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Dear :

This is in response to your letter dated September 16, 2013, regarding whether payments received or to be received by Taxpayer (Company A and together with entities disregarded from Company A) from Corporation's bankruptcy estate (Corporation Estate), including amounts related to the settlement with Company B (the "Company B Settlement") will be treated either as qualifying income under section 856(c)(2) and (c)(3) of the Internal Revenue Code (Code), or excluded from gross income for purposes of the gross income tests of section 856(c)(2) and (c)(3) pursuant to section 856(c)(5)(J)(i).

### FACTS

Company A is a publicly-traded real estate investment trust (REIT) specializing in ownership and leasing of Business A, Business B, and Business C. Company A is a State A Entity that is headquartered in City.

Taxpayer's business model is to lease its properties on a triple-net basis primarily to Type X distributors and, to a lesser extent, individual operators. Its tenants operate the properties directly or sublet the properties to operators who operate Business A, Business B, and Business D, or other businesses at the properties.

As of Date 1, Taxpayer owned a properties and leased b properties from third parties. Taxpayer's c properties are located in d states. As of Date 1, approximately e of Taxpayer's owned or leased properties were previously leased to Corporation pursuant to a master lease (Master Lease), and Taxpayer derived a majority of its revenue from the leasing of these properties under the Master Lease. Landlord in the Master Lease is a qualified REIT subsidiary of Company A.

On Date 2, Corporation filed for Chapter 11 bankruptcy protection in the Bankruptcy Court. Taxpayer submitted claims of:

- (i) over \$f million in unpaid rent,
- (ii) over \$g million in real estate taxes,
- (iii) over \$h million to repair properties that were not returned in accordance with the standards provided for in the Master Lease,
- (iv) over \$i million to pay for the registration and removal of Assets on the properties that were the responsibility of the tenant pursuant to the Master Lease,

- (v) over \$j million in environmental remediation costs that were the responsibility of the tenant pursuant to the Master Lease,
- (vi) over \$k million in expenses that were incurred to enter into new arrangements with tenants,
- (vii) over \$l million in legal costs,
- (viii) over \$m million in litigation settlements that involve items such as insurance claims received by Corporation attributable to damages to Taxpayer's property that were required to be remitted to Taxpayer or used for repairs on Taxpayer's property that were not undertaken
- (ix) other items that total less than \$n million

Taxpayer expects the above amounts to increase as damages accrue. In addition, the Bankruptcy Court has not yet determined which claims submitted by Taxpayer and other creditors of Corporation will be accepted in determining Taxpayer's proportionate interest in the liquidation of the Corporation Estate. Therefore, Taxpayer believes that it is not possible at this time to determine the total amount Taxpayer will receive or to calculate the taxable income that will result from claims received from the Corporation Estate.

Taxpayer represents that some damages attributable to unpaid rent and real estate taxes may be payments attributable to rental income that have otherwise been included in Taxpayer's gross income. Some of that rental income has been offset as a bad debt expense and will be included in income when it is recovered. Some of the damages are attributable to payments that cover expenses that are capital expenditures, reimbursements of expenses that are deducted, and damages for which there may not have been any amount expended by Taxpayer as of this time.

On Date 3, Taxpayer entered into a stipulation with Corporation and with the Official Committee of Unsecured Creditors in the Bankruptcy proceedings. The stipulation was approved and made an order by the Bankruptcy Court on Date 4 (Stipulation). Pursuant to the Stipulation and Taxpayer's other pre-petition and post-petition claims, Taxpayer is entitled to recover an administrative claim capped at \$o million for the partial payment of fixed rent and performance of other obligations due from Corporation under the Master Lease from Date 2 until possession of the properties subject to the Master Lease was returned to Taxpayer effective Date 5 (Administrative Claim). Taxpayer's Administrative Claim has priority over the claims of other creditors and certain of its other claims.

The Bankruptcy Court appointed a liquidating trustee (Liquidating Trustee) to oversee the liquidation of the Corporation Estate. The Liquidating Trustee continues to oversee the Corporation Estate and pursue claims for the benefit of its creditors, including those related to the recovery of various deposits, including surety bonds, insurance policy claims and claims made to state funded reimbursement programs.

During Date 6, the Corporation Estate filed a lawsuit against Corporation's former parent, Company B, and certain of its affiliates (collectively, "Company C"), as well as the former directors and officers of Corporation (the "Company C Claim"). The Company C Claim asserted, among other claims, that Corporation's sale of assets to Company C during Date 7 constituted a fraudulent conveyance, and that the assets or their value can be recovered from Company C. In addition, the Company C Claim asserted that the former directors and officers violated their fiduciary duties to Corporation in approving and effectuating the challenged sale and are liable for money damages.

The Corporation Estate lacked sufficient funds to pursue the Company C Claim. Taxpayer decided to pursue the Company C Claim in order to realize a meaningful recovery from the Corporation Estate. As a result, during Date 8, Taxpayer entered into an agreement with the Corporation Estate to fund up to an aggregate amount of \$p million to fund the prosecution of the Company C Claim and certain Liquidating Trustee expenses incurred in connection with the wind-down of the Corporation Estate (Litigation Funding Agreement). The Litigation Funding Agreement effectively provided Taxpayer with the opportunity to share in more of the recovered proceeds than otherwise would have been the case and to recover more of Taxpayer's losses. The Litigation Funding Agreement provided Taxpayer with the following: (1) more control over the proceedings which would allow Taxpayer to protect its interests during the course of the litigation, and (2) the right to receive a portion of the recovered proceeds shortly after receipt of such proceeds by the Corporation Estate and significantly before any remaining proceeds are allocated and distributed to the unsecured creditors in the liquidation of the Corporation Estate. The Litigation Funding Agreement was agreed to by the trustee of the Corporation Estate and approved by the Bankruptcy Court.

The Litigation Funding Agreement provides that Taxpayer is entitled to receive proceeds, if any, from the successful prosecution of the Company C Claim in an amount equal to the sum of (i) all funds advanced for wind-down costs and expert witness and consultant fees plus interest accruing at q% per annum on such advances made by it; plus (ii) the greater of (a) all funds advanced for legal fees and expenses relating to the prosecution of the Company C Claim plus interest accruing at q% per annum on such advances made by it, or (b) r% of the gross proceeds from any settlement or favorable judgment obtained by the Liquidating Trustee due to the Company C Claim. Taxpayer advanced \$s million in the aggregate to the Corporation Estate pursuant to the Litigation Funding Agreement. Of the \$s million, \$t million was advanced for wind-down costs and expert witness fees and \$u was advanced for litigation costs. The Litigation Funding Agreement also provides that Taxpayer is entitled to be reimbursed for up to \$v million of its legal fees in connection with the Litigation Funding Agreement. Taxpayer has recorded on its financial statements a receivable of \$w million as of Date 1, which includes amounts advanced, accrued interest, and amounts due for reimbursable legal fees it incurred in connection with the Litigation Funding Agreement. Taxpayer's counsel has indicated to Taxpayer that the terms in the Litigation Funding Agreement

are terms similar to those in other situations where an insolvent bankrupt estate required funds to pursue a legal claim, did not have the funds to pursue the claim itself and only one creditor of the estate (in this case, Taxpayer) provided the funds needed to pursue the claim. During Date 9, Landlord assigned its rights in the Litigation Funding Agreement to Landlord Sub, an entity wholly owned by Landlord.

On Date 10, the Bankruptcy Court issued an order approving the Company B Settlement. Corporation Estate, Company C and certain directors and officers of Corporation agreed to settle the Company C Claim. The terms of the settlement include a release of the defendants from the claims alleged by the Corporation Estate in the Company C Claim and a collective payment by or on behalf of the defendants to the Corporation Estate of approximately \$x million (the Company B Settlement above).

During Date 11, Taxpayer received from the Corporation Estate \$y million from the proceeds of the Company C Claim. This was comprised of approximately \$t million related to advances for wind-down costs and expert witness and consultant fees, \$z million of accrued interest on those advances, \$aa million as a share of the proceeds received (such amount being greater than amounts advanced for legal fees and expenses plus interest accruing on such advance), \$v million for reimbursable legal fees, \$bb million for the remainder of its Administrative Claim and \$cc million of interest that had accrued on its Administrative Claim. Over time, Taxpayer had previously received approximately \$dd million from the Corporation Estate in connection with its Administrative Claim.

In addition to the amounts already received, Taxpayer expects to receive up to an additional \$ee million withheld from the proceeds of the Company C Claim by the Liquidating Trustee in connection with the alleged failure of Taxpayer to fund an advance for legal fees and expenses when properly made by the Liquidating Trustee. Taxpayer also expects to receive its allocable share of the liquidated assets of the Corporation Estate remaining after deductions for administrative expenses incurred or to be incurred by the Corporation Estate (“Remainder Share”, and collectively with all other amounts received or to be received from the Corporation Estate, the “Taxpayer Recovery”).

In summary, Taxpayer suffered damage resulting from lost rents, unpaid real estate taxes and environmental liabilities and other expenses relating to the properties previously leased to Corporation as a result of Corporation’s default under the Master Lease and its filing of bankruptcy. Taxpayer indicated in bankruptcy filings that its damages exceeded \$ff million. Taxpayer entered into the Litigation Funding Agreement which allowed the Corporation Estate to pursue legal action and enhanced Taxpayer’s claims against the limited assets of the Corporation Estate in order to substantially increase Taxpayer’s recovery of its damages resulting from the tenant’s default of its obligations under the Master Lease.

At best, it is estimated that the total of all amounts ultimately recovered by Taxpayer from the Corporation Estate would still be only a fraction of the damages incurred by Taxpayer due to Corporation's default under the Master Lease.

### LAW

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, in relevant part, that to the extent necessary to carry out the purposes of part II of subchapter M 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 (c)(3) may be considered as not constituting gross income for purposes of section 856(c)(2) or (c)(3), or (ii) otherwise constitutes gross income not qualifying under section 856(c)(2) or (c)(3) may be considered as gross income which qualifies under section 856(c)(2) or (c)(3).

Section 856(d)(1) provides that for purposes of sections 856(c)(2) and (c)(3), the term "rents from real property" includes rents from interests in real property, charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated, and rent attributable to personal property under certain circumstances specified in section 856(d)(1)(C).

Section 61(a) 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).

The staff of the Joint Committee on Taxation in its General Explanation of the Tax Legislation Enacted in the 110th Congress describes section 856(c)(5)(J) as follows: “The provision authorizes the Treasury Department to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases consistent with the purposes of the REIT provisions.” Footnote 309 of the General Explanation provides that income that is statutorily excluded from gross income computations under the provision is not intended to be within the authority to include as qualifying income. Joint Committee on Taxation Staff, General Explanation of the Tax Legislation Enacted in the 110th Congress, 110 Cong., 2d Sess. (2009), 239.

### ANALYSIS

Under the facts of this case, any amounts that Taxpayer will receive from Corporation Estate, including amounts related to the Company B Settlement, Remainder Share and Taxpayer Recovery, are not specifically described in section 856 or the regulations thereunder. The dispute that resulted in the Remainder Share was attributable to Corporation’s unpaid amounts under the Master Lease. Such amounts, if paid to Taxpayer, would have produced qualifying income under sections 856(c)(2) and (c)(3). Corporation’s bankruptcy and the intervening Company B Settlement should not cause any portions of the Remainder Share attributable to such unpaid amounts under the Master Lease to be treated as nonqualifying income. Pursuant to section 856(c)(5)(J), income may be either considered as not constituting gross income under section 856(c)(2) and (c)(3) or as qualifying gross income under those provisions. Accordingly, we conclude that the amount of Taxpayer’s allocable share of the Remainder Share that would have qualified as rents from real property as defined in section 856(d) will be treated as rents from real property under sections 856(c)(2) and (c)(3), pursuant to section 856(c)(5)(J)(ii), to the extent such amounts have not been included in the gross income of the REIT in a prior year. Furthermore, any amounts Taxpayer receives from the Taxpayer Recovery, to the extent that such amounts are treated as interest for Federal income tax purposes, will be qualifying income for purposes of section 856(c)(2), pursuant to section 856(c)(5)(J)(ii). Lastly, we rule that except as otherwise provided for here, the remainder of the Taxpayer Recovery is excluded from gross income for purposes of section 856(c)(2) and (c)(3) as provided for in section 856(c)(5)(J)(i). Under the facts of the instant case, excluding the remainder of the Taxpayer Recovery from gross income for purposes of section 856(c)(2) and (c)(3) does not interfere with Congressional policy objectives in enacting the income tests under those provisions.

CONCLUSION

Based on the facts and representations submitted by Taxpayer, we rule that:

1. The portion of the Remainder Share received or to be received by Taxpayer, in proportion to the claims accepted by the Bankruptcy Court that are attributed to the unpaid amounts of Corporation under the Master Lease that, if received, would have qualified as rents from real property as defined in section 856(d) will be treated as rents from real property under sections 856(c)(2) and (c)(3) to the extent such amounts have not been included in the gross income of the REIT in a prior year, pursuant to section 856(c)(5)(J)(ii).
2. The portion of the Taxpayer Recovery, to the extent it would otherwise be included in the gross income of Taxpayer, will be qualifying income for purposes of 856(c)(2) to the extent it is treated as interest for Federal income tax purposes, pursuant to section 856(c)(5)(J)(ii).
3. The remainder of the Taxpayer Recovery, to the extent it would otherwise be included in the gross income of Taxpayer, will be excluded from gross income for purposes of the gross income tests of sections 856(c)(2) and (c)(3), pursuant to section 856(c)(5)(J)(i).

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 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,

Jonathan D. Silver  
Jonathan D. Silver  
Assistant to the Branch Chief, Branch 2  
Office of Associate Chief Counsel  
(Financial Institutions & Products)