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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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CC:FIP:B02
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Date:
September 16, 2016

Legend:

Taxpayer =

Month 1 =
Year 1 =
Year 2 =
Year 3 =

Dear :

This is in reply to a letter dated May 12, 2016, requesting a ruling on behalf of Taxpayer. Taxpayer requests two rulings with respect to inclusions under section 481(a) of the Internal Revenue Code and earnings and profits ("E&P") associated with those inclusions.

Taxpayer is a calendar year taxpayer that uses an accrual method of accounting and that elected to be taxed as a real estate investment trust ("REIT") under section 856. Taxpayer acquires, leases, purchases, develops, and builds large storage buildings and licenses storage space within those buildings to tenants.

In Month 1 of Year 1, Taxpayer acquired the stock of an affiliated group of domestic corporations that files a consolidated return for federal income tax purposes ("Target"). Taxpayer initially acquired Target as a taxable REIT subsidiary. During Year 1, Target's operations were restructured and Target's assets ("the Assets") became a part of Taxpayer in a carryover basis transaction through the merger and liquidation of Target into a disregarded entity of Taxpayer.

As part of the transaction described above, Taxpayer caused Target to submit Forms 3115, Application 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 the Assets (the "Method Changes"). As a result of the Method Changes, Taxpayer represents that it will be required to include positive section 481(a) adjustments in its taxable income during its Year 1, Year 2, and Year 3 taxable years ("the Section 481(a) Adjustments").

Ruling Request 1: The Section 481(a) Adjustments will not be taken into account in determining whether Taxpayer satisfies the gross income tests of section 856(c)(2) and (3).

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, rents from real property.

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, rents from real property.

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 that – (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 that 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 caused Target to file Forms 3115 to change its methods of accounting for the Assets. The Method Changes have resulted in the Section 481(a) Adjustments that will be includible in taxable income. Sections 856(c)(2) and (3) (the "Income Tests") 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 the 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 822-823 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 either be considered as not constituting gross income under section 856(c)(2) or (c)(3) or as qualifying gross income under those provisions.

Excluding the Section 481(a) Adjustments from Taxpayer's gross income for purposes of section 856(c)(2) and (c)(3) does not interfere with Congressional policy objectives in enacting the Income Tests. Accordingly, pursuant to section 856(c)(5)(J)(i), the Section 481(a) Adjustments will not constitute gross income for purposes of section 856(c)(2) and (c)(3).

Ruling Request 2: **To the extent that the Section 481(a) Adjustments exceed the correlative E&P adjustments arising from the change in computing depreciation and amortization, any distributions of such excess (that are distributed and treated as dividends by Taxpayer) shall be treated as made from 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, 1976-2 C.B. 528. Due to differences in computing depreciation for E&P purposes versus income tax purposes, Taxpayer's correlative adjustments to its E&P are lower than the Section 481(a) Adjustments.

The Section 481(a) Adjustments are subject to the section 1374 built in gains tax, which is not eliminated or reduced by the dividends paid deduction. Under section 337(d), section 1.337(d)-7 of the Income Tax Regulations, section 1374, and the regulations thereunder, the Section 481(a) Adjustments are subject to corporate level taxation pursuant to section 1.1374-4(b) and (d). The net amount after the application of corporate level taxation is REIT taxable income ("REITTI") subject to the distribution requirements of section 857(a).

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 REITTI 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(a)(2) generally requires that, as of the close of a taxable year, a REIT has no E&P accumulated in any non-REIT year.

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.[1]

[1] Section 1434(b) of H.R. 3838 as 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 and profits) . . . 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)."

H.R. Conf. Rep. No. 99-841, at 218 (1986). Therefore, the regime governing the taxation of REITs, which requires distributions of taxable income, is intended to match the REIT's E&P to that income.

Based on the above, to the extent that the Section 481(a) Adjustments exceed the correlative E&P adjustments arising from the Method Changes, any distributions of such excess (that are distributed and treated as dividends by Taxpayer in the year in which such excess arises) shall be treated as made from E&P.

Caveat:

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 or implied on whether Taxpayer otherwise qualifies as a REIT under subchapter M of the Code. We further express no opinion on the amount of the Section 481(a) Adjustments or Taxpayer's methods of accounting for the Assets.

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,

Susan Thompson Baker
Senior Technician Reviewer, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: