

Internal Revenue Service

Number: **202522001**

Release Date: 5/30/2025

Index Number: 856.01-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:FIP:B02

PLR-115566-24

Date:

March 03, 2025

LEGEND:

Taxpayer =

Buyer =

State =

Taxable Year =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

a =

b =

c =

d =

e =

f =

Dear :

This is in reply to a letter dated August 29, 2024, and supplemental correspondence submitted on behalf of Taxpayer by its authorized representatives. Taxpayer requests a ruling under section 856 of the Internal Revenue Code (“Code”) regarding the treatment of the Deposit and Legal Fee Settlement (defined below) for purposes of section 856(c)(2) and (3) (the “Gross Income Tests”). Specifically, Taxpayer requests a ruling that any gross income arising from the Deposit and Legal Fee Settlement not be includable in Taxpayer’s gross income for purposes of determining whether Taxpayer has satisfied the Gross Income Tests.

Facts

Taxpayer is a State corporation that has elected to be treated as a real estate investment trust (“REIT”) beginning with Taxable Year. Taxpayer’s assets include a multi-family residential properties (the “Properties”), which are held through disregarded entities or a partnership (the “Affiliates”). Taxpayer represents that substantially all income derived from the Properties is qualifying income for the purposes of the Gross Income Tests.

Effective Date 1, Taxpayer and the Affiliates entered into an agreement to sell the Properties to Buyer for a sale price, as amended, of \$b (the “Agreement”). Taxpayer has represented that the gain from selling the Properties under the Agreement would have been qualifying income under the Gross Income Tests. The Agreement required Buyer to place \$c in escrow as an earnest money deposit (the “Deposit”), which was described by the terms of the Agreement as a credit toward the total purchase price and was to be released from escrow to Taxpayer once all conditions of closing were satisfied. The Agreement also specified that if closing were not to occur due to Buyer’s default, Taxpayer’s legal remedies would be limited to the retention of the Deposit as liquidated damages. Under these circumstances, the Agreement noted that the Deposit was intended to represent a reasonable measure of Taxpayer’s damages resulting from a termination of the Agreement due to a Buyer default.

Buyer failed to appear at the closing on Date 2. Taxpayer treated this as a Buyer default and demanded that the Deposit be released from escrow. Buyer objected and several years of litigation followed. The trial court determined that Buyer had breached

the Agreement by failing to appear at the closing but held that the liquidated damages provision was unenforceable. The trial court did, however, award Taxpayer and the Affiliates \$d in legal fees in response to a post-trial motion filed by Taxpayer.

Both parties appealed the trial court's decision. On Date 3, the appellate court affirmed that Buyer breached the Agreement, affirmed the award and amount of legal fees, but also enforced the liquidated damages clause of the Agreement. Following the appellate decision, Taxpayer, the Affiliates, and Buyer reached a settlement (the "Settlement") comprised of the Deposit plus a negotiated sum of \$e (an amount less than \$d) in lieu of the legal fee amount awarded by the courts (the "Legal Fee Settlement"), for a total of \$f. The Deposit and Legal Fee Settlement were received by the Taxpayer on Date 4 and Date 5, respectively.

Law

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from certain passive sources which include the gain from the sale or other disposition of stock, securities, and real property (including interests in real property and interests in mortgages on real property) which is not property described in section 1221(a)(1).

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from certain real estate sources, including the gain from the sale or other disposition of stock, securities, and real property (including interests in real property) which is not property described in section 1221(a)(1).

Section 856(c)(5)(J) provides that, to the extent necessary to carry out the purposes of part II of subchapter M of Chapter 1 of the Code (the "REIT Provisions"), the Secretary is authorized to determine whether any item of income or gain which — (i) does not otherwise qualify under section 856(c)(2) or (3) may be considered as not constituting gross income for the purposes of section 856(c)(2) or (3), or (ii) otherwise constitutes gross income not qualifying under sections 856(c)(2) or (3), may be considered as gross income which qualifies under section 856(c)(2) or (3).

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT's gross income should largely be derived from passive sources. 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."

Analysis

In this case, income attributable to the Deposit and Legal Fee Settlement constitutes gross income that is not listed as qualifying income under section 856(c)(2) or (c)(3).

With respect to the portion of the Settlement attributable to the retained Deposit, the Agreement between Buyer and Taxpayer specified that the Deposit was for Taxpayer's damages resulting from Buyer's breach of contract. The damages were derived from the attempted sale of the Properties, the gain from which would have been considered qualifying gross income under the Gross Income Tests had the sale of the Properties occurred. Taxpayer's receipt of the Deposit under these circumstances should not cause any portion of the Deposit to be treated as nonqualifying income. Excluding the Deposit from Taxpayer's gross income for purposes of the Gross Income Tests does not interfere with the Congressional policy objectives in enacting the Gross Income Tests under those provisions and would carry out the purposes of the REIT Provisions.

With respect to the Legal Fee Settlement, as noted above, the sale of the Properties (i.e., the origin of the dispute between Taxpayer and Buyer) would have produced qualifying income to Taxpayer if consummated. Given that the Legal Fee Settlement represents a partial reimbursement to Taxpayer of its court-determined legal fees incurred as a result of this real estate dispute, receipt of the Legal Fee Settlement should not result in nonqualifying income to Taxpayer. Excluding the Legal Fee Settlement from Taxpayer's gross income for purposes of the Gross Income Tests does not interfere with the Congressional policy objectives in enacting the Gross Income Tests under those provisions and would carry out the purposes of the REIT Provisions.

Conclusion

Based on the facts and representations submitted, we rule that, pursuant to section 856(c)(5)(J)(i), Taxpayer may exclude the Deposit and Legal Fee Settlement from gross income for purposes of the Gross Income Tests.

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. Except as specifically ruled upon above, no opinion is expressed or implied concerning any federal income tax consequences relating to the facts herein under any other provision of the Code. Specifically, we do not rule whether Taxpayer otherwise qualifies as a REIT under 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 the

provisions of a Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Bernard J. Audet, Jr.
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: