Internal Revenue
bulletin

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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2001–29, page 1348.
REIT and section 355(b) active conduct of a trade or business. A REIT can be engaged in the active conduct of a trade or business within the meaning of section 355(b) of the Code solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of section 856(d) of the Code. Rev. Rul. 73-236 obsoleted.

Rev. Rul. 2001–31, page 1348.
Captive insurance transactions. This ruling explains that the Service will no longer raise the "economic family theory," set forth in Rev. Rul. 77–316 (1977–2 C.B. 53), in addressing whether captive insurance transactions constitute valid insurance. Rather, the Service will address captive insurance transactions on a case-by-case basis. Rev. Ruls. 77–316, 78–277, 88–72, and 89–61 obsoleted. Rev. Ruls. 78–338, 80–120, 92–93, and 2000–3 modified.

Rev. Rul. 2001–32, page 1350.
Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning July 1, 2001, will be 7 percent for overpayments (6 percent in the case of a corporation), 7 percent for underpayments, and 9 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 will be 4.5 percent.

Notice 2001–40, page 1355.
Frivolous filing position based on section 861 of the Code. There is no basis in law for the view that U.S. citizens and residents are not subject to tax on wages and other U.S. source income because the Code only taxes foreign-based activities.

EXEMPT ORGANIZATIONS

Announcement 2001–67, page 1356.
Wentworth Community Services of Chicago, IL, no longer qualifies as an organization to which contributions are deductible under section 170 of the Code.

Announcement 2001–68, page 1356.
A list is provided of organizations now classified as private foundations.

ADMINISTRATIVE

Announcement 2001–65, page 1356.
The Service announces that an updated edition of Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities* (revised June 2001), is now available.

Announcement of Declaratory Judgment Proceedings Under Section 7428 begins on page 1358.
Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 118.—Contributions to the Capital of a Corporation

26 CFR 1.118–1: Contributions to the capital of a corporation.

The revenue ruling obsoletes Rev. Rul. 77–316 (1977–2 C.B. 53), which provided that payments between related parties that were disallowed as deductions for insurance premiums should be recharacterized as contributions to capital under I.R.C. § 118. See Rev. Rul. 2001–31, on this page.

Section 162.—Trade or Business Expenses

26 CFR 1.162–1: Business expenses.

The revenue ruling announces that the Service will not raise the economic family theory, originally set forth in Rev. Rul. 77–316 (1977–2 C.B. 53), in determining whether payments between related parties are deductible insurance premiums. See Rev. Rul. 2001–31, on this page.

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26 CFR 1.162–1: Business expenses.
(Also §§ 118, 165, 301, 801, 831; 1.118–1, 1.165–1, 1.301–1, 1.801–3, 1.831–3.)

This ruling explains that the Service will no longer raise the "economic family theory" set forth in Rev. Rul. 77–316 (1977–2 C.B. 53), in addressing whether captive insurance transactions constitute valid insurance. Rather, the Service will address captive insurance transactions on a case-by-case basis.

Rev. Rul. 2001–31

In Rev. Rul. 77–316 (1977–2 C.B. 53), three situations were presented in which a taxpayer attempted to seek insurance coverage for itself and its operating subsidiaries through the taxpayer's wholly-owned captive insurance subsidiary. The ruling explained that the taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary represented one "economic family" for purposes of analyzing whether transactions involved sufficient risk shifting and risk distribution to constitute insurance for federal income tax purposes. *See Helvering v. Le Gierse*, 312 U.S. 531 (1941). The ruling concluded that the transactions were not insurance to the extent that risk was retained within that economic family. Therefore, the premiums paid by the taxpayer and its non-insurance subsidiaries to the captive insurer were not deductible.

No court, in addressing a captive insurance transaction, has fully accepted the economic family theory set forth in Rev. Rul. 77–316. *See, e.g., Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989); *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297 (9th Cir. 1987) (employing a balance sheet test, rather than the economic family theory, to conclude that transaction between parent and subsidiary was not insurance); *Kidde Industries, Inc. v. United States*, 40 Fed. Cl. 42 (1997). Accordingly, the Internal Revenue Service will no longer invoke the economic family theory with respect to captive insurance transactions.

The Service may, however, continue to challenge certain captive insurance transactions based on the facts and circumstances of each case. *See, e.g., Malone & Hyde v. Commissioner*, 62 F.3d 835 (6th Cir. 1995) (concluding that brother-sister transactions were not insurance because the taxpayer guaranteed the captive's performance and the captive was thinly capitalized and loosely regulated); *Clougherty Packing Co. v. Commissioner* (concluding that a transaction between parent and subsidiary was not insurance).

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 77–316, 1977–2 C.B. 53; Rev. Rul. 78–277, 1978–2 C.B. 268; Rev. Rul. 88–72, 1988–2 C.B. 31; and Rev. Rul. 89–61, 1989–1 C.B. 75, are obsoleted.

Rev. Rul. 78–338, 1978–2 C.B. 107; Rev. Rul. 80–120, 1980–1 C.B. 41; Rev. Rul. 92–93, 1992–2 C.B. 45; and Rev. Proc. 2000–3, 2000–1 I.R.B. 103, are modified.

DRAFTING INFORMATION

The principal author of this revenue ruling is Robert A. Martin of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Mr. Martin at (202) 622-3970 (not a toll-free call).

Section 165.—Losses

26 CFR 1.165–1: Losses.

The revenue ruling obsoletes Rev. Rul. 77–316 (1977–2 C.B. 53), which provided that losses paid by a captive insurance company pursuant to a related-party transaction deemed not to be insurance were deductible by the captive insurer's respective parent or affiliate under IRC § 165(a). See Rev. Rul. 2001–31, on this page.

Section 301.—Distributions of Property

26 CFR 1.301–1: Rules applicable with respect to distributions of money and other property.

The revenue ruling obsoletes Rev. Rul. 77–316 (1977–2 C.B. 53), which provided that losses paid by a captive insurance company pursuant to a related-party transaction deemed not to be insurance were viewed, to the extent of available earnings and profits, as distributions under IRC § 301 to the respective parent. See Rev. Rul. 2001–31, on this page.

Section 355.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355–3: Active conduct of a trade or business.
(Also: § 856)

REIT and section 355(b) active conduct of a trade or business. A REIT can be engaged in the active conduct of a trade or business within the meaning of section 355(b) of the Code solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of section 856(d) of the Code.

Rev. Rul. 2001–29

ISSUE

Can a real estate investment trust (REIT) be engaged in the active conduct of a trade or business within the meaning of § 355(b) of the Internal Revenue Code solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of § 856(d)?

LAW AND ANALYSIS

Sections 355(a)(1)(C) and (b) require that both the distributing and controlled corporations be engaged, immediately after a distribution, in the active conduct of a trade or business that has been actively conducted throughout the five year period ending on the date of the distribution. Section 1.355–3(b)(2)(iii) of the Income Tax Regulations provides that the determination of whether a trade or business is actively conducted is made from all the facts and circumstances. Generally, a corporation is treated as actively

conducting a trade or business only if it performs active and substantial management and operational functions. Generally, activities performed by the corporation do not include activities performed by persons outside the corporation, including independent contractors. However, a corporation may satisfy the active trade or business test through the activities it performs itself, even though some of its activities are performed by others. For an illustration of active and substantial management and operational functions in the context of the rental of real property, *see generally* Rev. Rul. 79–394, 1979–2 C.B. 141, *as amplified by* Rev. Rul. 80–181, 1980–2 C.B. 121.

In Rev. Rul. 73–236, 1973–1 C.B. 183, X, an unincorporated domestic trust qualifying as an association taxable as a corporation under § 7701(a)(3), was engaged for more than five years in the sale of real estate that it developed and improved, and in the leasing of buildings that it constructed. In order to raise capital, X intended to convert to a REIT, as defined in § 856. In order to satisfy certain requirements of § 856, X had to dispose of property that it held primarily for sale to customers in the ordinary course of business. To accomplish this, X transferred this property to Y, a newly formed corporation, in exchange for all of the Y stock, which X distributed to its beneficiaries *pro rata*. Immediately following the Y stock distribution and as part of an overall plan, X elected REIT status. In order to ensure that it would meet the requirements of § 856(c), X managed and operated its real estate leasing operations through independent contractors so as to qualify all of its rental income as "rents from real property" within the meaning of § 856(d). Section 856(d)(3), as in effect when Rev. Rul. 73–236 was issued, excluded from the term "rents from real property" amounts received with respect to such property "if the real estate investment trust furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from whom the trust itself does not derive or receive any income." (In 1976, this provision was redesignated § 856(d)(2)(C). *See* Tax Reform Act of 1976, Pub. L. No. 94–455, § 1604(b), 90 Stat. 1520, 1749 (1976).)

The only issue that Rev. Rul. 73–236 considered was whether X, after the distribution and while qualifying as a REIT under § 856, was engaged in the active conduct of a trade or business within the meaning of § 355(b). Because X's rental activities conducted as a REIT were designed to qualify all of its rental income as "rents from real property" within the meaning of § 856(d), Rev. Rul. 73–236 concluded that X did not directly perform substantial management and operational activities and, therefore, that X was not engaged in an active trade or business within the meaning of § 355(b) immediately after the distribution of the Y stock.

Section 663 of the Tax Reform Act of 1986, Pub. L. No. 99–514, 100 Stat. 2085, 2302 (1986), amended § 856(d)(2)(C). Under the statute, as amended, amounts that would qualify as rents from real property under § 512(b)(3) if received by an organization described in § 511(a)(2) are not excluded from rents from real property under § 856(d)(2)(C). Section 512(b)(3) excludes rents from real property from unrelated business taxable income. Section 1.512(b)–1(c)(5) interprets § 512(b)(3) to permit an organization to 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 and are usually or customarily rendered in connection with the rental of real property. Such services include, for example, the furnishing of heat and light; the cleaning of public entrances, exits, stairways, and lobbies; and the collection of trash. Consequently, as a result of the 1986 amendment, a REIT is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property under § 856(d).

HOLDING

A REIT can be engaged in the active conduct of a trade or business within the meaning of § 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of § 856(d).

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 73–236 is obsoleted.

The obsolescence of Rev. Rul. 73–236, which denied § 355 treatment to a distribution of stock by a C corporation that converted to a REIT because the REIT was not engaged in the active conduct of a trade or business, does not imply a view as to whether a distribution of stock involving a REIT election by the distributing or controlled corporation would otherwise satisfy the requirements of § 355, including the corporate business purpose requirement of § 1.355–2(b).

DRAFTING INFORMATION

The principal author of this revenue ruling is Richard Passales of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Mr. Passales at (202) 622-7530 (not a toll-free call).

Section 801.—Tax Imposed

26 CFR 1.801–3: Definitions.

The revenue ruling obsoletes Rev. Rul. 77–316 (1977–2 C.B. 53), which provided that certain captive insurance companies were not taxable as insurance companies pursuant to IRC §§ 801, 831, and the applicable regulations because the related-party transactions could not be considered "insurance" for purposes of determining whether the captive insurer was "primarily and predominantly engaged in the insurance business," as required in Treas. Reg. § 1.801–3(a). See Rev. Rul. 2001–31, page 1348.

Section 831.—Tax on Insurance Companies Other Than Life Insurance Companies

26 CFR 1.831–3: Tax on insurance companies (other than life or mutual), mutual marine insurance companies, mutual fire insurance companies issuing perpetual policies, and mutual fire or flood insurance companies operating on the basis of premium deposits; taxable years beginning after December 31, 1962.

The revenue ruling obsoletes Rev. Rul. 77–316 (1977–2 C.B. 53), which provided that certain captive insurance companies were not taxable as insurance companies pursuant to IRC §§ 801, 831, and the applicable regulations because the related-party transactions could not be considered "insurance" for purposes of determining whether the captive insurer was "primarily and predominantly engaged in the insurance business," as required in Treas. Reg. § 1.801–3(a). See Rev. Rul. 2001–31, page 1348.

Section 856.—Definition of Real Estate Investment Trust

26 CFR 1.856–1: Definition of real estate investment trust.

REIT & § 355(b) active conduct of a trade or business: The ruling holds that a REIT can be engaged in the active conduct of a trade or business within the