

REIT SPIN-OFFS

Facts About IRS Revenue Ruling 2001-29

Background

In 1973, the IRS issued a revenue ruling concluding that a “regular” corporation may not distribute to its shareholders on a tax-free basis (called a “spin-off”) stock of a company that would elect REIT status. The IRS reasoned that a REIT could not satisfy one of the threshold requirements of a spin-off: both the distributing and distributed companies must operate an *active* trade or business for at least five years.

The IRS was then correct because at that time REITs were not allowed to use their own employees to offer even the most basic services to their tenants. Thirteen years later, however, a provision of The Tax Reform Act of 1986 allowed REITs to provide all customary services to their tenants. In the 15 years since then, REITs have naturally transformed from passive property-holding portfolios to active real estate companies.

In 1994, NAREIT first submitted an analytical brief and draft revenue ruling asking for a modification of the 1973 ruling, and since then has regularly advocated its support of that change. Since 1994, the IRS has informally advised taxpayers that the 1973 ruling would not prevent it from issuing a private letter ruling for a REIT that conducted the activities typical of a modern day REIT.

Recent IRS Action

On June 4, the IRS released a revenue ruling (Revenue Ruling 2001-29) that rendered the 1973 ruling obsolete and concluded that REITs operate an active trade or business as part of their typical real estate rental activities.

REITs, the agency reported, can be engaged in the active conduct of a trade or business within the meaning of the Internal Revenue Code solely by virtue of certain functions with respect to rental activity.

Under the current framework, an organization can treat rental income as rents from real property even if, in connection with the rental activity, it furnishes certain services that are not primarily for the convenience of the occupant. Such services include the furnishing of heat and light, the cleaning of public areas, providing security for the premises, and trash collection.

The IRS ruling recognized that by virtue of its rental activities, a REIT can be viewed as engaged in the active conduct of a trade or business and thus can meet *one* of several technical requirements to qualify for a tax-free spin-off.

NAREIT Analysis

Revenue Ruling 2001-29 is significant official recognition that REITs today are engaged in active business, and is therefore welcomed by NAREIT. This step by the Treasury Department and the IRS recognizes that REITs have evolved from passive holders of commercial real estate portfolios to full-fledged, active real estate companies.

It is important to note, however, that the ruling merely confirms an informal IRS ruling policy and does not address the other requirements necessary for REIT spin-offs.

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