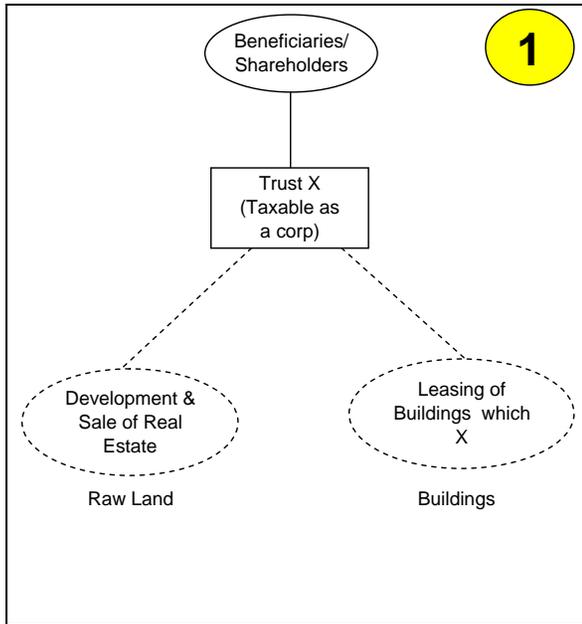
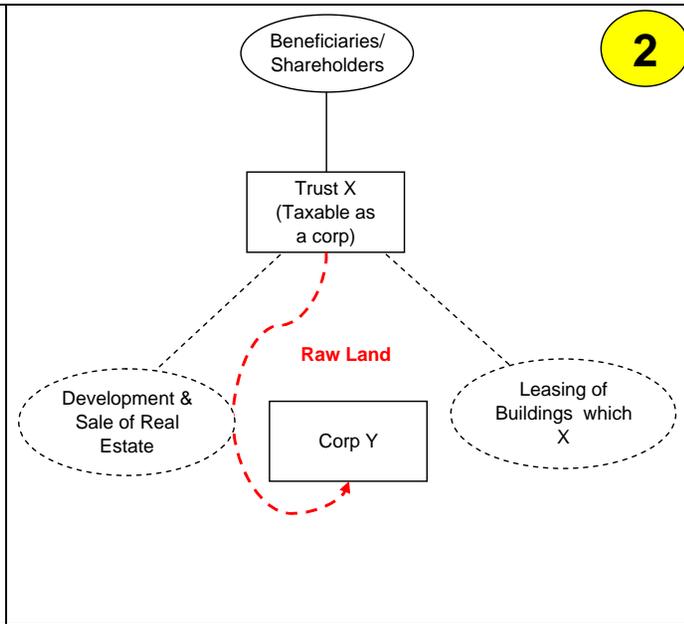


**REIT Rents Cannot Be Active Business Rents For Spin-Off**

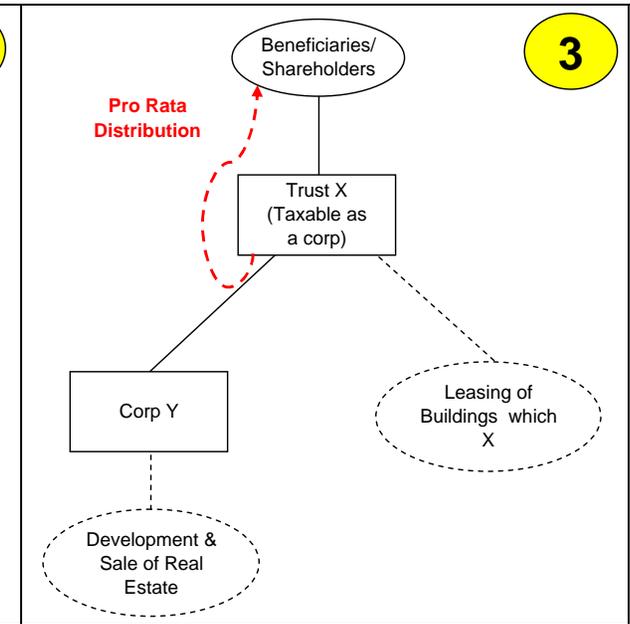
**Initial Structure**



**Drop Down**

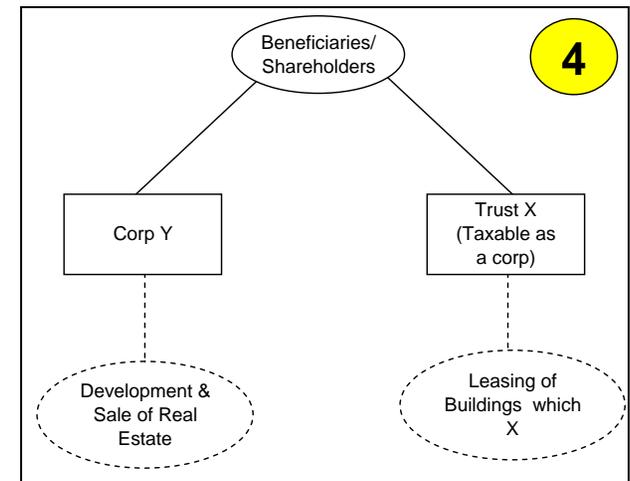


**Spin-Off**



For over five years X, an unincorporated domestic trust qualifying as an association taxable as a corporation under section 7701(a)(3), has been engaged in two businesses: (1) the sale of real estate which it develops and improves, and (2) the leasing of some of the buildings which it constructs. In order to avail itself of a means of attracting needed investment capital, X intends to qualify as a real estate investment trust ("REIT"), as defined in section 856. In order to meet the requirement of section 856(a)(4), X had to rid itself of property, including substantially all of its undeveloped land, that it held primarily for sale to customers in the ordinary course of its business. To accomplish this, X transferred this property to Y, a newly formed corporation, in exchange for all the Y stock and distributed the Y stock to its beneficiaries pro rata. Immediately after the distribution of the Y stock and as part of one overall plan, X converted itself to a REIT. X, in compliance with the provisions of section 856 of the Code, then engaged primarily in the leasing of real estate properties, each of which was managed and operated through an independent contractor.

**Ending Point**



Section 355 requires that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the "active conduct of a trade or business." Section 355(b)(2)(B) provides that a corporation will be treated as engaged

in the active conduct of a trade or business if, and only if, such trade or business has been actively conducted throughout the five-year period ending on the date of distribution. The only issue to which this Revenue Ruling was directed was whether X, after the distribution and while qualifying as a REIT under section 856 of the Code, is also engaged in the active conduct of a trade or business within the meaning of section 355(b).

Section 355, by requiring that a trade or business be actively conducted, connotes substantial management and operational activities directly carried on by the corporation itself. The activities of others outside the corporation, including independent contractors, may not be considered in determining whether the corporation itself is engaged in the active conduct of a trade or business for purposes of section 355. However, the fact that a portion of a corporation's business activities is performed by independent contractors will not preclude the corporation from being engaged in the active conduct of a trade or business if the corporation itself directly performs active and substantial management and operational functions.

The legislative history of section 856 states that its provisions were intended to be restricted to income "which is clearly passive income from real estate investments, as contrasted to income from the active operation of businesses involving real estate." In view of the foregoing it was concluded that X's rental activities conducted as a REIT preclude X from directly performing substantial management and operational activities, and, thus, X is not engaged in an active trade or business immediately after the distribution of the Y stock to its beneficiaries within the meaning of section 355(b).

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