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PLR: REIT preferential dividends

The IRS publicly released a private letter ruling* in which the IRS extended the status of a “publicly offered” real estate investment trust (REIT) to a subsidiary REIT of an exchange-listed REIT (parent REIT).

This ruling is based on the representation that the subsidiary REIT has been consolidated with the parent REIT under generally accepted accounting principles for purposes of the annual and periodic reports that the parent REIT is required to file with the U.S. Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934. Accordingly, notwithstanding that the subsidiary REIT might previously have made a disproportionate distribution to its common stockholders due to the rounding of the ownership percentages shown in the organizational charts, such distribution would not be considered a preferential dividend and would not adversely affect the subsidiary REIT.

Read [PLR 202051005](#) [PDF 78 KB] (release date December 18, 2020, and dated September 18, 2020)

*Private letter rulings are taxpayer-specific rulings furnished by the IRS Office of Chief Counsel in response to requests made by taxpayers and can only be relied upon by the taxpayer to whom issued. Pursuant to section 6110(k)(3), written determinations such as private letter rulings are not intended to be relied upon by third parties and may not be cited as precedent. These written determinations may, however, offer an indication of the IRS’s position on the issues addressed.

Background

For an entity to qualify and maintain REIT status, the entity generally must make distributions with respect to its stock that qualify as a dividends-paid deduction (DPD) equal to at least 90% of its “ordinary” taxable income.

Moreover, because it the DPD reduces a REIT’s taxable income, the DPD allows a REIT to avoid corporate-level income tax (to the extent that amounts are distributed to its stockholders). However, a distribution cannot generate a DPD unless the “distribution is 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 except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference”—that is, no preferential dividend.

Publicly offered REITs are exempt from this rule. A publicly offered REIT means a REIT that is required to file annual and periodic reports with the SEC under the Securities Exchange Act of 1934.

Summary

In the letter ruling:

- An exchange-listed REIT owns substantially all its assets first through its operating partnership and then through two lower-tier partnerships, Partnership X and Partnership Y, each of which own a portion of Partnership Z.
- Partnership Z owns **g**% of the taxpayer, another REIT (Subsidiary REIT), which was previously owned directly by Partnership X and Partnership Y.
- On **Date 4**, the Subsidiary REIT made a distribution (Distribution) on its common stock when it was owned directly by Partnership X and Partnership Y.
- The Distribution was intended to be pro rata, but an overdistribution was paid to Partnership Y due to the rounding of the ownership percentages shown in the organizational charts maintained by the operating partnership.
- Upon learning of the error, on **Date 5**, the overdistribution was returned to the Subsidiary REIT and distributed to Partnership X.

It was represented that the Subsidiary REIT has been included in the consolidated financial statements that the exchange-listed REIT is required to file with the SEC under the Securities Exchange Act of 1934 and is not presented separately.

Accordingly, and consistent with several previously issued private letter rulings, the IRS ruled that the Subsidiary REIT is a publicly offered REIT, and, therefore, the Distribution is not a preferential dividend.

KPMG observation

The PLR provides helpful guidance, given both the importance of the preferential-dividend issue generally but also given that private REITs (such as Subsidiary REIT in this latest ruling) are otherwise not exempt from the limitation on DPDs for preferential dividends. As many advisers and REITs unfortunately know, preferential dividend issues can arise in a number of circumstances, including as a result of minor foot-faults. Moreover, common and not-easily-solved commercial points, such as those related to sliding-scale management fees, also sometimes raise preferential-dividend issues. Read [PLR 201444022](#) [PDF 73 KB]

Moreover, if a distribution to a stockholder is deemed preferential (e.g., being disproportionate within a class or violating dividend rights of other class), it may cause the entire “distribution” to be considered a preferential dividend that is excluded from the DPD determination. By effectively expanding the exemption for publicly offered REITs to a private REIT, albeit by private letter ruling, the IRS has shown helpful flexibility—and advisers and investors will be relieved.

The IRS has done as much before. In [PLR 202051005](#) [PDF 78 KB], the IRS interpreted the definition of a publicly offered REIT to include the subsidiary REIT that is consolidated with the exchange-listed REIT, which is required to file reports with the SEC and meets the definition of a publicly offered REIT. Tax professionals view such interpretation as being sensible and as eliminating the uncertainties associated with having a preferential dividend. In [PLR 201924003](#) [PDF 46 KB], the IRS similarly extended the status of a publicly offered REIT to another exchange-listed REIT’s subsidiary REIT that appears to have made a distribution on its common stock in violation of the terms of its preferred stock.

With more and more widely held REITs forming joint ventures with institutional investors through subsidiary REITs, it has been observed that it would be beneficial if the IRS can turn these letter rulings

into more formal guidance under which a private REIT consolidated for accounting purposes with a publicly offered REIT can claim the same status and be exempt from the preferential dividend rule if certain conditions are met.

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