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Department of the Treasury  
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Person To Contact: \_\_\_\_\_, ID No.

Telephone Number:

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Date:  
March 11, 2020

Legend

Taxpayer =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Month =

Year =

Dear \_\_\_\_\_ :

This letter responds to a letter dated September 5, 2019, requesting rulings on behalf of Taxpayer. Taxpayer requests two rulings with respect to inclusions under section 481(a) of the Internal Revenue Code (Code) and earnings and profits (E&P) associated with those inclusions.

## FACTS

Taxpayer was organized as a State corporation on Date 1 and was a dormant entity for the taxable year that ended on Date 2. Beginning with its taxable year that commenced on Date 3, Taxpayer has elected to be taxed as a real estate investment trust (REIT) under sections 856 through 859 of the Code. Taxpayer's primary business is the leasing of space on and at communications sites to a diverse group of tenants in different industries. Taxpayer represents that its communications sites are comprised of real property or interests in real property within the meaning of §1.856-10. Taxpayer's overall method of accounting is an accrual method and its taxable year is the calendar year.

In Month of Year, Taxpayer conducted a review of its books and records in connection with a potential transaction. As a result of this review, Taxpayer submitted Forms 3115, Applications for Change in Accounting Method, under the automatic change procedure described in Rev. Proc. 2015-13, 2015-5 I.R.B. 419, to change its methods of accounting for depreciation and amortization of some of its assets beginning with the taxable year ended Date 4 (the Method Changes). Taxpayer represents that the assets to which the Section 481(a) Adjustments relate are real property or interests in real property and that Taxpayer's proposed method of accounting for such assets is to depreciate or amortize pursuant to methods that conform and align more closely with the applicable assets constituting real property and interests in real property for purposes of section 856 and §1.856-10. These Method Changes resulted in positive section 481(a) adjustments (the Section 481(a) Adjustments) that will be taken into account ratably over a four-year period (subject to possible acceleration) beginning with the taxable year ended Date 4, with corresponding changes to Taxpayer's E&P.

Taxpayer represents that it will take the correlative adjustments arising from the Method Changes in computing depreciation and amortization for E&P purposes into account ratably over the same period as the Section 481(a) Adjustments, consistent with Rev. Proc. 79-47, 1979-2 C.B. 528. Due to differences in computing depreciation and amortization for E&P purposes versus for income tax purposes, Taxpayer's correlative adjustments to its E&P may be lower than the Section 481(a) Adjustments.

Taxpayer represents that the Section 481(a) Adjustments will not be subject to the section 1374 built-in gains tax, which tax (where applicable) is not eliminated or reduced by the dividends-paid deduction per sections 337(d) and 1374 as well as §§1.337(d)-7 and 1.1374-4(b) and (d), because Taxpayer's Section 481(a) Adjustments relate to depreciation and amortization previously taken as a REIT (and not to depreciation or amortization previously taken as a non-REIT C corporation).

## LAW AND ANALYSIS

**Ruling Request #1: Pursuant to section 856(c)(5)(J), Taxpayer's Section 481(a) Adjustments will not be taken into account in determining whether Taxpayer satisfies the gross income tests of sections 856(c)(2) and (3).**

Section 856(c)(2) provides that in order for a corporation to qualify as a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from dividends; interest; rents from real property; gain from the sale or other disposition of stock, securities, and real property (other than property described in section 1221(a)); abatements and refunds of taxes on real property; income and gain derived from foreclosure property; commitment fees to make loans secured by mortgages on real property or on interests in real property or to purchase or lease real property; gain from certain sales or other dispositions of real estate assets; and certain mineral royalty income.

Section 856(c)(3) provides that in order for a corporation to qualify as a REIT, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from rents from real property; interest on obligations secured by mortgages on real property or on interests in real property; gain from the sale or other disposition of real property (other than property described in section 1221(a)); dividends or other distributions on, and gain from the sale or disposition of, transferable shares in other REITs; abatements and refunds of taxes on real property; income and gain derived from foreclosure property; commitment fees to make loans secured by mortgages on real property or on interests in real property or to purchase or lease real property; gain from certain sales or other dispositions of real estate assets; and qualified temporary investment income.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of part II of subchapter M of the Code, the Secretary is authorized to determine, solely for purposes of such part, whether any item of income or gain which (i) does not otherwise qualify under section 856(c)(2) or (3) may be considered as not constituting gross income for purposes of section 856(c)(2) or (3), or (ii) otherwise constitutes gross income not qualifying under section 856(c)(2) or (3) may be considered as gross income which qualifies under section 856(c)(2) or (3).

Section 481(a) provides that a taxpayer that changes its method of accounting takes into account necessary adjustments in computing its taxable income.

Section 1.481-1(d) provides that a section 481(a) adjustment must be properly taken into account for purposes of computing gross income, adjusted gross income, or taxable income in determining the amount of any item of gain, loss, deduction, or credit that depends on gross income, adjusted gross income, or taxable income.

As noted above, Taxpayer submitted Forms 3115 to change its methods of accounting for some of its real estate assets. The Method Changes resulted in positive Section 481(a) Adjustments that will be includible in taxable income over a four-year period beginning with the taxable year ended Date 4. Sections 856(c)(2) and (3) list the sources of permissible income for a REIT. Income from a section 481(a) adjustment is not specifically enumerated in section 856(c)(2) or (3).

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, “[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business.”

Any income resulting from a section 481(a) adjustment constitutes gross income. Pursuant to the authority under section 856(c)(5)(J), that income may be considered either as not constituting gross income under section 856(c)(2) or (3), or as gross income which qualifies under those provisions.

Exclusion of the Section 481(a) Adjustments from Taxpayer's gross income for purposes of sections 856(c)(2) and (3) does not interfere with Congressional policy objectives in enacting the income tests under those provisions. Accordingly, pursuant to section 856(c)(5)(J)(i), we conclude that Taxpayer's Section 481(a) Adjustments will not constitute gross income for purposes of sections 856(c)(2) and (3).

**Ruling Request #2: *If and to the extent that Taxpayer's Section 481(a) Adjustments exceed the correlative E&P adjustments arising from the changes in computing depreciation and amortization, any distributions of such excess (that are distributed and treated as dividends by Taxpayer in the year in which such excess arises) will be treated as made from E&P.***

Section 561(a) provides that the deduction for dividends paid shall be the sum of the dividends paid during the year and consent dividends for the taxable year.

Section 562(a) provides that the term “dividend” shall include only dividends as described in section 316. Section 316(a) defines the term “dividend” to mean any distribution of property made by a corporation to its shareholders out of either current year or accumulated E&P.

Section 857(a)(1) requires, in part, that a REIT's deduction for dividends paid for a taxable year equals at least 90 percent of its REIT taxable income for the taxable year, determined without regard to the deduction for dividends paid (as defined by section 561) or any net capital gains.

Section 857(b)(2)(B) provides that in determining a REIT's taxable income, the deduction for dividends paid (as defined in section 561) shall be allowed.

Section 857(d)(1)(A) provides that the E&P of a REIT for any taxable year (but not its accumulated earnings) shall not be reduced by any amount that is not allowable in computing the REIT's taxable income for such taxable year.

Section 857(d)(2) provides that a REIT is generally deemed to have sufficient E&P to cover any distribution that it treats as a dividend to the extent the distribution, when combined with other distributions in the same calendar year, does not exceed the distributions required by section 4981.

Section 4981 generally levies an excise tax on REITs that do not make required distributions under that section during the calendar year. In general, a REIT's required distribution equals at least 85 percent of its current year ordinary income and at least 95 percent of its current year capital gain net income. The remaining percentage of the REIT's current year ordinary income (up to 15 percent) and its current year capital gain net income (up to 5 percent) are included in its required distribution in the following year. For purposes of section 4981, "ordinary income" equals the REIT's taxable income as determined under section 857(b)(2) without regard to the section 857(b)(2)(B) dividends-paid deduction.

The House Conference Report for the Tax Reform Act of 1986 states the following in discussing its rejection of a Senate amendment to section 857:

The conference agreement does not contain the provision from the Senate amendment under which a REIT's [E&P] for a taxable year would not be less than its real estate [investment] trust taxable income for the taxable year (without regard to the dividends paid deduction), since the conferees believe that this provision is a restatement of present law.<sup>1</sup>

H.R. Conf. Rep. No. 99-841, at 218-19 (1986). Therefore, the regime governing the taxation of REITs, which requires distributions of taxable income, contemplates that the REIT will have sufficient E&P to meet the distribution requirements.

Rev. Proc. 79-47, 1979-2 C.B. 528, provides the procedures outlining the effect on E&P resulting from an adjustment required by section 481(a) for a change in method of accounting for taxable income purposes under section 446(e). In order to prevent distortions, when computing E&P (current and accumulated) available for the payment of dividends, the taxpayer shall follow its new method for reporting taxable income and

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<sup>1</sup> Prior to enactment of the Tax Reform Act of 1986, a version of the bill amended and passed by the Senate included a provision stating that "the earnings and profits of a real estate investment trust for any taxable year (but not its accumulated earnings) . . . shall not be less than its real estate investment trust taxable income for such taxable year determined without regard to the deduction for dividends paid (as defined in section 561)." See H.R. 3838, 99<sup>th</sup> Cong. § 1434(b) (as passed by the Senate, June 24, 1986).

shall take the applicable section 481(a) adjustments into account over the same period as it does for purposes of computing taxable income.

Taxpayer represents that due to differences in computing depreciation and amortization for E&P purposes versus for income tax purposes, Taxpayer's correlative adjustments to its E&P may be lower than the Section 481(a) Adjustments. Based on the above, we conclude that to the extent that Taxpayer's Section 481(a) Adjustments exceed the correlative E&P adjustments arising from the changes in computing depreciation and amortization, any distributions of such excess (that are distributed and treated as dividends by Taxpayer in the year in which such excess arises) will be treated as made from E&P.

#### CAVEATS

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed or implied regarding whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of chapter 1 of the Code. Additionally, we express no opinion on whether Taxpayer's communications sites are comprised of real property or interests in real property within the meaning of §1.856-10, the propriety of the amounts of the Section 481(a) Adjustments, or the propriety of Taxpayer's Method Changes.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

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

In accordance with the power of attorney on file with this office, copies of this letter are being sent to your authorized representatives.

Sincerely,

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Robert A. Martin  
Senior Technician Reviewer, Branch 1  
Office of Associate Chief Counsel  
(Financial Institutions & Products)

cc: