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Date:
April 24, 2009

LEGEND:

Taxpayer =

Company =

A =
B =
C =
D =
E =
F =
Date =
Agreement 1 =
Agreement 2 =

Dear :

This is in reply to a letter dated October 24, 2008, and subsequent communications on behalf of Taxpayer requesting a ruling with respect to whether amounts received by the Taxpayer as management fees include, for purposes of the gross income test of section and 856(c) of the Internal Revenue Code, the portion of those fees returned to its customer pursuant to an agreement.

Taxpayer, which uses the accrual method of accounting on a calendar year basis, is a self-administered real estate investment trust (REIT) operating as a fully integrated real estate company which acquires, develops, leases and manages shopping centers. Taxpayer owns and manages A retail operating and development properties in B states in the U.S., as well as in C, D, E and F. Taxpayer is a partner in Company, a joint venture, and in that capacity on Date, entered into Agreement 1 to receive fees to provide property management services for Company. Pursuant to Agreement 2, if Company's net operating income is below a certain level for the year beginning with the closing date of Agreement 1, during that year Taxpayer is required to repay Company a portion of those fees. Similarly, if Company's net operating income is below a certain level for the second year after the closing date of Agreement 1, during that year Taxpayer is required to repay Company a portion of those fees.

Law and Analysis

Section 856(c)(2) provides that a REIT must derive at least 95 percent of its gross income (excluding income from prohibited transactions) from certain enumerated sources, including dividend, interest, and rents from real property. Section 856(c)(3) provides that a REIT must derive at least 75 percent of its gross income (excluding income from prohibited transactions) from certain enumerated real estate sources, including rents from real property and qualified temporary investment income. Section 1.856-2(c)(1) of the Income Tax Regulations provides that the term gross income has the same meaning as that term has under section 61 and the regulations thereunder.

Section 61 provides that generally gross income includes all income from whatever source derived. In Commissioner v. Glenshaw Glass Co., 348 U. S. 426, 431 (1955), the Court held that payments were income to the recipients because they were “accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”

Purchase price adjustments and rebates are an exception to the broad definition of gross income. Generally, when a payment is made by a seller to a customer as an inducement to purchase the property, the payment does not constitute income but instead is an adjustment to the cost or price of the property. The payment is, in effect, a means by which the buyer and seller reach an agreed upon net price. In Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), nonacq. 1959-2 C.B. 8-9, nonacq. withdrawn and acq. 1962-2 C.B. 5-7, acq. withdrawn and nonacq. 1976-2 C.B. 3-4, and nonacq. withdrawn in part and acq. in part 1982-2 C.B. 2, the Tax Court concluded that allowances that a milk producer paid to buyers lowered the selling price of the milk for income tax purposes and held that only the net price was includable in the seller’s gross income. The court stated:

> It does not follow, of course, that all allowances, discounts, and rebates made by a seller of property constitute adjustments to the selling prices.

> Terminology, alone, is not controlling, and each type of transaction must be analyzed with respect to its own facts and surrounding circumstances. Such examination may reveal that a particular allowance has been given for a separate consideration -- as in the case of rebates made in consideration of additional purchases of specified quantity over a specified subsequent period; or as in the case of allowances made in consideration of prepayment of an account receivable, so as to be in effect a payment of interest. The test to be applied, as in the interpretation of most business transactions, is: What did the parties really intend, and for what purpose or consideration was the allowance actually made? Where, as here, the intention and purpose of the allowance was to provide a formula for adjusting a specified gross price to an agreed net price, and where the making of such adjustment was not contingent upon any subsequent performance or consideration from the purchaser, then, regardless of the time or manner of the adjustment, the net selling price agreed upon must be given recognition for income tax purposes. Pittsburgh Milk at 717.

See also, Dixie Dairies Corporation v. Commissioner, 74 T.C. 476 (1980), acq.,1982-2 C.B. 1.

More recent cases have applied a similar analysis. In Sun Microsystems, Inc. v. Commissioner, T.C. Memo 1993-467, the taxpayer manufactured computer work stations and granted stock warrants to a customer. The customer could exercise the stock warrants if it purchased a certain volume of workstations within a certain time. The customer met the volume purchase requirements and exercised the warrants. The Tax Court concluded that the stock warrants were issued to induce the customer to purchase a certain volume of computer workstations. The Tax Court further concluded that the taxpayer correctly treated the value of the warrants as a sales discount or allowance, excludable from gross sales. In so concluding, the court stated that a specified dollar amount of an allowance or discount is not necessary for a finding of an agreed net price, if a mechanism exists for the establishment of a price in the purchase arrangement.

Rev. Rul. 2008-26, 2008-21 C.B. 985, involves rebates paid by a pharmaceutical manufacturer pursuant to the Medicaid Rebate Program established by the Omnibus Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990). Under the Act, pharmaceutical manufacturers must sign a Rebate Agreement that requires the manufacturer to pay rebates directly to the State Medicaid Agency. Under the program the following events occur: (1) the manufacturer (M) sells a pharmaceutical (Product D) to a wholesaler (W); (2) W sells Product D to a retail pharmacy (R); (3) R dispenses Product D to a Medicaid beneficiary and then files a reimbursement claim with the State Medicaid Agency (S); (4) S approves the claim and then reimburses R for the cost of Product D, plus a dispensing fee; and (5) M pays the Medicaid Rebate to S pursuant to the Medicaid Rebate Agreement. The ruling concludes that, under the purpose and

intent test of Pittsburgh Milk, the Medicaid Rebate is a factor used in setting the actual selling price, negotiated and agreed to before the sale to W takes place. The revenue ruling holds that a Medicaid Rebate that the manufacturer pays to the State Medicaid Agency is an adjustment to the sales price of the pharmaceutical in calculating the manufacturer's gross receipts.

In the instant situation, under the purpose and intent test of Pittsburgh Milk, a payment that Taxpayer makes to Company under the Agreement if certain income levels are not achieved by Company is a factor used by Taxpayer and Company to reach an agreed price for the property management services, negotiated and agreed to before the Taxpayer undertakes the services. Accordingly, based on the information provided and the representations made, we conclude that the payment that Taxpayer makes to Company under the Agreement is an adjustment to the price for the property management services in calculating Taxpayer's gross income.

Further, the payment that Taxpayer makes to Company under the Agreement must be taken into account in the taxable year in which the all events test of section 461 is met. Section 1.461-1(a)(2) of the regulations provides that under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(h)(1) provides that, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

Section 1.461-4(g)(3) provides that if the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed. This subparagraph applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold.

The adjustment to the price for the property management services is in the nature of a rebate. Therefore, the adjustment must be taken into account by Taxpayer in the taxable year in which all events have occurred to establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability (that is, when payment is made to Company). Accordingly, the portion of the property management services fees repaid

to the Company results in a reduction of Taxpayer's gross income in the years in which the repayment occurs.

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. Specifically, we do not rule whether Taxpayer otherwise 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. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

David B. Silber
David B. Silber
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)