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Department of the Treasury  
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Date: January 6, 2022

**Legend**

Taxpayer =

State A =

State B =

Company =

Date A =

Date B =

Year =

Type A =

Type B =

Dear :

This ruling responds to a letter dated July 16, 2021, and supplemental correspondence, submitted on behalf of Taxpayer. Taxpayer requests a ruling that a section 481(a) adjustment required to be included in gross income by Taxpayer will not be treated as gross income for purposes of section 856(c)(2) or (3).

## FACTS

Taxpayer is a State A Corporation that intends to elect to be taxed as a real estate investment trust ("REIT") under sections 856 through 860 beginning with its tax year ending Date B. Taxpayer is an indirect subsidiary of Company, a publicly traded State B corporation.

Taxpayer owns, through one or more entities that will be disregarded for federal tax purposes or as a partner in certain partnerships, interests in various real properties and provides property management to its own properties. Additionally, Taxpayer constructs, improves, and redevelops Type A and Type B buildings (the "Property"). Taxpayer's overall method of accounting is an accrual method, and its taxable year is the calendar year.

On Date A, Taxpayer filed Form 3115, Application for Change in Accounting Method, under the automatic change procedures described in Rev. Proc. 2015-13, 2105-5 I.R.B. 419, to change its method of accounting for certain costs associated with Property beginning with Year (the "year of change"). This automatic change resulted in a positive adjustment under section 481(a) that is includible in Taxpayer's taxable income over a period of four years beginning with the year of change (the "Section 481(a) Adjustment"). The Section 481(a) Adjustment relates to a change to allocate and capitalize certain administrative and mixed service costs related to Property rather than deducting those costs.

## LAW AND ANALYSIS

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 chapter 1 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 to prevent amounts from being duplicated or omitted.

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.

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."

As noted above, Taxpayer submitted a Form 3115 to change its method of accounting for certain costs associated with Property. The method change resulted in a positive Section 481(a) Adjustment that is includible in taxable income over a four-year period beginning with the year of change. The Section 481(a) Adjustment also constitutes gross income to the taxpayer that is of a type not listed in section 856(c)(2) or (3). Based on all the facts and circumstances, however, exclusion of the Section 481(a) Adjustment 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.

## CONCLUSION

Based on the information submitted and the representations made, we rule that, under section 856(c)(5)(J)(i), the Section 481(a) Adjustment will not be treated as gross income for purposes of section 856(c)(2) or (3).

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. Specifically, no opinion is expressed regarding whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of chapter 1 of the Code. Additionally, no opinion is expressed regarding the propriety of Taxpayer's method change or the amount of the Section 481(a) Adjustment.

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

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

Sincerely,

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Andrea M. Hoffenson  
Chief, Branch 2  
Office of Associate Chief Counsel  
(Financial Institutions & Products)

cc: