IRS Loosens Up on REIT Consent Dividends

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By Abraham Leitner

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A recent private letter ruling that permits the use of a consent dividend election for liquidating distributions provides greater flexibility to a real estate investment trust that does not have sufficient assets to meet the REIT distribution requirements in its final year.

A private letter ruling issued by the IRS earlier this year may provide greater flexibility when a real estate investment trust does not have sufficient assets to meet the REIT distribution requirements in its final year.[1]

Although classified as corporations, REITs are permitted to claim a deduction for ordinary dividends and capital gain dividends paid to their shareholders.[2] As a result of the dividends paid deduction, a REIT that distributes all of its income each year is not subject to any corporate-level tax. Moreover, REITs are required to distribute the bulk of their ordinary income annually, and a REIT that fails to distribute at least 90 percent of its REIT taxable income for the year may be disqualified as a REIT.[3] A REIT that lacks sufficient cash or other assets to fund the required distributions or eliminate its taxable income is permitted, with the consent of its shareholders, to designate an amount as a deemed dividend (consent dividend).[4] Although it is not actually distributed, a consent dividend is treated like an actual distribution under the code for all purposes, allowing the REIT to deduct the amount of the consent dividend and requiring the shareholders to include the amount in income as if it were actually distributed.[5]

These rules operate differently in the year(s) that the REIT is liquidated and wound up. To maintain REIT qualification for its final year and to avoid corporate-level taxation, a REIT that is undergoing liquidation may need to be able to claim a dividends paid deduction if it is still generating operating income. Moreover, the REIT may recognize gain under section 336 on assets that it distributes to its shareholders in the liquidation. Under the general rules of sections 561(a)(1) and 562(a), only a distribution that qualifies as a dividend for purposes of section 316 is allowed to be claimed for a dividends paid deduction. However, liquidating distributions are generally not treated as dividends under section 316, but rather are taken into account by a corporation's shareholders as amounts received in exchange for their stock in the corporation.[6] Nevertheless, a special rule in section 562(b) permits liquidating distributions to be deducted by the REIT as if they were dividends paid.

Except for a REIT that is a personal holding company,[7] a liquidating distribution is deductible to the extent that either (1) the distribution is made out of the REIT's accumulated earnings and profits;[8] or (2) if the REIT does not have accumulated E&P (because it has an E&P deficit from prior years that exceeds its current E&P), the distribution is made within 24 months of the REIT's adoption of a liquidation plan.[9]

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[1] LTR 201103001, *Doc 2011-1357*, *2011 TNT 15-51*.

[2] Sections 857(b)(2)(B) and 857(b)(3)(A)(ii) permit a REIT to claim a deduction for dividends paid, as defined in section 561. The rules for determining the dividends paid deduction appear in sections 561 through 565.

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

[4] Section 565(a).

[5] Section 565(c).

[6] Section 331(a) and (b).

[7] Although a corporation that meets the personal holding company "closely held" test of section 542(a)(2) cannot qualify as a REIT under section 856(a)(5) and (h), the closely held test is modified for REIT purposes to eliminate the partner-to-partner attribution rule in section 544(a)(2). *See* section 856(h)(1)(B)(i). Thus, a REIT owned by a partnership that has individual partners can be a personal holding company by reason of partner-to-partner attribution while still not being treated as closely held for REIT purposes.

[8] Section 562(b)(1)(A). This rule also permits a deduction for a distribution in partial liquidation of the REIT (see section 302(e)) or for a redemption of a shareholder that is not treated as a dividend under section 302, but no deduction is allowed for those distributions in the case of a mere holding or investment company that is not a regulated investment company.

[9] Section 562(b)(1)(B).

For a REIT that is a personal holding company, a liquidating distribution can qualify for the dividends paid deduction only if it is made to a corporate distributee within 24 months of the adoption of a liquidation plan and the amount distributed represents the corporate distributee's allocable share of the undistributed personal holding company income for the tax year.[10] A personal holding company is also permitted to designate a liquidating distribution made to a noncorporate distributee as a dividend. In that case, the corporation would be entitled to deduct the distribution, and the distributee would have to include it in income as a dividend.[11]

In some situations a REIT that has adopted a liquidation plan may not have sufficient assets available to meet its distribution requirements. Can a REIT that has adopted a liquidation plan use the consent dividend mechanism to get the benefit of a dividends paid deduction? This question is not directly addressed by the code or the regulations. However, section 565(b)(2) provides that a consent dividend shall not include ''an amount specified in a consent which would not constitute a dividend (as defined under section 316) if the total amounts specified in consents filed by the corporation had been distributed in money to shareholders on the last day of the taxable year of such corporation.'' Since amounts distributed to a shareholder under a plan to liquidate a corporation are not treated as dividends under section 316, but rather as amounts received in exchange for the shareholder's stock in the corporation, those distributions would appear at first blush to violate the restriction in section 562(b)(2).

On closer examination, however, this objection does not stand up to scrutiny. The reason it fails is that section 562(b) does not merely provide that a liquidating distribution is eligible for the dividends paid deduction. Rather, section 562(b) says that a qualifying liquidating distribution ''shall be treated as a dividend for purposes of computing the dividends paid deduction.'' Therefore, if a consent dividend election is made for an amount that if actually distributed would be treated as a liquidating distribution as described in section 562(b), the amount would be treated as a dividend for purposes of section 565 and would not violate the restriction of section 565(b)(2). Accordingly, a liquidating distribution should be eligible to be the subject of a consent dividend election.

Astute readers may be wondering, if section 565(b)(2) was not intended to exclude liquidating distributions from being treated as consent dividends, what was the ''would not constitute a dividend'' limitation in that provision intended to exclude? An example in reg. section 1.565-2(c)(2) indicates that one target of the exclusion is situations in which the amount specified in the consent dividend election exceeds the corporation's current and accumulated E&P. In that situation, section 565(b)(2) could protect shareholders from earning additional dividend income when there is an erroneous designation of a consent dividend in excess of the corporation's earnings.[12] The section 565(b)(2) limitation also applies when a liquidating distribution would not qualify under section 562(b), for example, because the corporation has current but no accumulated E&P and more than 24 months have elapsed since the adoption of the liquidation plan. In that context, section 565(b)(2) prevents the consent dividend mechanism from being used to obtain a deduction for a distribution that would not have been deductible if it were actually made.[13]

Another potential objection against making a consent dividend election for a liquidating distribution is the language of section 565(f), which defines the term ''consent stock.'' Only stock that qualifies as consent stock may be the subject of a consent dividend election.[14] Consent stock is defined as ''the class or classes stock entitled, after the payment of preferred dividends, to a share in the distribution (other than in complete or partial liquidation) within the same taxable year of all the remaining earnings and profits, which share constitutes the same proportion of such distribution regardless of the amount such distribution.''[15] The parenthetical exclusion in this definition, which excludes stock entitled only to distributions in liquidation, could be understood as implying that liquidating distributions are excluded from the consent dividend rules altogether. However, if nonliquidating distributions don't qualify for consent dividend treatment in the first place (even in the case of stock that qualifies as consent stock, for example, because the stock is also entitled to nonliquidating distributions), it seems superfluous to exclude from the consent stock definition stock that is entitled only to nonliquidating distributions. Thus, the better reading of the exclusion in section 565(f) is the literal

[10]Section 562(b)(2).

[11]*See* section 316(b)(2)(B).

[12]Section 562(b)(2) would also limit the availability of a dividend carryover deduction to a succeeding year under section 564.

[13]Similarly, the rule prevents a personal holding company from deducting a liquidating distribution to a noncorporate shareholder without making a section 316(b)(2)(B) election (and subjecting the shareholder to dividend treatment).

[14]Section 565(a).

[15]Section 565(f)(1).

one, namely, that the statute merely requires that the consent stock have some entitlement to nonliquidating distributions.

The legislative history of the consent dividend provisions also supports the conclusion that a consent dividend may be made for an amount that is treated as a liquidating distribution. The consent dividend rules were first enacted as section 28 of the Revenue Act of 1938. Section 28(b) of the 1938 act provided that a consent dividend election could not be made if the corporation had taken any steps in pursuance of a plan of complete or partial liquidation of all or part of the consent stock.[16] The limitation in section 28(b) was not carried over to the consent dividend provision that was imported into section 565 of the Internal Revenue Code of 1954. This suggests that the consent dividend election in section 565 was intended to be available to liquidating distributions.[17]

Despite the foregoing analysis, taxpayers have been hesitant to assume that a liquidating distribution can be the subject of a consent dividend, given the potentially disastrous consequences if the REIT were disqualified for failing to meet the mandatory distribution requirements. The IRS recently issued a ruling permitting a consent dividend election for a distribution that the corporation and its shareholders intended to treat as a liquidating distribution. The facts in the ruling also illustrate that such an election is a powerful planning tool for private REITs.

LTR 201103001 involved a private REIT that was structured as a domestically controlled REIT to facilitate a foreign investor's investment in a U.S. property (a sale of shares in a domestically controlled REIT is exempt from U.S. taxation under the 1980 Foreign Investment in Real Property Tax Act).[18] The property was actually owned through a partnership in which the REIT was a partner. The foreign investor owned a less-than-controlling interest in the REIT (the precise size of that investment is not disclosed in the ruling), with the balance of the REIT's common stock being owned by a limited partnership (the operating partnership, or OP), which was in turn controlled by a publicly traded REIT. The foreign investor eventually sold its interest in the REIT to the OP, which left the OP owning 100 percent of the private REIT's common shares.

The following year the REIT refinanced its property and distributed proceeds to its shareholder, the OP[19] (the amount of the debt to which the property was then subject exceeded its basis). Later, the OP decided to liquidate the REIT and hold the property directly. The REIT's distribution of the property resulted in gain recognition under section 336. Normally that gain would be offset by the deduction for the property being distributed by the REIT, but because the property was subject to a liability that exceeded its basis, the net value of the property distributed by the REIT was smaller than the amount of gain recognized by the REIT.

Accordingly, the REIT sought to use a consent dividend to shelter the full amount of its gain. However, the REIT and the OP intended to treat the consent dividend as an amount received as a distribution in liquidation rather than as an ordinary dividend. Moreover, since the OP had recently purchased the shares from its foreign co-investor, it seems likely that the OP was in a position to treat all or most of the distribution attributable to those recently acquired shares as a tax-free recovery of its basis under section 331. The OP would then acquire the property with a basis equal to its fair market value.[20] Nevertheless, the IRS analyzed the consent dividend statutory provisions and legislative history and came to the correct conclusion that Congress intended to allow the consent dividend mechanism to be used regardless of whether the shareholders would be subject to tax on the resulting deemed distribution.

To fully appreciate the effect of these transactions, it is necessary to consider the treatment of the foreign investor. Section 897(h)(2) permits a foreign investor in a domestically controlled REIT to sell its shares in the REIT without being subject to U.S. federal tax. In contrast, if the underlying property were sold by the domestically controlled REIT and the proceeds distributed to the foreign investor, the distribution would generally be treated as a capital gain distribution characterized in the hands of the foreign investor as a fully taxable gain from the sale of a U.S. real property interest. One planning technique for a foreign investor in a domestically controlled REIT is for the foreign investor to sell its shares in the REIT to a domestic co-shareholder in the REIT before the property is sold by the REIT. However, a potential obstacle to this approach is that the co-shareholder purchaser may find it difficult to finance the buyout of the foreign investor

[16] A deduction was allowed, however, for an actual liquidating distribution. *See* section 27(g) of the Internal Revenue Code of 1938.

[17] The legislative history does not shed any light on why the definition of consent stock continues to exclude stock that is entitled only to liquidating distributions.

[18] *See* section 897(h)(2).

[19] The property was actually owned by a partnership in which the REIT was a limited partner.

[20] Section 334(a). Thus, the OP's gain would be limited to the appreciation attributable to its historic shares in the REIT.

without borrowing against the underlying property of the REIT. If the buyout is financed through a borrowing by the REIT and a distribution of the loan proceeds, the REIT could find itself without sufficient assets to shelter the future gain it will recognize when it ultimately sells the property.

LTR 201103001 suggests that this problem can be solved by using a liquidating consent dividend in the year the REIT disposes of the property. The consent dividend can enable the REIT to deduct an amount equal to the gain from the disposition, even when the gain exceeds the available cash, while permitting the shareholder to recover the cost of the shares it purchased from the foreign investor as a tax-free return of capital.