CLIENT
MEMORANDUM

NEW REIT SPIN-OFF RULING

On June 4, 2001, the IRS ruled that a real estate investment trust (REIT) can satisfy the active business requirement for a tax-free spin-off. (Revenue Ruling 2001-29) The ruling declares obsolete Revenue Ruling 73-236 which held, under the law then in effect, that a REIT is, by definition, too passive to satisfy the active business requirement laid down by Internal Revenue Code section 355. Under the law in effect in 1973, REITs were not permitted to manage their properties directly. Since the 1973 ruling, Congress has acted a number of times to amend the REIT rules, and it has been clear for more than a decade that REITs can be active managers of their own properties and can provide certain customary services to their tenants. Today, REITs actively manage and operate shopping centers, office buildings, as well as other, less traditional types of real estate.

Under section 355, a corporation may spin off a subsidiary in a transaction that is tax-free at both the corporate and shareholder level, but only if several specific requirements are satisfied. These requirements include that (i) the distributing corporation and spun-off corporation both must have been engaged in an active trade or business for the 5-year period preceding the distribution (the "active business requirement"), (ii) the spin-off must have a valid business purpose other than the reduction of federal income taxes (the "business purpose requirement"), and (iii) the spin-off may not be a device for the distribution of earnings and profits (the "device requirement").

The new ruling addresses only the active business requirement and arguably does no more than withdraw a ruling that many tax advisors have long believed to be obsolete. The ruling specifically states that it does not address whether a spin-off of a REIT would satisfy the other requirements of section 355, including the business purpose requirement. IRS ruling guidelines continue to require a description of any reduction in federal taxes that can be expected to occur as a result of the spin-off, and also require disclosure of whether either party is, or is expected to become, a REIT. The IRS will continue to weigh the tax reduction that would occur from a spin-off of real property into an entity that will elect REIT status against the business purpose of the distribution. Although the ruling does remove one potential roadblock to REIT spin-offs such as the pending Georgia Pacific/Plum Creek transaction, it may be reading too much into the ruling to conclude that it signals a fundamental change in the IRS's view of the section 355 business purpose and device requirements as it relates to REITs. The full implications of this new IRS view will depend in part on a case-by-case analysis of all the relevant circumstances and a specific analysis of the tax-free spin-off requirements in each case.

If you have any questions regarding this ruling, please call Richard L. Reinhold at (212) 728-8292, Bruce M. Montgomerie at (212) 728-8248, Henry M. Cohn at (212) 728-8209, or Andrew W. Needham at (212) 728-8728.

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June 6, 2001