

LTC PROPERTIES INC
Form 10-K
February 23, 2006

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2005

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number: 1-11314

LTC PROPERTIES, INC.

(Exact name of Registrant as specified in its charter)

MARYLAND

(State or other jurisdiction of incorporation or organization)

71-0720518

(I.R.S. Employer Identification No.)

**31365 Oak Crest Drive Suite 200
Westlake Village, California 91361**

(Address of principal executive offices)

Registrant's telephone number, including area code: **(805) 981-8655**

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common stock, \$.01 Par Value	New York Stock Exchange
8.50% Series E Cumulative Convertible Preferred Stock, \$.01 Par Value	New York Stock Exchange
8.00% Series F Cumulative Preferred Stock, \$.01 Par Value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **NONE**

Indicate by checkmark if the Registrant is a well-know seasoned issuer, as defined in Rule 405 of the Securities Act Yes No

Indicate by checkmark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicated by check mark whether the registrant is a shell company Yes No

The aggregate market value of voting and non-voting stock held by non-affiliates of the Company was approximately \$412,369,295 as of June 30, 2005 (the last business day of the Company's most recently completed second fiscal quarter).

The number of shares of common stock outstanding as of February 17, 2006 was 23,289,191.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement for the Registrant's 2006 Annual Meeting of Stockholders have been incorporated into Part III of this Report.

STATEMENT REGARDING FORWARD LOOKING DISCLOSURE

Certain information contained in this annual report includes statements that are not purely historical and are "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding our expectations, beliefs, intentions or strategies regarding the future. All statements other than historical facts contained in this annual report are forward looking statements. These forward looking statements involve a number of risks and uncertainties. All forward looking statements included in this annual report are based on information available to us on the date hereof, and we assume no obligation to update such forward looking statements. Although we believe that the assumptions and expectations reflected in such forward looking statements are reasonable, no assurance can be given that such expectations will prove to have been correct. The actual results achieved by us may differ materially from any forward looking statements due to the risks and uncertainties of such statements.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Stockholders and investors are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in our filings and reports.

Item 1. BUSINESS

General

LTC Properties, Inc., a health care real estate investment trust (or REIT), was incorporated on May 12, 1992 in the State of Maryland and commenced operations on August 25, 1992. We invest primarily in long-term care and other health care related properties through mortgage loans, property lease transactions and other investments. Our primary objectives are to sustain and enhance stockholder equity value and provide current income for distribution to stockholders through real estate investments in long-term care properties and other health care related properties managed by experienced operators. To meet these objectives, we attempt to invest in properties that provide opportunity for additional value and current returns to our stockholders and diversify our investment portfolio by geographic location, operator and form of investment.

In accordance with "plain English" guidelines provided by the Securities and Exchange Commission, whenever we refer to "our company" or to "us", or use the terms "we" or "our", we are referring to LTC Properties, Inc. and/or our subsidiaries.

We were organized to qualify, and intend to continue to qualify, as a REIT. So long as we qualify, with limited exceptions, we may deduct distributions, both preferred dividends and common dividends, to our stockholders from our taxable income. We have made distributions, and intend to continue to make distributions to our stockholders, in order to eliminate any federal tax liability.

Owned Properties. As of December 31, 2005, our investment in owned properties consisted of 59 skilled nursing properties with a total of 7,103 beds, 88 assisted living properties with a total of 4,175 units and one school in 23 states, representing a gross investment of approximately \$500.7 million. See Item 8. FINANCIAL STATEMENTS Note 6. *Real Estate Investments* for further description.

The following operators accounted for more than 10% of our 2005 rental revenue:

Lessee	Percent of Rental Revenue
Alterra Healthcare Corporation	19.0%
Extendicare Healthcare Services, Inc.	19.0%
Sunwest Management, Inc.	13.1%
CLC Healthcare, Inc.	12.7%

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Mortgage Loans. As part of our strategy of making long-term investments in properties used in the provision of long-term health care services, we provide mortgage financing on such properties based on our established investment underwriting criteria. See "*Investment and Other Policies*" in this section for further discussion. We have also provided construction loans that by their terms converted into purchase/lease transactions or permanent financing mortgage loans upon completion of construction. See Item 8. FINANCIAL STATEMENTS *Note 6. Real Estate Investments* for further description.

See Item 8. FINANCIAL STATEMENTS *Note 10. Debt Obligations* for a description of our Senior Mortgage Participation Payable, which is secured by certain of our mortgage loans receivable.

REMIC Certificates. In the past, we have completed securitizations by transferring mortgage loans to newly created Real Estate Mortgage Investment Conduits (or REMIC) that, in turn, issued mortgage pass-through certificates aggregating approximately the same amount. A portion of the REMIC Certificates were then sold to third parties and a portion of the REMIC Certificates were retained by us. The REMIC Certificates we retained were subordinated in right of payment to the REMIC Certificates sold to third parties and a portion of the REMIC Certificates we retained were interest-only certificates which had no principal amount and entitled us to receive cash flows designated as interest. Between 1993 and 1998 we completed four REMIC pools. The 1993, 1994, and 1996 REMIC pools have been fully retired. During 2005, a loan was paid off in the 1998 REMIC pool which caused the last third party REMIC Certificate holders entitled to any principal payments to be paid off in full. Under Emerging Issues Task Force No. 02-9 ("EITF 02-9") "*Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold*", a Special Purpose Entity ("SPE") may become non-qualified or tainted which generally results in the "repurchase" by the transferor of all the assets sold to and still held by the SPE. Since we are now the sole REMIC Certificate holder entitled to principal from the underlying loan pool, we bear all the risks and are entitled to all the rewards from the underlying loan pool. As required by EITF 02-9, the repurchase for the transferred assets was accounted for at fair value. At December 31, 2005, we did not have any investment in REMIC Certificates on our balance sheet. See Item 8. FINANCIAL STATEMENTS *Note 2. Summary of Significant Accounting Policies-Securitization Transactions, Note 6. Real Estate Investments, and Note 7. Asset Securitizations* for further description of our historical investments in REMIC Certificates.

We maintain a long-term investment interest in mortgages we originate either through the direct retention of the mortgages or historically through the retention of REMIC Certificates originated in our securitizations. We are a REIT and, as such, make our investments with the intent to hold them for long-term purposes. However, in the past we have securitized a portion of our mortgage loan portfolio when a securitization provided us with the best available form of capital to fund additional long-term investments. In addition, we believe that the REMIC Certificates we retained in the past from our securitizations provided our stockholders with a more diverse real estate investment while maintaining the returns that provided value to our stockholders.

Investment and Other Policies

Objectives and Policies. Our investment policy is to invest primarily in income-producing long-term care properties. Also see "*Government Regulation*" below. Primarily, as a result of obligations we had under our Secured Revolving Credit, we made few investments in years 2000 through 2002. Over the past three years (2003 through 2005), we invested approximately \$59.3 million in mortgage loans and we acquired skilled nursing and assisted living properties for approximately \$37.9 million. At this time, we anticipate completing some level of new investments in 2006; however, given the highly competitive environment for health care real estate acquisitions and mortgages, we can give no assurances that we will complete a significant level of new investments in 2006.

We believe that this competitive market has created an environment of very highly priced properties and low yielding mortgages. Because our historical strategy has been to invest in low cost

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per bed properties, we believe there is an opportunity for us to invest additional funds in our owned properties where the lessees have high occupancies and expansion ability. This market is captive to us since we own the properties. We are actively reviewing all of our owned properties and discussing additional investments with such likely lessees. We would make these investments at rates that would approximate our historical lease rates.

Historically our investments have consisted of:

mortgage loans secured by long-term care properties;

fee ownership of long-term care properties which are leased to providers; or

participation in such investments indirectly through investments in real estate partnerships or other entities that themselves make direct investments in such loans or properties.

In evaluating potential investments, we consider factors such as:

type of property;

the location;

construction quality, condition and design of the property;

the property's current and anticipated cash flow and its adequacy to meet operational needs and lease obligations or debt service obligations;

the experience, reputation and solvency of the licensee providing services;

the payor mix of private, Medicare and Medicaid patients;

the growth, tax and regulatory environments of the communities in which the properties are located;

the occupancy and demand for similar properties in the area surrounding the property; and

the Medicaid reimbursement policies and plans of the state in which the property is located.

For investments in long-term care properties we favor low cost per bed opportunities, whether in fee simple properties or in mortgages. In addition, with respect to skilled nursing properties, we attempt to invest in properties that do not have to rely on a high percentage of private-pay patients. We seek to invest in properties that are located in suburban and rural areas of states. Prior to every investment, we conduct a property site review to assess the general physical condition of the property and the potential of additional sub-acute services. In addition, we review the environmental reports, state survey and financial statements of the property before the investment is made. We prefer to invest in a property that has a significant market presence in its community and where state certificate of need and/or licensing procedures limit the entry of competing properties.

We believe that assisted living facilities are an important sector in the long-term care market and our investments include direct ownership of assisted living properties. For assisted living investments we have attempted to diversify our portfolio both geographically and across product levels. Thus, we believe that although the majority of our investments are in affordably priced units, our portfolio also includes upscale units in

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appropriate markets with certain operators.

Borrowing Policies. We may incur additional indebtedness when, in the opinion of our Board of Directors, it is advisable. We may incur such indebtedness to make investments in additional long-term care properties or to meet the distribution requirements imposed upon REITs under the Internal Revenue Code of 1986, as amended. For other short-term purposes, we may, from time to time, negotiate lines of credit, or arrange for other short-term borrowings from banks or otherwise. We may also arrange for long-term borrowings through public offerings or from institutional investors.

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In addition, we may incur mortgage indebtedness on real estate which we have acquired through purchase, foreclosure or otherwise. We may also obtain mortgage financing for unleveraged or underleveraged properties in which we have invested or may refinance properties acquired on a leveraged basis. There is no limitation on the number or amount of mortgages that may be placed on any one property, and we have no policy with respect to limitations on borrowing, whether secured or unsecured.

Prohibited Investments and Activities. Our policies, which are subject to change by our Board of Directors without stockholder approval, impose certain prohibitions and restrictions on our investment practices or activities including prohibitions against:

investing in any junior mortgage loan unless by appraisal or other method, the Directors determine that

- (a) the capital invested in any such loan is adequately secured on the basis of the equity of the borrower in the property underlying such investment and the ability of the borrower to repay the mortgage loan; or
- (b) such loan is a financing device we enter into to establish the priority of our capital investment over the capital invested by others investing with us in a real estate project;

investing in commodities or commodity futures contracts (other than interest rate futures, when used solely for hedging purposes);

investing more than 1% of our total assets in contracts for sale of real estate unless such contracts are recordable in the chain of title;

holding equity investments in unimproved, non-income producing real property, except such properties as are currently undergoing development or are presently intended to be developed within one year, together with mortgage loans on such property (other than first mortgage development loans), aggregating to more than 10% of our assets.

Competition

In the health care industry, we compete for real property investments with health care providers, other health care related REITs, real estate partnerships, banks, venture capital funds and other investors. Many of our competitors are significantly larger and have greater financial resources and lower cost of capital than we have available to us. Our ability to compete successfully for real property investments will be determined by numerous factors, including our ability to identify suitable acquisition targets, our ability to negotiate acceptable terms for any such acquisition and the availability and our cost of capital.

The lessees and borrowers of our properties compete on a local, regional and, in some instances, national basis with other health care providers. The ability of the lessee or borrower to compete successfully for patients or residents at our properties depends upon several factors, including the levels of care and services provided by the lessees or borrowers, the reputation of the providers, physician referral patterns, physical appearances of the properties, family preferences, financial condition of the operator and other competitive systems of health care delivery within the community, population and demographics.

Government Regulation

The health care industry is heavily regulated by the government. Our borrowers and lessees who operate health care facilities are subject to extensive regulation by federal, state and local governments. These laws and regulations are subject to frequent and substantial changes resulting from legislation, adoption of rules and regulations, and administrative and judicial interpretations of existing law. These

changes may have a dramatic effect on the definition of permissible or impermissible activities, the relative costs associated with doing business and the amount of reimbursement by both government and other third-party payors. These changes may be applied retroactively. The ultimate timing or effect of these changes cannot be predicted. The failure of any borrower of funds from us or lessee of any of our properties to comply with such laws, requirements and regulations could result in sanctions or remedies such as denials of payment for new Medicare and Medicaid admissions, civil monetary penalties, state oversight and loss of Medicare and Medicaid participation or licensure. Such action could affect our borrower's or lessee's ability to operate its facility or facilities and could adversely affect such borrower's or lessee's ability to make debt or lease payments to us.

The properties owned by us and the manner in which they are operated are affected by changes in the reimbursement, licensing and certification policies of federal, state and local governments. Properties may also be affected by changes in accreditation standards or procedures of accrediting agencies that are recognized by governments in the certification process. In addition, expansion (including the addition of new beds or services or acquisition of medical equipment) and occasionally the discontinuation of services of health care facilities are, in some states, subjected to state and regulatory approval through "certificate of need" laws and regulations.

The ability of our borrowers and lessees to generate revenue and profit determines the underlying value of that property to us. Revenues of our borrowers and lessees are generally derived from payments for patient care. Sources of such payments for skilled nursing facilities include the federal Medicare program, state Medicaid programs, private insurance carriers, health care service plans, health maintenance organizations, preferred provider arrangements, and self-insured employers, as well as the patients themselves.

A significant portion of the revenue of our skilled nursing facility borrowers and lessees is derived from governmentally-funded reimbursement programs, such as Medicare and Medicaid. Because of significant health care costs paid by such government programs, both federal and state governments have adopted and continue to consider various health care reform proposals to control health care costs. There have been fundamental changes in the Medicare program that resulted in reduced levels of payment for a substantial portion of health care services. In many instances, revenues from Medicaid programs are already insufficient to cover the actual costs incurred in providing care to those patients. According to a report issued by the Kaiser Commission on Medicaid and the Uninsured in October 2005, nursing home rates were cut or frozen in 10 states in fiscal year 2005 and cuts were planned in 15 states in fiscal year 2006. Moreover, health care facilities continue to experience pressures from private payors attempting to control health care costs, and reimbursement from private payors has in many cases effectively been reduced to levels approaching those of government payors.

Governmental and public concern regarding health care costs may result in significant reductions in payment to health care facilities, and there can be no assurance that future payment rates for either governmental or private payors will be sufficient to cover cost increases in providing services to patients. Any changes in reimbursement policies which reduce reimbursement to levels that are insufficient to cover the cost of providing patient care could adversely affect revenues of our skilled nursing property borrowers and lessees and to a much lesser extent our assisted living property borrowers and lessees and thereby adversely affect those borrowers' and lessees' abilities to make their debt or lease payments to us. Failure of the borrowers or lessees to make their debt or lease payments would have a direct and material adverse impact on us.

On August 4, 2005, the Centers for Medicare & Medicaid Services, commonly known as CMS, published a final rule updating skilled nursing facility prospective payment rates for fiscal year 2006, which began October 1, 2005. This update implements refinements to the patient classification system and triggers the expiration of a temporary payment add-on for certain high-acuity patients, effective January 1, 2006. The final rule also adopts a 3.1 percent market basket increase for fiscal year 2006.

CMS estimates that the final rule will have no net financial impact on skilled nursing facilities in fiscal year 2006 because the \$1.02 billion reduction due to the expiration of temporary add-on payments will be more than offset by a \$510 million increase from the refined classification system and a \$530 million increase from the payment rate update. While the fiscal year 2006 skilled nursing facility rates will not decrease payments to skilled nursing facilities, the loss of revenues associated with future changes in skilled nursing facility payment rates could, in the future, have an adverse effect on the financial condition of our borrowers and lessees which could, in turn, adversely impact the timing or level of their payments to us.

The federal physician self-referral law, commonly known as Stark II (or Stark Law), prohibits certain types of practitioners (including a medical doctor, doctor of osteopathy, optometrist, dentist or podiatrist) from making referrals for certain designated health services paid in whole or in part by Medicare and Medicaid to entities with which the practitioner or a member of the practitioner's immediate family has a financial relationship, unless the financial relationship fits within an applicable exception to the Stark Law. The Stark Law also prohibits the entity receiving the referral from seeking payment under the Medicare and Medicaid programs for services rendered pursuant to a prohibited referral. If an entity is paid for services rendered pursuant to a prohibited referral, it may incur civil penalties of up to \$15,000 per prohibited claim and may be excluded from participating in the Medicare and Medicaid programs.

Legislative Developments

Each year, legislative proposals are proposed in Congress and in some state legislatures that would affect major changes in the health care system, either nationally or at the state level. Among the proposals under consideration are additional cost controls on the Medicare and Medicaid programs, health care provider cost-containment initiatives, health care coverage expansion for the uninsured, measures to prevent medical errors, limits on damages that could be claimed in physician malpractice lawsuits, and a "Patient Bill of Rights" to increase the liability of insurance companies as well as the ability of patients to sue in the event of a wrongful denial of claim. We cannot predict whether any proposals will be adopted or, if adopted, what effect, if any, such proposals would have on our business.

Environmental Matters

Under various federal, state and local environmental laws, ordinances and regulations, an owner of real property or a secured lender (such as us) may be liable for the costs of removal or remediation of hazardous or toxic substances at, under or disposed of in connection with such property, as well as other potential costs relating to hazardous or toxic substances (including government fines and damages for injuries to persons and adjacent property). Such laws often impose such liability without regard to whether the owner or secured lender knew of, or was responsible for, the presence or disposal of such substances and may be imposed on the owner or secured lender in connection with the activities of an operator of the property. The cost of any required remediation, removal, fines or personal or property damages and the owner's or secured lender's liability therefore could exceed the value of the property, and/or the assets of the owner or secured lender. In addition, the presence of such substances, or the failure to properly dispose of or remediate such substances, may adversely affect the owner's ability to sell or rent such property or to borrow using such property as collateral which, in turn, would reduce our revenues.

Although the mortgage loans that we provide and leases covering our properties require the borrower and the lessee to indemnify us for certain environmental liabilities, the scope of such obligations may be limited and we cannot assure that any such borrower or lessee would be able to fulfill its indemnification obligations.

Insurance

It is our current policy and we intend to continue this policy that all borrowers of funds from us and lessees of any of our properties secure adequate comprehensive property and general and professional liability insurance that covers us as well as the borrower and/or lessee. Even though that is our policy, certain borrowers and lessees have been unable to obtain general and professional liability insurance in the specific amounts required by our leases or mortgages because the cost of such insurance has increased substantially and some insurers have stopped offering such insurance for long-term care facilities. Additionally, in the past, insurance companies have filed for bankruptcy protection leaving certain of our borrowers and/or lessees without coverage for periods that were believed to be covered prior to such bankruptcies. The unavailability and associated exposure as well as increased cost of such insurance could have a material adverse effect on the lessees and borrowers, including their ability to make lease or mortgage payments. Although we contend that as a non-possessory landlord we are not generally responsible for what takes place on real estate we do not possess, claims including general and professional liability claims, may still be asserted against us which may result in costs and exposure for which insurance is not available. Certain risks may be uninsurable, not economically insurable or insurance may not be available and there can be no assurance that we, a borrower or lessee will have adequate funds to cover all contingencies. If an uninsured loss or a loss in excess of insured limits occurs with respect to one or more of our properties, we could be subject to an adverse claim including claims for general or professional liability, could lose the capital that we have invested in the properties, as well as the anticipated future revenue for the properties and, in the case of debt which is with recourse to us, we would remain obligated for any mortgage debt or other financial obligations related to the properties. Certain losses such as losses due to floods or seismic activity if insurance is available may be insured subject to certain limitations including large deductibles or co-payments and policy limits.

Employees

We currently employ 12 people. The employees are not members of any labor union, and we consider our relations with our employees to be excellent.

Taxation of Our Company

General. We believe that we have been organized and have operated in such a manner as to qualify for taxation as a REIT under Sections 856 to 860 of the Internal Revenue Code of 1986, as amended, commencing with our taxable year ended December 31, 1992. We intend to continue to operate in such a manner, but no assurance can be given that we have operated or will be able to continue to operate in a manner so as to qualify or to remain qualified. This summary is qualified in its entirety by the applicable Internal Revenue Code provisions, rules and regulations, and administrative and judicial interpretations.

If we continue to qualify for taxation as a REIT, we will generally not be subject to federal corporate income taxes as long as we distribute all of our taxable income as dividends. This treatment substantially eliminates the "double taxation" (*i.e.*, at the corporate and stockholder levels) that generally results from investment in a corporation. However, we will continue to be subject to federal income tax as follows:

First, we will be taxed at regular corporate rates on any undistributed taxable income, including undistributed net capital gains.

Second, under certain circumstances, we may be subject to the alternative minimum tax, if our dividend distributions are less than our alternative minimum taxable income.

Third, if we have (i) net income from the sale or other disposition of foreclosure property which is held primarily for sale to customers in the ordinary course of business or (ii) other non-qualifying income from foreclosure property, we may elect to be subject to tax at the highest corporate rate on such income, if necessary to maintain our REIT status.

Fourth, if we have net income from prohibited transactions (which are, in general, certain sales or other dispositions of property (other than foreclosure property) held primarily for sale to customers in the ordinary course of business), such income will be subject to a 100% tax.

Fifth, if we fail to satisfy the 75% gross income test or the 95% gross income test, but nonetheless maintain our qualification as a REIT because certain other requirements have been met, we will be subject to a 100% tax on an amount equal to (a) the gross income attributable to the greater of the amount by which we fail the 75% or 95% test multiplied by (b) a fraction intended to reflect our profitability.

Sixth, if we fail to distribute during each calendar year at least the sum of (i) 85% of our ordinary income for such year, (ii) 95% of our REIT capital gain net income for such year, and (iii) any undistributed taxable income from prior periods, we will be subject to a 4% excise tax on the excess of such required distribution over the amounts actually distributed.

Seventh, if we acquire an asset which meets the definition of a built-in gain asset from a corporation which is or has been a C corporation (i.e., generally a corporation subject to full corporate-level tax) in certain transactions in which the basis of the built-in gain asset in our hands is determined by reference to the basis of the asset in the hands of the C corporation, and if we subsequently recognize gain on the disposition of such asset during the ten-year period, called the recognition period, beginning on the date on which we acquired the asset, then, to the extent of the built-in gain (i.e., the excess of (a) the fair market value of such asset over (b) our adjusted basis in such asset, both determined as of the beginning of the recognition period), such gain will be subject to tax at the highest regular corporate tax rate, pursuant to IRS regulations.

Eighth, if we have taxable REIT subsidiaries, we will also be subject to a tax of 100% on the amount of any rents from real property, deductions or excess interest paid to us by any of our taxable REIT subsidiaries that would be reduced through reapportionment under certain federal income tax principles in order to more clearly reflect income for the taxable REIT subsidiary.

Requirements for Qualification. The Internal Revenue Code defines a REIT as a corporation, trust or association:

- (1) which is managed by one or more trustees or directors;
- (2) the beneficial ownership of which is evidenced by transferable shares, or by transferable certificates of beneficial interest;
- (3) which would be taxable, but for Sections 856 through 860 of the Internal Revenue Code, as a domestic corporation;
- (4) which is neither a financial institution; nor, an insurance company subject to certain provisions of the Internal Revenue Code;
- (5) the beneficial ownership of which is held by 100 or more persons;
- (6) during the last half of each taxable year not more than 50% in value of the outstanding stock of which is owned, actually or constructively, by five or fewer individuals (including specified entities); and
- (7) which meets certain other tests, described below, regarding the amount of its distributions and the nature of its income and assets.

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The Internal Revenue Code provides that conditions (1) to (4), inclusive, must be met during the entire taxable year and that condition (5) must be met during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months.

Income Tests. There presently are two gross income requirements that we must satisfy to qualify as a REIT:

First, at least 75% of our gross income (excluding gross income from "prohibited transactions," as defined below) for each taxable year must be derived directly or indirectly from investments relating to real property or mortgages on real property, including rents from real property, or from certain types of temporary investment income.

Second, at least 95% of our gross income (excluding gross income from prohibited transactions) for each taxable year must be derived from income that qualifies under the 75% test or from dividends, interest and gain from the sale or other disposition of stock or securities.

Cancellation of indebtedness income generated by us is not taken into account in applying the 75% and 95% income tests discussed above. A "prohibited transaction" is a sale or other disposition of property (other than foreclosure property) held for sale to customers in the ordinary course of business. Any gain realized from a prohibited transaction is subject to a 100% penalty tax.

If we fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, we may nevertheless qualify as a REIT for the year if we are eligible for relief. These relief provisions will be generally available if: our failure to meet the tests was due to reasonable cause and not due to willful neglect, we attach a schedule of the sources of our income to our return; and any incorrect information on the schedule was not due to fraud with intent to evade tax.

Asset Tests. We, at the close of each quarter of our taxable year, must also satisfy four tests relating to the nature of our assets.

First, at least 75% of the value of our total assets must be represented by real estate assets (including stock or debt instruments held for not more than one year purchased with the proceeds of a stock offering or long-term (at least five years) public debt offering of our company), cash, cash items and government securities.

Second, not more than 25% of our total assets may be represented by securities other than those in the 75% asset class.

Third, of the investments included in the 25% asset class, the value of any one issuer's securities owned by us may not exceed 5% of the value of our total assets and we may not own more than 10% of any one issuer's outstanding voting securities.

Fourth, the Tax Relief Extension Act of 1999 (or 99 Act), provides that, subject to certain exceptions, for taxable years commencing after December 31, 2000, we may not own more than 10% of the total value of the securities of any issuer. See the 99 Act description beginning on page 12.

Fifth, the 99 Act also provides that not more than 20% of our value may be represented by securities of one or more taxable REIT subsidiaries.

With the passage of the American Jobs Creation Act of 2004 (2004 Act), for years beginning after the effective date of October 22, 2004, if we meet certain requirements, a violation of the prohibition of owning securities of any one issuer that exceeds 5% of the value of our assets or owning securities of any one issuer that exceeds 10% of that issuer's voting securities or 10% of the value of that issuer's outstanding securities may not result in disqualification as a REIT.

The 2004 Act provides that a *de minimis* failure, where we dispose of assets in order to meet these requirements within six months of the last day of the quarter in which the failure is identified or the requirements are otherwise met within this time frame, will not result in disqualification. A *de minimis* failure is one where the failure is due to ownership of assets the total value of which does not exceed the lesser of one percent of the total value of our assets at the end of the quarter or \$10.0 million.

In addition, a failure exceeding the *de minimis* amount is considered to have satisfied the requirements if such failure is due to reasonable cause and not due to willful neglect, a description of each asset that causes the failure is filed with the Internal Revenue Service, a certain tax is paid, and the assets that cause the failure are disposed of within six months of the last day of the quarter in which we identify the failure. The tax is the greater of \$50,000 or the net income generated by such assets during the period beginning on the date of failure until disposal taxed at the highest corporate rate.

Ownership of a Partnership Interest or Stock in a Corporation. We own an interest in a partnership. In the case of a REIT that is a partner in a partnership, Treasury regulations provide that for purposes of the REIT income and asset tests the REIT will be deemed to own its proportionate share of the assets of the partnership, and will be deemed to be entitled to the income of the partnership attributable to such share. The ownership of an interest in a partnership by a REIT may involve special tax risks, including the challenge by the Internal Revenue Service of the allocations of income and expense items of the partnership, which would affect the computation of taxable income of the REIT, and the status of the partnership as a partnership (as opposed to an association taxable as a corporation) for federal income tax purposes.

We also own interests in a number of subsidiaries which are intended to be treated as qualified real estate investment trust subsidiaries. The Internal Revenue Code provides that such subsidiaries will be ignored for federal income tax purposes and all assets, liabilities and items of income, deduction and credit of such subsidiaries will be treated as assets, liabilities and such items of ours.

If any partnership or qualified real estate investment trust subsidiary in which we own an interest were treated as a regular corporation (and not as a partnership or qualified real estate investment trust subsidiary) for federal income tax purposes, we would likely fail to satisfy the REIT asset test prohibiting a REIT from owning greater than 10% of the voting power of the stock or value of securities of any issuer, as described above, and would therefore fail to qualify as a REIT. As described above, the 2004 Act provides relief for certain failures of the REIT asset test for years beginning after October 22, 2004. We believe that each of the partnerships and subsidiaries in which we own an interest will be treated for tax purposes as a partnership or qualified real estate investment trust subsidiary, respectively, although no assurance can be given that the Internal Revenue Service will not successfully challenge the status of any such organization.

REMIC. A regular or residual interest in a REMIC will be treated as a real estate asset for purposes of the REIT asset tests, and income derived with respect to such interest will be treated as interest on an obligation secured by a mortgage on real property, assuming that at least 95% of the assets of the REMIC are real estate assets. If less than 95% of the assets of the REMIC are real estate assets, only a proportionate share of the assets of and income derived from the REMIC will be treated as qualifying under the REIT asset and income tests. All of our historical REMIC Certificates were secured by real estate assets, therefore we believe that our historic REMIC interests fully qualified for purposes of the REIT income and asset tests.

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Annual Distribution Requirements. In order to qualify as a REIT, we are required to distribute dividends (other than capital gain dividends) to our stockholders annually in an amount at least equal to:

- (1) the sum of:
 - (a) 90% (95% for taxable years ending prior to January 1, 2001) of our "real estate investment trust taxable income" (computed without regard to the dividends paid deduction and our net capital gain); and
 - (b) 90% (95% for taxable years ending prior to January 1, 2001) of the net income, if any (after tax), from foreclosure property; minus
- (2) the excess of certain items of non-cash income over 5% of our real estate investment trust taxable income.

These annual distributions are paid in the taxable year to which they relate. Alternatively, they must be declared and payable to stockholders of record in either October, November, or December and paid during January of the following year. In addition, if we elect, the dividends may be declared before the due date of the tax return (including extensions) and paid on or before the first regular dividend payment date after such declaration, and we must specify the dollar amount in our tax returns.

Amounts distributed must not be preferential; that is, every stockholder of the class of stock with respect to which a distribution is made must be treated the same as every other stockholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class.

To the extent that we do not distribute all of our net long-term capital gain or distribute at least 90% (95% for taxable years ending prior to January 1, 2001), but less than 100%, of our "real estate investment trust taxable income," as adjusted, it will be subject to tax on such amounts at regular corporate tax rates. Furthermore, if we should fail to distribute during each calendar year (or, in the case of distributions with declaration and record dates in the last three months of the calendar year, by the end of the following January) at least the sum of:

- (1) 85% of our real estate investment trust ordinary income for such year;
- (2) 95% of our real estate investment trust capital gain net income for such year; and
- (3) any undistributed taxable income from prior periods;

we would be subject to a 4% excise tax on the excess of such required distributions over the amounts actually distributed. Any real estate investment trust taxable income and net capital gain on which this excise tax is imposed for any year is treated as an amount distributed during that year for purposes of calculating such tax.

Failure to Qualify. If we fail to qualify for taxation as a REIT in any taxable year, and certain relief provisions do not apply, we will be subject to tax (including any applicable alternative minimum tax) on our taxable income at regular corporate rates. Distributions to stockholders in any year in which we fail to qualify as a REIT will not be deductible by us, nor will any distributions be required to be made. Unless entitled to relief under specific statutory provisions, we will also be disqualified from taxation as a REIT for the four taxable years following the year during which qualification was lost. It is not possible to state whether in all circumstances we would be entitled to the statutory relief. Failure to qualify for even one year could substantially reduce distributions to stockholders and could result in our incurring substantial indebtedness (to the extent borrowings are feasible) or liquidating substantial investments in order to pay the resulting taxes.

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99 Act. The 99 Act made a number of substantial changes to the qualification and tax treatment of REITs. Certain of those provisions were subsequently modified by the 2004 Act effective concurrently with the 99 Act. The following is a brief summary of certain of the significant REIT provisions in the 99 Act, as modified by the 2004 Act.

1)

Investment limitations and taxable REIT subsidiaries. The 99 Act modified the REIT asset test by adding a requirement effective for years beginning after December 31, 2000 that, with the exception of the stock of a taxable REIT subsidiary, a REIT cannot own more than 10% of the total value of the "securities" of any issuer (10% Rule). Excluded from the definition of "securities" are straight debt securities, a REIT's interest as a partner in a partnership, any loan to an individual or an estate, certain rental agreements, any obligation to pay rents from real property, certain securities issued by States, the District of Columbia, a foreign government, or the Commonwealth of Puerto Rico, any security issued by a REIT, and any other arrangement that is determined by the Internal Revenue Service. Straight debt securities are non-convertible, non-contingent debt provided that the REIT or any controlled taxable REIT subsidiaries does not own any other "securities" of the issuer that have an aggregate value greater than 1% of the issuer's outstanding securities.

2)

For a corporation to qualify as a taxable REIT subsidiary the following requirements must be satisfied.

(1)

The REIT must own stock in the subsidiary corporation.

(2)

Both the REIT and the subsidiary corporation must join in an election that the subsidiary corporation be treated as a "taxable REIT subsidiary" of the REIT.

(3)

The subsidiary corporation cannot directly or indirectly operate or manage either a lodging or health care facility.

(4)

The subsidiary corporation generally cannot provide to any person rights to any brand name under which lodging or health care facilities are operated.

A taxable REIT subsidiary can provide a limited amount of services to tenants of REIT property (even if such services were not considered customarily furnished in connection with the rental of real property) and can manage or operate properties, generally for third parties, without causing the rents received by the REIT from such parties not to be treated as rent from real properties. The rule that rents paid to a REIT do not qualify as rental from real property if the REIT owns more than 10% of the corporation paying the rent is modified by excepting rents paid by taxable REIT subsidiaries provided that 90% of the space is leased to third parties at comparable rents for comparable space. The 2004 Act prospectively removes the safe harbor for rents received by a REIT for customary services performed by a taxable REIT subsidiary. Instead, such payments will satisfy the existing safe harbor if the REIT pays the taxable REIT subsidiary 150% of the cost to the taxable REIT subsidiary of providing any services.

Interest paid by a taxable REIT subsidiary to the related REIT is subject to the earnings stripping rules contained in Section 163(j) of the Code and therefore the taxable REIT subsidiary cannot deduct interest in any year that it would exceed 50% of the subsidiary's adjusted gross income. If any amount of interest, rent, or other deductions of the taxable REIT subsidiary to be paid to the REIT is determined not to be at arm's length, an excise tax of 100% is imposed on the portion that is determined to be excessive. However, rent received by a REIT shall not fail to qualify as rents from real property by reason of the fact that all or any portion of such rent is redetermined for purposes of the excise tax.

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The Act permits a REIT to own up to 100% of the stock of a "taxable REIT subsidiary." However, the value of all of the securities of taxable REIT subsidiaries owned by the REIT cannot exceed 20% of the value of the REIT's assets.

The 10% Rule generally will not apply to securities owned by a REIT on July 12, 1999 (or Transition Rule). However, the Transition Rule would cease to apply to securities of an issuer if, after July 12, 1999, the REIT acquires additional securities of such issuer or if such issuer engages in a substantial new line of business, or acquires any substantial assets, other than in a reorganization or in a transaction qualifying under Section 1031 or 1033 of the Code.

- 3) *Ownership of health care facilities.* The 99 Act permits a REIT to own and operate a health care facility for at least two years, and treat it as permitted "foreclosure" property, if the facility is acquired as the result of a default (or imminent default) of a lease or indebtedness.
- 4) *REIT distribution requirements.* The 99 Act reduces the requirement that a REIT must distribute at least 95% of its income as deductible dividends to 90% of its income.
- 5) *Rents from personal property.* A REIT may treat rent from personal property as rent from real property so long as the rent from personal property does not exceed 15% of the total rent from both real and personal property for the taxable year. The Act provides that this determination will be made by comparing the fair market value of the personal property to the fair market value of the real and personal property.

State and local taxation. We may be subject to state or local taxation in various state or local jurisdictions, including those in which we transact business or reside. Our state and local tax treatment may not conform to the federal income tax consequences discussed above.

Investor Information

We make available to the public free of charge through our internet website our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after we electronically file such reports with, or furnish such reports to, the Securities and Exchange Commission. Our internet website address is www.ltcproperties.com. We are not including the information contained on our website as part of, or incorporating it by reference into, this Annual Report on Form 10-K.

Posted on our website and available upon request of any shareholder to our Investor Relations Department are the charters for our Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee, our Corporate Governance Guidelines and a Code of Business Conduct and Ethics governing our directors, officers and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code Business Conduct and Ethics and any waiver applicable to our senior financial officers and our executive officers or directors. In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors. Our Investor Relations Department can be contacted at:

LTC Properties, Inc.
31365 Oak Crest Drive, Suite #200
Westlake Village, California 91361
Attn: Investor Relations
(805) 981-8655

You may read and copy materials that we file with the SEC at the SEC's Public Reference Room at 100 F Street, N.E., Washington D.C. 20549. Information on the operation of the Public Reference

Room is available by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy statements and other information we file. The address of the SEC website is www.sec.gov.

Our company is listed on the New York Stock Exchange (or NYSE), ticker symbol LTC. Section 303A.12(a) of the NYSE Listed Company Manual requires that listed companies disclose in their annual report to stockholders that the previous year's NYSE Annual CEO Certification has been filed with the NYSE and disclose any qualifications. We filed, with the NYSE, our Annual CEO Certification for our Annual Report on Form 10-K for the fiscal year ended December 31, 2004 without any qualifications.

Item 1A. RISK FACTORS

Certain information contained in this annual report includes statements that are not purely historical and are "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding our expectations, beliefs, intentions or strategies regarding the future. All statements other than historical facts contained in this annual report are forward looking statements. These forward looking statements involve a number of risks and uncertainties. All forward looking statements included in this annual report are based on information available to us on the date hereof, and we assume no obligation to update such forward looking statements. Although we believe that the assumptions and expectations reflected in such forward looking statements are reasonable, no assurance can be given that such expectations will prove to have been correct. The actual results achieved by us may differ materially from any forward looking statements due to the risks and uncertainties of such statements.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Stockholders and investors are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in our filings and reports.

Such risks and uncertainties include, among other things, the following risks including those described in more detail below:

the status of the economy;

the status of capital markets, including prevailing interest rates;

compliance with and changes to regulations and payment policies within the health care industry;

changes in financing terms;

competition within the health care and senior housing industries; and

changes in federal, state and local legislation.

Recently Enacted Tax Legislation Could have an Adverse Effect on the Market Price of our Equity Securities. On May 28, 2003, President Bush signed into law legislation that, for individual taxpayers, will generally reduce the tax rate on corporate dividends to a maximum of 15% for tax years 2003 to 2008. REIT dividends generally will not qualify for this reduced tax rate because a REIT's income generally is not subject to corporate level tax. This new law could cause stock in non-REIT corporations to be a more attractive investment to individual investors than stock in REITs and could have an adverse effect on the market price of our equity securities.

A Failure to Maintain or Increase our Dividend Could Reduce the Market Price of Our Stock. In December 2005, we declared a \$0.12 per share monthly dividend for the first quarter of calendar 2006. During calendar 2005, we paid a \$0.30 dividend in the first quarter and a \$0.11 monthly dividend in each of the second, third and fourth quarters on our common stock. During calendar 2004, we paid a

\$0.25 dividend in the first quarter, a \$0.275 dividend in the second quarter and a \$0.30 dividend in each of the third and fourth quarters on our common stock. The ability to maintain or raise our common dividend is dependent, to a large part, on growth of funds from operations. This growth in turn depends upon increased revenues from additional investments and loans, rental increases and mortgage rate increases.

At Times, We May Have Limited Access to Capital Which Will Slow Our Growth. A REIT is required to make dividend distributions and retains little capital for growth. As a result, growth for a REIT is generally through the steady investment of new capital in real estate assets. Presently, we believe capital is readily available to us. However, there will be times when we will have limited access to capital from the equity and/or debt markets. During such periods, virtually all of our available capital will be required to meet existing commitments and to reduce existing debt. We may not be able to obtain additional equity or debt capital or dispose of assets on favorable terms, if at all, at the time we require additional capital to acquire health care properties on a competitive basis or meet our obligations.

Income and Returns from Health Care Facilities Can be Volatile. The possibility that the health care properties in which we invest will not generate income sufficient to meet operating expenses, will generate income and capital appreciation, if any, at rates lower than those anticipated or will yield returns lower than those available through investments in comparable real estate or other investments are additional risks of investing in health care related real estate. Income from properties and yields from investments in such properties may be affected by many factors, including changes in governmental regulation (such as zoning laws and government payment), general or local economic conditions (such as fluctuations in interest rates and employment conditions), the available local supply of and demand for improved real estate, a reduction in rental income as the result of an inability to maintain occupancy levels, natural disasters (such as hurricanes, earthquakes and floods) or similar factors.

We Depend on Lease Income and Mortgage Payments from Real Property. Since a substantial portion of our income is derived from mortgage payments and lease income from real property, our income would be adversely affected if a significant number of our borrowers or lessees were unable to meet their obligations to us or if we were unable to lease our properties or make mortgage loans on economically favorable terms. There can be no assurance that any lessee will exercise its option to renew its lease upon the expiration of the initial term or that if such failure to renew were to occur, we could lease the property to others on favorable terms.

We Rely on a Few Major Operators. Extencicare Healthcare Services, Inc. (or EHSI), a wholly owned subsidiary of Extencicare Inc., leases 37 assisted living properties with a total of 1,427 units owned by us representing approximately 11.6%, or \$68.1 million, of our total assets at December 31, 2005.

Alterra Healthcare Corporation (or Alterra), a wholly owned subsidiary of Brookdale Senior Living, Inc., leases 35 assisted living properties with a total of 1,416 units owned by us representing approximately 11.5%, or \$67.2 million, of our total assets at December 31, 2005.

CLC Healthcare, Inc. (or CLC) operates 26 skilled health care properties with a total of 3,014 beds that we own or on which we hold mortgages secured by first trust deeds. This represents approximately 9.5% or \$55.6 million of our total assets at December 31, 2005.

Sunwest Management, Inc. (or Sunwest) operates eight assisted living properties with a total of 958 units that we own or on which we hold mortgages secured by first trust deeds. This represents approximately 9.5% or \$55.6 million of our total assets at December 31, 2005. Subsequent to December 31, 2005, we sold four assisted living properties operated by Sunwest with a total of 431 units to an entity formed by the principals of Sunwest for \$58.5 million. We received \$54.6 million in

proceeds after paying \$3.8 million of 8.75% State of Oregon bond obligations related to one of the properties sold. As a result of the sale, we will recognize a gain of \$31.9 million in 2006.

Our financial position and ability to make distributions may be adversely affected by financial difficulties experienced by any of our other lessees and borrowers, including bankruptcies, inability to emerge from bankruptcy, insolvency or general downturn in business of any such operator, or in the event any such operator does not renew and/or extend its relationship with us or our borrowers when it expires.

Our Borrowers and Lessees Face Competition in the Health Care Industry. The long-term care industry is highly competitive and we expect that it may become more competitive in the future. Our borrowers and lessees are competing with numerous other companies providing similar long-term care services or alternatives such as home health agencies, hospices, life care at home, community-based service programs, retirement communities and convalescent centers. There can be no assurance that our borrowers and lessees will not encounter increased competition in the future which could limit their ability to attract residents or expand their businesses and therefore affect their ability to make their debt or lease payments to us.

The Health Care Industry is Heavily Regulated by the Government. Our borrowers and lessees who operate health care facilities are subject to extensive regulation by federal, state and local governments. These laws and regulations are subject to frequent and substantial changes resulting from legislation, adoption of rules and regulations, and administrative and judicial interpretations of existing law. These changes may have a dramatic effect on the definition of permissible or impermissible activities, the relative costs associated with doing business and the amount of reimbursement by both government and other third-party payors. These changes may be applied retroactively. The ultimate timing or effect of these changes cannot be predicted. The failure of any borrower or funds from us or lessee of any of our properties to comply with such laws, requirements and regulations could affect its ability to operate its facility or facilities and could adversely affect such borrower's or lessee's ability to make debt or lease payments to us.

Our Borrowers and Lessees Rely on Government and Third Party Reimbursement. The ability of our borrowers and lessees to generate revenue and profit determines the underlying value of that property to us. Revenues of our borrowers and lessees are generally derived from payments for patient care. Sources of such payments include the federal Medicare program, state Medicaid programs, private insurance carriers, health care service plans, health maintenance organizations, preferred provider arrangements, self-insured employers, as well as the patients themselves.

A significant portion of the revenue of our borrowers and lessees is derived from governmentally-funded reimbursement programs, such as Medicare and Medicaid. Because of substantial health care costs paid by such government programs, both federal and state governments have adopted and continue to consider various health care reform proposals to control health care costs. There have been fundamental changes in the Medicare program that resulted in reduced levels of payment for a substantial portion of health care services. In many instances, revenues from Medicaid programs are already insufficient to cover the actual costs incurred in providing care to those patients. According to a report issued by the Kaiser Commission on Medicaid and the Uninsured in October 2005, nursing home rates were cut or frozen in 10 states in fiscal year 2005 and in 15 states in fiscal year 2006 (although nursing homes were the provider group most likely to be granted a rate increase in both years, with increases in 41 states in fiscal year 2005 and in 36 states in fiscal year 2006). Moreover, health care facilities have experienced increasing pressures from private payors attempting to control health care costs, and reimbursement from private payors has in many cases effectively been reduced to levels approaching those of government payors.

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Governmental and public concern regarding health care costs may result in significant reductions in payment to health care facilities, and there can be no assurance that future payment rates for either governmental or private payors will be sufficient to cover cost increases in providing services to patients. Any changes in reimbursement policies which reduce reimbursement to levels that are insufficient to cover the cost of providing patient care could adversely affect revenues of our borrowers and lessees and thereby adversely affect those borrowers' and lessees' abilities to make their debt or lease payments to us. Failure of the borrowers or lessees to make their debt or lease payments would have a direct and material adverse impact on us.

On August 4, 2005, the Centers for Medicare & Medicaid Services, commonly known as CMS, published a final rule updating skilled nursing facility prospective payment rates for fiscal year 2006, which began October 1, 2005. This update implements refinements to the patient classification system and triggers the expiration of a temporary payment add-on for certain high-acuity patients, effective January 1, 2006. The final rule also adopts a 3.1 percent market basket increase for fiscal year 2006. CMS estimates that the final rule will have no net financial impact on skilled nursing facilities in fiscal year 2006 because the \$1.02 billion reduction due to the expiration of temporary add-on payments will be more than offset by a \$510 million increase from the refined classification system and a \$530 million increase from the payment rate update. While the fiscal year 2006 skilled nursing facility rates will not decrease payments to skilled nursing facilities, the loss of revenues associated with future changes in skilled nursing facility payment rates could, in the future, have an adverse effect on the financial condition of our borrowers and lessees which could, in turn, adversely impact the timing or level of their payments to us.

Congress and the States Have Enacted Health Care Reform Measures. The health care industry continues to face various challenges, including increased government and private payor pressure on health care providers to control costs. For instance, the Balanced Budget Act of 1997 enacted significant changes to the Medicare and Medicaid programs designed to modernize payment and health care delivery systems while achieving substantial budgetary savings. In seeking to limit Medicare reimbursement for long-term care services, Congress established the prospective payment system for skilled nursing facility services to replace the cost-based reimbursement system. Skilled nursing facilities needed to restructure their operations to accommodate the new Medicare prospective payment system reimbursement. Since the skilled nursing facility prospective payment system was enacted, several then publicly held operators of long-term care facilities and at least two then publicly held operators of assisted living facilities have filed for reorganization under Chapter 11 of the federal bankruptcy laws. While certain long-term care operators and both assisted living operators have emerged from bankruptcy, during their reorganizations and in some instances subsequent thereto, they reduced their operations by rejecting leases and/or defaulting on loans resulting in properties being returned to lessors or lenders. There can be no assurances given that there will not be additional bankruptcies of skilled nursing and assisted living operators in the future.

In recent years, Congress has adopted legislation to somewhat mitigate the impact of the Balanced Budget Act on providers, including skilled nursing facilities. Most recently, on December 8, 2003, President Bush signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (P.L. 108-173). In addition to providing expanded Medicare prescription drug coverage, the new act modifies Medicare payments to a variety of health care providers. With respect to skilled nursing facilities, the act provides a temporary 128% increase in the Medicare payment for skilled nursing facility residents with acquired immune deficiency syndrome, applicable to services furnished on or after October 1, 2004.

On the other hand, in February 2006 Congress gave final approval to the Deficit Reduction Act (or DRA), which will reduce net Medicare and Medicaid spending by approximately \$11 billion over five years. Among other things, the legislation reduces Medicare skilled nursing facility bad debt payments by 30 percent for those individuals who are not dually eligible for Medicare and Medicaid,

and strengthens Medicaid asset transfer restrictions for persons seeking to qualify for Medicaid long-term care coverage. Congress may consider legislation in the future that would further restrict Medicare and Medicaid funding. No assurances can be given that any additional Medicare or Medicaid legislation enacted by Congress would not reduce Medicare or Medicaid reimbursement to skilled nursing facilities or result in additional costs for operators of skilled nursing facilities.

On February 6, 2006, the Bush Administration released its fiscal year (FY) 2007 budget proposal, which would reduce Medicare spending by \$2.5 billion in FY 2007 and \$35.9 billion over 5 years. In particular, the budget would freeze payments in fiscal year 2007 for skilled nursing facilities, among other providers. In 2008 and 2009, the payment update would be market basket minus 0.4 percent. To enhance the long-term financing of the Medicare program, the budget also proposes automatic reductions in provider updates if general revenues are projected to exceed 45 percent of total Medicare financing. The budget also includes a series of proposals impacting Medicaid, including administrative changes to the financing structure of Medicaid that would save more than \$12 billion over five years. These changes include proposed reforms to Medicaid provider taxes, which some states use to finance Medicaid long term care services.

In addition, comprehensive reforms affecting the payment for and availability of health care services have been proposed at the federal and state levels and major reform proposals have been adopted by certain states. Congress and state legislatures can be expected to continue to review and assess alternative health care delivery systems and payment methodologies. Changes in the law, new interpretations of existing laws, or changes in payment methodology may have a dramatic effect on the definition of permissible or impermissible activities, the relative costs associated with doing business and the amount of reimbursement by the government and other third party payors.

Moreover, many states are facing significant budget shortfalls, and all states have taken steps in recent years to implement cost controls within their Medicaid programs, including freezes or reductions in nursing home reimbursement in some states. According to a report issued by the Kaiser Commission on Medicaid and the Uninsured in October 2005, nursing home rates were cut or frozen in 10 states in fiscal year 2005 and in 15 states in fiscal year 2006 (although nursing homes were the provider group most likely to be granted a rate increase in both years, with increases in 41 states in fiscal year 2005 and in 36 states in fiscal year 2006). The DRA also gives states greater flexibility to expand access to home and community based services by allowing states to provide these services as an optional benefit without undergoing the waiver approval process. Moreover, the DRA includes a new demonstration to encourage states to provide long-term care services in a community setting to individuals who currently receive Medicaid services in nursing homes. Together the provisions could increase state funding for home and community based services, while prompting states to cut funding for nursing facilities and homes for persons with disabilities. In light of continuing state Medicaid program reforms, budget cuts, and regulatory initiatives, no assurance can be given that the implementation of such regulations and reforms will not have a material adverse effect on the financial condition or results of operations of our lessees and/or borrowers which, in turn, could effect their ability to meet their contractual obligations to us.

We Could Incur More Debt. We operate with a policy of incurring debt when, in the opinion of our Directors, it is advisable. We may incur additional debt by issuing debt securities in a public offering or in a private transaction. Accordingly, we could become more highly leveraged. The degree of leverage could have important consequences to stockholders, including affecting our ability to obtain additional financing in the future for working capital, capital expenditures, acquisitions, development or other general corporate purposes and making us more vulnerable to a downturn in business or the economy generally.

We Could Fail to Collect Amounts Due Under Our Straight-line Rent Receivable Asset. Straight-line accounting requires us to calculate the total fixed rent we will receive over the life of the lease and

recognize that revenue evenly over that life. In a situation where a lease calls for fixed rental increases during the life of the lease rental income recorded in the early years of a lease is higher than the actual cash rent received, which creates an asset on the balance sheet called deferred rent receivable. At some point during the lease, depending on the rent levels and terms, this reverses and the cash rent payments received during the later years of the lease are higher than the rental income recognized, which reduces the deferred rent receivable balance to zero by the end of the lease. We periodically assess the collectibility of the deferred rent receivable. If during our assessment we determined that we were unlikely to collect a portion or all of the deferred rent receivable balance, we may record an impairment charge in current period earnings for the portion, up to its full value, that we estimate will not be recovered.

Our Assets May be Subject to Impairment Charges. We periodically but not less than quarterly evaluate our real estate investments and other assets for impairment indicators. The judgment regarding the existence of impairment indicators is based on factors such as market conditions, operator performance and legal structure. If we determine that a significant impairment has occurred, we would be required to make an adjustment to the net carrying value of the asset, which could have a material adverse affect on our results of operations and a non-cash impact on funds from operations in the period in which the write-off occurs.

A Failure to Reinvest Cash Available to Us Could Adversely Affect Our Future Revenues and Our Ability to Increase Dividends to Stockholders; There is Considerable Competition in Our Market for Attractive Investments. From time to time, we will have cash available from (1) proceeds of sales of shares of securities, (2) proceeds from new debt issuances, (3) principal payments on our mortgages and other investments, (4) sale of properties, and (5) funds from operations. We may reinvest this cash in health care investments in accordance with our investment policies, repay outstanding debt or invest in qualified short-term or long-term investments. We compete for real estate investments with a broad variety of potential investors. The competition for attractive investments negatively affects our ability to make timely investments on acceptable terms. Delays in acquiring properties or making loans will negatively impact revenues and perhaps our ability to increase distributions to our stockholders.

Our Failure to Qualify as a REIT Would Have Serious Adverse Consequences to Our Stockholders. We intend to operate so as to qualify as a REIT under the Internal Revenue Code (the Code). We believe that we have been organized and have operated in a manner which would allow us to qualify as a REIT under the Code beginning with our taxable year ended December 31, 1992. However, it is possible that we have been organized or have operated in a manner which would not allow us to qualify as a REIT, or that our future operations could cause us to fail to qualify. Qualification as a REIT requires us to satisfy numerous requirements (some on an annual and quarterly basis) established under highly technical and complex Code provisions for which there are only limited judicial and administrative interpretations, and involves the determination of various factual matters and circumstances not entirely within our control. For example, in order to qualify as a REIT, at least 95% of our gross income in any year must be derived from qualifying sources, and we must pay dividends to stockholders aggregating annually at least 90% (95% for taxable years ending prior to January 1, 2001) of our REIT taxable income (determined without regard to the dividends paid deduction and by excluding capital gains). Legislation, new regulations, administrative interpretations or court decisions could significantly change the tax laws with respect to qualification as a REIT or the federal income tax consequences of such qualification. However, we are not aware of any pending tax legislation that would adversely affect our ability to operate as a REIT.

If we fail to qualify as a REIT in any taxable year, we will be subject to federal income tax (including any applicable alternative minimum tax) on our taxable income at regular corporate rates. Unless we are entitled to relief under statutory provisions, we would be disqualified from treatment as a REIT for the four taxable years following the year during which we lost qualification. If we lose our

REIT status, our net earnings available for investment or distribution to stockholders would be significantly reduced for each of the years involved. In addition, we would no longer be required to make distributions to stockholders.

Our real estate investments are relatively illiquid. Real estate investments are relatively illiquid and, therefore, tend to limit our ability to vary our portfolio promptly in response to changes in economic or other conditions. All of our properties are "special purpose" properties that cannot be readily converted to general residential, retail or office use. Health care facilities that participate in Medicare or Medicaid must meet extensive program requirements, including physical plant and operational requirements, which are revised from time to time. Such requirements may include a duty to admit Medicare and Medicaid patients, limiting the ability of the facility to increase its private pay census beyond certain limits. Medicare and Medicaid facilities are regularly inspected to determine compliance, and may be excluded from the programs in some cases without a prior hearing for failure to meet program requirements. Transfers of operations of nursing homes and other healthcare-related facilities are subject to regulatory approvals not required for transfers of other types of commercial operations and other types of real estate. Thus, if the operation of any of our properties becomes unprofitable due to competition, age of improvements or other factors such that our lessee or mortgagor becomes unable to meet its obligations on the lease or mortgage loan, the liquidation value of the property may be substantially less, particularly relative to the amount owing on any related mortgage loan, than would be the case if the property were readily adaptable to other uses. The receipt of liquidation proceeds or the replacement of an operator that has defaulted on its lease or loan could be delayed by the approval process of any federal, state or local agency necessary for the transfer of the property or the replacement of the operator with a new operator licensed to manage the facility. In addition, certain significant expenditures associated with real estate investment, such as real estate taxes and maintenance costs, are generally not reduced when circumstances cause a reduction in income from the investment. Should such events occur, our income and cash flows from operations would be adversely affected.

Our Remedies May Be Limited When Mortgage Loans Default. To the extent we invest in mortgage loans, such mortgage loans may or may not be recourse obligations of the borrower and generally will not be insured or guaranteed by governmental agencies or otherwise. In the event of a default under such obligations, we may have to foreclose on the property underlying the mortgage or protect our interest by acquiring title to a property and thereafter make substantial improvements or repairs in order to maximize the property's investment potential. Borrowers may contest enforcement of foreclosure or other remedies, seek bankruptcy protection against such enforcement and/or bring claims for lender liability in response to actions to enforce mortgage obligations. If a borrower seeks bankruptcy protection, the Bankruptcy Court may impose an automatic stay that would preclude us from enforcing foreclosure or other remedies against the borrower. Relatively high "loan to value" ratios and declines in the value of the property may prevent us from realizing an amount equal to our mortgage loan upon foreclosure.

We are Subject to Risks and Liabilities in Connection with Properties Owned Through Limited Liability Companies and Partnerships. We have ownership interests in limited liability companies and/or partnerships. We may make additional investments through these ventures in the future. Partnership or limited liability company investments may involve risks such as the following:

our partners or co-members might become bankrupt (in which event we and any other remaining general partners or members would generally remain liable for the liabilities of the partnership or limited liability company);

our partners or co-members might at any time have economic or other business interests or goals which are inconsistent with our business interests or goals;

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our partners or co-members may be in a position to take action contrary to our instructions, requests, policies or objectives, including our policy with respect to maintaining our qualification as a REIT; and

agreements governing limited liability companies and partnerships often contain restrictions on the transfer of a member's or partner's interest or "buy-sell" or other provisions which may result in a purchase or sale of the interest at a disadvantageous time or on disadvantageous terms.

We will, however, generally seek to maintain sufficient control of our partnerships and limited liability companies to permit us to achieve our business objectives. Our organizational documents do not limit the amount of available funds that we may invest in partnerships or limited liability companies. The occurrence of one or more of the events described above could have a direct and adverse impact on us.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

Investment Portfolio

At December 31, 2005, our "direct real estate investment portfolio" (properties that we own or on which we hold promissory notes secured by first mortgages) consisted of investments in 126 skilled nursing properties with 14,792 beds, 101 assisted living properties with 5,108 units and two schools in 33 states. We had approximately \$500.7 million (before accumulated depreciation of \$95.8 million) invested in properties we own and lease to lessees and approximately \$149.3 million invested in mortgage loans (before allowance for doubtful accounts of \$1.3 million). Subsequent to December 31, 2005, we sold four assisted living properties operated by Sunwest with a total of 431 units to an entity formed by the principals of Sunwest for \$58.5 million. We received \$54.6 million in proceeds after paying \$3.8 million of 8.75% State of Oregon bond obligations related to one of the properties sold. As a result of the sale, we will recognize a gain of \$31.9 million in 2006.

Skilled nursing facilities provide restorative, rehabilitative and nursing care for people not requiring the more extensive and sophisticated treatment available at acute care hospitals. Many skilled nursing facilities provide ancillary services that include occupational, speech, physical, respiratory and IV therapies, as well as provide sub-acute care services which are paid either by the patient, the patient's family, or through federal Medicare or state Medicaid programs.

Assisted living facilities serve elderly persons who require assistance with activities of daily living, but do not require the constant supervision skilled nursing facilities provide. Services are usually available 24-hours a day and include personal supervision and assistance with eating, bathing, grooming and administering medication. The facilities provide a combination of housing, supportive services, personalized assistance and health care designed to respond to individual needs.

The schools in our real estate investment portfolio are charter schools. Charter schools provide an alternative to the traditional public school. Charter schools are generally autonomous entities authorized by the state or locality to conduct operations independent from the surrounding public school district. Laws vary by state, but generally charters are granted by state boards of education either directly or in conjunction with local school districts or public universities. Operators are granted charters to establish and operate schools based on the goals and objectives set forth in the charter. Upon receipt of a charter, schools receive an annuity from the state for each student enrolled.

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Owned Properties. At December 31, 2005, we owned 59 skilled nursing properties with a total of 7,103 beds, 88 assisted living properties with a total of 4,175 units and one school in 23 states, representing a gross investment of approximately \$500.7 million. The properties are leased pursuant to non-cancelable leases generally with an initial term of 10 to 30 years. The leases provide for a fixed minimum base rent during the initial and renewal periods. Most of the leases provide for annual fixed rent increases or increases based on consumer price indices over the term of the lease. In addition, certain of our leases provide for additional rent through revenue participation (as defined in the lease agreement) in incremental revenues generated by the facilities over a defined base period, effective at various times during the term of the lease. Each lease is a triple net lease which requires the lessee to pay additional charges including all taxes, insurance, assessments, maintenance and repair (capital and non-capital expenditures), and other costs necessary in the operation of the facility. Most of the leases contain renewal options. Subsequent to December 31, 2005, we sold four assisted living properties operated by Sunwest with a total of 431 units to an entity formed by the principals of Sunwest for \$58.5 million. We received \$54.6 million in proceeds after paying \$3.8 million of 8.75% State of Oregon bond obligations related to one of the properties sold. As a result of the sale, we will recognize a gain of \$31.9 million in 2006.

The following table sets forth certain information regarding our owned properties as of December 31, 2005 (*dollar amounts in thousands*):

Location	No. of SNFs	No. of ALFs	No. of Schools	No. of Beds/Units(1)	Encumbrances	Lease Term(2)	Current Investment
Alabama	3	1		458	\$	93	\$ 16,539
Arizona	5	3(5)		1,220		172	50,128
California	1	3(5)		436	17,002	73	36,713
Colorado	4	6		562	6,415	244	27,265
Florida	3	6		776	2,172	173	32,082
Georgia	2	1		292		70	6,550
Idaho		4		148		108	9,756
Indiana		2					