Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
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Refer Reply To:
CC:FIP:B02
PLR-153847-06

Date:
February 21, 2007

Legend:

Taxpayer =

Corporation A =

Date 1 =

Business =

x =

Date 2 =

Acquirer =

Dear :

This is in reply to a letter dated November 14, 2006, requesting a ruling on behalf of Taxpayer. Specifically, you requested a ruling concerning the treatment of gain from goodwill ("Goodwill Gain") under sections 856(c)(2) and (3) of the Internal Revenue Code.

Facts:

Taxpayer is a domestic corporation that has elected to be taxed as a real estate investment trust (REIT) under subchapter M for each of its tax years commencing with its tax year ended Date 1. Taxpayer was formerly known as Corporation A. Taxpayer focuses on the ownership and management of Business properties leased to Business operators under long-term triple-net leases. As of June 30, 2006, Taxpayer owned x properties throughout the United States. Taxpayer believes that its properties are generally easy to re-tenant and re-lease because they are on attractive sites and the buildings can be converted with relative ease to alternative uses by prospective tenants. Taxpayer represents that its success in triple-net leasing is attributable to its strong reputation and operating history along with its assembly of a senior employee group with considerable experience in real estate finance.

In addition to Taxpayer's core real estate business, Taxpayer owns 100 percent of the stock of a corporation that has jointly elected with Taxpayer to be treated as a taxable REIT subsidiary (TRS) of Taxpayer within the meaning of section 856(l). The TRS owns and operates a specialty finance business, an investment property sales business, and a development business.

On Date 2, Taxpayer entered into a definitive merger agreement with Acquirer, pursuant to which a subsidiary of Acquirer will acquire Taxpayer in a merger that is expected to close in early 2007. The merger is intended to be a forward cash merger, whereby Taxpayer will be merged with and into a wholly-owned subsidiary of Acquirer, which will be the surviving corporation. All issued and outstanding stock of Taxpayer will be converted into the right to receive a specified amount of cash and Taxpayer's preferred stockholders will receive either cash or preferred stock in the surviving corporation. All property rights, privileges, powers, and franchises of Taxpayer will be vested in the surviving corporation, and all debts, liabilities, and duties of Taxpayer will become those of the surviving corporation. The merger consideration, together with the assumption of Taxpayer's debts, liabilities, and duties is referred to as the "Purchase Price". For federal income tax purposes, the merger will be treated as a sale of all of Taxpayer's assets to the surviving corporation in exchange for the Purchase Price, followed by a distribution to Taxpayer's stockholders of the Merger consideration in complete liquidation of Taxpayer. The surviving corporation will be required to file Taxpayer's final income tax return for the short tax year ending on the date of the merger.

Taxpayer represents that if all of the gain recognized by Taxpayer upon the merger that is attributable to goodwill is treated as nonqualifying income, Taxpayer would fail to satisfy the 95 percent gross income test under section 856(c)(2) and may fail to satisfy the 75 percent gross income test under section 856(c)(3) for its final tax year.

Law and Analysis:

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 mortgages on real property or on interests in real property; gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) which is not property described in section 1221(a)(1); dividends or other distributions from the sale or other disposition of transferable shares of other REITs; abatements and refunds of taxes on real property; income and gain derived from foreclosure property; amounts (other than amounts the determination of which depends in whole or part on the income or profits of any person) received or accrued as consideration for entering into agreements (i) to make loans secured by mortgages on real property or (ii) to purchase or lease real property (including interests in real property and interests in mortgages on real property); gain from the sale or other disposition of a real estate asset which is not a prohibited transaction solely by reason of section 857(b)(6); and qualified temporary investment income.

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from the sources listed in section 856(c)(3); dividends; interest; and gain from the sale or disposition of stock or securities.

Section 1060 generally provides the method that is required to be used by a transferor to allocate the consideration received on the sale of assets that constitute a trade or business. Under section 1.1060-1 of the Income Tax Regulations, assets will be considered a trade or business if either (1) the use of such assets would constitute an active trade or business within the meaning of section 355 or (2) goodwill or going concern value could attach to the assets under any circumstances. The regulations further provide that goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. *See also* Newark Morning Ledger Co. v. United States, 507 U. S. 546, 556 (1993).

Although the income and asset tests under section 856(c) require a REIT to hold primarily assets that generate passive income for purposes of subchapter M, a REIT may be considered an active trade or business for other areas of the Code. For example, Rev. Rul. 2001-29, 2001-1 C.B. 1348, provides that a self-managed REIT will be considered to be engaged in an active trade or business within the meaning of section 355. The revenue ruling concludes that a REIT's rental activity that produces income that qualifies as rents from real property under section 856(d) satisfies the active trade of business requirement of section 355(b) although that activity is considered "passive" for purposes of subchapter M.

It follows, therefore, that a REIT such as Taxpayer that is engaged in the trade or business of renting real property (within the scope of subchapter M) will generate goodwill that increases the value of the REIT. Goodwill is inseparable from the business from which it arose. See Hatch's Estate v.Commissioner, 198 F.2d 26 (9th Cir. 1952); Pfleghar Hardware Specialty Company v. Blair, 30 F.2d 614 (2d Cir. 1929).

In this case, the goodwill generated by Taxpayer's trade or business is integrally related to the rental of real property. Although goodwill is treated as a separate asset for purposes of section 1060, it may be characterized for purposes of the REIT income tests based upon the characterization of the income produced by Taxpayer's activities in its trade or business. To the extent that Taxpayer's trade or business that generates goodwill produces qualifying income under either section 856(c)(2) or section 856(c)(3), gain from goodwill related to the trade or business will be treated as qualifying income for purposes of the REIT income tests.

Accordingly, to the extent that gain derived from the sale of Taxpayer's trade or business produces qualifying income under section 856(c)(2) or (3), gain allocated to goodwill that relates to the trade or business (Goodwill Gain) will be treated for purposes of the REIT income tests as being derived proportionately from the same source as the gain recognized on the sale to which the goodwill gain relates.

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under section 1060 or any other provision of the Code. Specifically, we do not rule 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 who requested it. Section 6110(k)(3) 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 yours,

William E. Coppersmith
William E. Coppersmith
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)