IRS Letter Rulings and TAMs (1954-1997), UIL No. 7704.05-00, Letter Ruling 9420013, (Feb. 15, 1994), Internal Revenue Service, (Feb. 15, 1994)

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[Code Sec. 7704]

This responds to a letter dated December 20, 1993, and prior correspondence, submitted on behalf of P, in which a ruling is requested concerning P's treatment as a publicly traded partnership under §7704 of the Internal Revenue Code.

FACTS

The information submitted discloses that P is a publicly traded partnership within the meaning of §7704(b) that was formed on d1. P is an "existing partnership" within the meaning of §1.7701-2 of the Income Tax Regulations. Substantially all of P's assets consist of a 99 percent limited partnership interest in O. O is a limited partnership that acquires and manages office, retail, and industrial real estate properties. O is not a publicly traded partnership.

Most of the real estate assets O currently owns are net leased to corporate tenants. Substantially all of P's items of income, gain, loss, etc. consist of P's distributive share from O.

Two of the properties owned by O are hotel properties. These properties, acquired by O from unrelated partnerships, were immediately net leased to the seller by those partnerships. The seller/lessee subsequently filed a petition for reorganization under Chapter 11 of the Bankruptcy Code. On d2, the seller/lessee rejected the leases, which reverted back to O. Since that time, O has attempted to sell or re-let the hotel properties and to distance itself from the day-to-day management of the properties. Toward that end, O has entered into management agreements for the operation of the two hotel properties.

Most of O's income is generated by renting real property through net lease transactions and by disposing of real property. This income passes through to P via its distributive share. P represents that gross income generated by the two hotels could exceed 15 percent of P's gross income in 1994.

LAW AND ANALYSIS

Section 7704 provides that for purposes of Title 26 and except as provided in §7704(c) , a publicly traded partnership is treated as a corporation. The term "publicly traded partnership" means any partnership if (1) interests in the partnership are traded on an established securities market, or (2) interests in the partnership are readily tradable on a secondary market (or its substantial equivalent).

Section 7704 generally applies to taxable years beginning after December 31, 1987. However, §1.7704-2 provides a transitional rule for "existing partnerships." An "existing partnership" means, among other things, a partnership that was publicly traded on December 17, 1987. In the case of an existing partnership, §7704 and the regulations thereunder apply to taxable years beginning after December 31, 1997. A partnership ceases to qualify as an existing partnership with the addition of a substantial new line of business. Section 1.7704-2

(b)(2) .

An activity conducted by a partnership in which an existing partnership holds an interest (directly or through another partnership) will be considered an activity of the existing partnership. Section 1.7704-2(f) . Therefore, O's activities are attributed to P.

A "new line of business" is any business activity of the partnership not closely related to a pre-existing business of the partnership to the extent that the activity generates income other than "qualifying income" within the meaning of §7704 and the regulations thereunder. Section 1.7704-2(d)(1) . A business activity is a pre-existing business if the partnership was actively engaged in the activity on or before December 17, 1987. Section 1.7704-2(d)(2) . Facts and circumstances determine whether a new business activity is closely related to a preexisting business of the partnership. Section 1.7704-2(d)(3) sets out the following nonexclusive list of relevant factors that tend to establish a close nexus:

(i) The activity provides products or services very similar to the products or services provided by the pre-existing business.

(ii) The activity markets products and services to the same class of customers as that of the pre-existing business.

(iii) The activity is of a type that is normally conducted in the same business location as the pre-existing business.

(iv) The activity requires the use of operating assets similar to those used in the pre-existing business.

(v) The activity's economic success depends on the success of the pre-existing business.

(vi) The activity is of a type that would normally be treated as a unit with the pre-existing business in the business, accounting records.

(vii) If the activity and the pre-existing business are regulated or licensed, they are regulated or licensed by the same or similar governmental authority.

(viii) The United States Bureau of the Census assigns the activity the same four-digit Industry SIC Code as the preexisting business.

After considering the relevant factors, we conclude that O's activity of operating the hotel properties, attributed to P under §1.7704-2(f) , is not closely related to O's (and therefore P's) pre-existing business of leasing the hotel properties. However, this does not automatically cause P to have a new line of business. As stated above, a business activity is a new line of business only to the extent that the activity generates income other than "qualifying income."

Section 7704(d)(4) provides that the term "qualifying income" includes any income that would qualify under §856(c)(2) . Section 856(c)(2) provides that a corporation, trust or association will not be considered a real estate investment trust (REIT) for a taxable year unless 95 percent of its gross income is derived from, among other sources, income and gain from foreclosure property.

Foreclosure property is defined (in relevant part) in §856(e) to include any real property (including interests in real property) acquired by the REIT as a result of it having bid on the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law after there was a default (or default was imminent) on a lease of the property. Section 856(e)(5) requires a REIT to make an irrevocable election, as provided in §1.856-6(c) , in order to treat eligible property as foreclosure property. The regulations provide that an election to treat property as foreclosure property applies to all of the eligible real property acquired in the same taxable year by the REIT upon the default on a particular lease. The

regulations also prescribe rules relating to extensions of the general two-year period prescribed in §856(e)(2) during which foreclosure property retains its status.

Section 856(e) was added to the Code in 1975 to cover circumstances that arose from a serious downturn in the real estate industry. Prior to the enactment of §856(e) , a REIT may have been inadvertently disqualified or forced to take action which was not economically sensible in order to preserve its status, in a situation in which the REIT took over real property as a result of the unanticipated default of a mortgagor or lessee, and the property yielded nonqualified income for purposes of §856(c) . Section 856(e) provides a “safe harbor” for a REIT under these circumstances and allows it to receive nonqualified income from the foreclosure property for two years after the date of acquisition of the property by the REIT without suffering disqualification as a REIT. However, under §856(e)(3) , if the REIT establishes to the satisfaction of the Service that an extension of the two-year period is necessary for the orderly liquidation of the REIT’s interest in the foreclosure property, the Service (District Director) may grant one or more extensions of the two-year period up to a date which is not later than six years after the date on which the REIT acquired the foreclosure property.

Under §1.856-6(f)(1) , all real property for which the foreclosure election has been made ceases to be foreclosure property on the first day (occurring more than 90 days after the day on which the REIT acquired the property) on which the property is used in a trade or business conducted by the REIT, other than through an independent contractor from whom the REIT does not derive or receive any income. Thus, if a REIT acquires a hotel on foreclosure, the REIT is to operate the hotel through an independent contractor during the grace period. See S. Rep. No. 1357, 93rd Cong., 2d Sess. at 16 (1974); 1975-1 C.B. 538.

Although the acquisition of foreclosure property will not cause a REIT to lose its qualification, §857(b)(4) requires a REIT holding foreclosure property to pay a tax at the highest corporate rate on the net income from foreclosure property, as defined in §857(b)(4)(B) . By taxing the net income from foreclosure property at the highest corporate rate, Congress intended to encourage REITS to change the type of income received from foreclosure property to income that qualifies under §856(c)(3) . See S. Rep. No. 1357 at 17.

In the present case, the lessee of the hotel properties filed a petition for bankruptcy and rejected the hotel leases pursuant to the §365 of the Bankruptcy Code. As a result, O reduced the properties to possession by process of law after a default on a lease, and thus would be eligible to make a foreclosure property election if it was a REIT. Through the attribution of the activities and income of O to P as provided in §1.7704-2(f) , P is eligible to treat the income from O that relates to the defaulted leases as income from foreclosure property under §856(c)(2) , thus rendering that income as qualifying income under §7704(d)(4) . In addition, the requirements of §1.856-6(d) through (f) will apply, including the two-year grace period and the extension procedures.

CONCLUSIONS

Based on the information submitted, we conclude that the income generated by the operation of the hotel properties is “qualifying income” under §7704(d) . Furthermore, we conclude that this income will cease to be qualifying income after two years from the date the hotel properties are acquired by O (and, through attribution, acquired by P) unless P applies for, and is granted, an extension of the two-year grace period by the District Director under §1.856-6(g) .

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the above-described facts under any other provision of the Code. Specifically, no opinion is expressed or implied concerning the classification of P or O as partnerships for federal tax purposes, whether P is a publicly traded partnership within the meaning of §7704(b) , or whether any other type of income not addressed in this ruling is qualifying income under §7704(d) .

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely yours, David R. Haglund, Assistant to the Branch Chief, Branch 1, Office of the Assistant Chief Counsel, (Passthroughs and Special Industries).