

Part I

Section 355.00-00.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355-3: Active Conduct of a Trade or Business (Also: § 856)

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 obsolete.

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 on (202) 622-7530 (not a toll-free call).