Internal Revenue Service

Index Number: 856.01-00

Number: **200039027**
Release Date: 9/29/2000

Department of the Treasury

Washington, D.C. 20224

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CC:DOM:FI&P:1-PLR-103237-00
Date:
June 29, 2000

Legend:

Taxpayer =

LP1 =

LP2 =

LP3 =

LLC1 =

LLC2 =

LP4 =

a =

b =

Year 1 =

County =

LP5 =

LP6 =

Corporation =

Date 1 =

c =

Year 2 =

Mall A =

Mall B =

Month =

Date 2 =

d =

e =

f =

g =

h =

i =

Dear :

This is in reply to a letter dated February 2, 2000, requesting a ruling on behalf of Taxpayer. The requested ruling is that Taxpayer's allocable share of payments received by LP1 resulting from the settlement of a lawsuit and other legal claims described below are not includible in Taxpayer's gross income solely for purposes of the gross income tests described in §§ 856(c)(2) and 856(c)(3) of the Internal Revenue Code.

Facts:

Taxpayer is a domestic corporation that elected to be taxed as a real estate investment trust (REIT) in 1993, and has operated as a REIT since its election. Taxpayer conducts its business operations primarily through a limited partnership, LP1, of which Taxpayer owns approximately a percent of the interests. LP1 owns, develops, leases, and manages upscale and fashion-oriented manufacturers' outlet centers.

In Year 1, LP1 and LP2 agreed to jointly develop and own a manufacturers' outlet and shopping mall, Mall A, in County. Mall A was to be owned by LP3, a limited partnership formed by LP1 and LP2 for this purpose. LP3 closed on the purchase of land in early Month and proceeded with plans to construct the Mall A, including negotiating construction financing.

LLC1 is the general partner of LP3. LP1 and LP4 are the members of LLC1, which is treated as a partnership for federal income tax purposes. LLC2 and LP4 are the limited partners of LP3. LP1 is the sole member of LLC2, which is a disregarded entity for federal income tax purposes. LP4 is owned by LP2 and affiliates. Consequently, LP1 and LP2 and its affiliates indirectly each own b percent of the interests in LP3.

LP5 is a limited partnership whose general partner is Corporation. LP5 is in the business of developing and owning shopping centers that typically include various discount or off-price retailers, manufacturers' outlets, restaurants and entertainment venues. In Month, LP5 filed a lawsuit seeking injunctive relief and damages against Taxpayer, LP1, LP2, and LP3. The lawsuit alleged that:

In response to the lawsuit, the allegations of the lawsuit were denied and LP3 prepared (but ultimately did not file) a counterclaim requesting damages and injunctive relief from LP5,

The counterclaim, as drafted, identified three categories of damages, other than punitive damages, which were allegedly suffered as a result of the actions of LP5 and Corporation. Specifically, the identified damages were: 1) attorneys' fees and expenses; 2) construction delay damages caused by the actions of LP5 and Corporation that halted construction of Mall A; and 3) loss of future rental income due to potential tenants refusing to sign lease agreements while Mall A was embroiled in controversy and litigation. Although no dollar amounts were specified, Taxpayer concluded that LP3's damages could reach d dollars if construction was delayed 30 days and that the entire project would be jeopardized if construction was delayed 60 days or more.

In addition to pursuing their respective legal remedies, Taxpayer, LP1, LP3, and LP5, recognizing the high cost and economic harm that would result from the lawsuit and counterclaim, began discussing a possible settlement. On Date 2, Taxpayer, LP1, LP2, LP3, LP4, LP5, Corporation, and LP6 entered into an agreement (the Settlement Agreement) settling the lawsuit and related claims, including claims related to the development of Mall A. The parties entered into the Settlement Agreement before the counterclaim was filed with the court.

Under the Settlement Agreement, LP1 agreed to sell, transfer, and assign all of its right, title, and interest in and to LLC1 and LLC2 to LP6. The Settlement Agreement states that it was LP1's intention to transfer to LP6 all of its interests and rights in Mall A. In exchange, LP6 agreed to reimburse LP1 for all direct expenses incurred by LP1 in connection with Mall A (including costs relating to the lawsuit) and 50 percent of all third party development and construction costs incurred by LP1 on behalf of or by LP3 with respect to Mall A, provided that the total expenses to be reimbursed did not exceed $e. In addition to the $e transferred to LP1 as an expense reimbursement, the Settlement Agreement provided for a transfer by LP6 to LP1 of $f as consideration for LP1 transferring its indirect interests in LP3 to LP6. The Settlement Agreement also contains a restrictive covenant under which LP1, LP2, and LP3 agree not to open a large manufacturers' outlet type shopping center within a given radius of the proposed site of Mall A through 2002. The given radius of the restriction changes each year. In consideration for LP1's agreement to enter into the restrictive covenant, LP6 agreed to pay LP1 $g, including $h upon signing the agreement, and four annual payments of $i. The $g settlement amount equals Taxpayer's projection of the net present value of what would have been LP1's portion of the net cash flow from Mall A for 20 years.

The Settlement Agreement also requires LP1 to terminate all existing contracts relating to the construction of Mall A, including all tenant leases and permits LP5 to enter into leases with any tenants whose leases were terminated by LP1.

Law, Analysis and Conclusion:

Section 856(c)(2) of the Code provides that in order for a corporation to be considered 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 in which the corporation is a dealer), abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees, and gain from certain sales or other dispositions of real estate assets (the "95 percent gross income test").

Under § 856(c)(3) of the Code, 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 real property, gain from the sale or other disposition of real property (other than property in which the corporation is a dealer), dividends from REIT stock and gain from the sale of REIT stock, abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees, gain from certain sales or other dispositions of real estate assets, and qualified temporary investment income (the "75 percent gross income test").

Section 61(a) of the Code provides that, except as otherwise provided, gross income includes all income from whatever source derived.

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 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 § 61 of the Code. Those amounts were not, however, income from sources that, at the time the rulings were published, were described in § 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 § 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 § 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 § 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 how the settlement payments should be treated for purposes of § 856(c).

In view of the legislative intent to equate the tax treatment of REITs with that of RICs, it is appropriate to apply the rationale of Rev. Rul. 64-247 and Rev. Rul. 74-248 in a REIT context. There is nothing in the legislative history or any statutory interpretation that would indicate that by imposing parameters on the sources from which REITs and RICs may derive income Congress intended to discourage REITs and RICs from pursuing legal remedies from which damages may be collected.

In this case, the dispute that resulted in the Settlement Agreement concerned the development of real property that likely would have produced qualifying income under § 856(c)(3). The intervening dispute and settlement should not cause the payments received by Taxpayer through its interest in LP1 to be treated as nonqualifying income. Accordingly, we conclude that Taxpayer's allocable share of the payments received by LP1 under the Settlement Agreement are not includible in Taxpayer's gross income for purposes of determining whether Taxpayer has satisfied the gross income tests under §§ 856(c)(2) and 856(c)(3).

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 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.

Sincerely yours,
Assistant Chief Counsel
(Financial Institutions and Products)
By: Alvin J. Kraft
Chief, Branch 1

Enclosures:
Copy of this letter
Copy for § 6110 purposes