It's Time to Repeal the Preferential Dividend Rule for Private REITs

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In this report, Homayoun argues that in light of securities laws and other safeguards to protect the rights of shareholders, there is no justifiable policy reason to subject private real estate investment trusts to the preferential dividend rule, which Congress first enacted in 1936 and continues to be a significant obstacle in the REIT industry.

I. Background

Section 857(a)(1) requires, in part, that a real estate investment trust's deduction for dividends paid equal or exceed 90 percent of its REIT taxable income for the tax year (determined without regard to the deduction for dividends paid and by excluding any net capital gain). Because the dividends paid deduction reduces a REIT's taxable income, a REIT that makes annual distributions in an amount equal to its annual income, and in a manner that qualifies for the dividends paid deduction, can reduce its taxable income to zero and eliminate its federal income taxes.

However, for a private REIT, the dividends paid deduction is available only for distributions that are pro rata, without preference to any share of stock compared with any other shares in the same class and without preference between classes of stock, except to the extent that one class is entitled to that preference (the preferential dividend rule).[1] Unlike many of the other tests that an entity must satisfy to qualify as a REIT (for example, the assets tests and gross income tests), there is no specific cure or remedy for violations of the preferential dividend rule, even for an inadvertent or de minimis violation. A violation of this rule, therefore, can preclude a REIT from satisfying the distribution test and cause all its income to be subject to corporate taxation.

As part of the Protecting Americans From Tax Hikes (PATH) Act of 2015, Congress exempted publicly offered REITs from the preferential dividend rule.[2] In doing so, Congress did not provide a specific reason for the change in the accompanying legislative history beyond noting that similar rules apply to regulated investment companies and that the preferential dividend rule no longer applies to publicly offered RICs.[3] However, regardless of the rationale for eliminating the rule for publicly offered REITs, the language of the statute makes it clear that the preferential dividend rule remains applicable to REITs that do not file annual and periodic reports under the Securities Exchange Act of 1934.[4]

In light of the continued application of the preferential dividend rule to private REITs, there remains significant emphasis on this rule, in particular when shareholders invest directly in a private REIT with multiple classes of shares that are subject to different fee structures. That structure implicates the preferential dividend rule because the REIT allocates the fees among its

[1] Section 562(c).

[2] Division Q, section 314, of the Consolidated Appropriations Act, 2016 (P.L. 114-113) (Dec. 18, 2015). Section 562(c)(2) defines a publicly offered REIT as "a real estate investment trust which is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934." Thus, publicly registered but non-traded REITs are exempt from the preferential dividend rule.

[3] Joint Committee on Taxation, "Technical Explanation of the Protecting Americans From Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40)," JCX-144-15, at 173 (Dec. 17, 2015).

[4] Section 562(c).

various classes of shares and, as a result, effectively reduces the distributions each class receives. The concern over the application of the preferential dividend rule in a multiclass REIT structure became even more acute in 2014, when the IRS ruled that a private REIT with two classes of shares that charge different fees to different investors, such that each class pays different dividends to account for the differing fees, violates the preferential dividend rule.[5]

Many practitioners and interest groups have criticized the ruling and argued that the IRS's conclusion is inconsistent with the broader policy grounds underlying the preferential dividend rule.[6] Nevertheless, the ruling has caused some consternation within the REIT industry and, as a result, many tax practitioners are advising clients to avoid a private REIT structure with multiple classes of stock that are subject to different fee structures. Instead, because of concerns over the continued viability of the preferential dividend rule in the private REIT context, advisers are recommending alternative structures, such as forming an upper-tier partnership to own 100 percent of the common stock of the REIT, which in turn directly or indirectly owns the assets. Under this structure, investors would not be shareholders of the REIT[7] but instead would be limited partners in a partnership (or members in a limited liability company taxable as a partnership) that serves as the sole common shareholder of the REIT. The upper-tier partnership, as opposed to the REIT, would include different classes of partnership interests that are subject to different fee structures. In other words, the REIT would no longer have different common shareholders that receive varying amounts from the REIT as a result of different fee structures.

Although the use of this structure should mitigate the risk of violating the preferential dividend rule, the structure is more involved and complex,[8] and it is not free from doubt from a tax perspective. For instance, it will be critical for tax advisers to become comfortable that there are legitimate nontax business purposes for forming the upper-tier partnership that will own 100 percent of the common stock of the REIT. Otherwise, the IRS could apply the economic substance doctrine or similar judicial doctrines to effectively ignore the partnership and collapse the structure, thereby once again implicating the preferential dividend rule when there are multiple classes of interests with different fee structures. While I believe there are several legitimate nontax reasons for the use of the upper-tier partnership,[9] many tax practitioners, out of an abundance of caution, continue to apply the preferential dividend rule and its related restrictions and limitations in an upper-tier partnership structure. As a result, concerns over the application of the preferential dividend rule cause fund sponsors not only to implement more complex and involved structures, but in some cases to avoid REITs altogether. Moreover, many tax advisers are often reluctant or unable to deliver "will"-level opinions in a private REIT structure, thereby raising concerns from broker-dealers and investors that need certainty on the tax status of the REIT.

The preferential dividend rule, therefore, has proven to be a significant and persistent obstacle in the REIT industry. But did Congress intend for the rule to be applied so broadly? Should it even be applicable when there are varying distributions as a result of a private REIT structure with multiple classes of stock that are subject to different fee structures? Are the historical policies underlying the preferential dividend rule still applicable?

[5] LTR 201444022.

[6] Taking issue with the 2014 ruling is not the purpose of this report, but I note that the facts of the ruling are unique. For instance, as discussed in this report, earlier rulings generally involved various classes of stock that were subject to some combination of an upfront selling commission, a dealer manager fee, and a daily distribution (or "trailing") fee. The fees at issue in the 2014 ruling are more akin to annual investment management or advisory fees, which are more problematic from the IRS's perspective. Moreover, while not unprecedented, it is unusual for a private letter ruling to reach a negative result for a taxpayer.

[7] There must be at least 100 shareholders at the REIT level to satisfy the 100-shareholder test. *See* section 856(a)(5). REITs often satisfy this requirement through a preferred stock offering facilitated by well-known organizations that specialize in those offerings.

[8] Rather than having a single entity (in this case, a REIT) that directly or indirectly owns assets, the sponsor also must form a separate partnership entity or entities to own the common stock of the REIT, thereby increasing compliance and costs.

[9] For instance, to hold investments that may not be qualifying REIT assets.

In this report, I examine the history of the preferential dividend rule in the context of both REITs and RICs, and in particular explore the policies underlying the rule. In doing so, I hope to establish that the preferential dividend rule, which dates back to 1936 and before (I expect) anyone reading this report provided tax advice, has become outdated and that there are no longer any justifiable policy reasons for applying the rule to either publicly offered REITs or private REITs.

II. History of the Rule

A. Early Legislative History

Congress enacted the first rules concerning preferential dividends in 1936[10] as part of the dividends paid credit (which was the predecessor to the dividends paid deduction), and later restated those rules in 1938.[11] The 1938 version of the preferential dividend rule, which is substantially similar to the current version, provided that the dividends paid credit would not be allowed for any distribution unless the distribution was "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 with another class of stock except to the extent that the former is entitled . . . to such preference."[12]

Congress designed the preferential dividend rule under the Revenue Act of 1936 to prevent corporations from avoiding the accumulated earnings tax and the personal holding company tax by making disproportionate distributions to shareholders in lower-income tax brackets.[13] Similarly, the legislative history focuses on the need to prevent tax avoidance, but also to prevent shareholder injustice:

> 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 [that the preference may not be in favor of some shares of stock within the same class] has been expanded in this bill so as to leave no uncertainty as to its purpose in this respect. . . . The committee believes that no distribution which treats shareholders with substantial impartiality and in a manner consistent with their rights under their stock-holding interests, should be regarded as preferential by reason of minor differences in valuations of property distributed.[14]

B. Application to RICs

In addition to establishing the dividends paid credit and initial version of the preferential dividend rule, the Revenue Act of 1936 introduced the mutual investment company (MIC), the predecessor to the RIC.[15] The MIC was a new type of corporation that was not subject to tax on its distributed income, as measured by the dividends paid credit. Congress created MICs because it believed that passive investment fund shareholders should bear only one layer of tax on their investment income, as was the case for more affluent investors whose wealth allowed them to obtain professional management and diversification through individually managed accounts.

In 1942 Congress replaced MICs with RICs, which generally included investment companies

[10] Revenue Act of 1936 (P.L. 74-740), sections 13(a)(3), 27(g), and 48(e).

[11] P.L. 75-554, section 27(h).

[12] *Id*. The 1954 version of the code later replaced the dividends paid credit with the dividends paid deduction.

[13] These taxes discouraged deferral of shareholder-level taxation of corporate income because each tax measured the amount treated as distributed (and thus not subject to tax) by reference to the dividends paid credit, as limited by the preferential dividend rule.

[14] H.R. Rep. No. 75-1860 (1938) (Conf. Rep.).

[15] *See* P.L. 74-740, section 48(e).

that were registered under the Investment Company Act of 1940 and satisfied specified qualification requirements.[16] Under the Revenue Act of 1942, the taxation of RICs and MICs was similar in that each could determine the amount of income subject to tax after applying the dividends paid credit, which continued to be limited by the version of the preferential dividend rule then in effect.

In 1986 Congress introduced H.R. 3397, which included several proposed amendments to the rules on the taxation of RICs. Congressional testimony from Dennis E. Ross, tax legislative counsel for Treasury, provides some insight regarding Treasury's view on the advisability of legislation that permits sliding-scale management fees and the application of the preferential dividend rule.

> In the case of a sliding scale dividend arrangement that reflects management fees or cost savings, we do not believe that the concerns that motivate the disallowance of a deduction for preferential dividends — the potential for shareholder injustice or tax avoidance — are present. Although it may appear to be unfair for large shareholders to receive higher per share dividends than small shareholders, the costs per share of administering a shareholder's account may indeed be greater in the case of small shareholders than in the case of large shareholders. Accordingly, a sliding scale dividend arrangement may serve the valid business purpose of allocating administrative costs to the shareholders who generate those costs. We do not regard this as unjust. More importantly, while we realize that one of the historical policies underlying the preferential dividend provision is shareholder fairness, we believe that the relationship between RICs and their shareholders is more appropriately regulated by the Securities and Exchange Commission through the securities laws than by the Internal Revenue Service through the Internal Revenue Code.
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> We believe strongly, however, that the preferential dividend rule appropriately applies to dividend arrangements that have a tax avoidance purpose. In our view, a sliding scale dividend arrangement that truly reflects management fees or cost savings is unlikely to serve as a tax avoidance device. Nevertheless, it is possible for such a preferential dividend arrangement to reduce the overall taxes paid by the shareholders of a RIC. This would result, for example, if the larger shareholders of the RIC tend to be pension plans and other tax-exempt organizations and the smaller shareholders tend to be taxable individuals. We believe, however, that sliding scale dividend arrangements that reflect management fees or cost savings are primarily motivated by business reasons rather than tax avoidance. Accordingly, we would not oppose a provision to permit the deduction of dividends paid under such sliding scale arrangements.[17]

Congress later amended section 562(c) to provide for some types of volume discounts. Under that amendment, a distribution to a RIC shareholder who makes an initial investment of at least $10 million will not be treated as non-pro-rata or preferential solely because of reductions in administrative expenses of the RIC (and therefore causing an increase in distributions). The conference report explains:

> The conference agreement provides 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

[16] Revenue Act of 1942 (P.L. 77-753), section 170. Similar to current law, RICs were required to elect RIC status and satisfy both a gross income test and a diversification test. When the act was enacted, RICs also were required to limit their recognition of short-term gains, but Congress repealed that requirement in 1997. *See also* Taxpayer Relief Act of 1997 (P.L. 105-34), section 1271.

[17] Testimony of Treasury Tax Legislative Counsel Dennis E. Ross before House subcommittee on bills affecting passthrough entities (June 11, 1986).

> dividends are paid by a RIC to shareholders who have made initial investments of at least $10 million.[18]

The Joint Committee on Taxation further explained the amendment to section 562(c), stating:

> The Congress believed that preferential dividends that reflect only savings in administrative costs attributable to the size of a shareholder's holdings (and not differences in investment advisory fees) are not the type of preferential dividends that were intended not to qualify for the dividends paid deduction. The Congress believed that such preference dividends should be allowed only in cases where the shareholder who receives the preferential dividend was required to make an initial investment of at least $10 million.[19]

According to an IRS announcement, this legislative history indicates that "any difference in the investment advisory fee charged to shares of a RIC results in a preference."[20] The IRS, however, does not appear to have asserted this position in other published authoritative guidance.

In 1991 the IRS started to issue private letter rulings on the application of the preferential dividend rule to RICs with a multiclass stock structure.[21] These rulings, which number in the hundreds, generally tend to involve a RIC with multiple classes of shares with similar voting, distribution, and other rights. The RIC wishes to allocate certain expenses (which may include front-end loads, distribution fees, and distribution expenses falling under SEC Rule 12b-1) among its various classes of shares and accordingly reduce the distributions each class receives as a result. In these rulings, the IRS cites several SEC information releases to distinguish which expenses are shareholder-level expenses versus fund expenses, but it does not appear to consider SEC or state review of the RIC structures. The IRS concludes that the differences between the multiple classes of shares were not substantial enough to treat each class of shares separately, but that the differing distributions for the shares would not be considered preferential.[22] In doing so, the IRS notes that fund-level expenses were allocated pro rata, while shareholder-level expenses were allocated based on the shareholders' individual circumstances.

The IRS later released Rev. Proc. 96-47, 1996-2 C.B. 338, later modified by Rev. Proc. 99-40, 1999-2 C.B. 565, to provide a safe harbor in connection with the preferential dividend rule for RICs. Under the safe harbor, variations in distributions to holders of different "qualified groups of shares" would not prevent the distributions from being deductible if the variations "exist solely as a result of the allocation and payment of fees and expenses and the allocation of the benefit of waivers and reimbursements of fees and expenses in accordance with [the conditions set forth below]."[23] To qualify for the safe harbor, each of the RIC's qualified groups of shares (1) must have a different arrangement of shareholder servicing or distribution (or both) and be allocated and pay the fees and expenses of that arrangement; (2) may be allocated and pay a different share of other fees and expenses (other than advisory, custodial, or management-related fees) if actually incurred in different amounts or if the qualified group receives services of a different kind or degree; and (3) must be allocated all advisory, custodial, and management-related expenses pro rata in accordance with the qualified group's net asset value (NAV) relative to the RIC's NAV (except to the extent that differences result from the application of the same performance fee provision to the different performances of different qualified groups). Further, the rights and obligations of the RIC's shareholders must be set forth in the RIC's organizing documents, and each qualified group must individually meet the

[18] *See* H.R. Rep. No. 99-841, at II-246 (1986) (Conf. Rep.).

[19] JCT, "General Explanation of the Tax Reform Act of 1986, 99th Cong. 2d Sess.," JCS-10-87, at 377 (1987).

[20] Announcement 96-95, 1996-2 C.B. 10.

[21] *See, e.g.*, LTR 9147021; LTR 9305015; LTR 9422026; LTR 9429022; LTR 9438024; LTR 9441035; LTR 9443035; LTR 9508012; LTR 9509033; LTR 9519017; LTR 9520047; LTR 9605005; LTR 9644032; LTR 9704015; and LTR 9707011.

[22] *But see* LTR 8746045 (citing several factors — including the treatment of each class as separate for state law purposes, differences in voting rights, differing dividends paid based on specifically allocated expenses, and different charges on liquidation — the IRS did not collapse multiple classes of stock into one class).

[23] Rev. Proc. 99-40, section 5.

requirements under the code for shares of a publicly offered RIC.

Rev. Proc. 99-40 also provides safe harbor requirements for waivers or reimbursements of expenses incurred by a RIC. Those waivers are generally allocated among the classes in a manner similar to the allocations of the fees set forth above.

In 2010 Congress enacted the Regulated Investment Company Modernization Act,[24] which repealed the preferential dividend rule for publicly offered RICs, although it left the rule in place for non-publicly-offered RICs.[25] The JCT explained that the rule was not needed to protect shareholders of publicly offered RICs, and it referenced statutes that prohibit public RICs from issuing shares with preferences.[26]

C. Application to REITs

1. Background.

Congress introduced REITs in 1960.[27] Similar to RICs, REITs are allowed a dividends paid deduction (subject to the preferential dividend rule) as long as they meet a distribution requirement determined by reference to the dividends paid deduction.[28] Congress added the REIT provisions to give taxpayers "substantially the same tax treatment for real estate investment trusts as present law provides for regulated investment companies"[29] so that "individuals of small means [have] an opportunity to pool their investments in one of these companies, yet receive the same treatment as those of greater wealth can obtain by direct investments."[30]

In 1983 the IRS considered the application of the preferential dividend rule in the context of a REIT's dividend reinvestment plan.[31] In Rev. Rul. 83-117, 1983-2 C.B. 98, the IRS considers two scenarios. In 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. In situation 2, the REIT's shareholders also may have their cash dividends reinvested, but the stock acquired is priced at less than 95 percent of its FMV on the distribution date. The discount therefore exceeds 5 percent.

In situation 1, the IRS concludes that the REIT is entitled to a dividends paid deduction for the amount of any distribution made in both cash and discounted stock. The IRS emphasizes that the plan treats the shareholders impartially by giving them an equal opportunity to reinvest, and 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, however, the IRS finds 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 finding, the IRS concludes that the dividend in situation 2 is preferential and that the REIT is not entitled to any dividends paid deduction for the preferential dividend.

In 2010, the same year in which Congress repealed the preferential dividend rule for publicly offered RICs, the IRS began to issue private letter rulings that applied the same analysis used in the RIC context to analyze dividends paid by publicly offered non-traded REITs with a multiclass stock structure. Although these rulings acknowledge that publicly offered REITs technically do not fall within the scope of Rev. Proc. 99-40, the IRS noted that the rationale underlying Rev. Proc. 99-40 should apply equally to RICs and REITs.[32] Consistent with the JCT's explanation that the preferential dividend rule

[24] P.L. 111-325.

[25] A RIC is publicly offered for these purposes if its shares are (1) continuously offered in accordance with a public offering, (2) regularly traded on an established securities market, or (3) held by no fewer than 500 persons at all times during the tax year. *See* section 67(c)(2)(B).

[26] JCT, "Technical Explanation of H.R. 4337, 'The Regulated Investment Company Modernization Act of 2010,' for Consideration on the Floor of the House of Representatives," JCX-49-10, at 22 (Sept. 28, 2010). Section 18 of the act prohibits RICs from issuing debt or preferred stock having dividend or liquidation preferences unless specified asset coverage ratios are present. *See* 15 U.S.C. section 80a-18.

[27] P.L. 86-779, section 10.

[28] Section 857(a)(1).

[29] H.R. Rep. No. 86-2020 (1960).

[30] *Id.* at 821.

[31] *See* Rev. Rul. 83-117, 1983-2 C.B. 98.

[32] LTR 201135002.

was not needed to protect shareholders of publicly offered RICs because of the protections afforded by securities laws,[33] the rulings reference and place heavy emphasis on the significant review processes and investor protections (for example, SEC, Financial Industry Regulatory Authority (FINRA), and state review) that would apply in connection with the offerings of REIT securities and conclude that the issuance of multiple classes of common stock, which are subject to different fees, would not cause distributions paid for those classes of stock to be treated as preferential dividends under section 562(c)(1).[34]

LTR 201205004 is generally representative of these rulings. In that ruling, the taxpayer offered class A common stock and proposed to offer two more classes of common stock: class I and class W. Class W shares would be subject to a selling commission, dealer manager fee, and distribution fee (which would accrue daily) and would be available to investors acquiring their shares from broker-dealers managing their accounts on a fee-for-service basis (that is, wrap accounts). Class I shares would be available only to investors who pay an asset-based fee to their investment advisers for investment advisory services and would be subject only to the dealer manager fee. Class A shares would only be available to current owners through a distribution reinvestment program and would not be subject to any of the above-mentioned fees. As a result, holders of the class W shares would pay higher fees than holders of the class I shares. Also, holders of class A shares would not be subject to any future distribution fees. Because the NAV per class could vary based on the varying fees per class, the annual advisory fee charged to each class would vary, and the performance fee due to the adviser could also vary based on the NAV. Thus, investor returns could vary. The taxpayer planned to allocate class-specific expenses to the applicable class.

The IRS noted that "the rationale underlying Rev. Proc. 99-40 applies equally to both RICs and REITs,"[35] and therefore the taxpayer's special allocations of the selling commission, distribution fee, and advisory fee were consistent with Rev. Proc. 99-40. Although not subject to SEC Rule 18f-3, as a publicly offered REIT, the IRS noted that the taxpayer also would be subject to extensive SEC, FINRA, and state restrictions. Accordingly, the IRS ruled that dividends payable to shareholders for the different classes of common stock would not be treated as preferential dividends for purposes of section 562(c)(1).

After these initial REIT rulings, however, the IRS no longer referenced Rev. Proc. 99-40 in private letter rulings.[36] Instead, the IRS based its opinion solely on the literal language of section 561, section 562, and the regulations thereunder. Nevertheless, in more recent years, the IRS appears to have reverted to its original position in addressing proposed multiclass structures by publicly offered REITs. Although the IRS does not go as far as saying Rev. Proc. 99-40 should apply equally to RICs and REITs, it has stated that "Rev. Proc. 99-40 is instructive by analogy in determining whether the distribution of fees and expenses to different classes of shareholders results in the fair and equal treatment of such shareholders."[37] These rulings also approve multiclass stock structures.[38]

2. The 2014 letter ruling.

On October 31, 2014, the IRS issued LTR 201444022. Under the facts of this letter ruling, the taxpayer, a REIT, proposed to create two classes of common shares: class A shares and class B shares. The taxpayer's NAV would be allocated between the class A shares and class B shares. The taxpayer paid its adviser a quarterly management fee (the base fee) and an annual incentive management fee (the incentive fee). The base fee would be determined only by reference to the taxpayer's NAV that is attributable to the class A shares, although the base fee would reduce the NAV attributable to class A shares and class B shares proportionately. The incentive fee would accrue

[33] *See* JCX-49-10, *supra* note 26, at 22; and P.L. 86-779, section 10.

[34] *See* LTR 201109003; LTR 201119025; LTR 201135002; LTR 201205004; LTR 201244012; LTR 201304004; LTR 201316013; and LTR 201408014.

[35] *See* LTR 201205004.

[36] *See, e.g.*, LTR 201244012; LTR 201304004; LTR 201316013; and LTR 201327006.

[37] *See* LTR 201408014.

[38] *See, e.g.*, LTR 201244012; LTR 201304004; LTR 201316013; and LTR 201327006.

and be payable for the NAV attributable to both the class A and class B shares.

Investors that contribute capital below a fixed amount would be entitled to receive only class A shares. Investors that contribute over that amount would be entitled to a combination of class A shares and class B shares, with the proportion of class B shares increasing as the capital commitment increased above defined thresholds.

Each class B share would receive a special dividend equal to a fixed percent of the NAV attributable to the class B shares, which initially would equal the reduction in the amount of the base fee that otherwise would have been charged for the portion of the aggregate NAV of the class B shares. The taxpayer would declare and pay the special dividend separately from the common dividends otherwise declared and paid for those shares.

If the base fee remained constant over the life of the taxpayer and all investors continued to hold class A and class B shares together in the proportions originally acquired, the special dividend would have the effect of reducing the base fee borne by investors that committed larger amounts of capital by a predetermined amount. If, however, the amount of the base fee was changed or waived, the amount of the special dividend could not be adjusted in the absence of an amendment of the REIT's charter, which would require a shareholder vote. A proposed increase in the special dividend would be subject to a vote only by the class A shareholders, and a proposed decrease would be subject to a vote only by the class B shareholders. Shareholders would be entitled to tender for redemption only shares of one class or the other, thereby potentially creating a break in the link between the special dividend and the proportionate base fee reduction originally negotiated for the specific shareholder.

Each class A share and class B share would generally be entitled to one vote, and the classes would vote jointly on matters affecting the taxpayer as a whole. However, the classes would vote separately on any matter that might have an adverse effect on the class.

The taxpayer argued that the class A shares and class B shares should be treated as separate classes and that the shareholders would receive dividends that were consistent with the terms of those classes. The IRS disagreed and stated as follows:

> To accept Taxpayer's argument on the facts presented here would significantly undermine the preferential dividend rules. The 1986 revision to section 562(c) and its legislative history indicate Congress' understanding and intent that, while differences in distributions paid to certain larger shareholders of a class to reflect reductions in associated administrative expenses are permissible and do not cause the distributions to be preferential dividends, differences in distributions due to a reduction in investment advisory fees for a particular class are not permissible. The purpose and effect of Taxpayer's proposed share arrangements are, however, precisely to differentially allocate investment advisory fees to shareholders holding shares with otherwise identical share rights based on the amount of their respective investments in Taxpayer.[39]

Moreover, according to the IRS, "in substance, the proposed [multiclass stock] arrangement would exist to implement a tiered investment advisory structure based on the amount invested for shareholders whose shares otherwise confer substantially the same rights and obligations."[40]

The ruling concludes that the class A shares and class B shares should not be recognized as separate classes. The IRS therefore treated the special dividend as a preferential dividend, thereby causing all dividends paid on the class A shares and class B shares to be treated as preferential. As a result, dividends payable on the class A shares and class B shares would be ineligible for the dividends paid deduction, and therefore the taxpayer could not qualify as a REIT because it failed to satisfy the distribution requirement under section 857(a)(1).

[39] LTR 201444022.

[40] *Id.*

3. The PATH Act.

As part of the PATH Act, Congress exempted publicly offered REITs from the preferential dividend rule.[41]

The PATH Act also gave the Treasury secretary authority to provide an appropriate remedy to cure the failure of a REIT to comply with the preferential dividend rule when the secretary determines that the failure is inadvertent or is attributable to reasonable cause and not willful neglect, or if the failure is of a type that the secretary specifically identifies.[42] This remedy applies in lieu of disallowing the entire dividend as preferential for purposes of computing the dividends paid deduction. The Treasury secretary has not set forth such a remedy to date.

III. Discussion

As previously discussed, Congress did not specify the reasons for repealing the preferential dividend rule for publicly offered REITs. However, when reading the rulings on the application of the preferential dividend rule to REITs (as well as RICs) that had multiple classes of stock with different fee structures, the government's rationale becomes quite apparent. Consistent with the JCT's explanation that the preferential dividend rule was not needed to protect shareholders of publicly offered RICs because of the protections afforded by the securities laws,[43] these rulings emphasize that shareholders are subject to SEC, FINRA, and state oversight for stock offerings, operations, and the rights of shareholders in general, thereby effectively mitigating the "potential for shareholder injustice."[44] In other words, the IRS has taken the position in numerous rulings that there is no need to protect shareholders from injustices through the application of the tax laws (that is, the preferential dividend rule) when securities laws provide ample protections.

I believe this same rationale should apply to private REITs. Although private REITs are not subject to SEC, FINRA, or state review, there are various securities rules in place that provide sufficient safeguards to protect the rights of shareholders of private REITs and help ensure that those shareholders are treated fairly. I now provide an overview of those rules to help illustrate that shareholders of private REITs enjoy ample protection under the securities laws and that the preferential dividend rule is therefore no longer necessary to protect them against injustices.

A. Securities Laws

1. Sales through FINRA member firms.

Dealer-managers generally enter into selling arrangements with broker-dealers that are also member firms of FINRA. Although private REIT offerings are not subject to SEC, FINRA, or state review, participating broker-dealers must comply with specific FINRA rules, regardless of whether they are compensated on a commission basis or on a fee-for-service basis (that is, broker wrap accounts).

FINRA Rule 2111, which became effective in 2012, is particularly relevant for this discussion. It requires that each broker-dealer that participates in the distribution of shares "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile." To comply with FINRA Rule 2111 and FINRA notices issued thereunder, each broker-dealer must either conduct its own due diligence or hire a third party to assess the transaction before it can recommend it to a customer.

The broker-dealer also must assess a prospective investor's suitability to make an investment based on the prospective investor's profile. That profile includes the prospective investor's age, concomitant investment horizon, experience, financial situation, liquidity needs, exposure to other investments, tax status, investment objectives, and risk tolerance. Thus, the broker-dealer must have adequate knowledge about the proposed investment to recommend it, and the broker-dealer must be able to ascertain that the proposed investment is suitable for the

[41] P.L. 114-113, division Q, section 314.

[42] Section 562(e)(2); *see also* PATH Act section 315.

[43] *See* JCX-49-10, *supra* note 26, at 22; and P.L. 86-779, section 10.

[44] *See* Treasury counsel testimony, *supra* note 17.

prospective investor, from both a quantitative and qualitative standpoint.[45]

Moreover, on June 5, 2019, the SEC adopted its long-awaited Regulation Best Interest, which requires broker-dealers who make recommendations to retail customers to act in their customers' best interest. Regulation Best Interest enhances the suitability standard for broker-dealers by requiring them to "act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer."[46]

Regulation Best Interest imposes the following four obligations on broker-dealers:

a. Disclosure obligation.

Firms must disclose, "in writing, all material facts about the scope and terms of its relationship with the customer," including their capacity as broker-dealers, fees incurred, the scope of services provided, limitations, and conflicts of interest.[47]

b. Care obligation.

Firms must have "a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest ahead of the . . . customer's," including understanding the risks, rewards, and costs associated with the recommendation and considering them in light of the customer's investment profile.[48]

c. Conflict of interest obligation.

Firms must establish and enforce policies "reasonably designed to mitigate conflicts of interest that create an incentive for an associated person of the broker-dealer to place its interests or the interest of the firm ahead of the retail customer's interest" and "identify all such conflicts and at a minimum disclose or eliminate them."[49]

d. Compliance obligation.

Firms must implement policies "reasonably designed to achieve compliance with Regulation Best Interest as a whole."[50]

2. Sales through registered investment advisers.

Private REIT shares are often available for purchase through registered investment advisers not affiliated with participating broker-dealers. The Investment Advisers Act of 1940, as amended (the Advisers Act), imposes a broad fiduciary duty on registered investment advisers to act in the best interest of their clients. Under the act, a registered investment adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all facts material to the client's engagement of the adviser, as well as a duty to avoid misleading the client.[51] A registered investment adviser also must disclose all material facts regarding actual or potential conflicts of interest so that the client can make an informed decision on whether to enter into or continue an advisory relationship with the adviser or take some action to protect himself or herself from the conflict.[52] Further, registered investment advisers owe their clients a duty to provide only suitable investment advice. This duty generally requires an adviser to make a reasonable inquiry into the client's financial situation, investment experience, and investment objectives, and to make a reasonable determination that the advice is suitable in light of the client's situation, experience, and objectives.[53]

3. Sales through other intermediaries.

Private REIT shares are also often available for purchase by employee benefit plans, separate accounts of insurance companies that support

[45] *See generally* FINRA, "FINRA Rule 2111 (Suitability) FAQ" (2003).

[46] 17 C.F.R. section 240.15l-1 (2019).

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *See Morris v. Wachovia Securities Inc.*, 277 F. Supp. 2d 622 (E.D. Va. 2003).

[52] *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 191-192 (1963).

[53] *See* SEC, "Suitability of Investment Advice Provided by Investment Advisers," Investment Advisers Act Release No. 1406, 59 F.R. 13464 (Mar. 22, 1994).

variable annuities and variable life insurance products, and bank collective trusts (collectively, institutional investors). Institutional investors are in all cases represented by advisers with the requisite knowledge and sophistication to understand the terms of offerings and recommend to their clients whether the proposed investment is suitable.

4. Applicability of anti-fraud provisions.

Private REIT offerings are subject to federal and state anti-fraud laws, which, for example, declare it illegal to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading"[54] and in many cases not only give the SEC and state securities administrators the right to pursue stop orders and other remedies, but also give individual investors private rights of action. Also relevant is that an offering conducted under SEC Rule 506, although not subject to regulation by the states,[55] does not prevent a state from requiring notice of the offering.[56] In fact, most states do require that notice, which may alert securities examiners to the unregistered offering. Also notable is that FINRA Rule 2210, which is applicable to FINRA member firms that participate in private REIT offerings, requires that all communications with prospective investors be fair, balanced, not misleading, and generally comply with the standards of applicable SEC rules.

5. Accredited investor.

Private REIT offerings typically require that each investor qualify as an accredited investor as defined under Regulation D promulgated under the Securities Act of 1933. An investor qualifies as an accredited investor for these purposes if, among other things, he or she:

1. had income exceeding $200,000 per year for the past two years or had joint income with a spouse exceeding $300,000 per year for the past two years, and has an expectation of reaching the same income level in the current year;
2. has a net worth, individually or jointly with a spouse or spousal equivalent, exceeding $1 million; or
3. holds in good standing a series 7, 65, or 82 license.

For purposes of calculating net worth under clause 2, an investor (1) may not include the value of a primary residence as an asset; (2) subject to clause 3, need not include as a liability indebtedness that is secured by a primary residence, up to the estimated FMV of the primary residence at the time the investor subscribes for securities; (3) must include any liability secured by a primary residence to the extent that it exceeds the amount outstanding 60 days before the subscription, other than as a result of the acquisition of the primary residence; and (4) must include as a liability indebtedness that is secured by a primary residence to the extent that the indebtedness exceeds the estimated FMV of the primary residence at the time the investor subscribes for securities. The definition of accredited investor also includes separate rules for qualifying an entity.

The legislative history clarifies that the income and net worth thresholds under the accredited investor standard were intended to serve as proxies for financial experience, sophistication, and adequate bargaining power.[57] Moreover, the Government Accountability Office determined that the intended purposes of the accredited investor standard are to (1) protect investors by allowing only those who can withstand financial losses access to unregistered securities offerings, and (2) streamline capital formation for small businesses.[58]

B. Suitability Requirements

In addition to the ample protections that investors enjoy under the securities laws, private REIT offerings generally require investors to

[54] *See* SEC Rule 10b-5, 17 C.F.R. section 240.10b-5.

[55] Securities sold under SEC Rule 506 are covered securities under section 18(b)(4)(F) of the Securities Act of 1933 and thus, according to section 18(a) of the act, are not subject to registration or qualification of securities.

[56] Section 18(b)(4)(F) of the Securities Act.

[57] *See* "Proposed Revision of Certain Exemptions From the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales," Securities Act Release No. 6339, 46 F.R. 41791 (Aug. 18, 1981).

[58] GAO, "Alternative Criteria for Qualifying as an Accredited Investor Should Be Considered" (July 2013).

represent in writing that they meet specific suitability requirements to be shareholders. While these requirements can vary from offering to offering, typical private REIT offerings generally include the following suitability requirements:

1. the investor has received, read, and fully understands the offering memorandum and all appendices and attachments to it;
2. the investor understands that an investment is speculative and involves substantial risks;
3. the investor's overall commitment to investments that are not readily marketable is not disproportionate to the investor's individual net worth, and the investment will not cause that overall commitment to become excessive;
4. the investor has adequate means of providing for his or her financial requirements, both current and anticipated, and has no need for liquidity from the investment;
5. the investor can bear and is willing to accept the economic risk of losing his or her entire investment;
6. the investor is acquiring the shares for his or her own account and for investment purposes only, and has no intention, agreement, or arrangement for the distribution, transfer, assignment, resale, or subdivision of the shares;
7. the investor understands that because of the lack of any existing market for the shares, and the probability that no such market will exist in the future, the investment is, and is likely to remain, highly illiquid and may have to be held indefinitely;
8. the investor has enough knowledge and experience in financial and business matters that he or she can evaluate the merits and risks of an investment in the shares and can protect his or her own interests in connection with that investment;
9. the investor has had the opportunity to ask questions concerning the terms and conditions of the offering and obtain any additional information deemed necessary; and
10. the investor is an accredited investor and will immediately notify the REIT if he or she no longer qualifies as an accredited investor.

The suitability requirements, however, often represent the minimum requirements for investors to acquire shares. In fact, even if a potential investor satisfies the suitability requirements, a REIT may still determine that its shares are not a suitable investment and therefore elect not to accept the potential investor's subscription. REITs also typically reserve the right to modify and raise the suitability requirements.

C. Analysis

1. Protections under the securities laws.

As discussed earlier, the securities laws provide several safeguards to protect the rights of shareholders and help ensure that they are treated fairly. Substantially all sales in private REIT offerings are through FINRA member firms. Broker-dealers therefore have a legal obligation under FINRA Rule 2111 in all cases to understand the nature of the investment and specifically assess through due diligence whether the investment is suitable for a given prospective investor. Broker-dealers also must act in their customers' best interest and satisfy the specific obligations set forth under Regulation Best Interest.

Moreover, private REIT offerings are typically conducted under SEC Rule 506(b). Therefore, each participating broker-dealer is required to facilitate the sale of shares only to clients with whom it has a substantive preexisting relationship or if it otherwise has reason to believe that the prospective investor is an accredited investor.[59] Further, as discussed earlier, private REIT offerings invariably include extensive suitability requirements that demand, among other considerations, that each investor qualify as an accredited investor and possess the requisite financial knowledge and experience to make an investment. Although public offerings may also include some eligibility requirements for investors, the suitability requirements — and the

[59] Under SEC Rule 506(c), which allows for the general solicitation of securities, broker-dealers must take "reasonable steps to verify" that all investors are accredited.

accredited investor standard in particular — are more extensive and generally establish a higher bar to make an investment.

For instance, a standard public offering for a non-traded REIT, which is subject to SEC, FINRA, and state review, is also subject to the REIT guidelines established by the North American Securities Administrators Association. Those guidelines require a prospective investor to represent that he or she has (1) a minimum net worth (exclusive of the value of their home, home furnishings, and personal automobiles) of at least $250,000 or (2) a minimum net worth of at least $70,000 and a minimum annual gross income of at least $70,000, and, if applicable, meets specified net worth and gross income requirements for the investor's state of primary residence. These requirements are considerably less rigorous than typical suitability requirements and the accredited investor standard, which require much higher net worth or income thresholds.

For investors who purchase shares through registered investment advisers, the Advisers Act imposes a broad fiduciary duty on registered investment advisers to act in the best interest of their clients. Registered investment advisers owe their clients a duty to provide only suitable investment advice and must determine that the advice is suitable in light of the client's situation, experience, and objectives.[60]

Based on these rules, while it is arguable that the tax laws — and in particular the preferential dividend rule — were necessary to protect shareholders decades ago when there were not as many protections under the securities laws, the current climate is much different. For instance, FINRA Rule 2111, which imposes extensive obligations on broker-dealers to ensure that investments are suitable for prospective investors, became effective in 2012. FINRA Rule 2210, SEC Rule 506, and the accreditor investor rule also were either not in place or not in their current form when Congress expressed concerns about the rights of shareholders and shareholder fairness in general. Rather, most of the rules discussed in this report were enacted under more recent laws, which should address the historic concerns that resulted in the enactment of the preferential dividend rule. As the IRS itself has recognized in numerous rulings, there is no longer a need to protect shareholders from injustices through the application of the tax laws when securities laws provide ample protections.

2. Policy considerations.

While the securities rules described herein should provide sufficient safeguards to protect the rights of shareholders and help ensure that shareholders are treated fairly, the policy considerations underlying the preferential dividend rule also are important and should be further considered.

As previously discussed, Congress was principally concerned about preferential dividend arrangements with a tax avoidance purpose. The legislative history of the predecessors of section 562(c) reveals that the preferential dividend rule was enacted to preclude "an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance."[61] During the 1930s, when the preferential dividend rule was first enacted, Congress appears to have been primarily concerned about tax avoidance in the context of the personal holding company tax and the accumulated earnings tax. In each case, Congress believed that the preferential dividend rule was necessary to prevent corporations from avoiding these taxes by shifting income to shareholders in lower tax brackets (for example, through dividend waivers and nontaxable stock dividends).

While it was a legitimate concern in the 1930s, the tax law is now much stronger and better equipped to address these issues. The IRS has since ruled that dividend waivers will not be respected for federal income tax purposes if there are business or family relationships between the waiving and non-waiving shareholders.[62] Moreover, in 1954 Congress enacted rules regarding the taxation of stock dividends. In particular, section 305(b) and (c) specifically prevent corporations from making taxable stock distributions to some shareholders while

[60] *See* SEC, *supra* note 53.

[61] H.R. Rep. No. 75-1860 (1938) (Conf. Rep.).

[62] *See* Rev. Rul. 45, 1953-1 C.B. 178.

deferring other shareholders' receipt of that income.

A typical REIT multiclass share structure is not intended to avoid taxes and does not cause injustice to shareholders. Rather, the allocation of fees is intended to broaden the investor market for shares by allowing prospective investors to purchase shares through different distribution channels, while simultaneously allowing the REIT to pass on savings associated with lower distribution costs associated with particular distribution channels.

IV. Conclusion

In 2015 Congress correctly recognized that the preferential dividend rule should no longer apply to publicly offered REITs. Private REITs, however, continue to be subject to the preferential dividend rule, which remains a significant obstacle in the REIT industry and in many cases discourages the use of REITs in real estate funds. As discussed in this report, those concerns persist regardless of whether shareholders invest directly in a REIT with multiple classes of stock or if investors are limited partners in a partnership that owns all the common stock of the REIT.

I believe that the preferential dividend rule no longer serves a purpose and should not apply to either publicly offered REITs or private REITs. The IRS has in many rulings recognized that there is no need to protect shareholders from injustices through the application of the tax laws (that is, the preferential dividend rule) when securities laws provide ample protections. Indeed, as discussed in this report, applicable FINRA rules, federal and state anti-fraud rules, the Advisers Act, the accredited investor standard, and the suitability requirements all provide sufficient safeguards to protect the rights of shareholders and help ensure that they are treated fairly. Accordingly, I believe it is time to repeal the preferential dividend rule and remove an unnecessary barrier to investment in real estate.

Importantly, many of the other tests that entities must satisfy to qualify as a REIT include specific cure provisions to address inadvertent violations. For instance, under section 856(c)(6), if a REIT fails to satisfy either or both of the gross income tests for any tax year, the REIT may still qualify as a REIT in that year if (1) following its identification of the failure to meet the requirements of either or both of the gross income tests for a tax year, a description of each item is set forth in a schedule for that tax year, and the REIT pays a penalty tax based on the income that caused the failure; and (2) the failure to meet the gross income tests was attributable to reasonable cause and not willful neglect.[63] Moreover, this provision does not include any specific limitations on the amount of nonqualifying income. A REIT, therefore, could presumably have substantial nonqualifying income and remain a REIT, as long as it satisfies the requirements of the statute. However, there is no specific cure or remedy for violations of the preferential dividend rule, even for an inadvertent or de minimis violation.

Therefore, at a minimum, if repeal is for any reason not an option under the authority granted to Treasury under the PATH Act, it is long overdue for Treasury to issue guidance on how to cure the failure of a REIT to comply with the preferential dividend rule when the failure is inadvertent or is attributable to reasonable cause and not willful neglect.[64] ■

[63] Reg. section 1.856-7(c)(1). Reasonable cause for these purposes requires that the REIT exercise ordinary business care and prudence in trying to satisfy the gross income requirements of section 856(c).

[64] Section 562(e)(2); *see also* PATH Act section 315.