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# IRS Allows REITs To Engage In Tax-Free Spin-Offs

A new ruling from the Internal Revenue Service concerning real estate investment trusts (REITs) presents new opportunities for corporations with real estate holdings. The ruling, Rev. Rul. 2001-29, 2001-26 I.R.B. 1348, recognizes a real estate investment trust (REIT) as an active trade or business for the purpose of a tax-free spin-off of assets by a U.S. corporation to its shareholders. Prior to Rev. Rul. 2001-29, the IRS held that a REIT could not qualify as a business soley based on its function of producing income qualifying as rent; therefore, a REIT could not satisfy the requirements for a tax-free spin-off.

The new IRS ruling gives a company options for restructuring or refinancing its real estate assets where management of these assets has qualified as an active trade or business. For example, a parent corporation could arrange a sales-leaseback to a REIT and spin off the REIT to shareholders. This type of transaction would relieve the corporation's balance sheet of real estate assets while allowing it to realize the appreciation of the assets. Also, the shareholders receive direct interest in valuable real estate assets. The lease payment to the REIT would be currently deductible for tax purposes contributing to after tax cash flow. Additionally, if the REIT holds the spun-off real estate for ten years, there might not be any federal tax imposed on the gain from the sale of the real estate.

## REIT QUALIFICATIONS

A REIT is a corporation, trust, or association which would be taxable as a domestic corporation if not for its qualification and election to be treated as a REIT. The purpose of a REIT is to combine capital from different investors. The REIT's investments in real estate are designed for marketing to large groups of investors. To qualify as a REIT, a corporation, trust or association must meet three sets of criteria - organizational, asset, and income.

- **Organizational** - One or more directors or trustees must manage the corporation, trust or association. Its shares or certificates of beneficial ownership must be freely transferable and must be held by 100 or more persons. A REIT cannot be closely held, that is, no more than 50% of the value of its shares or certificates can be held by five or fewer individuals. There are timing and due diligence rules which govern a REIT's obligation to determine its ownership to avoid being closely held.

- **Asset** - At least 75% of the entity's total assets must consist of real estate, cash or cash items including receivables generated in the ordinary course of business, and government securities. For the remaining 25% of total asset value, no more than than 25% can consist

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of securities, no more than 5% can be attributable to the securities of one particular issuer, and the REIT cannot hold more than 10% of the vote or value of the securities of one particular issuer. Finally, no more than 20% of the total value of the assets can be attributable to the securities of one or more taxable REIT subsidiaries.

- **Income** - At least 75% of gross income must consist of rents from real property, interest on obligations secured by mortgages, gain from the sale of real property that was not held primarily for sale, dividends from other REITs and gain from the sale of REITs shares, refunds and abatements of real property taxes, income and gain from foreclosure property, commitments and certain other fees, qualified temporary investment income, and gain from the sale of certain identifiable property. In addition, 95% of gross income must consist of these items plus dividends, interest, and gain from the sale or disposition of stocks and securities.

### TAX ISSUES

If the organizational, asset and income requirements are met, and a proper election to be treated as a REIT is in effect, the income earned by the REIT is not taxed at its level. Rather, distributions the REIT is required to make are taxed at the level of the stock or certificate holder. The REIT must generally distribute at least 90% of its income and the distributions are identified to the investors as ordinary income or capital gains depending on the underlying transactions of the REIT generating the income. The REIT must be careful to both declare and pay the proper dividend amount to its stockholders or it could be subject to excise tax or income tax at its level.

### SPIN-OFF RULES

Under the new IRS ruling, a corporation can spin off a REIT tax-free provided that the overall requirements of section 355 of the Internal Revenue Code are met. With respect to the trade or business requirement, the REIT must have been enaged in an active trade or business for five years before the spin-off. The active trade or business requirement was enacted to prevent a tax-free cashing out of an appreciated equity interest. The interests held by the participants after the spin-off must be equity interests in the same business activity and such activity must remain ongoing. In order to receive tax-free treatment, the spin-off must also serve a valid business purpose (other than a reduction of federal taxes). In addition, the spun-off REIT would be required to distribute any earnings and profits gained from the distributing corporation since the spun-off REIT is not allowed to have any such earnings and profits.

The success of a sales-leaseback and spin-off involving a REIT is contingent on a proper valuation of the underlying assets. In the event of a spin-off, a fairness opinion may be required to justify the transaction to shareholders. Valuation Research Corporation has extensive experience providing the valuations needed to support these types of transactions. For more information, contact your Valuation Research representative or Bill Schoenecker at 414/221-6252. **VR**

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