolted to the façade of the property in a manner designed to remain permanently in place with no plans for removal, and any removal would be costly, time consuming and require heavy construction equipment. In both PLRs the IRS noted that the sign structures were inherently permanent structures and structural components of the property themselves and therefore not assets accessory to the operation of a business. As a result, the rulings concluded that the sign structures constituted real estate assets for purposes of the REIT asset tests.

It is important to note that the rulings addressed the treatment of the permanent sign structures, but did not include all assets related to signs. For example, the 2011 ruling noted that vinyl signs were separately installed by a TRS and the 2012 PLR noted that the advertisers had the right to place signs on the sign structures.

Rights to use sign structures treated as interest in real property

The 2012 ruling concluded not only that the sign structures themselves qualified as real property, but also that the right to use the structures qualified as interests in real property. In this ruling, the REIT, through one of its partnerships, held certain "use rights" that granted it, among other things, the exclusive right to use existing sign structures located on the façade and exterior of the property. With the understanding that the sign structures qualify as real property, the IRS ruled that the "use rights" constituted an interest in real property.

Income received for use of sign structures treated as rents from real property

In the 2012 ruling, the IRS explicitly ruled that license fees paid by advertisers for the right to place advertising signage on the sign structures qualified as rents from real property. The IRS noted that license fees were payments in exchange for the right to use space on the property and therefore similar to rent payments that would be required under a lease. As a result, the license fees are treated as rents received for the use of real property and qualify as good income.

It is interesting to note that the IRS previously ruled that income from renting space on a wall for advertising does not qualify as rents from real property for purposes of the unrelated business income tax ("UBIT") rules. Therefore, care should be taken when considering whether the IRS would have reached the same result in the UBIT context or when applying it to the lease of internal space for advertising.

Production and installation services not treated as impermissible tenant services

The 2012 PLR concluded that the REIT's supervision and coordination of the sign installation process by an independent contractor would not cause the license fees to be treated as impermissible tenant services income ("ITSI") and excluded from rents from real property. The taxpayer represented that the services were provided for the convenience of the tenant by an independent contractor and are customarily furnished by similar properties in the geographic market in which the property is located. The IRS noted that as part of their fiduciary duties, the directors of the REIT have an obligation to ensure the signs are properly produced and installed on the sign structure.

The 2011 PLR concluded that installation services performed by a TRS would not be ITSI if the amounts for the services were either (a) separately stated from the rents and collected and retained by the TRS or (b) included in the rent received by the REIT and the REIT compensated the TRS on an arm's length basis. The ruling noted that the sign installation service was not customarily furnished or arranged by similar properties in the geographic area. However, the IRS concluded that the services were not impermissible tenant services noting that the TRS also bore all the costs related to the services either through its staff or by contracting with third parties.

Sponsorship services provided by a TRS not considered impermissible tenant services

In the 2012 PLR, the IRS ruled that sponsor fees charged to advertisers for services related to sponsorship, media, merchandising and other similar rights that were performed through a partnership in which the REIT's interest was held by a TRS were not services rendered by the REIT to advertisers in connection with the rental of real property. Therefore, the ruling concluded that the sponsorship services would not cause the license fees to be treated as other than rents from real property. The IRS noted that this was a separate line of business as the services performed were generally available to any interested companies and no discounts were provided to the tenants that rented signs from the landlord. Additionally, the partnership providing the services kept separate books and records and was held through the TRS - evidence that it is a separate line of business. As a result, the sponsor fees were not considered ITSI.

Income from non-customary services performed by a partnership is allocable between its TRS partner and unrelated partner

In the 2012 PLR, the IRS ruled that event sponsor rights related to an event in the area provided by a partnership would not generate ITSI to the extent the partnership was owned by a TRS but would be treated as ITSI to the extent held by non-TRS partners. The REIT had a unique license agreement with an advertiser on the sign structure in which the advertiser paid a single monthly fee for rights to use the sign and for numerous event sponsor rights. The event sponsor rights were treated as non-customary services but were deemed to be provided to the advertiser by both the TRS and an unrelated partner as partners in the partnership. The portion allocable to the TRS's interest in the service partnership were treated as provided by a TRS and therefore not treated as the provision of an impermissible tenant service. The taxpayer represented that the ITSI allocable to the non-TRS partner would be less than the 1% of income from the property which would satisfy the de minimis exception for impermissible tenant services. Therefore, while the ITSI would be non-qualifying income for purposes of the REIT income tests, it would not cause all of the income from the property to become non-qualifying.

Although not explicitly stated in the ruling, the services deemed provided by the third party partner presumably were not eligible for the independent contractor exception from ITSI because the service was not customary and the amounts were not separately stated from the rent as required in Treas. Reg. § 1.856-4(b)(5)(i) and/or the REIT was treated as receiving income from the independent contractor because it was a tenant at the property.

TRS Rent for Non-Comparable Space

In the 2011 PLR, the IRS ruled that when there is no comparable space at a particular property, comparable space at properties in the same geographic area may be used for purposes of satisfying the TRS limited rental exception under section 856(d)(8)(A) of the Code. The Taxpayer represented that there was no space comparable to the sign structures at the particular property. The Taxpayer had no comparable space within its portfolio of properties and as a result, used rent paid for comparable space at properties within the same geographic area.

The 2012 PLR raised an issue in the facts related to whether rent paid by a TRS would meet the limited rental exception if there is no comparable space at the REIT's property. The taxpayer represented that the TRS paid rent for space that was unusual and unlike any other space at the property, and that they had no way to determine whether the space leased to the TRS was comparable to any other space in the geographic market in which the property was located. The Taxpayers also represented the rent was approximately equal to fair market rental value. However, no ruling was given regarding whether that treatment would be respected and it is not clear if the silence was because no ruling was sought on the matter or because an issue with respect to such a ruling arose during the process.

Conclusion

For REITs that own or may acquire buildings with billboards or other signs, the rulings provide helpful guidance regarding the treatment of those structures and issues related to their income and services provided in connection with those structures.

For additional information concerning this issue, please contact:

Jeff Johnson
703-918-3626
jeffrey.t.johnson@us.pwc.com

Angela Depoy
703-918-3207
angela.m.depoy@us.pwc.com

Adam Feuerstein
703-918-6802
adam.s.feuerstein@us.pwc.com

It is important to note that the rulings issued are private letter rulings and, therefore, REITs may not rely on these rulings as precedent, although they do provide insight into the IRS' view on the issue and the likelihood that other REITs would receive similar rulings from the IRS.

PwC Real Estate Tax Practice – National and Regional Contacts:

National

Paul Ryan
US RE Tax Leader
New York
646-471-8419
paul.ryan@us.pwc.com

Regional

Atlanta

Dennis Goginsky
678-419-8528
dennis.goginsky@us.pwc.com

Tim Trifilo
678-419-1740
timothy.j.trifilo@us.pwc.com

Boston

Timothy Egan
617-530-7120
timothy.s.egan@us.pwc.com

Laura Hewitt
617-530-5331
laura.a.hewitt@us.pwc.com

Rachel Kelly
617-530-7208
rachel.d.kelly@us.pwc.com

Chicago

Jill Loftus
312-298-3294
jill.h.loftus@us.pwc.com

Alan Naragon
312-298-3228
alan.naragon@us.pwc.com

Los Angeles

Adam Handler
213-356-6499
adam.handler@us.pwc.com

Phil Sutton
213-830-8245
philip.c.sutton@us.pwc.com

New York

Eugene Chan
646-471-0240
eugene.chan@us.pwc.com

Dan Crowley
646-471-5123
dan.crowley@us.pwc.com

Martin Doran
646-471-8010
martin.doran@us.pwc.com

James Guiry
646-471-3620
james.m.guiry@us.pwc.com

Sean Kanousis
646-471-4858
sean.richman.kanousis@us.pwc.com

Christine Lattanzio
646-471-8463
christine.a.lattanzio@us.pwc.com

James Oswald
646-471-4671
james.a.oswald@us.pwc.com

Oliver Reichel*
971 (2) 694 6946
oliver.reichel@us.pwc.com

John Sheehan
646-471-6206
john.f.sheehan@us.pwc.com

Steve Tyler
646-471-7904
steve.tyler@us.pwc.com

David Voss
646-471-7462
david.m.voss@us.pwc.com

San Francisco

Warren Glettner
415-498-6070
warren.glettner@us.pwc.com

Kevin Nishioka
415-640-8541
kevin.s.nishioka@us.pwc.com

Neil Rosenberg
415-498-6222
neil.rosenberg@us.pwc.com

Washington DC

Karen Bowles
703-918-1576
karen.bowles@us.pwc.com

Adam Feuerstein
703-918-6802
adam.s.feuerstein@us.pwc.com

Kelly Nobis
703-918-3104
kelly.s.nobis@us.pwc.com

Shannon Stafford
703-918-3031
shannon.m.stafford@us.pwc.com

* Currently resident in Abu Dhabi

www.pwc.com/us/assetmanagement

© 2012 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved.

PwC refers to the US member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details. This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

Solicitation