

Rev. Proc. 2017-_____

1. Purpose

Pursuant to authority under § 562(e)(2) and § 856(g) of the Code, this revenue procedure sets forth a safe harbor under which dividends from a real estate investment trust (“REIT”) will not be treated as preferential dividends under § 562(c) of the Internal Revenue Code and will be treated as dividends for purposes of computing the dividends paid deduction.

2. Background

.01. Under § 857(a)(1), the REIT’s deduction for dividends paid generally must equal or exceed: (A) the sum of (i) 90 percent of the REIT taxable income for the taxable year (determined without regard to the deduction for dividends paid (as defined in § 561) and by excluding net capital gain); and (ii) 90 percent of the excess of the net income from foreclosure property over the tax imposed on such income; minus (B) any excess noncash income (as determined under § 857(c)).

.02. The amount of any distribution by a REIT is not considered as a “dividend” for purposes of computing the dividends paid deduction if it is treated as a “preferential dividend” under § 562(c). The failure of a REIT distribution to be considered as a “dividend” for purposes of computing the dividends paid deduction could cause the REIT to lose its status as such.

.03. The Protecting Americans from Tax Hikes Act of 2015 (Pub. L. 114-113, Division Q), December 18, 2015 (“PATH Act”) amended § 562(c) to exempt publicly offered REITs, which are defined as REITs that are required to file annual and periodic reports with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, from the preferential dividend rule. For this purpose, publicly offered REITs include not only the parent REIT filing such reports with the SEC, but also its subsidiary REITs that are consolidated with it on such filed reports under generally accepted accounting principles. REITs that are not publicly offered are still subject to the preferential dividend rule of § 562(c) but Congress expressly provided the Secretary of the Treasury with authority in § 562(e)(2) to make exceptions or remedies.

.04. Under § 562(c)(1), a REIT dividend distribution is treated as a preferential distribution unless:

- (1) the distribution is pro rata,
- (2) the distribution is made with no preference to any share of stock as compared with other shares of the same class, and
- (3) if multiple classes of stock exist, the distribution is made 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.

.05. The legislative history of the preferential dividend rule indicates that the rule was meant to prevent income shifting among shareholders of a personal holding company (as defined in § 542), which, by definition under § 542(a)(2), is closely held. *See* H.R. Rep. No. 1860, 75th Cong., 3d Sess. 23 (1938) (“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 stockholdings, whether the preferential distribution reflects an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance. . . . The committee believes that no distribution which treats shareholders with substantial impartiality and in a manner consistent with their rights under their stock-holding interests, should be regarded as preferential by reason of minor difference in valuations of property distributed.”). Consistent with this legislative history, the IRS has decided that some *de minimis* and relatively minor differences in distributions to shareholders are not treated as preferential dividends. *See, e.g.*, Rev. Rul. 83-117, 1983-2 C.B. 98.

.06. A REIT, by definition under § 856(a)(6) (as governed by § 856(h)) cannot be closely held, and so concern about income shifting among shareholders is not operative to the same extent in the REIT context as it is in the context of a personal holding company (as defined in § 542).

.07. Under § 1.562-2(a) of the Income Tax Regulations, specific illustrations of preferential dividends are set forth as follows:

(1) A corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class.

(2) A corporation will not be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock.

.08. As a general matter, § 1.562-2(a) of the Income Tax Regulations provides that a preference exists if any rights to preference inherent in any class of stock are violated. The three Examples set forth in § 1.562-2(b) of the Income Tax Regulations reflect the focus of the preferential dividend concept on discrepancies in the treatment of different holders of the same class or financially advantaging holders of one class of stock to the detriment of holders of another class of stock. Particularly when inadvertent, errors that are *de minimis* should not constitute preferential dividends. *See Hanco Distributing, Inc. v. Commissioner*, 32 AFTR 2d 73-5485 (D. Utah 1973).

.09. When a preferential dividend is found to exist, the entire amount of the REIT’s dividend distribution that includes the preferential dividend is not entitled to the dividends paid deduction. However, this taint does not extend to the REIT’s prior or subsequent dividend distributions, in that prior or subsequent dividend distributions are tested separately to determine whether or not they are preferential. *See Henry Schwartz Corp. v. Commissioner*, 60 T.C. 728 (1973).

.10. The PATH Act also amended § 562(e) to provide the Secretary with authority to provide an appropriate remedy to cure the failure of a non-publicly offered REIT to comply with the preferential dividend requirements in lieu of not considering the distribution to be a dividend for purposes of computing the dividends-paid deduction. That is, Congress has indicated that denial of the dividends-paid deduction is a harsh and inappropriate penalty when the violation of the preferential dividend rule is inadvertent or is due to reasonable cause and not due to willful neglect. In addition, with respect to a *de minimis* violation, there may be no contravention of the preferential dividend rule in the first place and so in any event relief without penalty should be made available to taxpayers for a *de minimis* violation.

.11. Historically, § 856(g) has provided relief when a REIT termination results from a violation of the preferential dividend rule, provided that the violation was due to reasonable cause and not due to willful neglect, and provided further that the Secretary collected a \$50,000 penalty for each failure if, as, and when prescribed.

3. Scope

This revenue procedure applies to the situations listed below that are recognized as not constituting tax avoidance or other circumstances that the Congress intended to be considered as preferential dividends.

The following examples are illustrative of situations that the Service will not treat as involving preferential dividends as to REITs. The Service will supplement this list as it becomes aware of similar circumstances through private ruling letter requests, fact patterns that are the subject of closing agreements and other sources of information. The Service recognizes that the examples provided in this revenue procedure are not exhaustive. No inference is intended that REIT dividends that are not specifically described in this revenue procedure constitute preferential dividends.

.01. The REIT's charter requires that dividends on preferred stock be declared or declared and paid before any dividends are paid on common stock. However, the board of directors of the REIT declares and pays dividends on the preferred and common stock simultaneously. Alternatively, the REIT's charter provides that dividends with respect to a certain class of shares be paid on a specific date, and either: a) the dividend payments with respect to that class of shares are not all mailed, wired or otherwise transmitted on the correct day, but within several days of one another; or, b) the dividend payments with respect to that class of shares are not all mailed, wired or otherwise transmitted on the correct day, but as soon as the REIT realizes the error, the relevant dividend payments are mailed, wired or otherwise transmitted.

(1) In both situations, no share of stock and no class of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, the full amount of dividends distributable on the preferred shares, as well as on the common shares, has been distributed, although not in strict accord with the charter provisions.

(2) In both situations, the only question is timing, and the value of any timing differential is considered to be *de minimis*.

(3) Thus, there is no preferential dividend paid by the REIT with respect to this dividend.

.02. The REIT's charter provides that dividends on all classes of preferred stock shall be paid semi-annually and before any dividends are paid on the common stock. However, the board of directors adopts a practice of making distributions to the holders of all classes of preferred stock annually and to the holders of all common stock on a monthly basis.

(1) In this situation, no share of stock and no class of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, the full amount of dividends distributable on the preferred shares, as well as on the common shares, has been distributed, although not in strict accord with the charter provisions. Finally, each share in each class received the same dividend distribution at or about the same time.

(2) In this situation, the only question is timing, and the value of any timing differential is considered to be *de minimis*.

(3) Thus, there is no preferential dividend paid by the REIT with respect to this dividend.

.03 The REIT's charter provides the method by which distributions and other payments are to be made with respect to shares of its stock (*e.g.*, by check mailed to the holder of record). However, the REIT makes a dividend distribution or other required payment to one or more shareholders by a method not in strict conformity with the requirements of the charter. Alternatively, the REIT makes a payment to one or more shareholders in a combined payment (*e.g.*, accrued dividend plus redemption premium) that the charter requires to be made in one or more separate payments.

(1) In this situation, no share of stock and no class of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, the full amount of dividends distributable on the stock has been paid, although not in strict compliance with the formal procedures for payment.

(2) In this situation, the only issue involves certain mechanical formalisms and *de minimis* errors.

(3) Thus, there is no preferential dividend paid by the REIT with regard to these dividends.

.04. The REIT's charter provides that dividends on all classes of preferred stock and all classes of common stock shall be authorized by the board of directors before payment. Although the board of directors fails to formally authorize such payments to be made, the REIT makes dividend distributions on the preferred stock in general accordance with the provisions of the charter. In addition, the board of directors from time to time authorized and the REIT made dividend payments on the common stock during the period when no formal authorizations were in place for the dividend distributions paid on the preferred stock. Some years later, the board of directors formally ratifies the dividend distributions that have been paid on the preferred stock.

(1) In this situation, no share of stock and no class of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, the full amount of dividends distributable on the preferred stock has been paid, although not in strict compliance with the formal procedures for authorization.

(2) In this situation, the only issue involves certain mechanical formalisms and *de minimis* errors, and the errors are, as and when discovered, rectified to the extent practicable.

(3) Thus, there is no preferential dividend paid by the REIT with regard to these preferred and common dividends.

.05. The records of the REIT contain errors regarding share transfers or the identity of its shareholders, either because of internal record-keeping discrepancies or because the shareholders (or their agents or representatives) failed to furnish correct or updated information to the REIT on a timely basis. The REIT thus erroneously pays dividends to some persons who are not shareholders and fails to pay dividends to some other persons who are shareholders. As and when such errors are discovered, they are rectified to the extent practicable.

(1) In this situation, but for such errors, no share of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, but for such errors, the full amount of dividends distributable on the shares has been distributed.

(2) In this situation, such errors are *de minimis* and are, as and when discovered, rectified to the extent practicable.

(3) Thus, there is no preferential dividend paid by the REIT with respect to these dividends or with respect to any payment made to rectify the errors.

.06. The records of the REIT contain errors regarding the number of shares of one or more classes of stock that are outstanding because of internal record-keeping discrepancies. For example, this situation could occur if REIT employees vest in restricted stock on a certain date, but the REIT's agent is unable to update its records in time to make the correct dividend payment. The REIT thus erroneously fails to pay dividends to some persons who are shareholders. As and when such errors are discovered, they are rectified to the extent practicable.

(1) In this situation, but for such errors no share of stock and no class of stock has received more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, but for such errors the full amount of dividends distributable on the shares has been distributed.

(2) In this situation, such errors are *de minimis* and are, as and when discovered, rectified to the extent practicable.

(3) Thus, there is no preferential dividend paid by the REIT with respect to these dividends or with respect to any payments made to rectify the errors.

.07. The REIT has made all distributions with respect to its classes of stock in general accordance with the terms governing the same, but such amounts distributed are rounded up, down or to the nearest whole cent in order to avoid making distributions that include a fraction of a cent.

(1) In this situation, some holders of stock may receive a dividend differential, due to such rounding.

(2) The rounding of a dividend up, down or to the nearest whole cent is *de minimis*.

(3) Thus, there is no preferential dividend paid by the REIT with respect to these dividends.

.08. The REIT's charter provides for classes A, B, and C of preferred stock, as well as for common stock. Dividends on the preferred stock are to be paid before dividends are paid on the common stock. The REIT erroneously fails to pay any dividends on class C preferred stock, although it pays dividends on the other classes of preferred and on the common. The total amount of dividends paid by the REIT is 95% or more of the amount which would have been paid had the REIT paid dividends on the common and on all classes of preferred. As soon as the error is discovered, the REIT pays the amounts that it should have paid on the class C preferred stock, plus (if the REIT so chooses) an amount in the nature of interest to compensate the class C preferred shareholders for the delay in paying their dividend.

(1) In this situation, the amount of the errors was *de minimis*, and the errors are, as and when discovered, rectified. Moreover, any additional amount in the nature of interest payable as compensation for delay in payment of the dividend is intended to treat all shareholders with substantial impartiality.

(2) Thus, there is no preferential dividend paid by the REIT with respect to the dividends which were paid on the class A and class B preferred stock and the common or with respect to the payments made to rectify the error with respect to the class C preferred stock.

.09. The REIT acquires outstanding shares of its stock by purchase at arms' length from certain of its shareholders. Depending on the circumstances of the selling shareholders of these shares, the purchases by the REIT will be treated either as dividends under § 301 or as distributions in redemption under § 302. In both cases, under § 562(b) a portion of the amounts paid by the REIT for the shares could constitute dividends for purposes of computing the dividends paid deduction.

(1) In this situation, only the shareholders who sold their shares to the REIT will be considered to have received dividends from the REIT.

(2) All purchases by the REIT were made at arms' length. Accordingly, all shareholders were treated with substantial impartiality.

(3) Whether or not a deduction for dividends paid is permissible under § 562(c) and § 1.562-2 of the Income Tax Regulations with respect to the REIT's redemption of its shares, the redemption will not cause any prior or subsequent distribution by the REIT to be tainted and

thus any prior or subsequent dividend distributions are tested separately to determine whether or not they are preferential.

.10. The REIT is an “eligible entity” under § 301.7701-3 of the Income Tax Regulations that has elected to be taxed as a corporation for federal income tax purposes. The REIT adopts a plan of liquidation for federal income tax purposes that it intends to be governed by §§ 331, 336, and 562(b)(1)(B). Pursuant to the REIT’s organic documents and in connection with the adopted plan of liquidation, the REIT calls its preferred stock for redemption, although there are some small irregularities, nonconformities and inadvertent errors or omissions in providing redemption notices and in the mechanics of paying redemption proceeds and any accrued and unpaid cumulative dividends. Following the redemption of the preferred stock and also pursuant to the adopted plan of liquidation, the common shareholders of the REIT elect to liquidate the REIT for federal income tax purposes by having it elect to be classified as a partnership or disregarded entity for federal income tax purposes, all in the manner contemplated by § 301.7701-3(g) of the Income Tax Regulations.

(1) In this situation, no share of stock and no class of stock has received (or is deemed to have received) more or less than the amount to which it is entitled as compared with any other share in the same class or any other class of stock. Moreover, the full amount of dividends distributable on the preferred shares, as well as on the common shares, has been distributed (or is deemed to have been distributed), although not in strict accord with the charter provisions. Finally, each share in each class received the same dividend distribution at or about the same time.

(2) In this situation, the only questions are one or more of defects in notice, method of payment and timing, and the value of any notice or payment defects and timing differential is considered to be *de minimis*.

(3) Thus, there is no preferential dividend paid by the REIT with respect to its actual or deemed distributions in connection with its plan of liquidation.

4. Procedure

Dividend distributions made by a REIT that satisfy the safe harbors of Section 3 of this revenue procedure (including combinations of one or more such safe harbors) will not be treated as a preferential dividend for purposes of § 562(c).

If a REIT discovers an inadvertent distribution that it believes could be considered a preferential dividend before being notified about that distribution by the Internal Revenue Service, the REIT may remedy that apparent preferential dividend by: 1) including in its next filed tax return a statement describing the inadvertent failure or the basis on which the failure was due to reasonable cause and not due to willful neglect, along with a certification under penalty of perjury by the person signing the return; 2) if appropriate, take action to reverse the preferential dividend; and, 3) paying a \$50,000 penalty to the Internal Revenue Service. If the same or a substantially similar failure has occurred with respect to multiple distributions before being identified as a preferential dividend rule violation, and the REIT’s self-reporting is made before the failures were discovered

by the IRS, then the REIT shall be considered to have had a single failure for purposes of exacting the \$50,000 self-remediation penalty.