[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-139991-08]

RIN 1545-BI84

Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs]

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to regulations under section 337(d) of the Internal Revenue Code. The proposed regulations provide guidance concerning certain transfers of property from a C corporation to a Regulated Investment Company (RIC) or a Real Estate Investment Trust (REIT) and will affect the parties to such transactions. This document also invites comments from the public regarding these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER THE DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-139991-08), room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-139991-08), Courier's Desk, Internal Revenue

Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at http://www.regulations.gov (IRS REG-139991-08).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Grid Glyer (202) 622-7930 or Maury Passman (202) 622-7750 with respect to the corporate issues, and David H. Kirk (202) 622-3060 with respect to the partnership issues; concerning submissions of comments, Oluwafunmilayo Taylor (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Congress repealed the *General Utilities* doctrine in the Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 2085), as amended by the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100-647, 102 Stat. 3342), when sections 336 and 337 of the Internal Revenue Code 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)(1) directs the Secretary to prescribe regulations as may be necessary to carry out the purposes of *General Utilities* repeal, including rules to "ensure that such purposes may not be circumvented * * * through the use of a regulated investment company, a real estate investment trust, or tax-exempt entity * * *."

On March 18, 2003, regulations under §1.337(d)-7 (the regulations) were published in the **Federal Register** (TD 9047, 68 Fed. Reg. 12817). The regulations generally provide (in paragraphs (a) and (b)(1)) that if property of a C corporation (the C corporation transferor) becomes the property of a RIC or REIT by the qualification of

that C corporation as a RIC or REIT or by the transfer of assets of that C corporation to a RIC or REIT (a conversion transaction), then the RIC or REIT will be subject to tax on the net built-in gain in the converted property under the rules of section 1374 and the underlying regulations. This treatment, however, does not apply if the C corporation transferor elects to recognize gain and loss as if it sold the converted property to an unrelated party at fair market value (deemed sale treatment).

Explanation and Summary of Comments

This preamble first discusses the proposal as it relates to net built-in gain property acquired by a RIC or REIT either in a like-kind exchange (where the C corporation transferor's gain is not recognized by reason of section 1031) or in an involuntary conversion (where such gain is not recognized by reason of section 1033). This preamble then discusses a proposed revision to the definition of a C corporation in the regulations, which provides that a transfer of property by a tax-exempt entity to a RIC or REIT is not treated as a conversion transaction unless the tax-exempt entity would have been subject to tax if a deemed sale election had been made.

In addition, the proposed regulations also add definitions for the terms RIC, REIT, and S corporation. While these terms are not explicitly defined in the regulations, their meanings are both self-evident and unambiguous in that context. Nonetheless, for clarification and ease of use, the proposed regulations add explicit definitions.

A. Like-Kind Exchanges and Involuntary Conversions.

The current regulations generally provide that if property of a C corporation becomes the property of a RIC or REIT in a conversion transaction, then, absent a deemed sale election, the RIC or REIT will be subject to tax on the net built-in gain in

the converted property under the rules of section 1374 and the underlying regulations (as modified in paragraph (b) of the regulations), as if the RIC or REIT were an S corporation.

Commentators have expressed concern that the general rule may inappropriately expose property transferred in certain exchanged basis transactions – specifically, like-kind exchanges and involuntary conversions – to this treatment. In these transactions, the C corporation transferor replaces property it transferred to a RIC or REIT with property that has an equivalent basis and built-in gain, and as a result, the built-in gain remains subject to corporate tax in the hands of the transferor. Therefore, there would not be any circumvention of the purposes of *General Utilities* repeal. Section 1.337(d)-4(b)(3) provides an exception in an analogous context (where a C corporation transfers all or substantially all of its assets to a tax-exempt entity) to the extent the transaction qualifies for nonrecognition treatment under section 1031 or section 1033.

Accordingly, the proposed regulations provide an exception from the general rule of the current regulations for a transfer of property by a C corporation to a RIC or REIT to the extent that the transfer qualifies for non-recognition treatment under either section 1031 or 1033. In such a transaction, the C corporation transferor's basis in the property it receives is derived from its basis in the transferred property, and thus reflects the built-in gain. At the same time, the basis of the transferee RIC or REIT in the converted property has no relation to the C corporation transferor's basis therein.

Treasury and the IRS are not proposing to extend this treatment to all exchanged basis transactions, such as exchanges that would otherwise qualify for nonrecognition treatment under section 351 of the Code, out of a concern that such an exemption could

create opportunities to avoid corporate-level tax on built-in gains and would give rise to administrative difficulties that could be addressed only through extensive rulemaking.

B. Transfers by Tax-Exempt Entities.

The regulations apply to property transferred by a C corporation directly to a RIC or REIT, and indirectly through a partnership to the extent of any C corporation partner's proportionate share of the transferred property (the partnership rule). The regulations state that if the partnership elects deemed sale treatment with respect to such transfer, then any net gain recognized by the partnership on the deemed sale must be allocated to the C corporation partner.

Commentators have expressed concern that the partnership rule presents unintended effects when the partnership has multiple C corporation partners including both taxable and tax-exempt entities. If such a partnership transfers built-in gain property to a RIC or REIT in a conversion transaction without making a deemed sale election (that is, section 1374 treatment applies), and if the transferee RIC or REIT sells the converted property during the recognition period, then the RIC or REIT is subject to a corporate-level tax on the net built-in gain, including the portion of the net built-in gain that otherwise would have been allocated to tax-exempt C corporation partners had a deemed sale election been made. This is because the net recognized built-in gain is determined with reference to the amount of gain that would have been allocated to all C corporation partners, regardless of their taxable or tax-exempt status. In contrast, if the transferring partnership were to make a deemed sale election, the taxable C corporation partners would recognize gain that otherwise could have been deferred if section 1374 treatment had applied.

Treasury and the IRS believe that the inclusion of direct or indirect transfers by tax-exempt entities in the scope of the final regulations furthers the purposes of *General Utilities* repeal only to the extent that those entities would have been subject to tax had a deemed sale election been made (for example, if a deemed sale election would have generated unrelated business taxable income or would have adversely affected the entity's tax-exempt status). Accordingly, the proposed regulations would amend the final regulations to provide that the definition of a C corporation excludes tax-exempt entities within the meaning of §1.337(d)-4(c)(2). As a result, transfers of property by a tax-exempt entity to a RIC or REIT (or by a partnership to a RIC or REIT to the extent of a tax-exempt partner's distributive share of the gain in the transferred property) generally will not be subject to section 1374 treatment. For this purpose, however, an entity will not be considered to be tax-exempt to the extent it would be subject to tax (such as under section 511) under Title 26 of the United States Code with respect to gain (if any) resulting from a deemed sale election if such an election were made under §1.337(d)-7(c)(5) with respect to the transfer. Thus, for example, if a partnership in which a tax-exempt C corporation described in §1.337(d)-4(c)(2) is a partner transfers property to a RIC or REIT in a conversion transaction, and the tax-exempt entity would not have been subject to unrelated business income tax under section 511 or to tax under any other provision of the Code had the partnership made a deemed sale election in connection with the transfer, the transfer would be excluded from the scope of the final regulations (and the transferee RIC or REIT will not be subject to section 1374 treatment) to the extent of the tax-exempt entity's distributive share of the built-in gain or loss in the converted property. However, to the extent the tax-exempt partner would

have been subject to unrelated business income tax under section 511 or to tax under any other provision of the Code with respect to its distributive share of the built-in gain on the property, the transferee RIC or REIT would be subject to tax on the built-in gain on the property under the rules of section 1374 as if the RIC or REIT were an S corporation unless the transferring partnership elects deemed sale treatment.

Section 1.337(d)-7(e) provides that the principles of §1.337(d)-7 apply to property transferred by a partnership to a RIC or REIT to the extent of any C corporation partner's distributive share of the gain or loss in the transferred property. The proposed regulations provide that §1.337(d)-7(e) also applies to determine the distributive share of the gain or loss in the transferred property of a C corporation partner of a higher-tier partnership in a tiered partnership structure in which the transferor partnership is a lower-tier partnership.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13565. Therefore, a regulatory assessment is not required. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations would not have a significant economic impact on a substantial number of small entities because the proposed regulations limit the situations in which these regulations apply to all businesses, including small businesses. This certification is based on the fact that these proposed regulations do not create additional obligations for, or impose an economic impact on, small entities. Therefore, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, these proposed

regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. Treasury and the IRS request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Grid Glyer and Maury Passman of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.337(d)-7 is also issued under 26 U.S.C. 337(d) * * *

Par. 2. Section 1.337(d)-7 is amended by:

1. Revising paragraphs (a)(2), (d)(1), (e) and (f)

2. Adding paragraph (d)(3),

The revisions and addition read as follows:

§1.337(d)-7 Tax on property owned by a C corporation that becomes property of a RIC or REIT.

(a) * * *

(2) Definitions. For purposes of this section:

(i) C corporation. The term C corporation has the meaning provided in section 1361(a)(2) except that the term does not include a RIC, a REIT, or a tax-exempt entity within the meaning of paragraph (a)(2)(vi) of this section.

(ii) Conversion transaction. The term conversion transaction means the qualification of a C corporation as a RIC or REIT or the transfer of property owned by a C corporation to a RIC or REIT.

(iii) RIC. The term RIC means a regulated investment company within the meaning of section 851(a).

(iv) REIT. The term REIT means a real estate investment trust within the meaning of section 856(a).

(v) S corporation. The term S corporation has the meaning provided in section 1361(a)(1).

(vi) Tax-exempt entity. The term tax-exempt entity, with respect to a conversion transaction, means an entity--

(A) Described in §1.337(d)-4(c)(2), and

(B) That would not be subject to tax under Title 26 of the United States Code with respect to gain (if any) resulting from a deemed sale election if such an election were made under paragraph (c)(5) of this section with respect to the conversion transaction.

* * * * *

(d) Exceptions.—(1) Gain otherwise recognized. Paragraph (a) of this section does not apply to any conversion transaction to the extent that gain or loss otherwise is recognized on such conversion transaction by the C corporation that either qualifies as a RIC or a REIT or that transfers property to a RIC or REIT. See, for example, sections 311(b), 336(a), 351(b), 351(e), 356, 357(c), 367, 368(a)(2)(F), 1001, 1031(b), and 1033(b).

* * * * *

(3) Special rules for like-kind exchanges and involuntary conversions.—(i) In general. Paragraph (a) of this section does not apply to a conversion transaction to the extent that a C corporation transfers property with a built-in gain to a RIC or REIT and the C corporation's gain is not recognized by reason of either section 1031 or 1033.

(ii) Clarification regarding exchanged property previously subject to section 1374 treatment. Notwithstanding paragraph (d)(3)(i) of this section, if, in a transaction described in paragraph (d)(3)(i) of this section, a RIC or REIT surrenders property that was subject to section 1374 treatment immediately prior to the transaction, the rules of section 1374(d)(6) will apply to continue section 1374 treatment to the replacement property acquired by the RIC or REIT in the transaction.

(iii) Examples. The rules of this paragraph (d)(3) are illustrated by the following examples. In each of the examples, X is a REIT, Y is a C corporation, and X and Y are

not related.

Example 1. Section 1031(a) exchange. (i) Facts. X owned a building that it leased for commercial use (Property A). Y owned a building leased for commercial use (Property B). On January 1, Year 3, Y transferred Property B to X in exchange for Property A in a transaction that qualified for nonrecognition treatment under section 1031(a). Immediately before the exchange, Properties A and B each had a value of $100, X had an adjusted basis of $60 in Property A, Y had an adjusted basis of $70 in Property B, and X was not subject to section 1374 treatment with respect to Property A.

(ii) Analysis. The transfer of property (Property B) by Y (a C corporation) to X (a REIT) is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section. The conversion transaction qualified for nonrecognition treatment under section 1031(a) as to Y; thus, Y did not recognize any of its $30 gain. Therefore, the conversion transaction is not subject to paragraph (a) of this section by reason of paragraph (d)(3)(i) of this section.

Example 2. Section 1031(a) exchange of section 1374 property. (i) Facts. The facts are the same as in Example 1, except that X had acquired Property A in a conversion transaction in Year 2, and immediately before the Year 3 exchange X was subject to section 1374 treatment with respect to $25 of net built-in gain in Property A.

(ii) Analysis. The Year 3 transfer of Property B by Y to X is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section. The conversion transaction qualified for nonrecognition treatment under section 1031(a) as to Y; thus, Y did not recognize any of its $30 gain. Therefore, the Year 3 transfer is not subject to paragraph (a) of this section by reason of paragraph (d)(3)(i) of this section. However, X had been subject to section 1374 treatment with respect to $25 of net built-in gain in Property A immediately before the Year 3 transfer, and X's basis in Property B is determined (in whole or in part) by reference to its adjusted basis in Property A. Accordingly, the rules of section 1374(d)(6) apply and X is subject to section 1374 treatment on Property B with respect to the $25 net built-in gain. See paragraph (d)(3)(ii) of this section.

Example 3. Section 1031(b) exchange. (i) Facts. The facts are the same as in Example 1, except that immediately before the Year 3 exchange Property A had a value of $92, and X transferred Property A and $8 to Y in exchange for Property B in a transaction that qualified for nonrecognition treatment under section 1031(b).

(ii) Analysis. The transfer of Property B by Y to X is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section. The conversion transaction qualified for nonrecognition treatment as to Y under section 1031(b) (resulting from the receipt of $8 in money or other property in addition to the replacement property); as a result, Y recognized $8 of its $30 gain, and did not recognize the remaining $22 of gain. Paragraph (a) of this section does not apply to the transaction to the extent of the $8 gain recognized by Y by reason of paragraph (d)(1) of this section, or to the extent of

the $22 gain realized but not recognized by Y by reason of paragraph (d)(3)(i) of this section.

Example 4. Section 1033(a) involuntary conversion of property held by a C corporation transferor. (i) Facts. Y owned uninsured, improved property (Property 1) that was involuntarily converted (within the meaning of section 1033(a)) in a fire. Y sold Property 1 for $100 to X, which owned an adjacent property and wanted Property 1 for use as a parking lot. Y had a $70 basis in Property 1 immediately before the sale. Y elected to defer gain recognition under section 1033(a)(2), and purchased qualifying replacement property (Property 2) for $100 from an unrelated party prior to the expiration of the period described in section 1033(a)(2)(B).

(ii) Analysis. The transfer of Property 1 by Y to X is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section. The conversion transaction (combined with Y's purchase of Property 2) qualified for nonrecognition treatment under section 1033(a) as to Y; thus, Y did not recognize any of its $30 gain. Therefore, the conversion transaction is not subject to paragraph (a) of this section by reason of paragraph (d)(3)(i) of this section.

Example 5. Section 1033(a) involuntary conversion of property held by a REIT. (i) Facts. X owned property (Property 1). On January 1, Year 2, Property 1 had a fair market value of $100 and a basis of $70, and X was not subject to section 1374 treatment with respect to Property 1. On that date, when Property 1 was under a threat of condemnation, X sold Property 1 to an unrelated party for $100 (First Transaction). X elected to defer gain recognition under section 1033(a)(2), and purchased qualifying replacement property (Property 2) for $100 from Y (Second Transaction) prior to the expiration of the period described in section 1033(a)(2)(B).

(ii) Analysis. The transfer of Property 2 by Y to X in the Second Transaction is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section. The Second Transaction (combined with the First Transaction) qualified for nonrecognition treatment under section 1033(a) as to X, but not as to Y. Assume no nonrecognition provision applied to Y; thus, Y recognized gain or loss on its sale of Property 2 in the Second Transaction, and the Second Transaction is not subject to paragraph (a) of this section by reason of paragraph (d)(3)(i) of this section.

(e) Special rule for partnerships--(1) In general. The principles of this section apply to property transferred by a partnership to a RIC or REIT to the extent of any gain or loss in the converted property that would be allocated directly or indirectly, through one or more partnerships, to a C corporation if the partnership sold the converted property to an unrelated party at fair market value on the deemed sale date (as defined

in paragraph (c)(3) of this section). If the partnership were to elect deemed sale treatment under paragraph (c) of this section in lieu of section 1374 treatment under paragraph (b) of this section with respect to such transfer, then any net gain recognized by the partnership on the deemed sale must be allocated to the C corporation partner, but does not increase the capital account of any partner. Any adjustment to the partnership's basis in the RIC or REIT stock as a result of deemed sale treatment under paragraph (c) of this section shall constitute an adjustment to the basis of that stock with respect to the C corporation partner only. The principles of section 743 apply to such basis adjustment.

(2) Example. Transfer by partnership of property to REIT. (i) Facts. PRS, a partnership for Federal income tax purposes, has three partners: TE, a tax-exempt entity (within the meaning of §1.337(d)-7(a)(2)(vi)), owns 50 percent of the capital and profits of PRS; A, an individual, owns 30 percent of the capital and profits of PRS; and Y, a C corporation (within the meaning of §1.337(d)-7(a)(2)(i)), owns the remaining 20 percent. PRS owns a building that it leases for commercial use (Property 1). On January 1, Year 2, when PRS has an adjusted basis in Property 1 of $100 and Property 1 has a fair market value of $500, PRS transfers Property 1 to X, a REIT, in exchange for stock of X in an exchange described in section 351. PRS does not elect deemed sale treatment under paragraph (c) of this section.

(ii) Analysis. The transfer of Property 1 by PRS to X is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section to the extent of any gain or loss that would be allocated to any C corporation partner if PRS sold Property 1 at fair market value to an unrelated party on the deemed sale date. Y is a C corporation, but neither TE nor A is a C corporation within the meaning of paragraph (a)(2)(i) of this section. Therefore, the transfer of Property 1 by PRS to X is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section to the extent of Y's share of any such gain of PRS in Property 1. If PRS were to sell Property 1 to an unrelated party at fair market value on the deemed sale date, PRS would allocate $80 of built-in gain to Y. Thus, X is subject to section 1374 treatment on Property 1 with respect to $80 of built-in gain.

(f) Effective/Applicability date-- (1) In general. Except as provided in paragraph (f)(2) of this section, this section applies to conversion transactions that occur on or after January 2, 2002. For conversion transactions that occurred on or after June 10, 1987,

and before January 2, 2002, see §§1.337(d)-5 and 1.337(d)-6.

(2) Special rule. Paragraphs (a)(2), (d)(1), (d)(3) and (e) of this section apply to conversion transactions that occur on or after **[INSERT DATE OF PUBLICATION OF THE TREASURY DECISION ADOPTING THESE RULES AS FINAL REGULATIONS IN THE FEDERAL REGISTER]**. However, taxpayers may apply paragraphs (a)(2), (d)(1), (d)(3) and (e) of this section to conversion transactions that occurred before **[INSERT DATE OF PUBLICATION OF THE TREASURY DECISION ADOPTING THESE RULES AS FINAL REGULATIONS IN THE FEDERAL REGISTER]**. For conversion transactions that occurred on or after January 2, 2002 and

before **[INSERT DATE OF PUBLICATION OF THE TREASURY DECISION ADOPTING THESE RULES AS FINAL REGULATIONS IN THE FEDERAL REGISTER]**, see §1.337(d)-7 as contained in 26 CFR part 1 in effect on April 1, 2011.

Steven T. Miller
Deputy Commissioner for Services and Enforcement

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