April 17, 2003

Transfers to RICs and REITs

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A regulated investment company (RIC) or real estate investment trust (REIT) offers many of the same advantages from an income tax perspective as a pass-through entity such as a partnership. Although a RIC (as defined in IRC §851(a)) or REIT (as defined in IRC §856(a)) is a corporation for federal income tax purposes, distributions are generally deductible in computing the taxable income of a RIC or REIT, so that a RIC or REIT typically pays little or no federal income tax.

When Congress determined in 1986 to require that corporations recognize gain on the distribution of appreciated property in complete liquidation, in addition to the shareholder-level tax payable on such a liquidation, it was recognized that a corporation might seek to avoid the impact of the new rule by becoming a RIC or REIT, disposing of its assets, making deductible distributions to its shareholders of the proceeds, and thus paying little or no tax at the corporate level. Accordingly, Congress authorized the Treasury, in IRC section 337(d), to issue regulations to ensure that the purposes of the 1986 legislation would not be circumvented through the use of a RIC or REIT.

An analogous potential for tax avoidance was also identified with respect to the S corporation rules, because a corporation electing to be an S corporation is treated as a pass-through entity not generally subject to corporate-level income tax.

To limit the ability of existing regular (or "C") corporations with appreciated assets to use the S corporation rules to avoid tax on the disposition of property, a built-in gains tax was imposed by IRC section 1374, whereby a C corporation which elects to be an S corporation is required to pay a tax, computed at the highest corporate rate, on property that it owns at the time the S election is made and sells during a 10-year "recognition period" beginning with the first day of the first year for which the S election was made. The tax is generally computed by reference to the gain inherent in the property at the time the S election is made, but is payable at the time of disposition of the property (rather than at the time of the S election).

The built-in gains tax of section 1374 is designed not to apply to gains in excess of the difference between the fair market value and basis of property owned by a corporation at the time the S election is made. Thus, the tax is designed to be limited to gains that are "built in" at the time of the election and not to apply to subsequent appreciation in the corporation's assets.

The IRS announced in 1988 its intention to promulgate regulations under the authority of IRC section 337(d) whereby the assets of a C corporation that became owned by a RIC or REIT, either through the qualification of the C corporation itself as a RIC or REIT or through the transfer of such assets to an existing RIC or REIT in a carryover basis transaction (collectively, a "conversion transaction"), would be treated as if sold by the C corporation for fair market value, thus causing the built-in gain to be subject to immediate tax (IRS Notice 88-19, 1988-1 C.B. 486). Immediate gain recognition would be avoided, however, if the corporation electing to qualify as a RIC or REIT, or the RIC or REIT receiving assets from a C corporation in a carryover basis transaction, elected to be subject to tax under rules similar to the S corporation rules described above with respect to the C corporation property.

The Notice stated that the regulations to be issued would, in general, apply retroactively to transactions occurring on or after June 10, 1987, and to corporations qualifying to be taxed as a RIC or REIT effective for taxable year beginning on or after that date.

Temporary regulations (Temp. Reg. §1.337(d)-5T) were issued in 2000 that reflected the principles of Notice 88-19. After comments and a hearing regarding the temporary regulations and the related proposal to issue final regulations, additional temporary regulations were issued in January 2002 as Reg. section 1.337(d)-6T (relating to conversion transactions occurring before January 2, 2002) and Reg. section 1.337(d)-7T (relating to conversion transactions occurring on or after January 2, 2002). In March, 2003, these regulations, with some changes, were issued in final form.

Overview of Final Regulations and Changes Made

Under section 1.337(d)-6 of the final regulations, applicable to conversion transactions occurring before January 2, 2002, deemed sale treatment, resulting in a current tax at the time of the conversion transaction, will generally apply, unless the RIC or REIT elects to be subject to rules similar to those of section 1374 with respect to the conversion transaction. Under the final regulations, the election of section 1374 treatment for pre-January 2, 2002, transactions may be included in any federal income tax return filed by the RIC or REIT on or before September 15, 2003, as long as the RIC or REIT has reported consistently with such election for all taxable periods.

Under section 1.337(d)-7 of the regulations, applicable to conversion transactions occurring on or after January 2, 2002, the analysis is reversed -- section 1374 treatment will generally apply unless the C corporation elects deemed sale treatment with respect to the conversion transaction. The election of deemed sale treatment must be attached to the income tax return of the electing C corporation (or partnership if, pursuant to a special rule relating to corporate partners that is described below, the partnership is subject to the principles of these rules) for the taxable year in which the deemed sale occurs.

Although the deemed sale election will by its nature accelerate income, the election may be attractive where, for example, net operating loss carryforwards are about to expire or the availability of such losses will be limited under IRC section 382 after the completion of a transaction.

The final regulations include provisions providing for (i) the application of the rules of section 1374 where property owned by a RIC, REIT, or S corporation becomes owned by a successor RIC or REIT in a carryover basis transaction, and (ii) the effective exclusion, from the gain subject to tax under the built-in gains tax, of gains that are otherwise subject to corporate-level tax under various provisions of Code section 857(b) relating to REITs, such as the provisions relating to income derived from "prohibited transactions" and certain income from "foreclosure property." The regulations also contain an exception from the general rule of section 1374 treatment that is applicable in certain situations in which a former RIC or REIT re-elects RIC or REIT status.

A full review of these regulations is beyond the scope of this article. Noted below, however, are certain changes made in the final regulations as compared to the temporary regulations previously in force.

Under the 2002 temporary regulations, RICs and REITs could use loss carryforwards and credit carryforwards, arising in taxable years in which the corporation that generated the tax attribute was not a RIC or REIT, to offset net recognized gain and reduce or eliminate the tax thereon, consistent with section 1374. It was unclear, however, whether a loss carryforward used to offset net recognized built-in gain would be available under the temporary regulations to reduce investment company taxable income under IRC section 852(b) or REIT taxable income for purposes of IRC section 857(b). Thus, it was unclear whether carryforward losses absorbed in offsetting recognized built-in gain would be available to reduce the amounts that a RIC or REIT must distribute to retain its qualification or to avoid a corporate-level tax.

In response to a comment, this rule was clarified in the final regulations. Under the final rules, net operating loss and capital loss carryforwards that are used by a RIC or REIT to offset recognized built-in gains are also allowable as deductions in computing investment company taxable income under section 852(b)(2) and REIT taxable income for purposes of section 857(b)(2), and for certain other purposes, but only to the extent that they are otherwise allowable as deductions under the Internal Revenue Code.

Partnerships

Under section 1.337(d)-7T of the temporary regulations, the built-in gain rules applied to property transferred by a partnership to a RIC or REIT to the extent of any C corporation's proportionate share of the transferred property as a partner of the partnership. Where a partner's proportionate share of the assets of the partnership is different from the amount of gain that would be allocated to the partner with respect to the gain or loss from a specific asset in light of the special allocation rules under section 704 (such as those relating to appreciated property contributed by a partner), the rule as initially proposed could yield results at odds with what would normally be anticipated under tax principles generally applicable to partnerships.

In response to comments, the preamble states that the final regulations clarify that, in determining the C corporation partner's share of property transferred by the partnership, the principles generally applicable in determining a partner's distributive share of partnership gain or loss (including principles of IRC §704(b) and §704(c)) will apply in this context as well. Thus, the principles of the built-in gain regulations apply only to the extent of the C corporation partner's distributive share of gain with respect to transferred property.

The final regulations also clarify the treatment of C corporation partners in situations where the deemed sale election is made and the partnership contributes multiple assets, the deemed sale of which results in losses with respect to some assets and gains with respect to others. The gain allocated to the C corporation partner in this situation is limited to the net gain recognized by the partnership by reason of the deemed sale, such that the C corporation partner will receive the benefit of any offsetting losses.

The final regulations also clarify that, where an adjustment to the basis of a partnership's stock in a REIT or RIC is required by reason of deemed sale treatment, the adjustment will be an adjustment to the basis of that stock with respect to the corporate partner only.

Through an amendment to the regulations under IRC section 514, the new regulations further provide that a special allocation of gain by a partnership to a tax-exempt partner that may be mandated by Reg. section 1.337(d)-7 (or, for that matter, under any statute or regulation other than under subchapter K of the IRC) will not prevent the partnership from meeting the requirements of the complex fractions rule under the unrelated business income tax (UBIT) provisions, which rule would be violated -- with resulting adverse consequences to tax-exempt partners under those provisions -- by many types of special allocations.