Federal Income Taxation of Business Passthroughs

New York University Law School
Law-L.W.11625.001
Mondays, 6:10 p.m.- 8:00 p.m.
FH 216

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The course will consist largely of lectures but with active participation by students. The goal is to understand the rules that apply to S corporations, partnerships, RICs, REITs and other passthrough entities and how those entities are used, both domestically and internationally. The course will also consider the tax policy issues that passthrough entities raise and, of course, possible changes to the Internal Revenue Code that may affect the rules that apply to passthroughs.

The questions are broad (e.g., Why do we have so many passthrough entities? Why do the rules for each differ? What are the issues for different classes of investors? Is simplification possible?) and narrow (e.g., How is entity-level tax eliminated in the case of a RIC? In the case of a REMIC? In the case of an S corporation?)

Apart from assigned materials, additional readings are set out at the end of this syllabus. These are not required but are for those students who want to go beyond the assigned readings.

Students should be prepared to discuss the course readings for the assigned date. Class participation will be a part of the grade for the course.

There will be a 3 hour open book exam or, at your option, a not-more-than 35 page paper (due at the end of the exam period) on an agreed-upon topic.
Class 1 – Wednesday, September 6

Course objectives, etc.
The corporate and individual income taxes, and payroll taxes
Unincorporated business arrangements

  Historical review – the Morrissey case and subsequent legislative and other developments
  How “conduits” work (e.g., how is the entity level tax eliminated, and what items and attributes pass through to the owners)

Materials
Chart on the historical evolution of pass-through entities and certain related developments – attached to this syllabus
IRC Sections 7701(a)(3) (definition of a corporation) and 7704 (certain publicly-traded partnerships)
Regs. §§301.7701-1 through 3; T.D. 8697, 1997-1 C.B. 215 (preamble to the adoption of the current classification regulations)
The prior classification regulations, which may be found at, e.g., T.D. 6503, 1960-2 C.B. 409

Morrissey v. Comm’r, 296 U.S. 344 (1935)

Classes 2 and 3 – Monday, September 11 and 18

Regulated investment companies
Substantive rules
  Pass-through taxation and qualification
  RIC structures – e.g., funds of funds, master-feeder structures, “blockers”

Materials
To get a sense of the RIC industry, go to the website for the Investment Company Institute (www.ici.com) and review the most recent annual “Fact Book” (at www.icifactbook.org).
IRC Sections 1(h)(11)(D)(iii), 67(c)(2), 851-855, 860, 4982, and 7704(c)(3).
Rev. Ruls. 2006-1 and 31 (qualifying income – commodities)

1-4, relating to trusts, will be considered in Class 10.
Rev. Rul. 83-69 ("issuer" of an exchange-traded call)
Rev. Rul. 2008-1 (foreign currency exchange-traded note)
Prop. Regs. §1.851-2(b)(2) (subpart F and PFIC inclusions)
Rev. Proc. 2016-50 (ruling policy on what is a "security")

Materials with respect to RIC distributions
IRC Sections 561-2, 564-5 and 4982
Section 312(n)(7) and Regs. §1.562-1
Rev. Proc. 2010-12 (stock distributions by publicly-held RICs and REITs)
Rev. Rul. 89-81 (non-proportionate designations of dividends)
Rev. Rul. 69-120 (deductibility of dividends by RIC that has a dividend reinvestment plan)
Rev. Rul. 55-416 (dividends paid deduction for redemptions of shares of an open-end fund)

Classes 4 and 5 – Monday, September 25 and October 2

Real estate investment trusts
   Historical development
   Substantive rules -- pass-through taxation and qualification
   REIT structures – e.g., UpREITs and DownREITs
   Like-kind exchanges \(^2\)
   State and local tax issues

Materials
For information on the industry, go to the website for the National Association of Real Estate Investment Trusts (www.reit.com) and review the most recent REITWatch.

IRC Sections 1(h)(11)(D)(iii), 67(c)(3), 561-2, 564-5, 856-860, 4981, and 7704
Regs. §1.701-2(d), Example (4) (UpReits)
Regs. §1.856-10, Definition of Real Property
Rev. Rul. 2004-24 ("rents" – income of a REIT from providing parking facilities)
Rev. Rul. 2002-38 (taxable REIT subsidiary performing non-customary services)

\(^2\) The rules for like-kind exchanges (which of course are not limited to REITs) are in Section 1031.
Class 6 – Monday, October 9

Additional issues for RICS and REITs
“Preferential” dividends
Tax-free reorganizations and spin offs and split ups
Other Subchapter M/Subchapter C issues
“Blockers” and economic substance

Materials
IRC Sections 269B, 332(c), 337(d), 351(e)(1) and 562(c)
Regs. §§1.337(d)-5T, 1.368-1(d) (continuity of business enterprise), and
1.7701(l)-3 (“fast-pay” arrangements)
Rev. Rul. 2001-29 (distributions of, or by, a REIT and Section 355)

Class 7 – Monday, October 16
Alternative investment entities, such as hedge and private equity funds
Publicly-traded and other large partnerships
What is an “enterprise?”
“Cell” or “series” companies
“Disregarded entities”

Materials
IRC Sections 775-71, 7704, 6221-6234, 6240-6255 and 7704
Regs. §§1.7704-1 and -3 (publicly-traded partnerships); Prop. Regs. §§301.7701-1(a)(5) and (7); review Regs. §§ 301.7701-1 through 3 (the current classification regulations); and Prop. Regs. §7704-4 (Qualifying income – Minerals and natural resources)
For information on publicly traded partnerships, go to the website of the Master Limited Partnership Association (formerly, the National Association of Publicly Traded Partnerships), http://www.mlpassociation.org.
United States v. Kintner, 216 F.2d 418 (9th Cir. 1954)
Luna v. Comm’r, 42 T.C. 1067 (1964)
Bergford v. Comm’r, 12 F.3rd 166 (9th Cir. 1993)
On “disregarded entities”, see Regs. §§301.7701-2 and 301.7701-3, Sections 856(i) and 1361(b)(3),

Class 8 – Monday, October 23
Subchapter S corporations
Historical development
Substantive rules
Comparison to partnerships
Materials
IRC Sections 1361-1379
Regs. §1.701-2(d), Example (2)
Rev. Rul. 94-43
McMahon and Simmons, When Subchapter S Meets Subchapter C, 67 The Tax Lawyer 231 (2014)

Class 9 – Monday, October 30
Continue S Corporations
Employment and self-employment taxes, and the 3.8% tax imposed on net investment income by Section 14113

Materials
Watson v. United States, 757 F. Supp. 2d 877 (S.D. Iowa 2010), aff’d 668 F. 3rd 1008 (8th Cir. 2012)4
Renkemeyer, Campbell & Weaver LLP v. Comm’r, 136 T.C. 137 (2011)5

Class 10 – Monday, November 6

3 The tax on self-employment income is imposed by Sections 1401-2 of the Internal Revenue Code – “The Self-Employment Contributions Act of 1954”. The limited partner exclusion is in Section 1402(a)(13). The deduction allowed for one half of the tax on self-employment income is in Section 164(f) and the exclusion from net earnings from self-employment is in Section 1402(a)(12). The employee’s share of the tax imposed on wages and the requirement that the employer withhold are in Sections 3101 and 3102; and the employer’s share of the tax on wages is imposed by Section 3111. The unearned income Medicare contribution tax is in Section 1411.


5 For other cases involving the issue in Renkemeyer, see Riether v. United States, 919 F. Supp. 2d 1140 (D.N.M. 2012); Howell v. Comm’r, 104 T.C.M. (CCH) 519 (2012); and Castigliola v. Comm’r, 113 T.C.M. (CCH) 1296 (2017).
Fixed investment trusts
- Historical development
- Substantive rules -- Permitted assets, powers and classes of interests
- Relevance today of fixed investment trusts

Liquidating and insolvency trusts
- Trusts as security devices
- Common trust funds, collective investment funds
- Other, or “ordinary”, trusts

**Materials**
- IRC Sections 584, 671-9, and 683
- Regs. §301.7701-4
- Regs. §1.671-2(e)(3)
- Comm’r v. Chase Nat’l Bank, 122 F.2d 540 (2d Cir. 1941)
- Comm’r v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941)
- T.D. 8080, 1986-1 C.B. 371 (preamble to the adoption of current Regs. §301.7701-4)
- Rev. Proc. 2009-23 (loan modifications)
- Rev. Rul. 2004-86 (IRC Section 1031 exchange for an interest in a trust)

**Class 11 – Monday, November 13**
- Real estate mortgage investment conduits (or REMICs)
  - Historical development
  - Substantive rules
  - Taxable mortgage pools
- Non-Real Estate Securitizations
  - FASITs
  - Credit cards, auto loans and other receivables

**Materials**
- IRC Sections 860A-860G, 7701(l)
- Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, pages 402-28 (“Mortgage-Backed Securities”)
- Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress, pages 258-67 (“Treatment of financial asset securitization investment trusts (“FASITs”)”)

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6 Available on the Joint Committee on Taxation website, www.jct.gov/publications. For a different and possibly more accurate history, see Chapter 1, “The Three Amigos” (and, in particular, pages 15-18), in McLean and Nocera, All The Devils Are Here: The Hidden History Of The Financial Crisis (Portfolio/Penguin: 2010).

Class 12 – Monday, November 20
Tax Exempt and Foreign Investors

Materials
IRC Sections 511-514 and Sections 864(b), 875, 892, 894, 897, 1445 and 1446

Article 10, United States Model Income Tax Convention of February 2016, Vol. 1, CCH Tax Treaties, and related Treasury Department explanation

Class 13 – Monday, November 27
Tax-exempt and foreign investors – continued

Class 14 – Monday, December 4
Proposals for reform
Review

Materials
Ways and Means Committee discussion draft provisions to reform the taxation of small businesses and passthrough entities and the related technical explanation (March 12, 2014)
Rates of payroll tax, etc.

**FICA.** Section 3101 (or FICA) imposes tax on the “wages” of an individual, for years after 1990, at the rate of

a. 6.2% (the old-age, survivors, and disability insurance component) on the taxable wage base (capped at $127,200 for 2017),\(^8\) plus

b. 1.45%, uncapped, of that base (the hospital insurance component), or in the aggregate at the rate of 7.65%.\(^9\)

c. For 2013 and later years, the tax on the hospital insurance component is increased by 0.9% in the case of an individual with wages of more than $200,000 ($250,000 on a joint return), bringing the top rate up to 8.55%.

d. Section 3111 imposes taxes at the same rates, but without the 0.9% increase, on the employer who pays the wages, leading to a combined rate of tax on wages of 16.2% (i.e., 8.55% plus 7.65%).\(^10\)

**SECA.** Section 1401 imposes a tax on the self-employment income of an individual equal, for years after 1989, to

a. 12.4% (the old-age, survivors, and disability insurance component) of such income (capped at $127,200 for 2017), plus

b. 2.9% uncapped of that base (the hospital insurance component), and

c. for 2013 and later years, in the case of an individual with self-employment income of $200,000 or more ($250,000 on a joint return), an additional 0.9% (or in the aggregate 3.8% uncapped).

d. This works out at the top to 16.2% in the aggregate.\(^11\) (Thus, the same rate as FICA.)

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\(^8\) And $118,500 for 2015 and 2016 and $117,000 for 2014.

\(^9\) For 2011 and 2012, the 6.2% rate was reduced to 4.2%.

\(^10\) Disregarding the reduction for 2011 and 2012.

\(^11\) For 2011 and 2012, the 12.4% rate was reduced to 10.4%.
e. The tax is self-assessed but, like FICA, is administered through the income tax system – that is, it ties into the taxpayer’s Form 1040.\textsuperscript{12} 

\textbf{0.9\% increase for 2013 and later years}. As noted, for 2013 and subsequent years, an additional tax of 0.9\% is imposed on net earnings from self-employment income and on an employee’s wages, in each case if in excess of $200,000 ($250,000 on a joint return), increasing rate of the hospital insurance or Medicare component on that amount to 3.8\% and to a top rate to 16.2\%. Unlike the other components of SECA and FICA, this is calculated on a joint return basis. The tax imposed on the employee is collected by withholding, without regard to the cap – \textit{i.e.}, the possibility that the individual’s spouse will also have wages and/or self-employment income.

\textbf{3.8\% tax on net investment income}. In the case of investment, or “unearned”, income, in order to replicate in part the Medicare component of FICA and SECA, which now is up to 3.8\%, a tax of 3.8\% is imposed by Section 1411 for 2013 and later years on interest, dividends, capital gain and other “investment income” of an individual or, if less, the excess of adjusted gross income over $200,000 ($250,000 on a joint return);\textsuperscript{13} or, in the case of an estate or trust, on undistributed net investment income or, if less the excess of adjusted gross income over the dollar amount at which the highest Section 1(e) bracket begins for the year. Administered through the personal income tax – \textit{i.e.}, reported on Form 8960 (Net Investment Income Tax – Individuals, Estates and Trusts).

\textsuperscript{12} As Business income (Schedule C or C-EZ) or Farm income (Schedule F), which are reported on the Form 1040. The self-employment tax and any unpaid (\textit{i.e.}, un-withheld) FICA taxes are then calculated on the Form 1040, from (1) the Schedule SE (Self-Employment Tax), (2) the Form 8919 (Uncollected Social Security and Medicare Tax on Wages), and (3) Form 4137 (Social Security and Medicare Tax on Unreported Tip Income) and Household employment taxes are added, from Schedule H. The sum, including any FICA that is withheld, is added to the income tax to reach total tax due. Excess social security tax is treated as a payment of tax. The Long Schedule SE has special rules for ministers, etc., for farm profits and payments under the Conservation Reserve Program. For the rest, the Schedule refers to Schedule C and Schedule K-1. Social security wages are a deduction from the capped base, which is then used to calculate the OASDI tax; and to this is then added 2.9\% of the uncapped amount.

\textsuperscript{13} So, borrowing an example in the Regulations, “A, an unmarried United States citizen, has modified adjusted gross income … of $190,000, which includes $50,000 of net investment income. A has a zero tax imposed under section 1411 because the threshold amount for a single individual is $200,000 … If during Year 2, A has modified adjusted gross income of $220,000, which includes $50,000 of net investment income, then the individual has a section 1411 tax of $760 (3.8\% multiplied by $20,000, the lesser of $50,000 net investment income or $20,000 excess of modified adjusted gross income over the threshold amount).”
Both the 0.9% increase and the 3.8% tax may be repealed as part of the repeal/amendment of the Affordable Care Act.
**Additional Materials**

Additional materials are not required but are included to assist those who want to go beyond the required materials.

**Class 1 (Introduction)**

Notice 95-14, announcing the check-the-box initiative; and Internal Revenue Service Form 8832 (Entity Classification Election)

Lyons, Comments on the New Regulations on Associations, 16 Tax Law Rev. 441 (1961)

Bittker, Professional Service Organizations: A Critique of the Literature, 23 Tax Law Rev. 429 (1968)


Willard B. Taylor and Diana Wollman, Why Can’t We All Just Get Along: Finding Consistent Solutions To The Treatment of Derivatives and Other Problems, 53 Tax Lawyer 95 (1999)

Willard B Taylor, “Blockers”, “Stoppers” and the Entity Classification Rules, 64 Tax Lawyer 1 (2011)

Martin Sullivan, Passthroughs Shrink the Corporate Tax by $140 Billion, Tax Notes Today (February 28, 2011).

On the validity of the check the box regulations, see, e.g., McMamee v. Dep’t of the Treasury, 488 F.3rd 100 (2d Cir. 2007); Littriello v. United States, 484 F.3rd 372 (6th Cir. 2007), cert. den.; Stearn & Co., LLC v. United States, 499 F. Supp. 2d 899 (E.D. Mich. 2007); and Medical Practice Solutions, LLC v. Comm’r, 132 T.C. 125 (2009).

**Classes 2 and 3 (RICs)**

Website for the Investment Company Institute (www.ici.com) and, in particular, see the annually-published “Fact Book” at www.icifactbook.org.

Johnston & Brown, Taxation of Regulated Investment Companies and Their Shareholders (W.G.& L.); also available on line.

BNA Tax Management Portfolio No. 740-2d, Taxation of Regulated Investment Companies

H.R. 4337 (December 8, 2010), The Regulated Investment Company Modernization Act of 2010, which was enacted but left out the commodities income and assets rule in Title II of S.3948 (November 17, 2010)

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Rev. Rul. 2003-84 (investments in “refunded” bonds)
Rev. Rul. 92-56 (qualifying income – reimbursements of investment advisory fees)
National Securities Series – Industrial Stocks Series, et al., v. Comm’r, 13 T.C. 884 (1949)
Steven Z. Hodaszy, Tax-Efficient Structure or Tax Shelter? Curbing ETFs’ Use of Sectopm 852(b)(6) for Tax Avoidance, 70 The Tax Lawyer 537 (2017)

Classes 4, 5 and 6 (REITs, and in Class 6, RICs as well)

Website for the National Association of Real Estate Investment Trusts
(www.reit.com)
Einhorn, Unintended Advantage: Equity REITs vs. Taxable Real Estate Companies, 51 Tax Lawyer 203 (1998)
BNA Tax Management Portfolio No. 742-3rd, Real Estate Investment Trusts
BNA Tax Management Portfolio No. 743, Structuring Real Estate Joint Ventures with Private REITs
Rev. Proc. 2003-65 (interest on a loan secured by a partnership interest)
Rev. Rul. 74-191 (foreign property) and Rev. Rul. 2007-33 (foreign currency gains)
Richard M. Nugent, REIT Spinoffs: Passive REITs, Active Businesses, Tax Notes, March 23, 2015
Peter E. Boos, Runaway REIT Train? Impact of Recent IRS Rulings, Tax Notes, September 16, 2015
Willard B. Taylor, Closing the Gap Between Private Letter Rulings and Regulations, Tax Notes, August 6, 2014
On “preferential” dividends:
New York Stocks, Inc. v. Comm’r, 164 F.2d 75 (2d Cir. 1947)
G.C.M. 39457 (December 18, 1985) (“preferential” dividends and variable charges for investment advisory fees)
Rev. Proc. 99-40 (“preferential” dividends and differential payments)
NYSBA Tax Section, Report on the Application of Code Section 562(c) to Regulated Investment Companies and Real Estate Investment Trusts (April 7, 2008)\(^\text{15}\)

**Class 7 (Partnerships; “enterprise”; “cell” companies; and “disregarded entities”)**

- Rev. Rul 2008-8 (cell company)
- Notice 2008-19 (cell companies)
- NYSBA Tax Section, Report on Notice 2008-19 and Protected Cell Companies Outside of the Insurance Arena (May 2, 2008)\(^\text{16}\)
- Union Trusteed Funds, Inc. v. Comm’r, 8 T.C. 1133 (1947)
- On disregarded entities, see, e.g.,
  - James M. Peaslee, Disregarded Entities and Debt Modifications, Tax Notes, March 7, 2016
  - Howard E. Abrams and Fred T. Witt, Disregarded Entities, Tax Management Portfolio No. 704-2d
  - David S. Miller, The Strange Materialization of the Tax Nothing, Tax Notes, May 1, 2000

**Classes 8 and 9 (S Corporations, Payroll taxes and the tax on net investment income)**

- Stewart Karlinsky, S Corporations: Let Me Count The Ways, Tax Notes, (January 17, 2012)
- Stephen R. Looney and Ronald A. Levitt, Drafting Shareholder Agreements for Closely-held C and S Corporations, Chapter 18 of Publication 500, NYU Institute on Federal Taxation (2002)
  - Roberta Mann, Subchapter S: Vive le Difference, 18 Chap. L. Rev. 65 (2014).
- McMahon and Simmons, When Subchapter S Meets Subchapter C, 67 The Tax Lawyer 231 (2014)

\(^{15}\)Available on line at www.taxanalysts.com.

\(^{16}\)Available on line at www.taxanalysts.com.
Deborah Schenk (NYU), Reforming Entity Taxation: A Role for Subchapter S?, 146 Tax Notes 1237 (Mar. 9, 2015)
David R. Sicular, Subchapter S at 55—Has Time Passed This Passthrough By? Maybe Not, 68 The Tax Lawyer 185 (2014)
Walter D. Schwidetzky, Integrating Subchapters K and S — Just Do It, 62 The Tax Lawyer 479 (2009)
Willard B. Taylor, Special Report, Payroll Taxes – Why Should We Care? What Should Be Done?, 137 Tax Notes 983 (2012), and the articles cited therein
Eustice & Kuntz, Federal Income Taxation of S Corporations (W,G&L)
Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, (W,G&L), Vol. 1, Chpt. 6 (Corporate Elections under Subchapter S)
Staff of the Joint Committee on Taxation, Background and Proposals Relating to S Corporations, JCX-62-03 (June 18, 2003)\(^\text{17}\)
Staff of the Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05 (January 27, 2005), pages 71-105; or Summary of Joint Committee Staff “Options To Improve Tax Compliance And Reform Tax Expenditures”, JCX-19-045R (April 12, 2005), pages 8-10
NYSBA Tax Section, Number 1284, Report on The Proposed Regulations under Section 1411 (May 2013)
NYSBA, Tax Section, Number 1285, Report on Proposed Regulations Section 1.1411-10 (May 2013)

**Class 10 (Fixed investment and other trusts)**

Pennsylvania Co. for Ins. v. United States, 146 F.2d 392 (3rd Cir. 1944)

\(^{17}\) Available on the website of the Joint Committee on Taxation, www.jct.gov/publications.
Class 11 (Real estate and non-real estate securitizations)

BNA Tax Management Portfolio No. 741, REMICs, FASITs and other Mortgage-Backed Securities
Peaslee and Nirenberg, Federal Income Taxation of Securitizations Transactions and Related Topics (Frank J. Fabozzi Associates 4 Ed. 2011)
Website for the Securities Industry and Financial Markets Association, of SIFMA, which is www.sifma.org. The websites of Fannie Mae and Freddie Mac also have information about (and prospectuses for) their REMICs.
Robert Scarborough, Partnerships as an Alternative to Secured Loans, 58 The Tax Lawyer 509 (2005)

Class 12 (Tax-exempt and foreign investors)

Rev. Rul. 79-222 (limited partner in a partnership)
Rev. Rul. 74-197 (partnership with debt)
NYSBA Tax Section, Number 1217, Report On Section 514: Debt-Financed Income Subject to UBIT, August 12, 2010
Rev. Rul. 91-32 (sale of partnership interest)
Notice 2007-55 (distributions in liquidation or redemption of a REIT)
Rev. Rul. 2005-31 (designation of dividends)
NYSBA Tax Section, Number 1354, Report on Report on the Changes to FIRPTA under the Protecting Americans from Tax Hikes Act of 2015, October 3, 2016

Proposals for Change

Ways and Means Committee Discussion Draft Provisions To Reform the Taxation of Small Businesses and Passthrough Entities, released on March 12, 2013
Willard B. Taylor, Subchapter S Out the Window? What’s Going On?, Special
Deborah H. Schenk, Reforming Entity Taxation: A Role for Subchapter S?, Tax Notes, March 9, 2015
Karen C. Burke, Unified Passthrough Misses the Mark, Tax Notes, March 16, 2015
Reorganizations involving RICs and REITs, disqualification and requalification rules, and related problems

1. **Spin-offs.** There have been a number of tax-free spin-offs in which one corporation was or became a REIT. The Consolidated Appropriations Act, enacted at the end of 2015, targeted these transactions and now requires the recognition of gain on a spin-off if either the distributing or the distributed corporation, but not both, is a REIT, and also provides that a corporation that was a distributed or distributing corporation in a tax free spin-off is not eligible to elect to be a REIT for the ten years following the spin-off.1

2. **Tax-free reorganizations and property transfers -- Section 337(d) and the repeal of General Utilities.** RICs and REITs are corporations and so may generally be parties to tax-free reorganizations. If the RIC or REIT acquires assets of a “C” corporation in a reorganization or other tax-free transaction, however, rules enacted in 1986, when General Utilities was repealed, and subsequently implemented by Regulations under Section 337(d), may tax the built-in gain in the C corporation’s assets, depending on when it is recognized;2 and, in addition, a reorganization may result in a carryover of earnings and profits that could affect eligibility to be a RIC or a REIT.3 The same issues come up if a C corporation converts to a REIT or a RIC.

   a. **Before 1986.** Before the repeal of General Utilities, there was an obvious tension in transactions in which the tax on the appreciation in the assets of a C corporation and/or its shares could in effect be avoided or deferred tax if the corporation migrated to Subchapter M. The result was, over time, a series of rules relating to tax free reorganizations involving RICs.4 A surprising amount

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1 This is effective for transactions after December 7, 2015, but with a grandfather for those transactions that had a ruling request pending with the IRS – apparently an exception intended to cover the planned spin-offs of Hilton Worldwide Holdings, Caesar’s Entertainment Corporation and Energy Future Holdings. On this, see Lobbyists Shield A Tax Loophole Worth $1 Billion, New York Times, December 21, 2015, http://www.nytimes.com/2015/12/21/us/politics/hospitality-and-gambling-interests-delay-closing-of-dollar1-billion-tax-loophole.html?_r=0. There is also an exception for a case where a REIT spins-off a taxable REIT subsidiary. At least one transactions designed to separate a corporation’s real estate and other assets has been announced since then -- Bob Evans Farms Inc.’s taxable sale and leaseback of some 200 restaurants. MGM Resorts is considering the transfer of 7 resorts to a partnership below a REIT that will go public – *i.e.*, an UpREIT structure..

2 Originally 10 years, but reduced for 2009-11 to 7 years and for 2012-4 to 5 years.

3 See the no-earnings-and-profits rules in Sections 852(a)(2) and 857(a)(2).

4 Consider a simple case in which a RIC agrees to acquire a privately-owned personal holding company – a way of raising capital for the RIC and a way of diversifying, and getting professional management, for the shareholders of the personal holding company. This was quite common until the changes described herein. The transaction would be
of the subchapter C reorganization rules have come from the RIC area. Note that, in cases where tax basis of assets carried over, the potential cost to the transferee was usually priced into the exchange.

b. 1976 – Section 368(a)(2)(F). Section 368(a)(2)(F) provides that a transaction between investment companies is not, as to the investment companies or their shareholders or security holders, a reorganization unless the investment company is a RIC, a REIT or an investment company that meets diversification requirements set out in Section 368(a)(2)(F)(ii). This was enacted in 1976 to restrict transactions between non-diversified holding companies and RICs, although it applies as well to REITs.\(^5\)

i. An investment company is a RIC or a REIT or other corporation if 50% or more in value of such corporation’s total assets consist of stock and securities and 80% or more in value of whose assets are held for investment. Elaborate definitions and special rules as to when a corporation is an investment company and when it is/is not diversified. A rather narrow test: More than 25% in value of assets invested in stocks or securities of one issuer or more than 50% in value invested in the stock and securities of 5 or fewer issuers. Regulations were proposed in 1981 but never adopted, because in part they did nothing to make the statute more workable, and the proposed regulations were withdrawn in 1998.

c. 1979 – Regs. §1.368-1(d) – continuity of business enterprise. Section 368(a)(2)(F) did not prevent a diversified investment company that was not a RIC from transferring its assets to a RIC in a “C” reorganization or prevent an investment company from getting around the Section 368(a)(2)(F) rules by selling its assets and diversifying and then engaging in a reorganization with a RIC. Selling and diversifying could of course require some payment of tax at the corporate level, but the cost may not have been prohibitive – for example, a case where the investment company had been reinvesting all along, and so had a reasonably high basis in its assets, although the shareholders had a very low basis in their shares.

i. While the existing regulations had always talked about the need for “continuity of business enterprise” in order to have a good reorganization, this was not, before 1979, spelled out and was not interpreted as preventing a corporation from selling assets in structured as a “C” reorganization – that is, an asset acquisition for voting stock – so that there was no carryover of liabilities, whether for taxes or otherwise.

\(^5\) For example, X transfers all of its assets to B for B voting stock and does not liquidate. This was, at the time, a good “C” reorganization because the requirement that the transferor liquidate in a “C” reorganization, which is now in Section 368(a)(2)(G), did not come into the statute until 1984. Then, sometime later, X transfers all of the B stock to a RIC in exchange for stock of the RIC in another “C” reorganization and liquidates. Statute prevents this because A is not diversified – a rather narrow target.
anticipation of a reorganization or as preventing the acquiring corporation from selling assets of the acquired corporation thereafter.\(^6\)

ii. Then, in 1979, the Treasury took a different view, and proposed continuity of business enterprise regulations that essentially required the continuation of the target’s historical business or the use of significant historic assets of the target. The concept was that “a transaction is not a tax-free reorganization if there is no continuing nexus between the shareholders and their former business or assets” – if you want to read more, see T.D. 7745, December 31, 1980, which adopted the final regulations. These regulations were directly about investment company-RIC transactions.\(^7\) They have a broad application, of course, but that was the target.\(^8\)

iii. Continuity of business requires that the acquiring corporation continue an historic business of the target or use a significant part of the historic business assets of the target. The Investment Company Institute would like it clarified that the historic business of a RIC is investing, regardless of what its investment target is and what kind of portfolio it has so that there is no need to rely on the “asset” branch of the continuity of business regulations.

iv. You can see the focus of the original regulations in Example (3) – T sells its manufacturing assets for cash and becomes an investment company. Then “[a]s part of the plan”, but three and one half years later, T transfers its assets to P, a RIC, for voting stock of P. The continuity of business enterprise requirement is not met.

d. 1984 – Amendment to Section 368(a)(1)(C). At the time Section 368(a)(2)(F) was enacted, there was no requirement that a corporation transferring assets in a “C” reorganization liquidate and distribute the shares received. Prior to Section

\(^6\) The continuity of business requirement had been interpreted, by IRS, as well as by practitioners, as simply requiring that the corporation engage in business activity after the reorganization. This reading was based on Becher v. Commissioner, 22 T.C. 932 (1954), aff’d 221 F.2d 252 (2d Cir. 1955).

\(^7\) At the same time that the regulations were proposed, IRS issued Rev. Rul. 79-434, which involved a corporation that sold its manufacturing business to an unrelated corporation, purchased short-term Treasury notes and then transferred its assets to a RIC for voting stock of the RIC and liquidated. There was an agreement with the RIC that was in place at the time of the sale of the manufacturing assets. The ruling says that the transaction with the RIC was not a reorganization because “in substance [the transaction with the investment company] represents a purchase by [the corporation] of the shares of [the RIC] prior to [its] liquidation”.

\(^8\) This part of the regulations is now in Regs. §1.368-1(d). Extensively modified in 1998 to deal with how the continuity of business enterprise requirement should be applied if assets are dropped down after a reorganization to a subsidiary or a controlled partnership.
368(a)(2)(F) and the new continuity of business regulations, this meant that a corporation could in a tax-free reorganization exchange its assets for voting stock of the acquiring corporation and then exchange those shares for shares of RIC and liquidate. In 1984 the statute was amended to add that requirement. Suppose history had evolved differently and the 1984 amendment requiring a liquidation after a “C” had preceded Congressional consideration of the transactions that motivated Section 368(a)(2)(F)? Would that section every have been enacted? In other words, would the liquidation requirement have meant that the phenomenon of reorganizations of un-diversified private investment companies would have disappeared?

e. 1984 – The no-earnings-and-profits-when-not-a-RIC rule. Neither Section 368(a)(2)(F) nor the continuity of business regulations dealt with the possibility that a regular “C” corporation would, in effect, move into subchapter M by selling its assets and itself becoming a RIC – in other words, the possibility that the corporation would have, or get, enough shareholders to register under the ’40 Act after it ceased to operate directly-conducted businesses. Where available, this obviously offered the same possibility as the transactions that the continuity of business enterprises regulations and other rules were directed at.

i. So, in 1984, the Code was amended to provide that subchapter M was not available, in the case of a RIC, unless – this is in Section 852(a)(2) – it has either continuously been a RIC since 1983 (more precisely, years ending on or after November 8, 1983) or, at the end of the year, has no earnings and profits accumulated in any year in which it was not a RIC.

ii. Although the focus of this rule was on companies that converted themselves to RICs, the REIT statute was also amended in 1986 to impose the same requirement. Section 857(a)(2) provides that subchapter M does not apply to a REIT unless it has been a REIT continuously since 1986 (more precisely, for taxable years beginning after February 28, 1986) or, at the end of the year, has no earnings and profits accumulated in any year in which it was not a REIT. Because of the wave of C corporations REIT spin-offs and REIT conversions.

iii. While the no-earnings-and-profits-while-not-a-RIC-or-REIT rule prevents the movement of a C corporation into subchapter M, unless the C corporation pays out all of its earnings and profits, going back to the beginning of time, it also means that, if there is a tax-free reorganization between a RIC (or a REIT) and a non-RIC (or non-REIT), that the RIC (or REIT) has a problem – under Section 381, the earnings and profits of the non-RIC or (non-REIT) carry over and get added to the accumulated earnings and profits of the RIC (or REIT). Clear that the IRS thinks these are earnings and profits accumulated in a non-RIC or non-REIT year. Also, there is the problem, as discussed below, of failure to qualify and re-qualification.

iv. Section 852(c)(3) provides that, in the case of a distribution made in order to comply with the no-earnings-and-profits rule, the distribution comes first out of the “bad” earnings and profits (on a FIFO basis) and is
not treated to that extent as a dividend for purposes of meeting the 90% distribution requirement. In other words, the 90% distribution requirement has to be met separately.

f. Section 337(d). Finally, in 1986, Congress repealed the so-called General Utilities doctrine that had limited the extent to which corporations recognized gain on the distribution of appreciated assets to shareholders and, in that connection, enacted Section 337(d)(1).
   i. Section 337(d)(1) provides that regulations shall be issued to carry out the purposes of the General Utilities repeal, including “regulations to ensure that such purposes may not be circumvented...through the use of a regulated investment company [or a] real estate investment trust....”
   ii. The concern was that, absent regulations, the transfer of property from a C corporation to a RIC or REIT, or the conversion of a C corporation into a RIC or REIT, would permanently eliminate the corporate tax on the gain, assuming that the transfer was in a reorganization – that is, passed muster under the rules set out above. For example, if a C corporation had assets with a basis of, say, $100X and a value of $150X, and the assets were transferred to a RIC in a C reorganization or the C corporation became a RIC, the gain would never be taxed at the corporate level absent regulations under Section 337(d) – there would, of course, be tax at the shareholder level, when the RIC sold the assets.
   iii. Regulations were issued in January of 2002. These replaced temporary regulations that were issued in February of 2000, which in turn replaced a notice (Notice 88-19) that was issued in 1988. The new regulations were in temporary and proposed form and were adopted in final form in March of 2003 – they are in Regs. §1.337(d)-7T.
   iv. To understand the Regulations, you have to know that there is a statutory rule that applies when a C corporation becomes an S corporation or an S corporation acquires assets from a C corporation in a carryover basis transaction. Section 1374 imposes corporate tax on gains of an S corporation that are recognized in a specified period beginning with its first year as an S corporation (or with the year in which it acquired the assets in a carryover basis transaction) if the gains were built-in at the time the corporation became an S corporation or acquired the assets. Net built-in gains are determined on an aggregate basis (so that built-in losses are taken into account in the calculation), and net operating loss and net capital loss carryovers are allowed against the recognized built-in gains.
   v. What the -7 regulations do is to apply the Section 1374 rule to what they call a “conversion” transaction unless the RIC or the REIT elects “deemed sale” treatment. A conversion transaction is a transaction in which a C corporation elects RIC or REIT treatment or a RIC or a REIT

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9 Reduced to 7 for 2009-11 and to 5 for 2012-14.
acquires assets from a C corporation in a carryover basis transaction. Assets acquired from a partnership are acquired from a C corporation to the extent of any C corporation partner’s proportionate share of the assets. If no deemed sale election is made, the built-in gain is taxed to the RIC or REIT as recognized, assuming it is recognized in the 5, 7 or 10 years following the conversion transaction. Any carryforward losses from the C corporation years can be used to offset the gain, and the tax paid by the RIC or REIT is treated as a deduction from its income for the purposes of applying subchapter M to the RIC or REIT. If the deemed sale election is made, the gain is recognized by, and thus taxed to, the C corporation immediately prior to the conversion transaction.\textsuperscript{10}

vi. This may be most easily understood by examples. Suppose – this is example (1) of -7(c)(6) – a C corporation transfers its assets to a RIC in exchange for RIC shares in a transaction which qualifies as a “C” reorganization. Assume that its assets consist, apart from cash, of appreciated securities with a basis of $40X and a value at the time of transfer of $100X, that the C corporation has earnings and profits of $50X and a net operating loss of $12X.

1. Assume that the C corporation makes the deemed sale election. It then recognizes in the year of the reorganization the $60X of gain, which it may reduce with its $12X net operating loss, resulting (at a 35% rate) in a tax of $16.8X. The RIC inherits the C corporation’s earnings and profits, which have been increased by the after-tax gain from the deemed sale from $50X to $93.2X, and since these were accumulated during a non-REIT year, the RIC must distribute them by the end of its taxable year in order to benefit from Subchapter M – this is the rule in Section 852(b)(2). The basis of the securities portfolio is increased from $40X to $100X to reflect the recognized gain.

2. Or suppose – this is the one example in -7(b) – that a C corporation elects to be a REIT at a time when it has real estate assets with a basis of $80X and a value of $100X, earnings and profits of $25X, and carryforwards of losses and credits. Assume that no deemed sale election is made, so that the default “Section 1374” rule kicks in, and that three years later the real estate is sold for $110X – in other words, for $10X more than when it was acquired.

   a. First, the REIT has $25X of earnings and profits accumulated during a non-REIT year which it has to get

\textsuperscript{10} They also deal with “continuation” transactions in which a RIC or REIT acquires property subject to the conversion transaction rules or property subject to Section 1374 from an S corporation.
rid of by the end of its first year as a REIT if it wants to benefit from Subchapter M.

b. Second, when the REIT sells the real estate in year 3, it recognizes the built-in gain of $20X. It pays tax on this, after taking into account any unused loss or credit carryforwards – assume that this is $3.95X. Its earnings and profits go up by $26.05 – $30X less the tax of $3.95X, but these are “good” earnings and profits which do not as such have to be distributed by the end of the year. The total gain of $30X is capital gain and, after deducting the tax, the addition to the REIT’s capital gain is $26.05X.

vii. The -7 regulations also address, and provide some relief from, the disqualification problem. Specifically, -7(d)(2) says that the built-in gain rule does not apply to any corporation that (1) was a C corporation for not more than two taxable years if (2) immediately before being a C corporation it was for at least one year a RIC or a REIT. This expands, from one year to two years, the relief formerly given; but still means that, if you fall out of the two year rule, all of the gains are built-in gains.

viii. The -7 regulations only require the recognition of corporate level gain. The other developments – Section 368(a)(2)(F) and the continuity of business requirement – go to whether there was a reorganization at all, and thus whether there is both corporate level and shareholder gain. The no-earnings-and-profits-while-not-a-RIC-or-a-REIT rule, of course, goes to qualification as a RIC or a REIT. Thus, the rules do not completely line up. Nonetheless, the bottom line result has been to largely eliminate cases in which there are reorganizations involving RICs and C corporations and thus it might be useful for someone to think about whether we need all of these rules – for example, does Section 368(a)(2)(F) really fill a useful function anymore? REITs don’t worry about that Section, largely because of the ability to transfer assets on a tax-deferred basis using UpREIT (or DownReit) Structures. The Section 337(d) and no earnings and profits rules continue to be important.

g. The amendment to Section 351 to disqualify a transfer to an investment company is also part of the story, although the transferors in the cases that were targeted were typically individuals, not corporations.

Disqualification and re-qualification of a RIC or REIT.

1. The Section 337(d) regulations and the no-earnings-and–profits rules are relevant to disqualification and re-qualification – re-qualification in effect involves moving from being a C corporation to a RIC or REIT. For example, if a RIC flunks the qualification tests in year 1 and then discovers that failure in year 2 or 3 or 4 and seeks to requalify, it is moving from subchapter C to subchapter M.
2. So how does this work?
   a. First, RICs. As in the case of REITs, there are now (since the Regulated Investment Company Modernization Act of 2010) rules (in Section 851(i) and Section 851(d)(2)) that allow a RIC to correct failures to meet the income and asset tests that are due to reasonable cause and not due to willful neglect (as well as a de minimis rule for the asset test in Section 851(d)(2)(B)) if disclosed. There is also an exception is Section 860, which allows a RIC (or a REIT) to meet the distribution requirements to the extent that it would not have done so because of adjustments that increase its investment company taxable income or reduce its dividends paid deduction. It does this by paying deficiency dividends in accordance with an elaborate procedure set out in Section 860. Unlike a REIT, there is no specific statutory rule that prevents a RIC, once it learns about its disqualification, from re-qualifying.
      i. A RIC which seeks to re-qualify, however, has two problems to deal with:
         1. First, Section 852(a)(2) says that it cannot have any earnings and profits from a year in which it was not a RIC, so it has got to get rid of any earnings and profits for the years in which it was disqualified. In addition, if it was a RIC that so qualified before 1984, when this rule was added to the Code, it has lost its grandfather for any prior years’ accumulations by virtue of not having been a RIC continuously since then.
         2. Second, it has to deal with the Regulations under Section 337(d) – if these applied, all of its gain, whether or not built-up during the RIC years, would be covered by the rule which forces the RIC to pay tax on the gain. As noted, there is now a limited safe harbor in the Section 337(d) regulations.
   b. Second, REITs. Under Section 856(c)(6) and (7), a failure to meet either or both of the two gross income tests or the asset test, if due to reasonable cause and not to negligence, and if disclosed, will not disqualify the REIT as a REIT. Likewise, in lieu of disqualification, the REIT rules impose tax on certain kinds of bad income – specifically, income from prohibited transactions, income “stripped” from taxable REIT subsidiaries and income from foreclosure property.
      i. In the case of a REIT, there are specific rules on disqualification and requalification in Section 856(g). Section 856(g)(4) says that, if there is a termination, the REIT can re-elect at any time so long as termination was due to reasonable cause, not willful neglect, and certain filing requirements are satisfied. Otherwise, under (g)(3), the REIT must wait a full five taxable years.

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11 There is a narrow exception to the distribution requirement where compliance was prevented by distributions made to avoid the Section 4982 excise tax.
ii. A REIT that sought to requalify would have to deal with the Section 337(d) and no earnings and profits rules.

2. **RIC-to-RIC reorganization.** The rules discussed above do not impede tax-free reorganizations involving two (or more) RICs – they are deemed to be diversified investment companies for the purposes of Section 368(a)(2)(F), the reorganization does not involve a conversion transaction that is subject to the -7 regulations (although it may involve a “continuation” transaction) and the no-earnings-and-profits-while-not-a-RIC rule would not apply. Continuity of business enterprise would, of course, be required (and the Investment Company Institute has repeatedly asked that it be deemed to be satisfied in a RIC-to-RIC reorganization). Likewise, the rules do not impede tax-free reorganizations involving two (or more) REITs.

3. **Like-kind exchanges.** Does a Section 1031 exchange between a REIT and a C corporation result in a “conversion” transaction? Regulations adopted in 2013 provide (which is logical) that it is not a conversion transaction.

4. **Special considerations for REITs.** A couple of special observations on REITs and corporate reorganizations and similar transactions:
   a. **First, spin-offs.** A tax-free spin-off requires, under Section 355, that both the distributing and the distributed – or “controlled” – corporation have been actively engaged in a trade or business for the prior 5 years. Regs. §1.355-3(b)(1)(iv) provides – and has provided for years – that “The active conduct of a trade or business does not include—(A) The holding for investment purposes of stock, securities, land or other property.”
   b. So it is clear that a RIC, or an operation that a RIC could carry on, would not be the active conduct of a trade or business. In other words, a manufacturing corporation could not take a portfolio of securities and spin it off to shareholders on a tax-free basis, taking the view that the management of the portfolio was an active trade or business.
   c. In Rev. Rul. 73-236, IRS took the view that the active trade or business requirement likewise prevented a real estate business from being spun off on a tax-free basis if the business then qualified as a REIT. In the specific case, the corporation was engaged in developing and selling real estate and it took a portfolio of developed properties and spun them out. In order to meet the REIT qualification requirements, as they stood then, it used an independent contractor to provide management and other services. An active trade or business cannot be conducted solely through an independent contractor.

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12 But the IRS continues to require that the continuity of business test be met, and in most RIC-to-RIC reorganizations the historical-assets branch of the test is relied on. See, e.g., PLR 121492-09 (July 15, 2009).
13 T.C. 9626. 2013-2 C.B. 149, which also covers involuntary conversions under Section 1033.
d. In Rev. Rul. 2001-29, however, the IRS obsoleted Rev. Rul. 73-236. It did so because, under the ’86 Act, a REIT could now directly perform those services which could be performed for tenants by a tax-exempt organization without resulting in unrelated business taxable income – that is, because of the amendment to Section 856(d)(2)(C), which allows a REIT to furnish services, and treat the income as rent, if they are not primarily for the convenience of the occupant and are customarily rendered. As a consequence, it concluded that a REIT could be engaged in the active conduct of a trade or business by virtue of functions it performed with respect to rented real estate: “A REIT can be engaged in the active conduct of a trade or business within the meaning of Section 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of Section 856(d).”

e. Rev. Rul. 2001-29 does not pass on any other issue involved in whether a controlled corporation could elect to be a REIT after a spin-off or a distributed corporation could make such an election. Whichever corporation elected to be a REIT would have to deal with the Section 337(d) regulations and it would also have to clean out any earnings and profits that were attributed to it in the spin-off. It is not clear to what extent Rev. Rul. 2001-29 has been used.¹⁴

f. As noted, there have been a number of tax-free spin-offs in which one corporation was or became a REIT, but the Consolidated Appropriations Act, enacted at the end of 2015, will slow this by requiring the recognition of gain on a spin-off if either the distributing or the distributed corporation, but not both, is a REIT, and by also providing that a corporation that was a distributed or distributing corporation in a tax free spin-off is not eligible to elect to be a REIT for the ten years following the spin-off.

5. Second, regulations with respect to disregarded entities. In 2006, the IRS adopted regulations (Regs. §1.368-2) which, broadly speaking, provide that there will be a statutory merger within the meaning of Section 368(a)(1)(A) if there is a merger under state law of a domestic corporation into a disregarded entity that is owned by a domestic corporation. A disregarded entity would include, for example, a single member LLC or a qualified REIT or S corporation subsidiary. The transaction must be non-divisive, resulting in the termination of the legal existence of the target, and satisfy certain other requirements.

a. The initially proposed regulations had said that “A” reorganization treatment was unavailable (May 2000) and then reversed that position

¹⁴ For recent rulings, see PLR 200910010 (November 25, 2008) (distribution of several REIT subsidiaries as tax free under §§ 355 and 368(a)(1)(D)) and PLR 200932018 (April 14, 2009), involving a corporation that spun off a subsidiary in a tax-free “D” reorganization, distributed earnings and profits to shareholders as a taxable dividend in order to avoid the no-earnings-and-profits rule, and merged in a tax-free reorganization into another corporation which continued to operate as a REIT.
IRFS did issue private rulings under the proposed regulations.

b. This is of some interest to REITs. A statutory merger of a target into a disregarded entity means for example that there is no assumption of the target’s debt, as there would be if the merger was into the REIT itself. Moreover, if a merger of the target into the REIT was followed by a drop down of assets, there would be Section 357(c) issues – that is, gain recognition if liabilities exceeded tax basis. Subsidiary mergers don’t address the problem because the REIT (or S corporation) doesn’t want subsidiaries (other than taxable REIT subsidiaries for specific purposes). If the REIT elected to treat the target as a qualified REIT subsidiary – which it now can do since, because of 1998 changes in the law, it is no longer the case that a qualified REIT subsidiary had to be 100% owned by the REIT since the beginning of its existence – there would probably be a deemed liquidation.

c. The only relevant private rulings involved REITs acquiring corporations through REIT subsidiaries – e.g., a merger of an S corporation into a qualified REIT subsidiary which then dropped the assets into a partnership; or a merger into a single member limited liability company owned by a REIT.

d. The “A” reorganization provisions provide the most flexibility of any of the reorganization definitions – no substantially-all-the-assets requirement; continuity of interest, not a specified amount of stock; any stock, not just voting stock.
“Preferential” Dividends

Until repealed at the end of 2010 for publicly-offered RICs,¹ and at the end of 2015 for ’34 Act registered REITs,² the exclusion of “preferential” dividends from the dividends paid deduction was an issue for both REITs and RICs, although as a practical matter mostly for RICs. Before the 2015 repeal, REITs sought and were issued rulings that were consistent with the rulings issued to RICs before the 2010 repeal,³ even when that was not the answer that the REIT wanted.⁴

The exclusion of preferential dividends is in Section 562(c) of the Internal Revenue Code⁵ and applies both to actual dividends and so-called “consent” dividends, defined in Section 565, which allows amounts set forth in a consent by a holder of “consent” stock⁶ to be treated as a dividend.⁷ The exclusion is not triggered by differences

¹ Defined in Section 67(c)(2)(B) as one whose shares are continuously offered pursuant to a public offering, which is regularly traded on an established securities market, or which is held by no fewer than 500 persons at all times during the taxable year.

² The Act repealed this for publicly-offered REITs (defined as a REIT required to file annual and periodic reports under the ’34 Act), and also provides that appropriate remedies, short of non-deductibility, if the failure is inadvertent or is due to reasonable cause and not willful neglect or is of a type identified by the IRS as being so described.

³ In PLR 201135002 (May 17, 2011), the IRS ruled (by analogy to the reasoning in Rev. Proc. 99-40, relating to RICs) that dividends paid on two classes of shares issued by a private REIT (“retail” and “institutional” shares) would not be preferential on account of different distribution fees. Purchasers of retail shares pay commissions and fees in connection with the acquisition, and these are passed on by the REIT to the dealer manager; purchasers of institutional shares bear distribution fees that are deducted from the net asset value payable on redemption and paid over by the REIT to the dealer manager. The IRS also ruled that the deferred distribution fees on the institution shares were deductible by the REIT (again by analogy to Rev. Rul. 94-70, relating to stock issuance expenses of a RIC).

⁴ See PLR 201444022 (July 21, 2014) discussed hereafter.

⁵ It provides that “The amount of any distribution shall not be considered as a dividend for purposes of computing the…deduction, unless such 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.”

⁶ Consent stock is common stock or other stock with an unlimited participation in earnings.

⁷ To illustrate, suppose one class of stock and that the issuer declares and pays a dividend of $1 share on 90% of the class and $.50 cents a share on the rest – there would be a
in dividends paid on separate classes of stock unless the preferences of a class are breached. (See the last part of the preferential dividend rule, which says that dividends are not preferential if paid “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.”) In the view of the IRS, however, whether there is a separate “class” is determined under tax, not corporate, law.

The dividends paid deduction rules in Sections 561-5 were enacted as part of the 1936 Act, which also enacted the accumulated earnings and personal holding company taxes and the first version of the RIC rules. The rules were then carried over to REITs when the REIT rules were enacted in 1960. It is not clear why the “preferential” dividend rule was imported into Subchapter M.8 For non-RICs and non-REITs, the apparent purpose was to prevent the deflection of dividends paid by closely-held corporations to lower-bracket shareholders (e.g., the children of a family-owned personal holding company), something that would likely not work in any event under present tax law.

Given the overlay of the ’40 Act and the changes (in Section 305, etc.) to deal with non-pro rata distributions, what was the tax policy for applying the preferential dividend to RICs? Repeal of the preferential dividend rule as it applies to RICs and REITs, or at least a significant modification, had long been suggested by a number of commentators9 and by the industry; and ultimately, in 2010, the rule was repealed for

“preferential” dividend and no deduction for any part of the distribution, not even the uniform amount of $.50 cents that was received by each shareholder. Each dividend is tested separately, not on the basis of cumulative dividends during the year.

8 The legislative history says that

“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 preferred distribution reflects an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance…. [but] a distribution which treats shareholders with substantial impartiality and in a manner consistent with their rights under their stock-holding interests should [not] be regarded as preferential by reason of minor differences in valuations of property distributed,” referring to a stock or cash choice, with the stock at a .25% discount from the cash.

publicly-offered RICs.\textsuperscript{10} The theory of the repeal for REITs registered under the ’34 Act was presumably the same.

**Technical Issues**

There are a large number of technical aspects of the preferential dividend rule, including the following:

**The amount disallowed** – Is the amount disallowed just the part that is preferential? Regs. §1.562-2(a) provides that the entire distribution is non-deductible. It is this all-or-nothing rule that put such pressure on making sure that a dividend paid by a RIC was not preferential.

**Timing** – Dividends that are pro rata but are declared and paid at different times during the year (or over a period of years) would be preferential. That seems to be the meaning of Example (1) of Regs. §1.562-2(b).

**One or all dividends?** What about pro rata distributions made during the year in which there is a non-pro rata distribution? They would seem not to be preferential on the theory that they are different distributions (the regulations throughout refer to “a” or “the” distribution); but there is a lack of authority and this conclusion is somewhat difficult to reconcile with all of the examples in the regulations.

**Class Preferences** – “and no class may be treated otherwise than in accordance with its dividend rights as a class”. \textit{See} Example (3) of regulations in which a dividend is preferential, to both common and cumulative preferred, because the dividend on the preferred, although equal to the current year’s preference, did not make up two years’ failure to pay the cumulative dividend.

**Earnings and profits?** What is the impact on earnings and profits, bearing in mind that earnings and profits are not allowed for non-RIC and non-REIT years and the effect of a preferential dividend may be to disqualify the RIC or REIT? Section 852(c)(1), in the case of a RIC, provides that earnings and profits are not reduced by amounts not allowed as deductions in computing taxable income. This has nothing whatsoever to do with Section 561 or 565 dividends, but is it a problem?

**De Minimis differences?** What about de minimis differences? \textit{See} the legislative history quoted in Note 5 above – but is that limited to the specific situation in which there was a property distribution and a slight variation in the value of the property and the alternative cash distribution? Or does the exception extend to other cases?

In the case of a consent dividend, the definition of a preferential dividend is the same, and (treating the consent dividend as cash) a consent dividend can be preferential if it is preferential in relation to the consent dividends of other shareholders as well as to

\textsuperscript{10} By the Regulated Investment Company Modernization Act of 2010.
cash dividends. See Example (2) of Regs. §1.565-2(b)(2). The consent dividend is deemed paid at the end of the year, however, and (presumably because the consent dividend does not involve a distribution of cash) the fact that the cash dividends were paid earlier in the year does not create a preferential dividend. See Example (1) of Regs. §1.565-2(b)(2).

Case law

Not much case law on what is “preferential”. In New York Stocks, Inc. v. Commissioner, 164 F.2d 75 (2d Cir. 1947), an open-end investment company allowed holders of each of its 21 series the option to be redeemed at net asset value less a small redemption charge. Net asset value included income earned or accrued during the year and not yet distributed – the IRS argued that this amount was not paid out as a dividend and thus was taxable to the investment company (but it did not seek to disqualify the investment companies as RICs on the basis that they did not meet the distribution requirement). The court had to pass on IRS’s theory that this amount, which the RIC had treated as a dividend, was a “preferential” dividend because not paid to shareholders who did not redeem. The court said that the legislative history suggested that “a distribution like this, which is open to all the shareholders ‘with substantial impartiality’, is not a preferential one.” The court said the IRS did not consider the context, i.e., RICs were not closely-held personal holding companies, and that redemptions by an open-end company were “intrinsically fair method for distributing its earnings to all shareholders….” Stress in the opinion was on the “equal opportunity” to redeem. No “special advantages,” as in other decided cases. The IRS sought to re-litigate the issue in National Securities Series v. Commissioner, 13 T.C. 884 (1949), Acq., and lost again.11

No case law relevant to the question of whether the existence of separate classes is to be determined by tax or State law.

G.C.M. 39457

In practice, the preferential dividend issue in the RIC industry has largely been related to the expenses of a RIC and how they are allocated among different shareholders. As it evolved, the question was what would have been paid out to the shareholders but for the allocation of expenses, what is paid out to the shareholders after the allocation, and did the difference result in a “preference”?

In G.C.M. 39457 (December 18, 1985) the IRS created agony in the RIC industry because it took the view that different charges to shareholders for advisory and management services, reflecting the economics of larger versus smaller shareholders, were constructive dividends that were “preferential”. So-called “sliding scale” dividends.

In the G.C.M., the fund proposed to shift the investment advisory fee paid by the fund to its shareholders by structuring the payment of fees so that they would

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11 Another issue in these cases was the treatment of amounts paid in redemption of shares for purposes of the distribution requirements.
henceforth be a shareholder expense; and then charging the fees on a sliding scale, more for smaller shareholders and less for larger shareholders. The IRS interpreted the preferential dividend rule to say that deductions for advisory fees are inherently corporate expenses that could only be taken at the RIC level and could not be treated under any structure as shareholder expenses. Therefore, there was no deduction by shareholders for the fees that they paid; and “it follows”, says the G.C.M., that the sliding scale will produce preferential dividends – a disproportionate deduction of fees from the dividend income of the shareholders.12

Depending on its scope, this position had the potential to disqualify RICs in a number of circumstances – for example, RICs that were open-end companies which had adopted plans (so-called Rule 12b-1 plans)13 which provided different ways of using fund assets to cover costs of distributing fund shares or which had different arrangements for shareholder services, or both – there were, in effect, different charges to shareholders depending on which share distribution program they participated in.14 Bear in mind that even a small difference, if treated as resulting in a preferential dividend, would be fatal because (as discussed above) it makes the whole dividend preferential – not just the difference.

History after G.C.M. 39457

A minor fix to the problem created by GCM 39457 was enacted in 1986 by the addition of the last sentence of Section 562(c) but that was limited;15 and, ironically (because it related only to “administrative” expenses), the amendment may have

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12 The G.C.M. goes on to say, gratuitously, that the sliding scale violates the ’40 Act and is inconsistent with the nature of RICs, which are intended only for small investors.

13 In 1980 the SEC issued Rule 12b-1, which permitted funds to finance distribution costs (previously paid by shareholders as “sales loads”) out of fund assets and this led to the issuance of different classes of shares in the same portfolio but with different arrangements – with/without sales loads, with/without 12b-1 fees, etc. This required an exemptive order from the SEC. In 1995, Rule 18f-3 permitted the issuance of multiple classes of shares but without an exemptive order. As noted hereafter, in July 2010 the SEC proposed to replace Rule 12b-1.

14 There is a Rev. Proc. 2000-38, dealing with the RIC’s method of accounting for such charges.

15 “In the case of a distribution by a regulated investment company to a shareholder who made an initial investment of at least $10,000,000 in such company, such distribution shall not be treated as not being pro rata or as being preferential solely by reason of an increase in the distribution by reason of reductions in administrative expenses of the company.”
encouraged the IRS in its view that a differential allocation of investment advisory or management fees was always a “preference”.\textsuperscript{16}

Over time the issue evolved – initially, RICs tried to deal with it by having separate classes of shares which differed only in the different expense charges (i.e., load and no-load shares). The IRS went along with this in private rulings,\textsuperscript{17} but in 1991 changed its mind and concluded that the separate classes of shares approach was not the way to go and that separate classes of shares that differed only because of different charges were not separate classes at all. However, it went on to reason that the distribution and servicing fees were, in fact, shareholder fees (not company expenses) and therefore that the different charges for these amounts (as opposed to advisory and management fees) did not affect the dividends – \textit{i.e.}, all the shareholders were receiving the same amount.

There is a whole industry of private rulings based on the GCM. By one estimate, there were 484 rulings issued between 1987 and 1997, representing 1.44\% of the total of all private letter rulings issued by the IRS on all subjects in this period.\textsuperscript{18}

\textbf{Rev. Procs. 96-47 and 99-40}

In Rev. Proc. 96-47, the IRS eliminated the need for private rulings in cases more or less covered by Rule 18f-3. The pressure to do so was in part because, under Rule 18f-3, no exemptive order was needed and therefore funds were not happy about waiting around for an IRS private ruling. The Revenue Procedure described conditions under which distributions might vary and nevertheless be deductible, but did not cover fee or expense waivers or reimbursements or allocations of performance-based advisory fees. When Rule 18f-3 of the SEC was amended in 1997 to expand permissible allocations of expenses, Rev. Proc. 96-47 was superseded by Rev. Proc. 99-40, which essentially extended its principles to the allocation of the benefit of a waiver or reimbursement of a fee or expense and addressed performance-based advisory fees.\textsuperscript{19} The concern of the SEC, and

\begin{itemize}
  \item \textsuperscript{16} For a good history, albeit as advocates, see the January 23, 2015 letter to the IRS from The Real Estate Roundtable, Comment Letter Relating to Preferential Dividend Analysis in P.L.R. 201444022.
  \item \textsuperscript{17} \textit{E.g.}, PLR 850055 (September 21, 1988), dealing with classes that differed in the sales load or charge.
  \item \textsuperscript{18} Letter from Dale S. Collinson and Louis W. Ricker to Donald C. Lubick, Acting Assistant Secretary, Treasury (February 3, 1998), \textit{98 TNT 48-37}.
  \item \textsuperscript{19} In relevant part, the Revenue Procedure provides (1) that each group of shares (so-called “qualified groups”) may have different arrangements for shareholder services or the distribution of shares or both, and shall be allocated and pay the fees and expenses of that arrangement; (2) that each qualified group may be allocated and may pay a different share of other fees and expenses, not including advisory or custodial fees or other fees and expenses related to the management of the RIC’s assets, if these expenses are actually incurred in a different amount by that group or if the group receives services of a different
also the IRS, was to prevent cross-subsidization of distribution expenses. The Revenue Procedures materially slowed but not eliminate request for private rulings.20

In July 2010 the SEC proposed to replace Rule 12b-1 with rules that would allow funds to continue to bear promotional costs, within limits; and allow investors alternatives for paying sales charges, again with limits. Additionally, shares could be offered through broker-dealers who would determine their own sales charges. The SEC proposal included liberal transition rules, and also grandfathers for 5 years shares issued before the compliance date.

**Repeal for REITs**

Some uncertainty with respect to REITs and preferential dividends.

In addition to repealing the preferential dividend rule for ’34 Act registered REITs, the Consolidated Appropriations Act, 2016 also provides that appropriate remedies, short of non-deductibility, may apply to preferential dividends if the failure is inadvertent or is due to reasonable cause and not willful neglect or is of a type identified by the IRS as being so described. Relevant because there are significant REITs not registered under the ’34 Act.

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20 See, e.g., PLR 201119025 (February 3, 2011) (two classes of shares with different distribution fees and class specific allocations of expenses and the performance component of the advisory fee will not result in preferential dividends); PLR 200942032 (June 26, 2009) holding that, in a fund of funds structure, payments by feeder funds to master funds under service agreements of a part of the master funds’ operating expenses will not result in preferential dividends; and PLR 20082510 (March 13, 2008), holding that reimbursements allocated to shareholders in proportion to the net asset values of shares would not result in preferential dividends.
For example, in PLR 201444022 (July 21, 2014) the IRS ruled that dividends paid by a “privately-held” REIT would be preferential. The REIT had two classes of shares would be preferential. In the ruling, a special dividend was paid to Class B shares, which were issued to shareholders who made larger capital commitments, representing a reduction in the management fee. Treating this as preferential would, of course, potentially disqualify all dividends paid on the Class A and Class B shares.

Not clear why the REIT insisted on getting an unfavorable ruling, but the ruling in any event has caused considerable concern in the REIT industry which apparently, Section 562(c) notwithstanding, commonly uses sliding scale dividend rights. Presumably based on the view that the separate class of stock rule trumps any assertion that the dividends are preferential.

While the Real Estate Roundtable’s objection to the ruling is based on the view that the separate class of stock rule in Section 562(c) should in such a case prevail, it is apparently the case that in other situations different dividend rights have been used as a way of converting fee income, which would be bad income for a REIT, into dividends from a REIT, which would be good income – e.g., a REIT and a pension fund form a REIT and, in lieu of paying the shareholder REIT a management fee (generally, 5%) the joint venture REIT simply pays the shareholder REIT a larger dividend than the pension fund. Sometimes a partnership may be inserted between the jointly-owned REIT and the joint-venturer so that there could be special allocations of the dividend income.  

21 See Amy S. Elliot, REIT Industry Stressed Over Adverse Preferential Dividend Ruling, Tax Notes, April 2, 2015.