

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

a =

b =

c =

d =

e =

f =

g =

Transaction 1 =

Transaction 2 =

Transaction 3 =

Lawsuit 1 =

Lawsuit 2 =

Lawsuit 3 =

Lawsuit 4 =

Lawsuit 5 =

Consequence 1 =

Consequence 2 =

Dear :

This ruling responds to a letter dated September 9, 2022, and subsequent correspondence, requesting a ruling on behalf of Taxpayer. Taxpayer requests a ruling that its D&O Insurance Proceeds (defined below) will not be treated as gross income for purposes of section 856(c)(2) and (c)(3) of the Internal Revenue Code (the Code).

FACTS

Taxpayer is a State corporation that elected to be taxed as a real estate investment trust ("REIT") within the meaning of section 856(a) beginning with its first taxable year ended Date 1. Parent is a publicly traded REIT which owns an a percent indirect interest in Taxpayer through Operating Partnership. Operating Partnership is a State limited partnership that is treated as a partnership for U.S. federal income tax purposes.

Taxpayer is in the business of owning and leasing Assets, which Taxpayer represents are primarily composed of real property for purposes of section 856. Taxpayer represents that it has qualified as a REIT under section 856 beginning with the year in which Taxpayer first elected to be taxed as a REIT and every year thereafter.

On Date 2, Company and Parent engaged in Transaction 1, Transaction 2, and Transaction 3. Transaction 3 resulted in Parent leasing a substantial portion of Assets to Company. Immediately after Transaction 3, approximately b percent of the gross income of Parent, Operating Partnership, and Parent's direct and indirect subsidiaries (collectively, the "Enterprise") was derived from rent payments made by Company. At all times since Transaction 3, at least c percent of the gross income of the Enterprise has been derived from rent payments made by Company.

In Year, Lawsuit 1, relating to Transaction 1, Transaction 2, and Transaction 3, was filed. On Date 3, the court in Lawsuit 1 entered Judgment. On Date 4, as a result of Judgment, Consequence 1 occurred, which resulted in Consequence 2. Consequence 2 led certain of Parent's shareholders to bring Lawsuit 2, Lawsuit 3, Lawsuit 4, and Lawsuit 5.

As is customary among publicly traded companies, Parent purchases insurance policies for certain potential losses that may arise in the ordinary course of business, including Directors, Officers and Corporate Liability Insurance (the "D&O Insurance"). Insurance such as the D&O Insurance generally is intended to protect a public company and its officers and directors from liability and related defense costs arising from certain types of lawsuits, including shareholder securities class actions and derivative lawsuits. The D&O Insurance has an aggregate coverage of d dollars for claims first made between Date 5 and Date 6 (the "Coverage Period"). The D&O Insurance for the Coverage Period covers Parent, any entity in which Parent directly or indirectly owns more than e percent of the issued and outstanding securities representing the right to vote (i.e., Taxpayer), and Parent's officers and directors.

On Date 7, a settlement agreement was reached in Lawsuit 2 for f dollars, to be funded entirely by the D&O Insurance. The D&O Insurance paid out on claims equal to the amount of the settlement plus related defense costs of approximately g dollars. Lawsuit 3 was dismissed, and the appeal of the dismissal was denied on Date 8. The D&O Insurance paid out on claims equal to the defense costs related to Lawsuit 3. On Date 9, settlement agreements were reached in Lawsuit 4 and Lawsuit 5. In connection with the settlements of Lawsuit 4 and Lawsuit 5, which remain subject to finalization of definitive settlement documents and court approval, the D&O Insurance carrier has agreed to pay on claims for plaintiff's attorney's fees and the amount of the settlement plus any related defense costs. As a named defendant in Lawsuit 2, Lawsuit 3, Lawsuit 4, and Lawsuit 5 and a named insured under the D&O Insurance, Taxpayer expects to include a portion of these D&O Insurance payments relating to Lawsuit 2, Lawsuit 3, Lawsuit 4, and Lawsuit 5 (collectively, the "D&O Insurance Proceeds") in gross income.

Taxpayer represents that its and Parent's officers were acting in their fiduciary capacities in settling Lawsuit 2, Lawsuit 4, and Lawsuit 5 to avoid the costs of additional litigation in the best interests of Parent, Taxpayer, and Parent's shareholders. Taxpayer represents that the D&O Insurance Proceeds will merely restore Taxpayer to the position it would have been had no lawsuits been filed, and that Taxpayer will not receive a net financial or economic benefit therefrom. Taxpayer will not profit from the D&O Insurance Proceeds and the D&O Insurance Proceeds will not exceed Taxpayer's expenses associated with the relevant lawsuits.

LAW & ANALYSIS

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

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income 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), abatement 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.

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income 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 disposition of real estate assets, and qualified temporary investment income.

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 Secretary is authorized to determine, solely for purposes of such part, 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 purposes of section 856(c)(2) or (3), or (ii) otherwise constitutes gross income not qualifying under section 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 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 822-23 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."

Section 1.856-4(b)(5)(ii) of the Income Tax Regulations provides that the trustees or directors of the REIT are not required to delegate or contract out their fiduciary duty

to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of its property or managing or operating the property. The Trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may deal with insurance relating to the trust's property.

Taxpayer's receipt of the D&O Insurance Proceeds does not relate to the active conduct of a trade or business, but rather, is traceable to Parent's leasing of real estate assets to Company. Taxpayer represents that Parent maintains the D&O Insurance to protect Taxpayer and its directors and officers from liability and to cover related defense costs arising from certain types of lawsuits. After a settlement agreement in Lawsuit 2, was reached, Taxpayer received proceeds from the D&O Insurance to recover its expenses related to the settlement in addition to related defense and other costs. Similarly, after the appeal in Lawsuit 3 was denied, Taxpayer received proceeds from the D&O Insurance to recover related defense costs. Subject to finalization of definitive settlement documents and court approval of the settlement agreements in Lawsuit 4 and Lawsuit 5, Taxpayer will receive proceeds from the D&O Insurance to recover its expenses associated with the settlements in addition to related defense costs. The D&O Insurance Proceeds do not represent an economic enrichment to Taxpayer, but rather merely restore Taxpayer to the position it would have been in had Lawsuit 2, Lawsuit 3, Lawsuit 4, and Lawsuit 5 not occurred.

The D&O Insurance Proceeds constitute gross income to Taxpayer that is of a type not listed in section 856(c)(2) and (3). However, the consequences of Taxpayer's and Parent's fiduciaries exercising their fiduciary duty to defend and settle lawsuits stemming from Transaction 3, a real estate transaction, should not cause Taxpayer to fail to qualify as a REIT. Based on all the facts and circumstances, treating the D&O Insurance Proceeds as excluded from gross income for purposes of section 856(c)(2) and (3) does not interfere with Congressional policy objectives in enacting the income tests under those provisions.

CONCLUSION

Based on the facts submitted and representations made, we rule that, pursuant to section 856(c)(5)(J)(i), the D&O Insurance Proceeds will be excluded from Taxpayer's gross income for purposes of section 856(c)(2) and (3).

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. 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. In particular, no opinion is expressed whether Taxpayer otherwise qualifies as a REIT under subsection M, part II of Chapter 1 of the Code. Additionally, no opinion is expressed or implied whether any amount qualifies as rents from real property under section 856(d).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cite as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer's authorized representatives.

Sincerely,

Bernard Audet
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Financial Institutions & Products)

cc: