

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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May 12, 2005

Legend:

Taxpayer =

State A =

Date 1 =

Date 2 =

x =

\$a =

\$b =

Date 3 =

\$c =

Dear :

This is in reply to a letter dated September 1, 2004, and a subsequent submission, requesting a ruling on behalf of Taxpayer. The requested ruling concerns Taxpayer's ability to pay capital gains dividends and thereby preserve a portion of its net operating loss (NOL) for its taxable year ended Date 2.

**Facts:**

Taxpayer is a State A corporation that elected to be taxed as a real estate investment trust (REIT) under sections 856 – 859 of the Internal Revenue Code, effective Date 1. Taxpayer is engaged in the business of x.

For its taxable year ended Date 2, Taxpayer had a net capital gain of approximately \$a. For the same taxable year, Taxpayer generated a net operating loss of approximately \$b, not taking into account Taxpayer's net capital gain.

In Forms 1099 issued to shareholders on Date 3, Taxpayer designated \$c of its distributions as capital gain dividends for the taxable year ended Date 2. Taxpayer made no other distributions for the taxable year ended Date 2. Taxpayer represents that it had no accumulated earnings and profits, as calculated under section 312, at the start of the taxable year ended Date 2. Furthermore, Taxpayer would not have had sufficient current earnings and profits to treat as a dividend the amount that it designated as capital gain dividends.

**Law and Analysis:**

Section 857(a)(1) requires, in part, that a REIT's deduction for dividends paid for a taxable year equal at least 90 percent of its real estate investment trust taxable income for the taxable year, excluding any net capital gain. REIT taxable income is defined in section 857(b)(2) as the taxable income of the REIT, with certain specified adjustments. Under this definition, net capital gain is included in determining REIT taxable income.

Section 857(b)(3)(B) provides that a capital gain dividend will be treated by shareholders as a gain from the sale or exchange of a capital asset held for more than one year. Section 857(b)(3)(C) defines a "capital gain dividend" as any dividend, or part thereof, which is designated by the REIT as a capital gain dividend in a written notice mailed to its shareholders . . . at any time before the expiration of 30 days after the close of its taxable year. If the aggregate amount designated as a capital gain dividend is greater than the REIT's net capital gain for the taxable year, the portion of each distribution which shall be a capital gain distribution will only be that portion of the amount so designated which such net capital gain bears to the aggregate amount so designated.

Section 172(c) provides that a "net operating loss" is the excess of deductions allowed by Chapter 1 of the Code over gross income. With respect to net losses of a REIT, section 172(d) provides that the net operating loss for a REIT's taxable year will be computed taking into account adjustments described in section 857(b)(2) (other than the deduction for dividends paid described in section 857(b)(2)(B)).

Section 857(b)(3)(E) provides that, for purposes of section 172, if a REIT pays capital gain dividends during any taxable year, the amount of the net capital gain for such taxable year (to the extent such gain does not exceed the amount of such capital gain dividends) shall be excluded in determining the net operating loss for the taxable year, and the amount of the net operating loss of any prior taxable year which may be carried through such taxable year under section 172(b)(2) to a succeeding taxable year.

Prior to 1986, REITs determined their taxable income by combining capital gains with their other income (or losses). Section 857(b)(3)(C), as it then existed, provided that for purposes of determining the amount of capital gains dividends that could be paid, the REIT's net capital gain could not exceed REIT taxable income for the taxable year, determined by taking into account the net operating loss deduction but not the deduction for dividends paid.

The Tax Reform Act of 1986, P.L. 99-514, eliminated the aforementioned provision in section 857(b)(3)(C) and added section 857(b)(3)(E). In doing so, the legislative history indicates that

[t]he Congress believed that a fundamental purpose for permitting conduit treatment of REITs is to enable small individual investors the opportunity to invest in a professionally managed diversified portfolio of real estate assets. Hence, Congress believed that if a REIT is required to offset its capital gain income with net operating losses, individual investors routinely are denied the benefit of capital gain treatment that they would receive if they were able to hold real estate assets directly. Thus, the Act provides that REITs may preserve the availability of capital gains treatment even if they have net operating losses.

Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 99<sup>th</sup> Cong., 385 (Comm. Print, 1987).

Based upon the language of section 857(b)(3)(E) and the legislative history underlying the statute, Taxpayer may designate all of its distributions for its taxable year ended Date 2, as capital gain dividends, and thereby cause an amount of net capital gain equal to the designated capital gain dividends to be excluded under section 857(b)(3)(E) in determining its NOLs for the taxable year.

#### **Other Information:**

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences related to the facts herein under any other provisions

of the Code. Specifically, we do not rule whether Taxpayer will otherwise qualify as a REIT under part II of subchapter M of Chapter 1 of the Code.

This ruling is directed only to the taxpayer requesting it. Taxpayer should attach a copy of this ruling to each tax return to which it applies. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent. In accordance with a Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

William E. Coppersmith  
William E. Coppersmith  
Chief, Branch 2  
Office of Associate Chief Counsel  
(Financial Institutions & Products)