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Conversion of Corporations to RICs and REITs

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Prior to 1986, the so-called "*General Utilities* doctrine," codified in sections 336 and 337 of the Internal Revenue Code (the "Code"), could protect a corporation from the recognition of gain on the distribution of its property in connection with the corporation's liquidation.

Although, in a liquidation, the corporation's shareholders would recognize any gain realized with respect to their stock, the corporation itself could frequently avoid being taxed on the appreciation in its property, thereby creating a large gap in the system of "double taxation" otherwise applicable to activities conducted through corporations.

In 1986, sections 336 and 337 were amended and the "*General Utilities* doctrine" was repealed. As a consequence, it became inevitable for taxpayers to seek other ways of avoiding corporate-level tax on dispositions of assets.

One method of avoiding corporate-level tax has been to bring the corporation within a specialized tax regime, such as those governing S corporations, regulated investment companies ("RIC's), or real estate investment trusts ("REIT's"). Although the details of these regimes vary, they share a common theme—corporate income of a qualifying entity is taxed only to the shareholders, and not to the corporation itself.

Congress in 1986 was aware of these tax saving opportunities and included with the 1986 tax law changes a series of provisions intended to limit those opportunities to "appropriate" situations. In the case of corporations wishing to qualify as S corporations, section 1374 of the Code was amended to impose a corporate-level tax on any gains recognized during the first 10 years of S qualification that were "built in" on the date that the corporation first became an S corporation (*i.e.*, to the extent of the unrealized appreciation in the corporation's assets on that date). Section 1374 is a highly detailed provision, with definitions, exceptions, and special rules, and has been implemented by extensive Treasury Regulations promulgated in 1994.

By contrast, the provisions applicable to corporations seeking to avoid the "double tax" regime by qualification as RIC's or REIT's are much more terse. Code section 337(d) simply directs the Secretary of the Treasury to prescribe Regulations that may be necessary to carry out the purposes of the repeal of *General Utilities*, including rules to "ensure that such purposes may not be circumvented through the use of ... a regulated investment company, real estate investment trust, or tax-exempt entity." The goal of such Regulations is to prevent gain accruing while a corporation is an "ordinary" (or "C") corporation—gain that should be subject to a double-tax regime—from escaping a corporate-level tax, either by the C corporation's electing RIC or REIT status or by the acquisition of assets of a C corporation by a RIC or REIT in a tax-free transaction.

For many years, the Treasury Department and Internal Revenue Service ("IRS") failed to fulfill the mandate of section 337(d), as it related to the use of RIC's and REIT's. However, on February 4, 1988 the IRS did issue Notice 88-19,[1] which announced that the IRS *intended* to promulgate Regulations under the authority of section 337(d) with respect to transactions or events that resulted in the ownership of C corporation assets by a REIT or RIC. The Notice contained a description of the anticipated Regulations as follows: unless an election were made by the RIC or REIT to be taxed under rules similar to the rules applicable to S corporations under Code section 1374, if a C corporation elected to become a RIC or a REIT (or if the assets of a C corporation were transferred to a RIC or REIT in a "carryover basis" transaction), the C corporation would be treated as if it had sold all of its assets at their respective fair market values and immediately liquidated. If an election were made to be subject to rules similar to those in section 1374, the special tax imposed by such rules would be administered under rules "similar to the rules relating to net income from foreclosure property of REITs." Notice 88-19 indicated that the

Regulations would be applicable retroactively to June 10, 1987.

New Regulations

Twelve years to the day after issuance of Notice 88-19, on February 4, 2000, the long-awaited Regulations became effective. The Regulations have been issued in both temporary and proposed form; thus, the Regulations are now in effect, but they are also being aired for discussion and comment.[2] Like Notice 88-19, the new Regulations provide that if a C corporation qualifies to be taxed as a RIC or REIT (or transfers assets to RIC or REIT in a carryover basis transaction), the C corporation is treated as if it sold its assets for their respective fair market values and immediately liquidated, unless the RIC or REIT elects to be subject to the rules of Code section 1374 and the Regulations thereunder. As noted above, section 1374 subjects an S corporation that used to be a C corporation to a corporate-level tax on "built-in gains" that are recognized during the first 10 years of its qualification as an S corporation. If the corporation becoming a RIC or a REIT does not elect section 1374 treatment, and thus recognizes its built-in gain at the time of its election to be a RIC or REIT, the basis of its assets is adjusted to fair market value to reflect the recognized gain.

For the most part, the new Regulations simply recapitulate Notice 88-19; however, some important questions of interpretation are raised by what the regulations do and do not say.

Failing to Elect Section 1374

The Regulations state:

> Unless an election is made pursuant to paragraph (b) of this section [to be subject to section 1374 treatment], the C corporation will be treated, for all purposes including recognition of net built-in gain, as if it had sold all of its assets at their respective fair market values on the deemed liquidation date described in paragraph (a)(7)of this section and *immediately liquidated*.[3]

What was intended by these last two words? Taken literally, they suggest that both a corporate-level and a shareholder-level tax may be triggered upon the deemed liquidation. After all, a corporate-level tax is triggered by the mere sale of assets. Distribution in liquidation of the sales proceeds would have no further corporate tax consequences, but would result in recognition of gain or loss by the shareholders. To what end, then, should such a liquidation be mentioned, if not to suggest the existence of shareholder-level tax consequences? Moreover, the Clinton Administration has, in the past, proposed to "tighten up" the section 1374 regime for certain "large" corporations, by requiring gain recognition at both the corporate and shareholder levels when a C corporation elects to become an S corporation. Nevertheless, in the absence of any specific reference to the shareholders in the body of the Regulations or in any of their accompanying materials, it appears to be the better reading that the shareholders would not be taxable.

Relief for Certain RIC's

The new Regulations add little to Notice 88-19, but they do provide a limited new relief provision in the case of certain C corporations which qualify as RIC's: If (1) prior to qualifying as a RIC, a corporation was a C corporation for a period not exceeding one year, and (2) before that, it was a RIC for at least one year, any assets acquired during the C corporation year in a transaction which did not result in a carryover basis will not be subject to the general rule which triggers built-in gain. The Regulations and their Supplementary Information give us no guidance regarding the purpose of this exception and it leaves us with a number of unanswered questions:

> (1) Why are only assets acquired *during* the C corporation year exempted? By contrast, assets acquired during the corporation's initial period of RIC qualification appear to be subject to the deemed sale rule upon requalification as a RIC; why should such assets be treated less favorably?
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> (2) Why are only RIC's exempted, and not REIT's?

Computation of Tax

The Regulations provide that the immediate triggering of gain upon qualification as a RIC or REIT does not apply if the corporation elects to be subject to the rules of Code section 1374 and the Regulations thereunder. The Regulations go on to tell us, however, that "the built-in gains of electing RICs and REITs, and the corporate-level tax imposed on such gains, are subject to rules similar to the rules relating to net income from foreclosure property of REITs."

This is all the guidance we are given with respect to the taxation of a RIC or REIT during the 10-year period following the effective date of an election to be subject to the rules of section 1374—no more than what we were told in Notice 88-19 twelve years ago.

Unfortunately, the rules governing Code section 1374 tax and the rules governing the tax on net income from foreclosure property of REIT's are not identical in many respects, *e.g.*, in their treatment of losses from activities not subject to the "special" tax. What happens if a corporation which elects REIT status has net operating loss carryovers ("NOL's") arising in years before it became a REIT? Can such NOL's be used against any built-in gain which would otherwise be subject to a corporate-level tax under the rules of section 1374? Section 1374(b)(2) allows an S corporation to use such NOL's to reduce the section 1374 tax; however, the REIT foreclosure property rules do not allow use of NOL deductions in computing the taxable "net income from foreclosure property."

Impact on Elections

As noted above, section 337(d) authorizes the Secretary of the Treasury to "prescribe such regulations" as may be necessary or appropriate to carry out the purposes of the amendments which repealed the *General Utilities* doctrine, including "regulations to ensure that such purposes may not be circumvented through the use of ... a regulated investment company, real estate investment trust, or tax-exempt entity." Notice 88-19 stated that the Service would issue such regulations under section 337(d) and that they would apply retroactively from June 10, 1987. As threatened, the Regulations that have now been issued, are, in fact, effective as of June 10, 1987.

As noted above, the "default rule" under the Regulations is that a corporation's built-in gain is taxable at the time of its election to be a RIC or a REIT. Only if an *election* is made is the built-in gain to be subject to taxation only upon recognition during the initial 10 years of RIC or REIT qualification. Fortunately, the Regulations do provide a mechanism for corporations which elected to be RIC's and REIT's commencing in periods between 1987 and 2000 to make an election.[4] RIC's and REIT's that are in such a position and that want to have made an effective election should be careful to follow these new procedures and not to rely on any elections they may have purported to make on prior returns.

Some more subtle planning possibilities may exist as well. Take the case of a C corporation which elected REIT status effective as of January 1, 1993. According to the new Regulations, in the absence of an effective election to apply rules similar to those of section 1374, the corporation would have been subject to tax on its built-in gain on its tax return for 1992. That return would ordinarily have been filed no later than September 15, 1993, and the statute of limitations with respect to it would have run no later than September 15, 1999.[5]

The taxpayer may have purported to make an election under Notice 88-19 on its 1992 and/or 1993 return(s) to apply rules similar to those of section 1374, but the new Regulations seem to take the position that no election was available at that time and that Notice 88-19 did not establish one. If the taxpayer were aggressive enough, could it *now* take the position that its built-in gains were taxable in 1992, a year closed by the statute of limitations, and that it is free to sell its assets without any further corporate tax consequences? Principles of estoppel might stand in the way of making such an argument, but the result is less than entirely clear.

The root of this problem is that the IRS was authorized to issue Regulations, but instead issued a Notice and then remained inactive for 12 years. As the new Regulations themselves seem to recognize, by their provision of a mechanism for corporations that elected to become RIC's or REIT's in prior years to make elections *now* to come within the rules of section 1374, it is at least arguable that Notice 88-19 has had no *legal* effect at all (other than providing information to taxpayers). As a result, we may now have a situation in which a taxpayer could arguably "whipsaw" the IRS.

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1 1988-1 C.B. 486.

2 The temporary Regulations are designated section 1.337(d)-5T and the proposed Regulations are designated section 1.337(d)-5.

3 In the case of a C corporation which qualifies to be taxed as a RIC or a REIT, the deemed liquidation date is the last day of its taxable year *before* the year in which it so qualifies. In the case of a C corporation that transfers property to a RIC or a REIT in a carryover basis transaction, the liquidation is deemed to occur on the day before the date of transfer.

4 In such case, the election may be filed with the first Federal income tax return *filed* by the RIC or REIT after March 8, 2000.

5 Code section 6501 provides that the statute of limitations for assessing and collecting tax generally runs for the three years following the date the return was filed. Section 6501(e)(1) provides that, if a taxpayer omits from gross income an amount properly includible therein which is in excess of 25% of the gross income stated in the return, then a six-year statute of limitations applies.