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Person to Contact:

Telephone Number:

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This is in reply to a letter dated August 8, 2000, requesting a private letter ruling that a positive adjustment required by section 481(a) of the Internal Revenue Code ("481 adjustment") will not be taken into account to determine whether X meets the gross income tests of sections 856(c)(2) and (3) of the Code.

FACTS

This letter relates to private letter ruling 200027034, dated April 10, 2000 ("the prior letter ruling").

X is a corporation. It owns 88% of the interests in P, a partnership that owns cold storage warehouses. X intends to make the election in section 856(c)(1) of the Code (to be treated as a real estate investment trust ("REIT")) for its taxable year ending December 31, 2000.

Pursuant to Internal Revenue Service audits for the taxable years ending X depreciated some of its assets as personal property. When X transferred those assets to P, P continued the depreciation method.

The prior letter ruling concludes that the warehouses and certain assets in them are, respectively, real property and real estate assets for pertinent purposes of section 856(c) of the Code.

Pursuant to Rev. Proc. 99-49, 1999-52 I.R.B. 725, modified by Rev. Rul. 2000-4 I.R.B. 331, modified by Rev. Rul. 2000-7, 2000-9 I.R.B. 712, modified by Rev. Proc. 2000-22, 2000-20 I.R.B. 1008, X and P have filed Forms 3115 to automatically change their method of depreciating certain assets from personal property to nonresidential real property.

The automatic method change will result in a positive 481 adjustment that will be includible in taxable income over a period of four taxable years.

X and P request a ruling on the effect of the 481 adjustment for purposes of the gross income tests contained in sections 856(c)(2) and (3) of the Code.

APPLICABLE LAW and ANALYSIS

Rev. Proc. 99-49 allows an automatic change in method of accounting for the items listed in the Appendix thereto.

Under section 481(a) of the Code, a taxpayer that changes a method of accounting takes into account necessary adjustments in computing its taxable income.

Under section 1.481-1(d) of the Income Tax Regulations, a 481 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.

Section 856(a) of the Code defines the term “real estate investment trust” (“REIT”). Section 856(c)(2) provides that a REIT must derive at least 95% of its gross income from particular sources, and section 856(c)(3) provides that a REIT must derive 75% of its gross income from particular sources.

Under section 1.856-2(c)(1) of the regulations, for purposes of both the numerator and denominator in the computation of the 95% and 75% ratios, the term “gross income” has the same meaning as that term has under section 61 and the regulations thereunder; thus, for example, a loss from the sale of an asset does not enter into the computation of the ratio.

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.” The legislative history also indicates that Congress intended to equate the tax treatment of REITs with the treatment accorded to regulated investment companies (RICs).

In Rev. Rul. 64-247, 1964-2 C.B. 179, a RIC recovered excess management fees from its investment manager. The recovery was made as a result of legal action brought against the company’s former officers and directors who had owned the investment manager. In Rev. Rul. 74-248, 1974-1 C.B. 167, a RIC’s former investment advisor paid the company an amount the advisor had improperly received for assigning its advisory contract. The payment was made pursuant to a settlement agreement that was reached after the company’s shareholders filed a derivative action against the investment advisor. In both rulings, the amounts in question were includible in gross

income under section 61 of the Code. Those amounts were not, however, income from sources that, at the time the rulings were published, were described in section 851(b)(2) of the Code. The rulings hold, nevertheless, that the companies' inclusion of the amounts in gross income did not cause the companies to fail to meet the definition of a RIC contained in section 851, provided the companies in all other respects qualified for RIC status for the tax year in question.

Rev. Rul. 64-247 and Rev. Rul. 74-248 were rendered obsolete, in part, for purposes of section 851 by Rev. Rul. 92-56, 1992-2 C.B.153, which holds that if, in the normal course of its business, a RIC receives a reimbursement from its investment advisor and the reimbursement is included in the RIC's gross income, the reimbursement is qualifying income under section 851(b)(2). Although Rev. Rul. 92-56 provides that the prior revenue rulings are, in part, obsolete, those revenue rulings remain instructive in determining whether the inclusion of the 481 adjustment should cause X to be disqualified from REIT status.

Similarly, in the present situation the section 481 adjustment should not affect X's status as a REIT.

CONCLUSION

The 481 adjustment in the instant case will not be taken into account to determine whether X meets the gross income tests of sections 856(c)(2) and (3) of the Code.

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.

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.

A copy of this letter must be attached to any income tax return to which it is relevant.

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

Sincerely,
Acting Associate Chief Counsel
(Financial Institutions & Products)
By: William E. Coppersmith
Chief, Branch 2