Proskauer

The Internal Revenue Service Rules in Favor of Multi-Class REIT Structure with Deductible Offering Costs

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In a private letter ruling (PLR) that we obtained on behalf of a client, the IRS extended rules applicable to open-end mutual funds (RICs) to a publicly registered, non-traded real estate investment trust (a REIT). The IRS held that: (1) the issuance of multiple classes of common stock that are subject to different fees, similar to RICs, (A) would not cause distributions paid by the REIT with respect to those multiple classes of stock to be treated as preferential dividends under Section 562(c)[1] and (B) would not cause the REIT to fail to qualify as a REIT; and (2) one of the REIT's fees, a deferred sales commission, would be deductible currently by the REIT under Section 162 rather than a non-deductible capital expenditure.[2]

Background

The Taxpayer is a Maryland corporation that intends to qualify as a REIT for U.S. federal income tax purposes. The Taxpayer will be what is commonly referred to as a "non-listed REIT" or "non-traded REIT" because its shares of common stock will be registered with the Securities and Exchange Commission (SEC) but will not be listed on a securities exchange. By registering its shares with the SEC, pursuant to applicable U.S. securities laws the Taxpayer can sell its shares in a public offering, through a network of participating broker-dealers, to investors who meet certain suitability standards but who may not be qualified to invest in a private offering. Non-traded REITs typically are marketed to retail investors (but generally not to institutional investors) seeking continuing current income and the potential for moderate, long-term capital appreciation.

In order to qualify as a REIT for U.S. federal income tax purposes, an entity must meet a number of ongoing tests relating to its assets, income, organization, operation and distributions. A REIT generally must distribute annually to its shareholders at least 90% of its net taxable income, taking into account certain adjustments. A REIT's special tax status allows the REIT a deduction for dividends paid to shareholders; however, it is not allowed a deduction for dividends paid if such dividends are "preferential."

Under Section 562(c), distributions must be pro rata and not prefer one share of stock over another share of the same class, and must not prefer one class of stock over another class except to the extent that one class is entitled (without reference to waivers of their rights by shareholders) to a preference. However, the Internal Revenue Service (the IRS) generally will treat two classes that are essentially equivalent to each other (i.e., they have the same voting rights, liquidation rights, etc.) as one class.

The Taxpayer's Proposal and Tax Issues

The Taxpayer proposed a multi-class structure similar to those offered by RICs. The Taxpayer will value its shares based on its net asset value (NAV) which will be determined daily (similar to RICs) which is unlike typical non-traded REITs where the board of directors typically sets the share price at a fixed price.

The Taxpayer will issue two classes of shares of its common stock: one class (Class A) which will bear an up-front selling commission and dealer manager fee, but not a deferred asset-based distribution fee, and another class (Class B) which will bear a deferred asset-based distribution fee, but not the selling commission or dealer manager fee, based on the NAV of the Class B shares. This deferred distribution fee is similar to fees subject to Rule 12b-1, under the Investment Company Act of 1940. The Taxpayer will also pay an annual advisory fee and certain other expenses and fees (e.g., asset management fees, real estate commissions, property management fees and operating expense reimbursements), each of which will be allocated between and be borne by the Class A and Class B shares based on the relative NAV of each class.

Preferential Dividend Issue

The special allocation of the selling commission and dealer manager fee, solely to the Class A shares, and the deferred distribution fee, solely to the Class B shares, could result in different NAVs for each class of shares. Distributions made by the Taxpayer to shareholders will be allocated to the shareholders in proportion to the relative NAV of each class of stock. Accordingly, because the Class A and Class B shares could be viewed as one class due to their similarity (other than the allocation of certain fees and expenses), distributions made on the Class A and Class B shares could be viewed as preferential under Section 562(c) which would jeopardize the Taxpayer's ability to qualify as a REIT. There has been no applicable guidance by the IRS for REITs on this issue until very recently. However, in Rev. Proc. 99-40,[3] the IRS has provided rules applicable to a RIC's multi-class structure whereby distributions made to shareholders may vary solely due to the allocation of fees and expenses and nevertheless be deductible as dividends under Section 562.

Deductible Expense Issue

The other primary concern with this structure is whether the deferred asset-based distribution fee allocated solely to the Class B shares (which is like a deferred stock issuance expense) would be deductible currently by the Taxpayer as a business expense under Section 162 rather than a non-deductible capital expenditure. In general, stock issuance expenses are capital expenditures, not deductible under Section 162.[4] However, in Rev. Rul. 73-463[5] the IRS provided an exception to the general rule of capitalization for RICs, holding that stock issuance expenses of an open-end investment company, not incurred in the initial 90-day offering period, after the company's registration statement becomes effective,[6] are deductible as ordinary and necessary business expenses. This rule was expanded by Rev. Rul. 94-70[7] to apply to Rule 12b-1 fees. As with the preferential dividend issue, until now, there has been no applicable guidance by the IRS for REITs on this issue.

Holdings and Impact of Ruling

Both Congress and the IRS have acknowledged the similarity between RICs and REITs in many areas and have afforded them similar treatment in many situations. RICs and REITs are each subject to the requirements under Section 562(c) prohibiting preferential dividends in order to be entitled to a deduction for dividends paid under Section 561.[8] The holdings obtained in this PLR indicate that the IRS is willing, in appropriate circumstances, to apply the rules applicable to Rule 12b-1 fees charged by RICs to REITs.

While the Taxpayer is not within the scope of Rev. Proc. 99-40, the IRS has now applied it to a REIT for the second time in holding that the Taxpayer's issuance of multiple classes of stock that are subject to different fees as described above will not cause (1) distributions paid by the Taxpayer with respect to those multiple classes of stock to be preferential dividends within the meaning of Section 562(c) or (2) the Taxpayer to fail to qualify as a REIT. Furthermore, the previous private ruling issued by the IRS on the multiple classes of stock issue[9] applied Rev. Proc. 99-40 to an open-ended REIT which could have a perpetual life; however, the Taxpayer in this PLR is a defined life REIT — i.e., a REIT that intends to begin the process of achieving a liquidity event not later than (in the case of the Taxpayer) three to six years after the termination of the primary offering.

In addition, while the Taxpayer is not within the scope of Rev. Rul. 94-70, the IRS has now applied it to a REIT, in holding that the deferred distribution fee would be deductible currently by the Taxpayer pursuant to Section 162, rather than a non-deductible capital expenditure.

It appears that the IRS is willing, in appropriate circumstances, to embrace this new share class structure for REITs which has the potential to expand what non-traded REITs have to offer to their potential investor pool and may make non-traded REITs more attractive to investors who do not currently invest in them.

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