

Internal Revenue Service

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Washington, DC 20224

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Person To Contact:

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Date:

December 17, 2003

Legend:

Taxpayer =

Date 1 =

OP =

a =

b =

c =

d =

Corporation A =

Month 1 =

Date 2 =

Corporation B =

X =

Dear _____ :

This is in reply to a letter dated August 15, 2003, and subsequent submission, requesting a ruling on behalf of Taxpayer. You have requested a ruling that a "Guarantor Substitution Payment", as described below, is not includible in Taxpayer's gross income for purposes of the gross income tests under sections 856(c)(2) and (c)(3) of the Internal Revenue Code.

Facts:

Taxpayer is a publicly traded real estate investment trust (REIT) that elected to be taxed as a REIT effective for its tax year ended Date 1. Taxpayer is the general partner and owns approximately a percent of OP, a limited partnership. Taxpayer owns substantially all of its assets and conducts all of its operations through OP. As a partner in OP, Taxpayer owns or has a leasehold interest in b healthcare properties (Properties), each of which is either leased back to the prior owner of the asset or leased to a third party pursuant to a long-term triple net lease. OP owns all of the Properties either directly or through ownership interests in affiliated partnerships and limited liability companies, all of which are controlled by OP (collectively, OP).

Approximately d percent of Taxpayer's consolidated assets consist of real estate properties leased to or managed by subsidiaries of Corporation A, or entities in which Corporation A has made equity investments (the Investees). Corporation A is a publicly-held corporation whose stock is traded on a national exchange. Corporation A provides healthcare and support services through skilled nursing and assisted living centers. As a result of its relationship with Corporation A, Taxpayer's revenues and its ability to meet its debt obligations depend, in significant part, upon the ability of Corporation A and the Investees to satisfy their lease obligations. Taxpayer represents that any failure of these entities to continue their operations and/or continue to make lease payments could have a significant adverse impact on Taxpayer's operations and cash flow.

Corporation A and OP entered into a guarantee of lease agreement (the Guarantee) for each Property leased by OP to a tenant that is directly or indirectly owned by Corporation A. Each Guarantee provides that Corporation A (Guarantor)

guarantees and agrees to be personally liable for any and all sums payable under the lease by tenant and for the full performance and observance of each and every covenant and agreement of tenant contained in the lease (including all exhibits thereto) to the same extent as if guarantor were the tenant under the lease and had executed and

delivered the lease (including all exhibits attached thereto). Guarantor unconditionally and irrevocably guarantees that all sums stated in the lease to be payable by tenant will be promptly paid in full when due in accordance with the lease and the tenant will perform and observe each and every covenant and agreement in the lease required to be performed and observed by tenant.

In addition to guaranteeing the payment of amounts due under a lease, the Guarantee provides that Corporation A agrees to pay OP amounts necessary to collect amounts due under the leases or to enforce the Guarantee, including reasonable attorneys' fees.

In Month 1, Corporation A announced a plan to spin-off its eldercare businesses into a separate publicly traded company, Corporation B. The spin-off, which was completed on Date 2, included Corporation A's ownership interests in its subsidiaries and the Investees that are tenants of certain of the Properties.

Taxpayer represents that under the terms of OP's leases with Corporation A, any assignment of a lease to a party in which Corporation A has no ownership interest requires the consent of the OP related entity that owns the Property subject to the lease. If a Corporation A lease is assigned with OP's consent, the Guarantee is eliminated. However, OP is entitled to obtain guarantees from other parties in control of the new tenant. Corporation A and OP have agreed that the spin-off constituted an assignment of the affected leases that required OP's consent.

In connection with the spin-off, OP and Corporation A have entered into a letter of intent under which OP will permit the substitution of Corporation B as guarantor on six leases that Corporation B will assume and the modification of those leases in consideration for a payment from Corporation A of approximately \$x (the Guarantor Substitution Payment). The payment is includible in gross income under section 61(a).

Law, Analysis and Conclusion:

Section 61(a) of the Code 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, among other sources, "rents from real property." Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, "rents from real property."

Section 856(d)(1) defines rents from real property to include rents from interests in real property, charges for services customarily rendered in connection with the rental of real property, and rent attributable to certain leased personal property.

Section 1.856-3(g) of the Income Tax Regulations provides that a REIT that is a partner in a partnership is deemed (1) to own its proportionate share of each of the assets of the partnership, and (2) to be entitled to the income of the partnership attributable to that share. For purposes of section 856, the partner's interest in the partnership's assets is determined in accordance with the partner's capital interest in the partnership.

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 following legal action 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 repaid an amount that the advisor had improperly received for assigning its advisory contract. The payment was the result of the settlement of a shareholder's derivative action against the investment advisor. In both rulings, the amounts in question were includible in gross income under section 61. At the time that the rulings were published, the amounts received were not included in the permissible sources of income for RICs described in section 851(b)(2). The rulings hold, however, that the inclusion of the amounts received by the RICs would not cause them to fail to meet the definition of a RIC in section 851, provided that the RICs qualified for RIC status in all other respects for the taxable year in question.

Rev. Rul. 64-247 and Rev. Rul. 74-248 were rendered obsolete, in part, for purposes of section 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 section 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 section 856(c). In view of the legislative intent to equate the tax treatment

of RICs and REITs, it is appropriate to apply Rev. Ruls. 64-247 and 74-248 in a REIT context.

In the present case, the Guarantor Substitution Payment results from Taxpayer agreeing to relinquish its right to pursue its legal remedies against Corporation A under the Guarantees that served to assure payment of otherwise qualifying rental income. Although the Guarantor Substitution Payment does not qualify as rent from real property under section 856(d)(1), it is similar to the settlement payments described in Rev. Ruls. 64-247 and 74-248, which held that such payments will not to cause a RIC to fail to qualify under the income tests in section 851. Furthermore, the legislative history underlying the REIT income tests under section 856(c) indicate a concern only that a REIT's income be derived from passive sources and not from participation in an active trade or business. There is no indication that Congress intended to discourage or limit a REIT from receiving compensation from the pursuit of legal remedies for which damages may be collected.

Accordingly, based on the information submitted and representations made, we conclude that the amount received by Taxpayer as a Guarantor Substitution Payment is not includible in Taxpayer's gross income for purposes of the gross income tests under sections 856(c)(2) and 856(c)(3).

Other Information:

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of the transaction discussed in this letter. For example, no opinion is expressed concerning whether Taxpayer qualifies as a REIT under section 856 or concerning the tax status of any other entity described herein. Additionally, no opinion is expressed regarding the amount treated as a Guarantor Substitution Payment.

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.

Sincerely yours,

Associate Chief Counsel
(Financial Institutions and Products)

By: _____
Patrick E. White
Senior Counsel, Branch 1

Enclosures:
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