TaxNewsFlash

United States

No. 2020-382
June 12, 2020

PLR: REIT's gross income includes section 481(a) adjustments from depreciation, amortization changes

The IRS today publicly released a private letter ruling* that concludes a real estate investment trust (REIT) is required to include in gross income section 481(a) adjustments resulting from changes to depreciation and amortization of certain assets.

Pursuant to section 856(c)(5)(J), the IRS ruled that the REIT's section 481(a) adjustments would not constitute gross income for purposes of the 75% and 95% income tests.

Also, to the extent that the REIT's section 481(a) adjustments exceed the correlative earnings and profits (E&P) adjustments arising from the method changes, the IRS ruled that any distributions of such excess (that are distributed and treated as dividends by the REIT in the year in which such excess arises) would be treated as made from E&P.

Read **PLR 202024003** [PDF 137 KB] (released June 12, 2020, and dated March 11, 2020)

*Private letter rulings are taxpayer-specific rulings furnished by the IRS Office of Chief Counsel in response to requests made by taxpayers and can only be relied upon by the taxpayer to whom issued. Pursuant to section 6110(k)(3), written determinations such as private letter rulings are not intended to be relied upon by third parties and may not be cited as precedent. These written determinations may, however, offer an indication of the IRS's position on the issues addressed.

Summary

In the letter ruling, a cell tower REIT submitted an application to change its methods of accounting for depreciation and amortization of some of its assets, which were represented to be real property or interests in real property. These method changes resulted in positive section 481(a) adjustments that is to be taken into account ratably over a four-year period for purposes of computing taxable income with corresponding changes to the REIT's E&P. Due to differences in computing depreciation and amortization for E&P purposes versus for income tax purposes, the REIT's correlative adjustments to its E&P may be lower than the section 481(a) adjustments.

For an entity to qualify and maintain its REIT status, it must derive 75% and 95% of its gross income from certain statutorily defined sources (such as rents from real property, mortgage interest, loan/lease commitment fees, etc.) The IRS noted that any income resulting from a section 481(a) adjustment constitutes gross income but is not specifically enumerated as a qualifying income for purposes of the 75% and 95% income tests. The IRS exercised its authority under section 856(c)(5)(J) and ruled that the REIT's section 481(a) adjustments would not constitute gross income for purposes of the 75% and 95% income tests.

Furthermore, a REIT generally must distribute at least 90% of its "ordinary" taxable income in the form of dividends and is subject to a corporate-level tax on any undistributed taxable income. To allow a REIT to satisfy this minimum distribution requirement and to avoid corporate-level tax, Congress enacted rules under which a REIT's current E&P: (1) is not reduced by any amount that is not allowable in computing the REIT's taxable income for such tax year; and (2) is increased by tax gains on sales of real property (rather than E&P gains). For example, a corporation's net capital loss for a tax year generally reduces its current E&P even though it is not taken into account in determining the corporation's taxable income for such year.

For a REIT, the determination of its current E&P is modified so that the net capital loss does not reduce its current E&P, and the REIT may have sufficient E&P to treat distributions as dividends for purposes of satisfying the minimum distribution requirement and avoiding corporate tax. However, these E&P modification rules may not apply to all items based on a literal reading of the statutory languages. As part of the legislative process of the Tax Reform Act of 1986, the two amendments to the REIT's E&P determination were proposed during the legislative process in the Senate. The Conference Report to the 1986 tax law reflects that the Senate's amendment—to insert a new provision stating that a REIT's current E&P would not be less than its REIT taxable income before the dividends paid deduction—was not adopted, "since the conferees believe that this provision is a restatement of present law." H.R. Conf. Rep. No. 99-841, at 218-19 (1986).

The REIT represented that due to differences in computing depreciation and amortization for E&P purposes versus for income tax purposes, its correlative adjustments to its E&P may be lower than the section 481(a) adjustments for purposes of computing taxable income. The IRS cited the 1986 legislative history and stated "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." Accordingly, the IRS ruled to the extent that the REIT'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 the REIT in the year in which such excess arises) would be treated as made from E&P.

KPMG observation

Note that the IRS similarly excluded section 481(a) adjustments from the REIT's income tests pursuant to section 856(c)(5)(J) in PLRs 201652012, 201537020, 201503010, and 201301007. In these letter rulings (and including the one released today, PLR 202024003), it is clear or represented that the assets subject to the method changes are considered real property. However, it is not entirely clear whether the IRS would have ruled similarly if the section 481(a) adjustments were with respect to non-qualifying income or non-real property.

These letter rulings also suggest that the IRS is comfortable with relying on the 1986 legislative history to deem a REIT to have sufficient E&P. However, this "deemed" E&P may result in over-taxation of distributions to a shareholder until the disposition of such shares. In comparison, special E&P rules have been incorporated for REITs in regulations promulgated under other Code sections. For example, pursuant to Prop. Reg. section 1.163(j)-4(c)(1), a C corporation would not wait to reduce its E&P for business interest expense until the tax year in which a deduction for such expense is allowed. However, under Prop. Reg. section 1.163(j)-4(c)(2), a REIT's E&P would be reduced in the tax year(s) in which the business interest expense is deductible or, if earlier, in the first tax year for which it no longer is a REIT. This would eliminate the need for a REIT to rely on the “deemed” E&P with respect to its business interest expense and the risk of an over-taxation.

For more information, contact a tax professional with KPMG’s Washington National Tax:

Stephen Giordano | +1 (202) 533-3535 | stephengiordano@kpmg.com

David W. Lee | +1 (202) 533-4071 | dwlee@kpmg.com