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Date:
July 21, 2014

Legend:

Taxpayer =

State X =

Year 1 =

Advisor =

a =

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Dear :

This is in reply to a letter dated April 11, 2013, requesting rulings on behalf of Taxpayer concerning Taxpayer's proposed restructuring that will result in two classes of common shares, with the mix of class shares held by an investor dependent upon the size of the investor's investment in Taxpayer (as described below). You requested rulings that (1) dividends paid by Taxpayer with respect to Taxpayer's two classes of common shares (as described below) will not be treated as preferential dividends within the meaning of section 562(c) of the Internal Revenue Code, and (2) the existence of the two classes of common shares (as described below) will not cause Taxpayer to fail to qualify as a real estate investment trust (REIT) under section 856 of the Code.

FACTS

Taxpayer is a privately held State X limited liability company that, at all times since Year 1, has been treated as a corporation for federal income tax purposes and has elected under section 856(c) to be treated as a REIT.

Taxpayer currently has two classes of outstanding limited liability company interests: (i) common shares ("Common Shares") and (ii) preferred shares ("Preferred Shares"). The Common Shares are participating, voting common interests that are neither limited nor preferred as to distributions or on liquidation. The Preferred Shares are non-participating, non-voting interests that are limited and preferred as to distributions and on liquidation.

Taxpayer is an externally managed REIT. Taxpayer's independent board has delegated to Advisor the authority to manage Taxpayer's investments and operations. As consideration for these services, Taxpayer pays Advisor a quarterly management fee ("Base Fee") currently equal to a% (per annum) of the Taxpayer's net asset value ("NAV") as of the beginning of the relevant quarter. Taxpayer also pays Advisor an annual incentive management fee ("Incentive Fee"), computed monthly, that is equal to the product of (i) b, (ii) the NAV of Taxpayer as of the beginning of the relevant month, and (iii) a specified measure of year-over-year income generated by assets held by Taxpayer for a specified minimum holding period.

Taxpayer proposes to enter into certain transactions to create two classes of shares, Class A Shares and Class B Shares (collectively, "Shares"). Taxpayer proposes to amend its management agreement with Advisor such that the Base Fee will be determined only by reference to the portion of Taxpayer's NAV that is attributable to the Class A Shares ("Class A NAV"), and the Incentive Fee will accrue on and be payable with respect to the Class A NAV and the portion of Taxpayer's NAV that is attributable to the Class B Shares ("Class B NAV") separately but on otherwise identical

terms (i.e., pursuant to the same formula but based on each class's share of Taxpayer's NAV).

Taxpayer proposes to amend its existing governing agreement to convert all outstanding Common Shares into Class A Shares and authorize the issuance of Class B Shares. Taxpayer will not alter the manner in which the Base Fee affects the NAV of the Shares. The Base Fee will reduce the Class A NAV and the Class B NAV on a pro rata basis.

Taxpayer proposes to extend a one-time offer to its shareholders pursuant to which a shareholder eligible to subscribe for Class B Shares may elect to convert a specified number of Class A Shares into Class B Shares representing the same portion of Taxpayer's NAV ("Conversion Offer"). Pursuant to the Conversion Offer, each such shareholder will be entitled to convert a number of Class A Shares such that, immediately following such conversion, the number of Class B Shares held by such shareholder would not exceed the number of Class B Shares that a new investor could purchase if such new investor made a cash investment in Taxpayer equal to the NAV of such shareholder's aggregate investment in Taxpayer.

New investors purchasing less than $c million of Shares will receive solely Class A Shares. Investors purchasing at least $c million of Shares may elect to receive a combination of Class A Shares and Class B Shares, as follows: (i) for purchases of at least $c million but less than $d million, up to e% Class B Shares and the remainder Class A Shares; (ii) for purchases of at least $d million but less than $f million, up to g% Class B Shares and the remainder Class A Shares; and (iii) for purchase of $f million or more, up to h% Class B Shares and the remainder Class A Shares.

An existing shareholder who acquires additional Shares (other than by dividend reinvestment) will receive solely Class A Shares, except that if the NAV of the shareholder's aggregate investment in Taxpayer immediately after acquisition of such additional Shares is at least $c million, the shareholder will be entitled to elect instead to receive a combination of Class A Shares and Class B Shares (or solely Class B Shares, as the case may be) such that, immediately after acquisition of such additional Shares, the number of Class B Shares held by the shareholder does not exceed the number of Class B Shares that a new investor could purchase if making a cash investment in Taxpayer equal to the NAV of the shareholder's aggregate investment in Taxpayer.

Except as otherwise provided in Taxpayer's existing governing agreement, each outstanding Class A Share and each outstanding Class B share will have one vote. The Shares will vote jointly on matters affecting Taxpayer as a whole. Class A Shares and Class B Shares will vote separately as a class on any matter that may have an adverse effect on the respective class of Shares, including for the Class B Shares any changes to the amount or other terms of the Special Dividends ("Special Dividends" as described below).

On each quarterly dividend date, after each Preferred Share has received its preferred dividend in accordance with its terms (i) first, each Class B Share will be entitled to receive on a pro rata basis any accumulated but unpaid Special Dividends, which will be equal to i% of the Class B NAV as of the beginning of each quarter, and (ii) thereafter, each Class A and Class B Share will be entitled to receive regular Common Dividends paid in an equal amount per Share. The Special Dividend will initially be equal to the reduction in the amount of the Base Fee formerly charged by the Advisor with respect to the portion of the aggregate NAV of the Class B Shares.

If in the future the Base Fee is charged on a different basis, the amount of the Special Dividend would not be adjusted in the absence of a shareholder vote approving the adjustment, with Class A and Class B Shares voting separately. A proposed increase in the amount of Special Dividends payable on the Class B Shares would be subject to a class vote by just the Class A Shares, and a proposed decrease in the amount of Special Dividends payable on the Class B Shares would be subject to a class vote by just the Class B Shares.

For purposes of determining the NAV of each class of Shares (and thus the computation of dividend entitlements and the amount payable by Taxpayer on the redemption of a share of any class), the Special Dividend will be treated as an amount similar to an expense that is borne pro rata by the Class A Shares and the Class B Shares, and will therefore reduce the Class A NAV and the Class B NAV on a pro rata basis.

If a shareholder elects to reinvest a dividend payable on its Class A Shares, Class B Shares, or both pursuant to Taxpayer's dividend reinvestment program, j% of the dividend will be reinvested in Class A Shares and e% of the dividend will be reinvested in Class B Shares, without regard to the NAV of the shareholder's aggregate investment in Taxpayer.

Shareholders holding Class A Shares and Class B Shares will be entitled to tender for redemption solely Class A Shares, solely Class B Shares, or a combination of Class A Shares and Class B Shares. If sufficient cash to redeem all tendered Shares is unavailable, the Class A Shares and Class B Shares tendered by a shareholder will be redeemed on a pro rata basis based on the relative NAVs of the Class A Shares and Class B Shares tendered by the shareholder.

LAW AND ANALYSIS

Section 857(a)(1) of the Code requires, in part, that a REIT's deduction for dividends paid for a tax year (as defined in section 561, but determined without regard to capital gains dividends) equal or exceed 90% 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).

For purposes of section 857, section 561(a) defines the deduction for dividends paid to include dividends paid during the taxable year.

Section 561(b) applies the rules of section 562 to identify dividends eligible for the section 561(a) dividends paid deduction.

Until 1986, section 562(c) provided that the amount of any distribution would not be considered as a dividend for purposes of computing the section 561 dividends paid deduction unless the distribution was pro rata. Section 562(c) further provided that the distribution must not prefer any shares of stock of a class over other shares of stock of that same class. In addition, section 562(c) provided that the distribution 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 stockholders) to that preference.

Section 1.562-2 of the Income Tax Regulations, which was promulgated in 1956 and has not since been amended, provides that a corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. Under the regulation, a preference exists if any rights to preference inherent in any class of stock are violated. In addition, the disallowance, when a preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution.

In 1986, Congress amended section 562(c) to provide that a distribution by a regulated investment company ("RIC") to a shareholder who made an initial investment of at least $10,000,000 in the RIC will not be treated as being preferential if the only reason for the increase in the distribution is a reduction in the administrative expenses of the RIC. The conference report explains this provision as follows:

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

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-246 (1986). The General Explanation of the Tax Reform Act of 1986 (P.L. 99-514) provides further explanation for the 1986 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.

Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 382 (Comm. Print 1987).

In Rev. Proc. 99-40, 1999-2 C.B. 565, the Service described conditions under which distributions made to shareholders of a RIC may vary and nevertheless be deductible as dividends under section 562. Rev. Proc. 99-40 provides, 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 do not prevent the distributions from being dividends eligible for the dividends paid deduction under the provisions of section 561 and section 562. The requirements of Rev. Proc. 99-40 are based on similar requirements contained in Rule 18f-3, 17 C.F.R. 270.18f-3, under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq. (1940 Act). Consistent with section 562(c), Rev. Proc. 99-40 and the 1940 Act require that the advisory fee generally must not be charged at different rates for different groups of shareholders. The groups of shareholders may be allocated and may pay a different advisory fee, however, to the extent that any difference in amount paid is the result of the application of the same performance fee provisions in the advisory contract to the different investment performance of each group of shareholders.

In 2010, Congress further amended section 562(c) to repeal the preferential dividend rule for publicly offered RICs, which are defined in section 67(c)(2)(B). Regulated Investment Company Modernization Act of 2010, Pub. L. No. 111-325, 124 Stat. 3537, § 307.

REITs were created to provide an investment vehicle similar to RICs for small investors to invest in real estate and real estate mortgages. Congress and the Service have acknowledged the similarity between RICs and REITs in many areas and have afforded them similar treatment in many situations. The legislative history underlying the provisions governing the tax treatment of REITs indicates that, except where specifically provided otherwise, Congress generally intended to equate the tax

treatment of REITs with the treatment accorded to RICs. See H.R. Rep. No. 2020, 86th Cong., 2d Sess. 3 (1960).

Congress did not, however, extend the liberalization of the RIC preferential dividend rules to REITs. Moreover, even if Taxpayer were a RIC, neither the 1986 nor the 2010 liberalization would expressly apply to the preference Taxpayer proposes. Taxpayer proposes to provide a preference for investment advisory fees for shareholders. The 1986 liberalization is specifically limited to "savings in administrative costs attributable to the size of a shareholder's holdings (and *not differences in investment advisory fees*)."[1] The 2010 liberalization is limited to publicly offered RICs, as defined in section 67(c)(2)(B).[2]

Taxpayer asserts that the dividends it will pay with respect to its Class A Shares and Class B Shares will not be preferential within the meaning of section 562(c) because (i) the two classes qualify as separate classes of stock for this purpose and (ii) all shareholders within each class will receive the same amount of dividends as every other shareholder of that class, in accordance with the dividend rights of that class.

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.

The Class A Shares and Class B Shares proposed by Taxpayer would confer the same voting, dividend, redemption, and liquidation rights, except for provisions that would enable holders of Class B Shares to receive, and preserve their rights to, the Special Dividend. The Special Dividend is an additional fixed and periodic distribution that represents the amount of the reduction in the Advisor Base Fee charged to Taxpayer under the proposed two common share class structure (as described above). Even though it is payable only to holders of Class B shares, the Special Dividend would be allocated between the Class A Shares and the Class B Shares pro rata, and accordingly it would reduce the Class A NAV and the Class B NAV on a pro rata basis.

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[1] Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 382 (Comm. Print 1987) (emphasis added). The preferential dividend relief provided for RICs by Rev. Proc. 99-40 is similarly inapplicable to advisory fees.

[2] Taxpayer's REIT shares are not publicly offered.

The net effect would generally be that holders of Class B Shares (in their capacity as such) would not bear the cost of the Advisor Base Fee, and that the Advisor Base Fee would be borne entirely by the holders of Class A Shares (in their capacity as such). Moreover, the provisions regarding the acquisition of Class B shares are intended to ensure that only shareholders making investments in Taxpayer above certain thresholds, or having such level of investments at the time of the Conversion Offer, may acquire Class B shares, and then only in proportions that depend on the amount of their investments. Accordingly, in substance, the proposed arrangement would exist to implement a tiered investment advisory fee structure based on the amount invested for shareholders whose shares otherwise confer substantially the same rights and obligations. Under these circumstances, the Class A and Class B shares are not appropriately recognized as separate classes for purposes of section 562(c).[3]

Taxpayer additionally asserts that, although the Special Dividend will initially be equal to the reduction in the Advisor Base Fee for the Class B Shares, the Special Dividend is not linked to the amount of the Advisor Base Fee paid because if the Advisor Base Fee were charged on a different basis in the future, the amount of the Special Dividend would not be adjusted in the absence of a shareholder vote approving the adjustment. This fact does not change the substance of the proposed dividend, which is to permit a difference in investment advisory fees between shareholders with otherwise substantially identical rights that own Class A Shares and Class B Shares in different proportions based on the amount of their respective investments in Taxpayer.

Based on the above facts and circumstances, and for the reasons stated above, we conclude that the Special Dividend paid by Taxpayer with respect to the proposed two classes of common shares (as described above) will be treated as a preferential dividend within the meaning of section 562(c). Pursuant to section 562(c), no dividends paid deduction is allowed for a preferential dividend, and under section 1.562-2(a) of the regulations, the disallowance of the deduction will extend to the entire amount of the distribution and not merely to a part of such distribution. Accordingly, Taxpayer's payment of a Special Dividend on the Class B shares (as described above) will cause Taxpayer's entire distribution made to the Class A and Class B shares to be a preferential dividend under section 562(c), making the distribution ineligible for the dividends paid deduction under section 561. In turn, the preferential dividend may result in Taxpayer failing to meet its 90% distribution requirement under section 857(a)(1), and may cause Taxpayer to fail to qualify as a REIT under section 856 of the Code.

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision

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[3] Indeed, if Taxpayer's assertions were accepted, the 1986 revision to section 562(c) would have been unnecessary, as any RIC or REIT could have differentiated between shareholders based on administrative expenses by setting up otherwise identical "classes" of shares with different dividend rights tied to administrative expense differentials.

of the Code. Specifically, we are not ruling on whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

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K. Scott Brown
Branch Chief, Branch 3
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: