

**REIT SPIN-OFFS**  
**Questions and Answers About IRS Revenue Rule 2001-29**

**Q:** Some have interpreted the rule to suggest that non-real estate companies with substantial real estate holdings may spin off their real estate assets on a tax-free basis into a REIT. What template must companies follow for such a spin-off?

**A:** A tax-free spin-off must satisfy several rigorous tax tests. First, both the distributing company and the distributed company each must have operated an active trade or business for at least five years. Note that merely owning real estate (*e.g.* a company's own corporate headquarters) is not an active trade or business. Further, it is still unsettled whether owning property that is "net leased" to a party that takes care of and operates the leased property qualifies as an active trade or business.

Second, both the distributing and distributed company must have a non-tax business purpose for the spin-off. In addition, the IRS requires a higher level of business purpose when either company is a single tax entity (*i.e.*, an "S" corporation, a mutual fund or a REIT).

Last, the spin-off cannot be viewed as a "device" to distribute earnings and profits of the distributing corporation.

Beyond the technical tax requirements, a spin-off must fit into the business plan of the enterprise. For example, a company that has adopted as a core business principal that it should own its real estate to control its underlying business would have to adopt a new business plan if it were to spin off its real estate to a separate company.

**Q:** What are the benefits of such a spin-off?

**A:** Corporate America has engaged in billions of dollars of spin-offs to better concentrate a company's business, both for operating efficiencies and to make it easier for investors to evaluate a company.

**Q:** Does the ruling make it significantly easier for regular corporations to spin-off subsidiaries on a tax-free basis, which then elect REIT status?

**A:** No. The revenue ruling merely confirms an informal ruling position of the IRS and does not resolve any of the thorny tax issues that still remain. Its major significance is that the Treasury Department and the IRS officially recognized that REITs' rental activities can qualify as an active trade or business and that since 1986 REITs are no longer merely passive owners of a portfolio of properties.

Q: What are the tax implications of a REIT spin-off?

A: The net tax implications of such a transaction today versus prior to the ruling are not materially different.

If the spin-off qualifies under the tax rules, there is no shareholder or corporate tax imposed from the shareholders' receipt of the distributed corporation's stock. However, any "regular" corporation electing REIT status (including a subsidiary of a corporation that elects REIT status and is distributed to the corporation's shareholders) is under an obligation by the end of the tax year in which it elects REIT status for the first time to make taxable distributions to its shareholders equal to the amount of earnings the company generated before becoming a REIT (including a subsidiary's pro rata amount of the earnings attributable to the real estate operations while it was part of the distributing corporation). Also, a corporation electing REIT status is subject to taxation at both the shareholder and corporate level as if it sold all its assets and distributed the proceeds to its shareholders. However, like S corporations, REITs can elect to defer any double-level tax event, which then is triggered only if the REIT sells the assets in a taxable transaction within 10 years of the election.

In the final analysis, any spin-off will be driven by the company's business purpose rather than tax considerations.

Q: Among the requirements for a tax-free spin-off is that both the distributing corporation and the spun-off subsidiary must each be engaged in the active conduct of a 5-year trade or business. How does the IRS define "active conduct"?

A: On a case-by-case basis. The regulations in effect for some time provide an example that the typical leasing of property, accompanied by customary services to tenants, constitutes an active trade or business.

Q: Does this mean we are unlikely to witness any REIT spin-offs by property-owning companies until 2006?

A: Among other factors, it depends on whether corporations have conducted an active third party rental business in the past.

Q: What constitutes a "substantial" business purpose?

A: The IRS has not established any clear guidelines, so this needs to be resolved on a case-by-case basis.

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