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Department of the Treasury

Washington, DC 20224

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Date:
April 4, 2001

Legend:

Trust A =

Trust B =

Partnership A =

Partnership B =

a =

Date 1 =

Month A =

Month B =

Date 2 =

x =

y =

Dear :

This is in reply to a letter dated December 1, 2000, and subsequent correspondence, submitted by your authorized representative requesting a ruling on behalf of Trust A. The requested ruling is that Trust A's allocable share of a payment received by Partnership A under a Termination Agreement, described below, and pursuant to a Merger Agreement, described below, is not includible in Trust A's gross income for purposes of determining whether Trust A has satisfied the gross income tests of §§ 856(c)(2) and (c)(3) of the Internal Revenue Code.

Facts:

Trust A is a publicly traded real estate investment trust (REIT) that elected to be taxed as a REIT in 1996 and has acted in a manner consistent with the provisions of §§ 856 - 860 of the Code since that time. Trust A is the sole general partner (through a wholly-owned direct subsidiary) of Partnership A and has an a percent ownership interest in Partnership A. Through its ownership interest in Partnership A, Trust A develops, leases, and manages office and industrial real estate properties across the United States.

On Date 1, Trust A and Partnership A entered into an Agreement and Plan of Merger (Merger Agreement) with Trust B, a REIT, and Partnership B, a limited partnership in which Trust B is the sole general partner. Pursuant to the Merger Agreement, Trust A agreed to merge with and into Trust B, with Trust B as the survivor. The Merger Agreement also provides that immediately prior to the merger of Trust A into Trust B, Partnership A would merge with and into Partnership B, with Partnership B continuing as the surviving partnership.

The Merger Agreement provides that the Merger Agreement may be terminated by either Trust A or Trust B, or both, at any time prior to the merger of the partnerships upon the occurrence of one of several events. One such event, as provided in the Merger Agreement, is that either Trust A or Trust B may terminate the Merger Agreement if the shareholders of Trust B do not approve the Merger Agreement at a duly held shareholder's meeting. The Merger Agreement provides that in such event, Trust B and Partnership B shall pay Partnership A an amount equal to the "Break-Up Fee."

The Merger Agreement defines the Break-Up Fee as x dollars less certain Break-Up Expenses, to the extent that the recipient of the Break-Up Fee can receive the amounts without causing the recipient to violate the REIT gross income tests of § 856(c). The Merger Agreement provides, in part, that the payment of the Break-Up Fee shall be compensation for the loss suffered by the applicable party as a result of the failure of the merger to be consummated (including, without limitation, opportunity costs and out-of-pocket costs and expenses) and to avoid the difficulty of determining damages under the circumstances.

After execution of the Merger Agreement, Trust B realized that its shareholders would not approve the merger with Trust A. As a result, Trust B expressed its desire to renegotiate certain provisions of the Merger Agreement. Trust A maintained a position that additional consideration would be necessary for it to renegotiate and amend the

Merger Agreement.

During Month A and Month B, Trust A had its legal counsel explore its legal alternatives for enforcing its right to the Break-Up Fee provided in the Merger Agreement. In Month B, Trust A demanded a definitive answer from Trust B as to whether it intended to proceed with the transaction. In Month B, faced with Trust B's desire to terminate the Merger Agreement and the mutual desire to bring quick and economical resolution to the differences between the parties, Trust A and Trust B began discussing a settlement.

On Date 2, the parties terminated the Merger Agreement. The same day, the parties to the Merger Agreement executed an agreement styled "Termination and Release Agreement" (Termination Agreement). Under the Termination Agreement, the parties agreed to terminate the Merger Agreement and agreed that Trust B and Partnership B would pay to Partnership A a Break-Up Fee of y dollars. Trust B then deposited y dollars in escrow for the benefit of Trust A. All parties to the Termination Agreement agreed to hold each other harmless for all present and future causes of action and liabilities of any kind arising from the proposed merger transaction. The Termination Agreement states that it is ". . . a settlement and compromise of disputed claims and nothing described herein is to be considered an admission of liability on the part of any of the Parties."

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.

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.

Under § 1.856-3(g) of the Income Tax Regulations, a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and to be entitled to the income of the partnership attributable to that share. For purposes of § 856, the interest of a partner in the partnership's assets is determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership retain the same character in the hands of the partners for all purposes of § 856.

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 payment 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 for which damages may be collected.

In the present case, the income at issue is derived from Trust A pursuing its legal remedies resulting in the settlement of an alleged breach of a contract for Trust A to merge into Trust B. Consequently, the dispute and settlement should not cause Trust A's allocable share of the y dollars payment to be considered nonqualifying for purposes of § 856(c)(2) and (3). Accordingly, we conclude that Trust A's allocable share of the y dollars payment received by Partnership A pursuant to the Merger Agreement and the Termination Agreement is not includible in Trust A's gross income for purposes of determining whether Trust A has satisfied the gross income tests under §§ 856(c)(2) and 856(c)(3) of the Code.

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences related to the facts herein under any other provision of the Code. Specifically, we do not rule whether either Trust A or Trust B qualifies 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. Trust A 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,

Acting Associate Chief Counsel
(Financial Institutions and Products)

By:_________________
Alvin J. Kraft
Chief, Branch 1

Enclosures:
Copy of this letter
Copy for § 6110 purposes