

FOCUS ON REITs

IRS RULING PERMITS REIT SPIN-OFFS

by David M. Einhorn, Adam O. Emmerich, & Robin Panovka

In a significant and long-anticipated ruling, the IRS has reversed a long-standing position and ruled that REITs may be sufficiently "active" to permit them to engage in tax-free spin-off transactions. As a result, many REITs will be able to spin-off parts of their businesses in order to create more focused companies and to carry out other strategic goals, including mergers and acquisitions.

While the ruling is most likely to stimulate transactions by REITs, it has also sparked a wave of discussion with regard to non-REIT public companies restructuring their real estate holdings by transferring their real estate to a newly-formed REIT, leasing back the real estate and distributing the REIT stock to their shareholders in a tax-free spin-off transaction. But while the IRS ruling has largely eliminated one of the impediments to such tax-free restructurings, there are still unanswered questions with regard to whether REIT spin-offs will satisfy other requirements for qualification as tax-free and whether such spin-offs will ultimately prove attractive and workable for many companies.

Certainly, the case for transferring real estate to a spun-off REIT can be compelling for some companies. The advantages include potential tax savings from holding real estate in a REIT (which generally does not pay entity-level tax on rental and other income), streamlining the company's balance sheet, enabling the company to focus on its core business and reduce its investment in real estate, enabling the company to raise capital efficiently in a concurrent IPO of up to 20 percent of the REIT's stock. On the other hand, the path to any such transaction presents the following potential pitfalls and issues, which may prove to be insurmountable:

- In any spin-off of a REIT (or other corporation) from a regular taxable corporation (a "C corporation"), the retained earnings and profits ("E&P") of the distributing company must be divided between the distributing company and the REIT on the basis of the relative fair market value of each company. This is potentially problematic because the REIT rules generally prohibit REITs from having C corporation E&P and would require the spun-off REIT to distribute its share of the E&P to shareholders in the form a taxable dividend. Companies considering a restructuring that have substantial retained E&P (which will be the case for many profitable companies) will need to consider the cost of such a taxable dividend and to measure it against the benefits of the transaction. While such a dividend may be paid with stock, companies must consider the reaction of their shareholders to a taxable non-cash dividend.
- Any restructuring will need to carefully balance the company's need for control and flexibility with respect to its real estate against a series of competing forces, including the capital markets' requirements with respect to the structure and governance of the REIT (which typically include the requirement for some degree

of independence and which will be particularly relevant if the restructuring involves capital raising through a public offering); the REIT rules' restrictive and potentially burdensome requirements with respect to the REIT's assets and activities; and tax and accounting considerations designed to ensure that the form of the transaction as a sale lease-back is respected. Depending on the real estate involved and the company's approach to its real estate, it may be that even the most thoughtful structuring will result in too great a loss of control and flexibility. These issues should, therefore, be considered early in the process.

- As noted, the recent IRS ruling spoke only to whether a REIT could satisfy the spin-off requirement that the companies involved be engaged in an active business. It remains unclear whether the other spin-off requirements can be satisfied, particularly the requirement that the spin-off must be motivated "in whole or substantial part" by a legitimate business purpose other than avoiding federal taxes and not be a "device" for the distribution of earnings and profits. Indeed, the

recent ruling expressly stated that the IRS was not ruling on the question of whether a spin-off of a REIT might satisfy the business purpose requirement.

It is also important to keep in mind that, while the REIT spin-off mechanic is now a hot topic, it may not be the best way for all interested companies to restructure their real estate holdings. Depending on the specific goals of the company, many of the desired objectives may be achievable with superior results through other transaction structures, including a tax-free contribution and lease-back transaction with an UPREIT (Umbrella Partnership REIT). The best structure for any company will be the product of careful analysis and will depend on the company's goals and business plan and the particular real estate involved.^{REI}

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David M. Einhorn, Adam O. Emmerich, & Robin Panovka are partners of *Wachtell, Lipton, Rosen & Katz* in *New York*.