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Final Guidance on C Corporations Conversions and Asset Transfers to REITS

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On March 18, 2003, the Treasury issued final regulations under Section 337(d)[1] providing extensive rules relating to the recognition of gain upon the conversion of a "C" corporation to a real estate investment trust (REIT) or the non-taxable transfer of property from a C corporation to a REIT ("conversion transactions").[2] These regulations bring an end to the long saga of Treasury and IRS guidance – or more accurately, the lack thereof for many years – relating to Section 337(d). The changes made in the final regulations are responsive to industry and bar comments and, together with the provisions carried over from the temporary regulations issued in January, 2002, provide much needed guidance to practitioners in the area. These regulations and the preceding 2002 temporary regulations represent the culmination of a very productive process involving government representatives and industry and professional groups working together to effectively deal with the issues relating to conversion transactions.[3]

Background

Section 337(d) was enacted as part of the Tax Reform Act of 1986 in connection with the repeal of the *General Utilities* doctrine.[4] Under the 1986 Act, Sections 336 and 337 were amended to require corporations to recognize gain or loss on the distribution of property in connection with complete liquidations, other than certain subsidiary liquidations. Section 337(d), added in 1988, directs the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments effected by the 1986 Act, including

> "(1) regulations to insure that such purposes may not be circumvented ... through the use of a regulated investment company, real estate investment trust or tax exempt entity...."

Congress was concerned that, absent special rules, the transfer of property owned by a C corporation to a REIT could result in permanently removing the property's built-in gain from

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[1] T.D. 9047, 2003 - ________ IRB ________, amending Reg. §1.337(d)-5, adding Reg. §§1.337(d)-6 and 1.337-7, and amending Reg. §1.514(c)-2.

[2] These regulations also apply to conversions of C corporations to Regulated Investment Companies ("RICs") and, in general, the provisions discussed herein relating to REITs are equally applicable to RICs. However, this article will deal only with REITs.

[3] The National Association of Real Estate Investment Trusts, the ABA Tax Section and the New York State Bar Association Tax Section participated in this process through the submission of many helpful comments.

[4] Under the principles of *General Utilities & Operating Co. v. Helvering*, 296 U.S.200 (1935), and Sections 336 and 337 gain was not recognized on the distribution of property by a corporation to its shareholders, except as specifically required under the Internal Revenue Code.

taxation at the corporate level, because REITs generally are not subject to tax on income that is distributed to their shareholders.

Notice 88-19. On February 4, 1988, the IRS issued Notice 88-19[5] announcing its intention to promulgate regulations under the authority of Section 337(d) with respect to transactions or events that result in a REIT's owning property that has a basis determined by reference to a C corporation's basis ("carryover basis"). Notice 88-19 provided that the regulations would apply with respect to the net built-in gain of C corporation assets that become assets of a REIT upon (1) the qualification of a C corporation as a REIT or (2) the transfer of assets to a REIT in a carryover basis transaction. Where the regulations applied, the C corporation would be treated for all purposes as if it had sold all of its assets at their respective fair market values and immediately liquidated, unless a Section 1374 election were made, as described below. The regulations would not, however, allow the recognition of a net loss.

The Notice also provided that immediate gain recognition could be avoided if the transferee REIT were to elect to be subject to the rules of Section 1374, which subjects newly-electing S corporations to corporate level taxation on built-in gains from C corporation years, as and when they are recognized, during a ten-year period following the conversion from C corporation to S corporation status. Significantly, the Notice added that the built-in gains of electing REITs and the corporate tax imposed on such gains would be subject to rules similar to the rules relating to "net income from foreclosure property of REITs".[6]

Most importantly, the Notice indicated that the regulations would apply retroactively to June 10, 1987. There were many practitioners who believed that Section 337(d) was not self-executing and that, absent the actual issuance of regulations, neither Section 337(d) nor the Notice itself should be given effect. To the author's knowledge, however, nobody has been brave enough to take this position in an actual case.

2000 regulations. Notwithstanding the anticipation created by Notice 88-19, more than 12 years passed after the enactment of Section 337(d) before any regulations were issued. Finally, on February 7, 2000, the Treasury published temporary regulations implementing Section 337(d) (the "2000 regulations").[7] Much to the consternation of practitioners who were hoping for regulations that would provide meaningful guidance, though, the 2000 regulations merely regurgitated the general principles set forth in Notice 88-19. Nevertheless, the 2000 regulations did provide for the mechanics of making the Section 1374 election, which were absent from Notice 88-19.[8]

2002 temporary regulations. At long last, on January 2, 2002, the Treasury promulgated meaningful temporary regulations (the "2002 temporary regulations") under Section 337(d).[9] The "-6T regulations," which applied to transactions occurring after June 9, 1987 and before January 2, 2002, and the "-7T regulations," which applied to transactions occurring after January 1, 2002, provided extensive and very helpful guidance on most of the issues involved.

Apart from different effective date rules, there were only three significant differences between the -6T and -7T regulations: First, under the -6T regulations, deemed sale treatment and recognition of gain immediately prior to the conversion transaction was the normal rule and the deferral of gain under Section 1374 had to be elected; whereas under the -7T regulations, Section

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5 1988-1 C.B. 486.
6 See I.R.C. §857(b)(4).
7 T.D. 8872, promulgating Temp. Reg. 1.337(d)-5T.
8 Temp. Reg.§1.337(d)-5T(b)(3).
9 T.D. 8975, amending Temp. Reg. 1.337(d)-5T, and adding Temp Reg. 1.337(d)-6T and 1.337-7T.

1374 treatment was automatic and an election of deemed sale treatment had to be made to obtain recognition of gain immediately before the conversion transaction. Second, the -7T regulation contained an "anti-stuffing" rule to prevent the contribution of loss properties to a C corporation in order to reduce built-in gain. Finally, the -7T regulation contained a special rule for partnerships with C corporation partners.

The final regulations

The final regulations are virtually identical to the 2002 temporary regulations, except in three important respects:

- They extend the time for making Section 1374 elections for transactions before January 2, 2002.
- They clarify the rules concerning the use of loss and credit carryforwards.
- They clarify and amplify the special rule for partnerships with corporate partners.

General Rules. The final regulations retain the same two-part structure as was contained in the 2002 temporary regulations: The -6 regulations cover transactions occurring after June 19, 1987 and before January 2, 2002; and the -7 regulations cover transactions occurring after January 1, 2002.[10]

Under the -6 regulations, if property of a C corporation that is not a REIT becomes the property of a REIT in a conversion transaction (i.e., either the qualification of a C corporation as a REIT or the non-taxable transfer of assets of a C corporation to a REIT), then the C corporation is subject to "deemed sale" treatment. Thus, the corporation generally recognizes gain as if it had sold the "converted property" to an unrelated party at fair market value immediately before the conversion transaction, unless the REIT elects to be subject to Section 1374 treatment, discussed below. Under the -7 regulations, however, in the case of transactions after January 1, 2002, Section 1374 treatment is automatic, unless an election is made to have "deemed sale" treatment.[11]

If the C corporation recognizes net gain on the deemed sale,[12] the basis of the converted property in the hands of the REIT is adjusted to its fair market value immediately before the conversion transaction. The regulations do not permit a C corporation to recognize a "net loss" on the deemed sale.[13] Where there is a net loss, the C corporation recognizes no gain or loss on the deemed sale and the C corporation's basis in the converted property carries over to the REIT.

Under the final regulations, the conversion transaction does not necessarily constitute a deemed sale of *all* of the assets of the C corporation, nor is it deemed to be an immediate liquidation of the C corporation. Thus, when a deemed sale is required or elected, net gain may be recognized only with respect to the assets that are actually transferred to the REIT. In addition, the elimination of the liquidation concept is extremely beneficial in that it avoids any possible implication of the imposition of a shareholder tax on the deemed liquidation, and also

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[10] The "-6 regulations" and the "-7 regulations" hereinafter refer to Reg. 1.337(d)-6 and Reg. 1.337(d)-7, respectively.

[11] The election of Section 1374 treatment under the -6 regulations or of deemed sale treatment under the -7 regulations can be made selectively with respect to separate conversion transactions, but an election will apply to all properties involved in any one conversion transaction.

[12] See Reg. 1.337(d)-6(b) and Reg. 1.337(d)-7(c).

[13] "Net loss" is defined as the excess of aggregate losses over aggregate gains, including certain items of ordinary income, without regard to the character of the income, determined at the time of the deemed sale. See Reg. 1.337(d)-6(b)(1).

avoids the potential elimination of the C corporation's tax attributes, such as net operating loss carryforwards, to which the REIT might otherwise succeed.

Deferral of recognition of gain -- Section 1374 treatment. Under both the -6 and the -7 regulations, the application of the Section 1374 rules to defer the recognition of built-in gain gives rise to several issues, most of which are dealt with effectively and favorably under the final regulations.

As specifically provided under Section 1374 in the case of C corporations converting to S corporations, the net built-in gain, *determined at the time of conversion*, is deferred and is recognized only as and if the built-in gain assets are sold during the ten-year period subsequent to the S corporation election.[14] To the extent that built-in gain assets are not sold during the ten-year recognition period, the built-in gain is no longer subject to a separate corporate tax.

Section 1374 provides an extensive set of rules governing the amount and timing of the recognition of such gains.[15] The final regulations import and elaborate on these provisions and the regulations thereunder for purposes of determining the manner in which built-in gains of C corporations that become REITs (or transfer properties to REITs) are recognized and treated during the ten-year period following the conversion transaction.

Characterization of built-in gains. Under Notice 88-19 and the 2000 temporary regulations, the built-in gains of electing REITs were to be subject to rules similar to the rules relating to "net income from foreclosure property" ("NIFP") of REITs. Although the implications of this reference were unclear, the effect of NIFP treatment might have been to treat all built-in gains as ordinary income, regardless of whether they were capital gains or ordinary income; and to prevent the use of net operating losses of a C corporation from being carried forward and offsetting built-in gains recognized by the REIT subsequent to the conversion transaction. Fortunately, the NIFP characterization and the potentially disastrous results were eliminated in the 2002 temporary regulations and now in the final regulations. Thus, the final regulations generally preserve the character of recognized built-in gains and recognized built-in losses, subject to certain limitations.

Loss and other carryforwards. The 2002 temporary regulations clearly permitted the use of C corporation loss carryforwards against built-in gains recognized by a REIT, and provided an ordering rule for applying C corporation loss carryforwards to reduce net recognized built-in gain (and the tax thereon) and REIT taxable income (and the tax thereon).[16] Under this ordering rule, these loss carryforwards first had to be used to reduce net recognized built-in gain (determined under Section 1374) for a REIT's tax year to the greatest extent possible; and it appeared that only any remaining portion of such loss carryforwards could be used to reduce REIT taxable income determined under Section 857(b), although this was not entirely clear.

In response to industry and bar association comments, including this author's, and to everyone's great relief, the final regulations make it clear that loss carryforwards that are used by a REIT to offset recognized built-in gains are also available to offset REIT taxable income for purposes of Section 857(b), to the extent otherwise allowable as deductions under the Internal

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[14] Section 1374(a). Recognized built-in gains during the 10-year recognition period are taxed at the highest corporate tax rate.

[15] Certain income and deduction items attributable to C corporation years may be treated as built-in gains or losses recognized in REIT years. See Section 1374(d)(5).

[16] Temp. Reg. 1.337(d)-6T(c)(1)(ii)(A) and 1.337(d)-7T(c)(1) (ii)(A). Similar rules apply to capital loss and tax credit carryforwards.

Revenue Code.[17] However, loss carryforwards from REIT tax years cannot be used to reduce net recognized built-in gains.

The tax imposed on the net recognized built-in gain is treated as a loss that reduces REIT taxable income and the REIT's earnings and profits.

Earnings and profits. The 2002 temporary regulations clarified that earnings and profits attributable to built-in gains recognized by a REIT during the ten-year recognition period are Subchapter M (REIT) earnings and profits even though they are derived from gains that accrued in C corporation years. This rule, which is carried over in the final regulations,[18] is important because these earnings and profits, if considered pre-REIT C corporation earnings and profits, would have to be distributed prior to the end of the REIT's taxable year;[19] otherwise the REIT would be disqualified.[20]

Example. The foregoing rules, as clarified in the final regulations, can be illustrated by the following example Realty, a calendar year C corporation, owns the following assets on December 31, 2003:

- Property A, with a fair market value of $100,000 and a tax basis of $75,000.
- Property B with a fair market value of $30,000 and a tax basis of $40,000.
- $30,000 in cash.

As of January 1, 2004, Realty has net operating loss carryforwards ("NOLCs") of $5,000 and earnings and profits of $20,000. Realty incurs a loss of $2,000 during 2004. It elects to be a REIT on its 2004 tax return filed on March 15, 2005. Realty, therefore, is a REIT for its tax year beginning January 1, 2004. Accordingly, it automatically would qualify for the deferral of its built-in gains under the Section 1374 rules, unless it elects "deemed sale" treatment under Reg. 1.337(d)-7(c) as of December 31, 2003, which it does not do. During 2004, Realty distributes $20,000 to its shareholders, an amount equal to its earnings and profits accumulated in C corporation (non-REIT) years, as required under Section 857(a)(2)(B).

On May 1, 2005, Realty sells property A for $140,000 and on September 1, 2005 sells property B for $20,000. For 2005, Realty has no other taxable income and does not make a capital gain distribution. It has a NOLC from 2004 of $2,000, in addition to the $5,000 of pre-2004 NOLCs. Upon Realty's sale of the properties, it recognizes gain of $65,000 on Property A and loss of $20,000 on Property B, for a net capital gain of $45,000. However, Realty's net recognized built-in gain under Section 1374 and Temp. Reg. 1.337(d)-7(b) would be only $15,000. (Realty's built-in gain on property A of $25,000, less Realty 's built-in loss on property B of $10,000, as of December 31, 2003.)[21] Realty 's $5,000 of pre-2004 NOLCs can be used as a deduction against the $15,000 of net recognized built-in gain, but its NOLC of $2,000 from 2004 cannot be applied against that gain. Accordingly, Realty 's tax on its net recognized built-in gain would be $3,500 (35% x $10,000). Its earnings and profits for 2005 would be increased by $41,500 ($45,000 net capital gain less the $3,500 tax under Reg. 1.337(d)-7(b)).

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[17] Reg. 1.337(d)-6(c)(2)(ii) and 1.337(b)(2)(ii).
[18] See Reg. 1.337(d)-6(c)(5) Example.
[19] Section 857(a)(2)(B).
[20] Conceivably this distribution, if not timely made, could be accomplished by the "deficiency dividend" procedure, but there are some complex issues relating to the use of that procedure. See Section 860.
[21] Because Realty has sufficient taxable income in excess of the recognized built-in gains for 2005, the taxable income limitation under Section 1374(d)(2) and Reg. 1.337(d)-6(c)(2)(i)(B) and -7(b)(2)(i)(B) doesn't apply.

For purposes of computing REIT taxable income and the tax thereon under Section 857(b), the $15,000 of net recognized built-in gain under Section 1374, less the $3,500 of tax thereon,[22] is added to the remaining portion of the 2005 capital gain of $30,000 (the excess of the capital gain over the net recognized built-in gain of $15,000), resulting in a gain of $41,500. In computing its REIT taxable income, the 2004 NOLC of $2,000 can be used against this gain, and, under the final regulations, all the pre-2000 NOLCs of $5,000 can also be applied against this gain. Thus, Realty would have to either pay a tax on $34,500, or distribute it to its shareholders who would be taxable on the distribution.

Method of Section 1374 election. In another change from the 2002 temporary regulations, the -6 final regulations allow a REIT that converted from a C corporation (or acquired property with a carryover basis from a C corporation) before January 2, 2002 to make a Section 1374 election with any Federal income tax return filed by the REIT on or before *September 15, 2003*, provided that the REIT has reported consistently with such election for all periods.[23] Thus, the final regulations continue to protect a REIT that did not file an election, or did not make a proper election, under Temp. Reg. 1.337(d)-5T of the 2000 regulations.

Post January 1, 2002 conversion transactions

The final -7 regulations, as did the 2002 temporary -7T regulations, apply to "conversion transactions that occur on or after January 2, 2002".[24] While it is obvious that these regulations apply to transfers of property to REITs after January 1, 2002, what is significant, but not so obvious, is that as to conversions of C corporations to REITs, they are effective only with respect to REIT tax years beginning on January 1, *2003*.

Section 1374 treatment as default rule. To reduce the incidence of inadvertent failures to make Section 1374 elections, the -7 regulations provide that Section 1374 treatment applies automatically and deemed sale treatment must be elected.[25] Thus, a potential trap for the unwary is avoided.

While the automatic Section 1374 treatment is likely to be the preferred alternative for most REITs to avoid the triggering of current income, a deemed sale election may be desirable where there are expiring net operating loss carryforwards or a potential limitation on the use of such carryforwards after an acquisition or merger covered by Section 382. In such a case, the REIT would be able to obtain a step-up in basis in those assets without the incidence of any tax.

The election of deemed sale treatment, if desired, must be made in a statement attached to the Federal income tax return of the C corporation for the taxable year in which the sale is deemed to occur.[26] This raises a potential practical problem which was not solved in the final regulations: Assume, for example, that a deemed sale election is made on the C corporation's tax return for 2004, filed on March 15, 2005, based on the corporation's intent to make a REIT election for 2005. However, the REIT election is to be made on the corporation's tax return for 2005, which is not initially due before March 15, 2006. Subsequent to the filing of its 2004 return with the deemed sale election, the corporation may determine that it cannot qualify as a

[22] The amount of tax imposed on net recognized built-in gain is treated as a loss sustained by the REIT during such taxable year. Reg. 1.337(d)-7(b)(3)(ii).

[23] Reg. 1.337(d)-6(C)(4)(ii). The 2002 temporary regulations had provided that such election had to be made by March 15, 2003. However, as commentators pointed out, this would have precluded an election on a 2002 return with an extended due date.

[24] Reg. 1.337(d)-7(f).

[25] Reg. 1.337(d)-7(b).

[26] Reg. 1.337(d)-7(c)(5).

REIT for 2005. Under the regulation saying that the deemed sale election is irrevocable, is the corporation stuck with the deemed sale election?

Anti-stuffing rule. Under this rule, a C corporation must disregard property in computing gain or loss recognized on the conversion transaction if (1) the converted property was acquired by the C corporation in a transaction to which Section 351 applied or as a contribution to capital, (2) the converted property had an adjusted basis in excess of its fair market value on the date of its acquisition, and (3) the acquisition by the C corporation was "part of a plan a principal purpose of which was to reduce gain recognized by the C corporation in connection with the conversion transaction."[27] This rule reflects the government's concern that taxpayers electing deemed sale treatment might attempt to decrease net gains on conversion transactions by "stuffing" loss properties into a C corporation prior to a conversion transaction.

Special rule for partnerships. Like the preceding 2002 temporary regulations, the final regulations apply the principles of the -7 rules to property transferred by a partnership to a REIT to the extent of any C corporation partner's proportionate share of the transferred property.[28] The 2002 temporary regulations, however, merely provided that if a C corporation owns a 20% interest in a partnership, and that partnership were to contribute an asset to a REIT in a Section 351 transaction, the partnership would be treated as a C corporation with respect to 20% of the assets contributed to the REIT;[29] and that if the partnership were to elect deemed sale treatment, any gain recognized by the partnership on the deemed sale would have to be specially allocated to the C corporation partner. Because the regulation said nothing further under this "special rule for partnerships," it was lacking in many details and needed to be fleshed out further.

Fortunately, the final regulation makes some clarifications and adds some further details.[30] First, the regulation clarifies that the principles of section 704(b) and (c) apply in determining the C corporation partner's share of the transferred property. As revised, the regulation provides that the principles of the final regulations apply to property transferred by a partnership to a REIT to the extent of any C corporation partner's distributive share of the gain or loss in the transferred property.

Second, where there is a contribution to a REIT by a partnership of multiple assets, including some with losses and some with gains, and a deemed sale election is made, the final regulation clarifies that the gain allocated to the C corporation partner on a deemed sale is the C corporation partner's distributive share of the *net* gain in the assets transferred to the REIT by the partnership. Thus, the corporate partner will receive the benefit of any offsetting losses.

Third, the final regulation provides that any adjustment to the basis of the REIT stock held by the partnership as a result of electing deemed sale treatment will constitute an adjustment to the basis of that stock with respect to the C corporation partner only.

Finally, concurrently with the issuance of the final regulations, the Treasury has amended the regulations under section 514 to provide that allocations that mandated by statute or regulation (other than subchapter K of the Code and the regulations thereunder) are not considered for purposes of determining qualification under the "fractions rule."[31] This rule,

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[27] Reg. 1.337(d)-7(c)(4). This rule is based on a similar rule under the Subchapter S corporation regulations. See Reg. 1.1374-9.

[28] Reg. 1.337(d)-7(e). This provision, of course, would not apply in the case of a mere conversion of a C corporation to a REIT.

[29] This provision may not be of very wide concern since Section 351(e) inhibits many Section 351 transactions with REITs.

[30] Reg. 1.337(d)-7(e).

[31] Reg. 1.514(c)-2(e)(1)(v).

which applies to partnership allocations made in taxable years beginning after 2001, will ensure that a special allocation of gain to a tax-exempt C corporation partner will not violate the complex "fractions rule" and thereby taint all income from the partnership for unrelated business income tax (UBIT) purposes.

Although one might argue that the entire special partnership rule in the -7 regulations goes beyond what was intended by the statute, without it there would appear to be too much of an opportunity to avoid the recognition of built-in gain through the use of partnerships.

Effective dates

The -6 regulations apply to conversion transactions occurring after June 9, 1987 and before January 2, 2002. The original 1987 effective date contained in Notice 88-19 has been retained, notwithstanding the views of many practitioners that the regulations should not be applied retroactively in light of the very sketchy nature of the rules set forth in the Notice and the 12-year gap between the enactment of the Section 337(d) and the issuance of the new regulations.

Notwithstanding the foregoing effective date rule, Temp. Reg. 1.337(d)-5 may be applied to determine the tax consequences of any transaction occurring after June 9, 1987 and before January 2, 2002 if the taxpayer believes a better result would be obtained by not applying the final -6 regulations. However, REITs subject to Section 1374 treatment must apply certain provisions of the -6 regulations with respect to built-in gains and losses recognized in taxable years beginning after January 1, 2002.[32]

The -7 regulations carry over several new provisions from the temporary regulations that, if made retroactive, could have had an adverse impact on taxpayers that have relied on the prior Notice and the 2000 regulations. Accordingly, the -7 regulations are effective with respect to transactions occurring on or after January 1, 2002.

Exception for re-election of REIT status

The rule requiring recognition of gain on a conversion transaction does not apply to a C corporation that qualified as a REIT for at least one taxable year, then failed to so qualify for a period not greater than two taxable years, and then requalified as a REIT.[33] In addition, in the case of a prior Section 1374 election, the ten-year recognition period under Section 1374 following re-election of REIT status is reduced by the portion thereof that expired before the non-qualification period.[34]

The "triple tax" problem

In a Section 351 transaction in which a C corporation transfers assets to a REIT in exchange for REIT shares,[35] or where the subsidiary of a C corporation is merged into a REIT in exchange for REIT shares, the possibility exists under the final regulations that the same income will be taxed three times – first, to the REIT when the transferred assets are sold within 10 years; second, to the REIT's shareholders when the shareholders receive distributions attributable to these assets; and third, to the C corporation when it sells its REIT shares. In this respect, the regulations may go beyond the legislative mandate to adopt rules "to require the recognition of gain if appreciated property of a C corporation is transferred to a ... REIT … in a carryover basis

[32] Reg. 1.337(d)-6(e).
[33] Reg. 1.337(d)-6(d)(2) and 1.337(d)-7(d)(2).
[34] Reg. 1.337(d)-6(d)(2)(iii) and 1.337(d)-7(d)(2)(iii).
[35] This may be more of a theoretical issue than a practical problem since Section 351 transactions with REITs are not common because of Section 351(e).

transaction *that would otherwise eliminate the corporate level tax on the built-in appreciation*."[36] (Emphasis added.) Although this issue was pointed out to the Government by commentators, the final regulations do nothing to resolve it.

Conclusion

The final regulations significantly enhance the excellent set of temporary regulations which the Treasury provided under Section 337(d) in 2002. They contain clear, practical rules regarding some of the most important issues involved in the formation of REITs or their acquisition of properties, particularly rules relating to the election of Section 1374 treatment, the characterization of built-in gains, the use of loss carryforwards and the timing of earnings and profits. By providing certainty in many areas and eliminating traps for the unwary, these regulations will help facilitate the formation of REITs or the transfer of properties to REITs.

[36] H.R. Rep. No. 795, 100th Cong., 2nd Sess. 65 (1988); S. Rep. No. 445, 100th Cong., 2nd Sess. 66 (1988).