Section 337.—Nonrecognition for Property Distributed to Parent in Complete Liquidation of Subsidiary

26 CFR 1.337(d)–5T: Tax on C assets becoming RIC or REIT assets (temporary).

T.D. 8975

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that apply to certain transactions or events that result in a Regulated Investment Company [RIC] or a Real Estate Investment Trust [REIT] owning property that has a basis determined by reference to a C corporation's basis in the property. These regulations affect RICs, REITs, and C corporations and clarify the tax treatment of transfers of C corporation property to a RIC or REIT. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin (REG–142299–01, REG–209135–88, page 418).

DATES: *Effective Date*: These regulations are effective January 2, 2002.

Applicability Dates: For dates of applicability, see §§1.337(d)–6T(e) and 1.337(d)–7T(f).

FOR FURTHER INFORMATION CONTACT: Lisa A. Fuller (202) 622–7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1672. Responses to this collection of information are required to obtain a benefit, *i.e.*, to elect to recognize gain as if the C corporation had sold the property at fair market value or to elect section 1374 treatment.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published elsewhere in this issue of the Bulletin.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. section 6103.

Background

Sections 631 and 633 of the Tax Reform Act of 1986 (the 1986 Act) (Public Law 99–514, 100 Stat. 2085, 2272), as amended by section 1006(e) and (g) of the Technical and Miscellaneous Revenue Act of 1988 (the 1988 Act) (Public Law 100–647, 102 Stat. 3342, 3400–01), amended the Internal Revenue Code (Code) to repeal the *General Utilities* doctrine. In particular, the 1986 Act amended sections 336 and 337 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) 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 . . . ." Absent special rules, the transfer of property owned by a C corporation to a RIC or REIT could result in permanently removing the property's built-in gain from tax at the corporate level, because RICs and REITs generally are not subject to tax on income that is distributed to their shareholders.

On February 4, 1988, the IRS issued Notice 88–19 (1988–1 C.B. 486) announcing its intention to promulgate regulations under the authority of section 337(d) with respect to transactions or events that result in a RIC or REIT owning property that has a basis determined by reference to a C corporation's basis (a 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 RIC or REIT by the qualification of a C corporation as a RIC or REIT or by the transfer of assets of a C corporation to a RIC or REIT (a conversion transaction). The Notice further provided that, where the regulations apply, 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. The Notice provided, however, that the regulations would not allow the recognition of a net loss and that, except as provided in the Notice, the regulations would not affect the characterization for tax purposes of, or the tax treatment of parties to, any transactions to which they apply. For example, shareholders of a C corporation who received RIC shares in a transaction that qualified as a reorganization under section 368(a)(1)(C) would not recognize gain or loss solely because the C corporation was subject to tax. The Notice also provided that immediate gain recognition could be avoided if the C corporation that qualified as a RIC or REIT or the transferee RIC or REIT, as the case may have been, elected to be subject to tax under section 1374 with respect to the C corporation property. Notice 88–19 also indicated that the regulations would apply retroactively to June 10, 1987. Notice 88–96 (1988–2 C.B. 420) amplifies Notice 88–19 by providing that the regulations described in Notice 88–19 would provide an exception to the general gain recognition rules for any C corporation that qualified to be taxed as a RIC for at least one taxable year, then failed to so qualify for one taxable year, and then requalified to be taxed as a RIC in the next taxable year.

On February 7, 2000, Treasury and the IRS published temporary regulations (T.D. 8872, 2000–8 I.R.B. 639) (the 2000 temporary regulations) reflecting the principles set forth in Notice 88–19 and Notice 88–96, a notice of proposed rulemaking by cross-reference to temporary regulations, and a notice of public hearing (REG–209135–88, 2000–8 I.R.B. 681). The 2000 temporary regulations apply retroactively to June 10, 1987.

Treasury and the IRS have received a number of comments, both written and oral, on the 2000 temporary regulations. A public hearing was held on May 10, 2000. After considering these comments, Treasury and the IRS have decided to issue two new sets of temporary regulations, one that will apply to conversion transactions occurring on or after June 10, 1987, and before January 2, 2002 (the –6T regulations), and another that will apply to conversion transactions occurring on or after January 2, 2002 (the –7T regulations). Alternatively, taxpayers generally may apply the 2000 temporary regulations in lieu of the –6T regulations to any conversion transaction that occurred on or after June 10, 1987, and before January 2, 2002. However, RICs and REITs that rely on the 2000 temporary regulations and that are subject to section 1374 treatment may not rely on certain provisions in the 2000 temporary regulations, but instead must apply certain provisions of the –6T regulations, with respect to built-in gains and losses recognized in taxable years beginning on or after January 2, 2002. Furthermore, taxpayers are not prevented from relying on the 2000 temporary regulations merely because they elect section 1374 treatment in the manner described in the –6T regulations rather than in the manner described in the 2000 temporary regulations.

Explanation of Provisions

This preamble first discusses the –6T regulations and how the –6T regulations differ from the 2000 temporary regulations. This preamble then explains the differences between the –7T regulations and the –6T regulations.

Summary of –6T Regulations

The –6T regulations provide that, if property of a C corporation that is not a RIC or REIT becomes the property of a RIC or REIT in a conversion transaction, then the C corporation is subject to deemed sale treatment, unless the RIC or REIT elects to be subject to section 1374 treatment. Thus, the C corporation generally recognizes gain and loss as if it sold the property converted to RIC or REIT property or transferred to the RIC or REIT (the converted property) to an unrelated party at fair market value immediately before the conversion transaction. If the C corporation recognizes net gain on the deemed sale, then the basis of the converted property in the hands of the RIC or REIT is adjusted to its fair market value immediately before the conversion transaction. The –6T regulations do not permit a C corporation to recognize a net loss on the deemed sale. For this purpose, net loss is defined as the excess of aggregate losses over aggregate gains (including items of income), without regard to character. 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 RIC or REIT.

Clarification of Deemed Sale Treatment

The 2000 temporary regulations provide that, unless a section 1374 election is made, a C corporation that elects RIC or REIT status or transfers property to a RIC or REIT is "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 . . . and immediately liquidated." Commentators objected to this provision on two grounds. First, they argued that the provision is overly broad, because it treats the C corporation that is transferring property to a RIC or REIT as having sold all of its property, even where all of its property may not have been transferred to the RIC or REIT. Second, they argued that the "for all purposes" language could be read to suggest that the deemed liquidation results in the imposition of a shareholder tax, a result that they view as inconsistent with Notice 88–19 and the purposes of section 337(d). Commentators also argued that deemed liquidation treatment would inappropriately eliminate the C corporation's tax attributes, such as net operating loss carryforwards and earnings and profits, to which the RIC or REIT might otherwise succeed.

Treasury and the IRS agree with these comments. Accordingly, the –6T regulations clarify that the C corporation is treated as having sold only that property actually transferred to the RIC or REIT and that a shareholder-level tax is not imposed. In addition, the deemed liquidation construct has been eliminated.

Deemed Sale Loss Disallowance

The 2000 temporary regulations do not permit a C corporation to recognize a net loss on a conversion transaction. Some commentators argued that loss disallowance is inappropriate, noting that a net loss can be recognized under sections 336 and § 1.337(d)–4, which govern certain transfers of property from taxable to tax-exempt entities.

Treasury and the IRS believe that loss disallowance is appropriate in the context of the –6T regulations for two reasons. First, Treasury and the IRS are concerned that a C corporation may selectively contribute loss property to a RIC or REIT in a section 351 transaction, generating an immediate loss. Because sections 336 and § 1.337(d)–4 apply only where a C corporation transfers substantially all of its assets, selective contribution concerns are minimal in those contexts. Second, sections 336 and § 1.337(d)–4 require C corporations to recognize both gains and losses immediately, whereas the –6T regulations allow taxpayers to defer the recognition of net gain on a conversion transaction by making an election to be subject to tax under section 1374. Allowing immediate net loss recognition while allowing deferral of net gain would provide C corporations engaging in conversion transactions with an inappropriate degree of selectivity. Taxpayers that otherwise would recognize a net gain on a conversion transaction would likely elect section 1374 treatment. Taxpayers that would recognize a net loss on a conversion transaction would likely choose deemed sale treatment. For these reasons, the –6T regulations disallow recognition of a net loss on a conversion transaction.

Section 1374 Double Tax Issue

Some commentators argued that conversion transactions do not implicate concerns regarding avoidance of *General Utilities* repeal to the extent that the RIC or REIT has C corporations as shareholders after the conversion transaction. The commentators explained that, if a C corporation continues to own stock in the RIC or REIT after a conversion transaction, then the built-in gain attributable to the transferred property is preserved in the basis of the C corporation's RIC or REIT stock. Further, the C corporation generally will be fully taxable on dividends distributed by the RIC or REIT, even where the RIC or REIT pays tax on built-in gains. Accordingly, the commentators requested that the 2000 temporary regulations be modified to mitigate the combined impact of tax at the RIC or REIT level under section 1374 and tax at the C corporation shareholder level on RIC and REIT dividends.

Treasury and the IRS considered several approaches suggested by commentators for mitigating this double corporate tax. These approaches include: (1) exempting section 351 transfers of property by a C corporation to a RIC or REIT from the scope of these regulations, (2) removing the requirement that RICs and REITs distribute recognized built-in gains, and (3) allowing C corporation shareholders of RICs and REITs to claim a dividends received deduction for built-in gains distributed by the RIC or REIT.

After consideration, Treasury and the IRS decided that it could not accept any of these approaches. The first two approaches were not accepted because they could create opportunities to avoid corporate-level tax on built-in gains. The third approach was not accepted because the dividends received deduction is only available for distributions characterized as ordinary income, not distributions characterized as capital gains. As explained below, under the –6T regulations, RICs and REITs may characterize most distributions of built-in gains as capital gain dividends. Moreover, all three approaches would give rise to administrative difficulties that could be addressed only through extensive rulemaking.

Section 1374 Operational Rules

The 2000 temporary regulations provide that the built-in gain of a RIC or REIT electing section 1374 treatment and the corporate-level tax imposed on that gain are subject to rules similar to the rules relating to net income from foreclosure property (NIFP) of REITs. The comments pointed out certain differences between the section 1374 rules and the NIFP rules. For example, under section 1374, any recognized built-in gain retains its character as capital gain or ordinary income. In contrast, NIFP is always treated as ordinary income. In addition, net operating losses of a C corporation can offset recognized built-in gains of an S corporation but cannot offset NIFP. Similarly, business credit carryforwards from a C corporation can reduce the tax on the net recognized built-in gain of an S corporation but cannot reduce the tax on NIFP.

In light of these differences, Treasury and the IRS have adopted an alternative approach that does not rely on the NIFP rules for coordinating the built-in gains tax imposed by this section with the provisions of subchapter M. Unlike the NIFP rules, this approach generally preserves the character of recognized built-in gains and recognized built-in losses. Under this approach, recognized built-in gains and recognized built-in losses that have been taxed in accordance with these regulations are treated like other gains and losses of RICs and REITs that are not subject to tax under these regulations. Thus, they are included in computing investment company taxable income for purposes of section 852(b)(2), real estate investment trust taxable income for purposes of section 857(b)(2), net capital gain for purposes of sections 852(b)(3) and 857(b)(3), gross income derived from sources within any foreign country or possession of the United States for purposes of section 853, and the dividends paid deduction for purposes of sections 852(b)(2)(D), 852(b)(3)(A), 857(b)(2)(B), and 857(b)(3)(A).

In addition, consistent with section 1374, the –6T regulations generally allow RICs and REITs to use loss carryforwards and credits and credit carryforwards arising in taxable years for which the corporation that generated the attribute was a C corporation (and not a RIC or REIT) to reduce net recognized built-in gain and the tax thereon, subject to the limitations imposed by sections 1374(b)(2) and (b)(3) and §§ 1.1374–5 and 1.1374–6. In addition, the –6T regulations provide an ordering rule for applying loss carryforwards, credits, and credit carryforwards to reduce net recognized built-in gain (and the tax thereon) and RIC or REIT taxable income (and the tax thereon). Under this ordering rule, loss carryforwards of a RIC or REIT must be used to reduce net recognized built-in gain for a taxable year to the greatest extent possible before such losses can be used to reduce investment company taxable income for purposes of section 852(b) or real estate investment trust taxable income for purposes of section 857(b) for that taxable year. Similarly, credits and credit carryforwards of a RIC or REIT must be used to reduce the tax on net recognized built-in gain imposed under this section for the taxable year to the greatest extent possible before such credits and credit carryforwards can be used to reduce the tax, if any, on investment company taxable income for purposes of section 852(b) or on real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

The –6T regulations also make adjustments to the taxable income limitation of section 1374 to take into account items that are unique to REITs. Under the –6T regulations, taxable income of a RIC or REIT is initially computed under sections 1374(d)(2) and 1375(b)(1)(B) as if the RIC or REIT were an S corporation. Thus, the RIC's or REIT's taxable income is its taxable income under section 63(a) without regard to — (i) deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organizational expenditures), and (ii) the deduction under section 172. In addition, the RIC or REIT would not be allowed a deduction for dividends paid, as the dividends paid deduction is not available to S corporations. Under the –6T regulations, this amount is then reduced for REITs by certain items that are subject to a 100-percent penalty tax. Items subject to a 100-percent penalty tax, along with net income from foreclosure property, are also excluded in computing a REIT's net recognized built-in gain.

In response to comments, the –6T regulations also provide that the entity-level tax imposed on net recognized built-in gain is treated as a loss that reduces the RIC's or REIT's taxable income and earnings and profits. The character of the loss attributable to the tax on net recognized built-in gain is determined by allocating the tax proportionately (based on recognized built-in gain) among the items of recognized built-in gain included in net recognized built-in gain. With respect to RICs, the tax imposed on net recognized built-in gain is treated as attributable to the portion of the RIC's taxable year occurring after October 31.

Commentators also requested that built-in gain recognized by a RIC or REIT that is subject to section 1374 treatment generate subchapter M earnings and profits. They explained that a RIC or REIT cannot qualify as such under subchapter M if it retains any subchapter C earnings and profits. Thus, if earnings and profits attributable to recognized built-in gain were subchapter C earnings and profits, a RIC or REIT would retain its qualification only if it distributed 100 percent of the net recognized built-in gain in excess of the entity-level tax. In response to these comments, the examples in the –6T regulations clarify that earnings and profits attributable to built-in gain recognized by a RIC or REIT are subchapter M earnings and profits.

Electing Section 1374 Treatment

The 2000 temporary regulations provide that a RIC or REIT makes a section 1374 election by attaching a statement to its Federal income tax return for the first taxable year in which the assets of a C corporation become assets of the RIC or REIT. The 2000 temporary regulations also provide a special rule for making a section 1374 election where the first taxable year in which the assets of a C corporation became the assets of a RIC or REIT ends after June 10, 1987, but before March 8, 2000 (an interim period election). Under the 2000 temporary regulations, a RIC or REIT may file an interim period election with its first Federal income tax return filed after March 8, 2000.

Commentators expressed concern that the rule applicable to interim period elections required a RIC or REIT to make an election on its first Federal income tax return filed after March 8, 2000, even if the RIC or REIT previously had made a section 1374 election. They also expressed concern that RICs and REITs were not given sufficient time after the promulgation of the 2000 temporary regulations to make interim period elections. In response to these comments, the –6T regulations allow a RIC or 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 RIC or REIT on or before March 15, 2003, provided that the RIC or REIT has reported consistently with such election for all periods. In addition, under the –6T regulations, an interim period election is not necessary if the RIC or REIT can demonstrate that it has previously informed the IRS of its intent to make a section 1374 election.

Some commentators also requested that Treasury and the IRS clarify that a RIC or REIT must make a separate section 1374 election for each conversion transaction in which it participates. The –6T regulations make this clarification. Thus, a RIC or REIT can elect section 1374 treatment for one conversion transaction and not elect section 1374 treatment for another conversion transaction.

Exception for Re-Election of RIC or REIT Status

Under the 2000 temporary regulations, the rule requiring recognition of gain on a conversion transaction does not apply to a C corporation that qualified to be a RIC for at least one taxable year, then failed to so qualify for a period not in excess of one taxable year, and then requalifies as a RIC. Although this exception implements Notice 88–96, the language of the 2000 temporary regulations differs slightly from the language used in Notice 88–96. Some commentators have noted that the change in language might be misinterpreted as a substantive change where none was intended. In response to these comments, this language has been clarified in the –6T regulations.

In addition, some commentators requested that the exception be expanded to cover periods longer than one taxable year. They argued that a corporation that fails to meet the RIC qualification requirements for as short a period as 6 months could be taxed as a C corporation for two taxable years. This could happen where a RIC fails the quarterly diversification test for the last quarter of one calendar year and the first quarter of the subsequent calendar year.

Other commentators requested that this exception be expanded to cover REITs. They noted that Congress generally treats RICs and REITs similarly and that there is no justification for excluding REITs from the benefit of this exception.

The –6T regulations incorporate these comments by extending the exception to REITs and the maximum period for loss of RIC or REIT status from one taxable year to two taxable years.

Retention of Retroactive Effective Date

Commentators argued that, due to the 12-year gap between the promulgation of Notice 88–19 and the issuance of the regulations implementing Notice 88–19, the regulations should not apply retroactively.

Notice 88–19 notified taxpayers that the section 337(d) regulations would apply as of June 10, 1987. The 2000 temporary regulations, which were published on February 7, 2000, do, in fact, apply as of June 10, 1987. Moreover, since February 7, 2000, taxpayers have relied on the 2000 temporary regulations. For these reasons, the 2000 temporary regulations and the –6T regulations retain the June 10, 1987, applicability date.

Summary of –7T Regulations

The –7T regulations follow the –6T regulations in most respects. However, certain changes were included in the –7T regulations that were not included in the –6T regulations, because Treasury and the IRS were concerned that these changes, if made retroactively, could have an adverse impact on taxpayers that have relied on the 2000 temporary regulations. The following sections highlight these differences between the –6T regulations and the –7T regulations.

Section 1374 Treatment as Default Rule

A number of commentators, particularly REIT commentators, expressed the view that, when a C corporation engages in a conversion transaction, section 1374 treatment should apply automatically and taxpayers that desire deemed sale treatment should be allowed to elect such treatment. They pointed out that the automatic application of a section 1374 regime is consistent with the treatment of C corporations that elect S status. Further, they argued that most taxpayers would prefer to be subject to section 1374 treatment than to deemed sale treatment. If section 1374 treatment is the default treatment, then the incidence of inadvertent failures to make elections will be reduced. However, to protect the expectations of taxpayers that engaged in conversion transactions prior to the promulgation of these regulations, the commentators recommended that section 1374 treatment be adopted as the default treatment on a prospective basis. In accordance with these comments, the –7T regulations provide that section 1374 treatment applies unless the C corporation elects deemed sale treatment.

Anti-Stuffing Rule for Taxpayers Electing Deemed Sale Treatment

Treasury and the IRS are concerned that taxpayers electing deemed sale treatment might attempt to decrease net gains on conversion transactions by stuffing loss property into a C corporation prior to a conversion transaction. Treasury and the IRS note that sections 336 and § 1.337(d)–4 both have anti-stuffing rules. Accordingly, the –7T regulations include an anti-stuffing rule applicable to transactions taxed under the deemed sale approach. The anti-stuffing rule is similar to those contained in section 336 and § 1.337(d)–4.

Aggregate Principles to Apply to Partnership Transactions

Treasury and the IRS believe that a partnership with C corporation partners should be treated as an aggregate for purposes of applying these regulations. Accordingly, the –7T regulations provide that these regulations apply to property transferred by a partnership to a RIC or REIT to the extent of any C corporation partner's proportionate share of the transferred property. For example, if a C corporation owns a 20 percent interest in a partnership and that partnership contributes an asset to a REIT in a section 351 transaction, then the partnership shall be treated as a C corporation with respect to 20 percent of the asset contributed to the REIT. If the partnership were to elect deemed sale treatment with respect to such transfer, then any gain recognized by the partnership on the deemed sale must be specially allocated to the C corporation partner.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Lisa A. Fuller of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury Department and the IRS participated in their development.

* * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

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

Section 1.337(d)–6T also issued under 26 U.S.C. 337.

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

Par. 2. §1.337(d)–5T is amended by:

1. Revising the section heading.
2. Revising paragraph (d).

The revisions read as follows:

§ 1.337(d)–5T Old transitional rules imposing tax on property owned by a C corporation that becomes property of a RIC or REIT (temporary).

* * * * *

(d) *Effective date*. In the case of carryover basis transactions involving the transfer of property of a C corporation to a RIC or REIT, the regulations apply to transactions occurring on or after June 10, 1987, and before January 2, 2002. In the case of a C corporation that qualifies to be taxed as a RIC or REIT, the regulations apply to such qualifications that are effective for taxable years beginning on or after June 10, 1987, and before January 2, 2002. However, RICs and REITs that are subject to section 1374 treatment under this section may not rely on § 1.337(d)–5T(b)(1), but must apply paragraphs (c)(1)(i), (c)(2)(i), (c)(2)(ii), and (c)(3) of § 1.337(d)–6T, with respect to built-in gains and losses recognized in taxable years beginning on or after January 2, 2002. In lieu of applying this section, taxpayers may rely on § 1.337(d)–6T to determine the tax consequences (for all taxable years) of any conversion transaction. For transactions and qualifications that occur on or after January 2, 2002, see § 1.337(d)–7T.

Par. 3. Sections 1.337(d)–6T and 1.337(d)–7T are added immediately after § 1.337(d)–5T to read as follows:

§ 1.337(d)–6T New transitional rules imposing tax on property owned by a C corporation that becomes property of a RIC or REIT (temporary).

(a) *General Rule*—(1) *Property owned by a C corporation that becomes property of a RIC or REIT*. If property owned by a C corporation (as defined in paragraph (a)(2)(i) of this section) becomes the property of a RIC or REIT (the converted property) in a conversion transaction (as defined in paragraph (a)(2)(ii) of this section), then deemed sale treatment will apply as described in paragraph (b) of this section, unless the RIC or REIT elects section 1374 treatment with respect to the conversion transaction as provided in paragraph (c) of this section. See paragraph (d) of this section for exceptions to this paragraph (a).

(2) *Definitions*—(i) *C corporation*. For purposes of this section, the term C corporation has the meaning provided in section 1361(a)(2) except that the term does not include a RIC or REIT.

(ii) *Conversion transaction*. For purposes of this section, 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.

(b) *Deemed Sale Treatment*—(1) *In general*. If property owned by a C corporation becomes the property of a RIC or REIT in a conversion transaction, then the C corporation recognizes gain and loss as if it sold the converted property to an unrelated party at fair market value on the deemed sale date (as defined in paragraph (b)(3) of this section). This paragraph (b) does not apply if its application would result in the recognition of a net loss. For this purpose, *net loss* is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.

(2) *Basis adjustment*. If a corporation recognizes a net gain under paragraph (b)(1) of this section, then the converted property has a basis in the hands of the RIC or REIT equal to the fair market value of such property on the deemed sale date.

(3) *Deemed sale date*—(i) *RIC or REIT qualifications*. If the conversion transaction is a qualification of a C corporation as a RIC or REIT, then the deemed sale date is the end of the last day of the C corporation's last taxable year before the first taxable year in which it qualifies to be taxed as a RIC or REIT.

(ii) *Other conversion transactions*. If the conversion transaction is a transfer of property owned by a C corporation to a RIC or REIT, then the deemed sale date is the end of the day before the day of the transfer.

(4) *Example*. The rules of this paragraph (b) are illustrated by the following example:

Example. Deemed sale treatment on merger into RIC. (i) X, a calendar-year taxpayer, has qualified as a RIC since January 1, 1991. On May 31, 1994, Y, a C corporation and calendar-year taxpayer, transfers all of its property to X in a transaction that qualifies as a reorganization under section 368(a)(1)(C). X does not elect section 1374 treatment under paragraph (c) of this section and chooses not to rely on § 1.337(d)–5T. As a result of the transfer, Y is subject to deemed sale treatment under this paragraph (b) on its tax return for the short taxable year ending May 31, 1994. On May 31, 1994, Y's only assets are Capital Asset, which has a fair market value of $100,000 and a basis of $40,000 as of the end of May 30, 1994, and $50,000 cash. Y also has an unrestricted net operating loss carryforward of $12,000 and accumulated earnings and profits of $50,000. Y has no taxable income for the short taxable year ending May 31, 1994, other than gain recognized under this paragraph (b). In 1997, X sells Capital Asset for $110,000. Assume the applicable corporate tax rate is 35%.

(ii) Under this paragraph (b), Y is treated as if it sold the converted property (Capital Asset and $50,000 cash) at fair market value on May 30, 1994, recognizing $60,000 of gain ($150,000 amount realized - $90,000 basis). Y must report the gain on its tax return for the short taxable year ending May 31, 1994. Y may offset this gain with its $12,000 net operating loss carryforward and will pay tax of $16,800 (35% of $48,000).

(iii) Under section 381, X succeeds to Y's accumulated earnings and profits. Y's accumulated earnings and profits of $50,000 increase by $60,000 and decrease by $16,800 as a result of the deemed sale. Thus, the aggregate amount of subchapter C earnings and profits that must be distributed to satisfy section 852(a)(2)(B) is $93,200 ($50,000 + $60,000 - $16,800). X's basis in Capital Asset is $100,000. On X's sale of Capital Asset in 1997, X recognizes $10,000 of gain, which is taken into account in computing X's net capital gain for purposes of section 852(b)(3).

(c) *Election of section 1374 treatment*—(1) *In general*—(i) *Property owned by a C corporation that becomes property of a RIC or REIT*. Paragraph (b) of this section does not apply if the RIC or REIT that was formerly a C corporation or that acquired property from a C corporation makes the election described in paragraph (c)(4) of this section. A RIC or REIT that makes such an election will be subject to tax on the net built-in gain in the converted property under the rules of section 1374 and the regulations thereunder, as modified by this paragraph (c), as if the RIC or REIT were an S corporation.

(ii) *Property subject to the rules of section 1374 owned by a RIC, REIT, or S corporation that becomes property of a RIC or REIT*. If property subject to the rules of section 1374 owned by a RIC, a REIT, or an S corporation (the predecessor) becomes the property of a RIC or REIT (the successor) in a continuation transaction, the rules of section 1374 apply to the successor to the same extent that the predecessor was subject to the rules of section 1374 with respect to such property, and the 10-year recognition period of the successor with respect to such property is reduced by the portion of the 10-year recognition period of the predecessor that expired before the date of the continuation transaction. For this purpose, a continuation transaction means the qualification of the predecessor as a RIC or REIT or the transfer of property from the predecessor to the successor in a transaction in which the successor's basis in the transferred property is determined, in whole or in part, by reference to the predecessor's basis in that property.

(2) *Modification of section 1374 treatment*—(i) *Net recognized built-in gain for REITs*—(A) *Prelimitation amount*. The prelimitation amount determined as provided in § 1.1374–2(a)(1) is reduced by the portion of such amount, if any, that is

subject to tax under section 857(b)(4), (5), (6), or (7). For this purpose, the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is computed as follows:

(*1*) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(A), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is the tax imposed by section 857(b)(5) multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in section 856(c)(2) and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in section 856(c)(2).

(*2*) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(B), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is the tax imposed by section 857(b)(5) multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in section 856(c)(3) and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in section 856(c)(3).

(B) *Taxable income limitation*. The taxable income limitation determined as provided in §1.1374–2(a)(2) is reduced by an amount equal to the tax imposed under sections 857(b)(5), (6), and (7).

(ii) *Loss carryforwards, credits and credit carryforwards*—(A) *Loss carryforwards*. Consistent with paragraph (c)(1)(i) of this section, net operating loss carryforwards and capital loss carryforwards arising in taxable years for which the corporation that generated the loss was not subject to subchapter M of chapter 1 of the Code are allowed as a deduction against net recognized built-in gain to the extent allowed under section 1374 and the regulations thereunder. Such loss carryforwards must be used as a deduction against net recognized built-in gain for a taxable year to the greatest extent possible before such losses can be used to reduce investment company taxable income for purposes of section 852(b) or real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

(B) *Credits and credit carryforwards*. Consistent with paragraph (c)(1)(i) of this section, minimum tax credits and business credit carryforwards arising in taxable years for which the corporation that generated the credit was not subject to subchapter M of chapter 1 of the Internal Revenue Code are allowed to reduce the tax imposed on net recognized built-in gain under this paragraph (c) to the extent allowed under section 1374 and the regulations thereunder. Such credits and credit carryforwards must be used to reduce the tax imposed under this paragraph (c) on net recognized built-in gain for a taxable year to the greatest extent possible before such credits and credit carryforwards can be used to reduce the tax, if any, on investment company taxable income for purposes of section 852(b) or on real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

(iii) *10-year recognition period*. In the case of a conversion transaction that is a qualification of a C corporation as a RIC or REIT, the 10-year recognition period described in section 1374(d)(7) begins on the first day of the RIC's or REIT's first taxable year. In the case of other conversion transactions, the 10-year recognition period begins on the day the property is acquired by the RIC or REIT.

(3) *Coordination with subchapter M rules*—(i) *Recognized built-in gains and losses subject to subchapter M*. Recognized built-in gains and losses of a RIC or REIT are included in computing investment company taxable income for purposes of section 852(b)(2), real estate investment trust taxable income for purposes of section 857(b)(2), capital gains for purposes of sections 852(b)(3) and 857(b)(3), gross income derived from sources within any foreign country or possession of the United States for purposes of section 853, and the dividends paid deduction for purposes of sections 852(b)(2)(D), 852(b)(3)(A), 857(b)(2)(B), and 857(b)(3)(A).

(ii) *Treatment of tax imposed*. The amount of tax imposed under this paragraph (c) on net recognized built-in gain for a taxable year is treated as a loss sustained by the RIC or the REIT during such taxable year. The character of the loss is determined by allocating the tax proportionately (based on recognized built-in gain) among the items of recognized built-in gain included in net recognized built-in gain. With respect to RICs, the tax imposed under this paragraph (c) on net recognized built-in gain is treated as attributable to the portion of the RIC's taxable year occurring after October 31.

(4) *Making the section 1374 election*—(i) *In general*. A RIC or REIT makes a section 1374 election with the following statement: "[Insert name and employer identification number of electing RIC or REIT] elects under § 1.337–6T(c) to be subject to the rules of section 1374 and the regulations thereunder with respect to its property that formerly was held by a C corporation, [insert name and employer identification number of the C corporation, if different from name and employer identification number of the RIC or REIT]." However, a RIC or REIT need not file an election under this paragraph (c), but will be deemed to have made such an election if it can demonstrate that it informed the IRS prior to January 2, 2002, of its intent to make a section 1374 election. An election under this paragraph (c) is irrevocable.

(ii) *Time for making the election*. An election under this paragraph (c) may be filed by the RIC or REIT with any Federal income tax return filed by the RIC or REIT on or before March 15, 2003, provided that the RIC or REIT has reported consistently with such election for all periods.

(5) *Example*. The rules of this paragraph (c) are illustrated by the following example:

Example. Section 1374 treatment on REIT election. (i) X, a C corporation that is a calendar-year taxpayer, elects to be taxed as a REIT on its 1994 tax return, which it files on March 15, 1995. As a result, X is a REIT for its 1994 taxable year and would be subject to deemed sale treatment under paragraph (b) of this section but for X's timely election of section 1374 treatment under this paragraph (c). X chooses not to rely on § 1.337(d)–5T. As of the beginning of the 1994 taxable year, X's property consisted of Real Property, which is not section

1221(a)(1) property and which had a fair market value of $100,000 and an adjusted basis of $80,000, and $25,000 cash. X also had accumulated earnings and profits of $25,000, unrestricted net operating loss carryforwards of $3,000, and unrestricted business credit carryforwards of $2,000. On July 1, 1997, X sells Real Property for $110,000. For its 1997 taxable year, X has net income other than recognized built-in gain. Assume the highest corporate tax rate is 35%.

(ii) Upon its election to be taxed as a REIT, X retains its $80,000 basis in Real Property and its $25,000 accumulated earnings and profits. X retains its $3,000 of net operating loss carryforwards and its $2,000 of business credit carryforwards. To satisfy section 857(a)(2)(B), X must distribute $25,000, an amount equal to its earnings and profits accumulated in non-REIT years, to its shareholders by the end of its 1994 taxable year.

(iii) Upon X's sale of Real Property in 1997, X recognizes gain of $30,000 ($110,000 - $80,000). X's recognized built-in gain for purposes of applying section 1374 is $20,000 ($100,000 fair market value as of the beginning of X's first taxable year as a REIT - $80,000 basis). Because X has net income other than recognized built-in gain for its 1997 taxable year, the taxable income limitation does not apply. X, therefore, has $20,000 net recognized built-in gain for the year. Assuming that X has not used its $3,000 of net operating loss carryforwards in a prior taxable year and that their use is allowed under section 1374(b)(2) and §1.1374–5, X is allowed a $3,000 deduction against the $20,000 net recognized built-in gain. X would owe tax of $5,950 (35% of $17,000) on its net recognized built-in gain, except that X may use its $2,000 of business credit carryforwards to reduce this tax, assuming that X has not used the credit carryforwards in a prior taxable year and that their use is allowed under sections 1374(b)(3) and § 1.1374–6. Thus, X owes tax of $3,950 under this paragraph (c). For purposes of subchapter M, X's earnings and profits for the year increase by $26,050 ($30,000 capital gain on the sale of Real Property - $3,950 tax under this paragraph (c)).

(iv) To compute X's net capital gain for purposes of section 857(b)(3) for the taxable year, the $20,000 of net recognized built-in gain less the $3,950 of tax imposed on that gain is added to X's capital gain (or loss), if any, that is not recognized built-in gain (or loss).

(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. See, for example, sections 336, 351(b), 356, 357(c), 367, and 1001.

(2) *Re-election of RIC or REIT status*—(i) *Generally*. Except as provided in paragraphs (d)(2)(ii) and (iii) of this section, paragraph (a)(1) of this section does not apply to any corporation that—

(A) Immediately prior to qualifying to be taxed as a RIC or REIT was subject to tax as a C corporation for a period not exceeding two taxable years; and

(B) Immediately prior to being subject to tax as a C corporation was subject to tax as a RIC or REIT for a period of at least one taxable year.

(ii) *Property acquired from another corporation while a C corporation*. The exception described in paragraph (d)(2)(i) of this section does not apply to property acquired by the corporation while it was subject to tax as a C corporation from another corporation (whether or not a C corporation) in a transaction that results in the acquirer's basis in the property being determined by reference to a C corporation's basis in the property.

(iii) *RICs and REITs previously subject to section 1374 treatment*. If the RIC or REIT had property subject to paragraph (c) of this section before the RIC or REIT became subject to tax as a C corporation as described in paragraph (d)(2)(i) of this section, then paragraph (c) of this section applies to the RIC or REIT upon its requalification as a RIC or REIT, except that the 10-year recognition period with respect to such property is reduced by the portion of the 10-year recognition period that expired before the RIC or REIT became subject to tax as a C corporation and by the period of time that the corporation was subject to tax as a C corporation.

(e) *Effective date*. This section applies to conversion transactions that occur on or after June 10, 1987, and before January 2, 2002. In lieu of applying this section, taxpayers generally may apply § 1.337(d)–5T to determine the tax consequences (for all taxable years) of any conversion transaction that occurs on or after June 10, 1987, and before January 2, 2002, except that RICs and REITs that are subject to section 1374 treatment with respect to a conversion transaction may not rely on § 1.337(d)–5T(b)(1), but must apply paragraphs (c)(1)(i), (c)(2)(i), (c)(2)(ii), and (c)(3) of this section, with respect to built-in gains and losses recognized in taxable years beginning on or after January 2, 2002. Taxpayers are not prevented from relying on § 1.337(d)–5T merely because they elect section 1374 treatment in the manner described in paragraph (c)(4) of this section instead of in the manner described in § 1.337(d)–5T(b)(3) and (c). For conversion transactions that occur on or after January 2, 2002, see §1.337(d)–7T. This section expires on December 31, 2004.

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

(a) *General Rule*—(1) *Property owned by a C corporation that becomes property of a RIC or REIT*. If property owned by a C corporation (as defined in paragraph (a)(2)(i) of this section) becomes the property of a RIC or REIT (the converted property) in a conversion transaction (as defined in paragraph (a)(2)(ii) of this section), then section 1374 treatment will apply as described in paragraph (b) of this section, unless the C corporation elects deemed sale treatment with respect to the conversion transaction as provided in paragraph (c) of this section. See paragraph (d) of this section for exceptions to this paragraph (a).

(2) *Definitions*—(i) *C corporation*. For purposes of this section, the term C corporation has the meaning provided in section 1361(a)(2) except that the term does not include a RIC or REIT.

(ii) *Conversion transaction*. For purposes of this section, 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.

(b) *Section 1374 treatment*—(1) *In general*—(i) *Property owned by a C corporation that becomes property of a RIC or REIT*. If property owned by a C corporation becomes the property of a RIC or REIT in 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 regulations thereunder, as modified by this paragraph (b), as if the RIC or REIT were an S corporation.

(ii) *Property subject to the rules of section 1374 owned by a RIC, REIT, or S corporation that becomes property of a RIC or REIT*. If property subject to the rules of section 1374 owned by a RIC, a REIT, or an S corporation (the predecessor) becomes the property of a RIC or REIT (the successor) in a continuation transaction, the rules of section 1374 apply to the successor to the same extent that the predecessor was subject to the rules of section 1374 with respect to such property, and the 10-year recognition period of the successor with respect to such property is reduced by the portion of the 10-year recognition period of the predecessor that expired before the date of the continuation transaction. For this purpose, a continuation transaction means the qualification of the predecessor as a RIC or REIT or the transfer of property from the predecessor to the successor in a transaction in which the successor's basis in the transferred property is determined, in whole or in part, by reference to the predecessor's basis in that property.

(2) *Modification of section 1374 treatment*—(i) *Net recognized built-in gain for REITs*—(A) *Prelimitation amount*. The prelimitation amount determined as provided in §1.1374–2(a)(1) is reduced by the portion of such amount, if any, that is subject to tax under section 857(b)(4), (5), (6), or (7). For this purpose, the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is computed as follows:

(*1*) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(A), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is the tax imposed by section 857(b)(5) multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in section 856(c)(2) and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in section 856(c)(2).

(*2*) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(B), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is the tax imposed by section 857(b)(5) multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in section 856(c)(3) and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in section 856(c)(3).

(B) *Taxable income limitation*. The taxable income limitation determined as provided in § 1.1374–2(a)(2) is reduced by an amount equal to the tax imposed under sections 857(b)(5), (6), and (7).

(ii) *Loss carryforwards, credits and credit carryforwards*—(A) *Loss carryforwards*. Consistent with paragraph (b)(1)(i) of this section, net operating loss carryforwards and capital loss carryforwards arising in taxable years for which the corporation that generated the loss was not subject to subchapter M of chapter 1 of the Code are allowed as a deduction against net recognized built-in gain to the extent allowed under section 1374 and the regulations thereunder. Such loss carryforwards must be used as a deduction against net recognized built-in gain for a taxable year to the greatest extent possible before such losses can be used to reduce investment company taxable income for purposes of section 852(b) or real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

(B) *Credits and credit carryforwards*. Consistent with paragraph (b)(1)(i) of this section, minimum tax credits and business credit carryforwards arising in taxable years for which the corporation that generated the credit was not subject to subchapter M of chapter 1 of the Internal Revenue Code are allowed to reduce the tax imposed on net recognized built-in gain under this paragraph (b) to the extent allowed under section 1374 and the regulations thereunder. Such credits and credit carryforwards must be used to reduce the tax imposed under this paragraph (b) on net recognized built-in gain for a taxable year to the greatest extent possible before such credits and credit carryforwards can be used to reduce the tax, if any, on investment company taxable income for purposes of section 852(b) or on real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

(iii) *10-year recognition period*. In the case of a conversion transaction that is a qualification of a C corporation as a RIC or REIT, the 10-year recognition period described in section 1374(d)(7) begins on the first day of the RIC's or REIT's first taxable year. In the case of other conversion transactions, the 10-year recognition period begins on the day the property is acquired by the RIC or REIT.

(3) *Coordination with subchapter M rules*—(i) *Recognized built-in gains and losses subject to subchapter M*. Recognized built-in gains and losses of a RIC or REIT are included in computing investment company taxable income for purposes of section 852(b)(2), real estate investment trust taxable income for purposes of section 857(b)(2), capital gains for purposes of sections 852(b)(3) and 857(b)(3), gross income derived from sources within any foreign country or possession of the United States for purposes of section 853, and the dividends paid deduction for purposes of sections 852(b)(2)(D), 852(b)(3)(A), 857(b)(2)(B), and 857(b)(3)(A).

(ii) *Treatment of tax imposed*. The amount of tax imposed under this paragraph (b) on net recognized built-in gain for a taxable year is treated as a loss sustained by the RIC or the REIT during such taxable year. The character of the loss is determined by allocating the tax proportionately (based on recognized built-in gain) among the items of recognized built-in gain included in net recognized built-in gain. With respect to RICs, the tax imposed under this paragraph (b) on net recognized built-in gain is treated as attributable to the portion of the RIC's taxable year occurring after October 31.

(4) *Example*. The rules of this paragraph (b) are illustrated by the following example:

Example. Section 1374 treatment on REIT election. (i) X, a C corporation that is a calendar-year taxpayer, elects to be taxed as a REIT on its 2004 tax return, which it files on March 15, 2005. As a result, X is a REIT for its 2004 taxable year and is subject to section 1374 treatment under this paragraph (b). X does not elect deemed sale treatment under paragraph (c) of this section. As of the beginning of the 2004 taxable year, X's property consisted of Real Property, which is not section 1221(a)(1) property and which had a fair market value of $100,000 and an adjusted basis of $80,000, and $25,000 cash. X also had accumulated earnings and profits of $25,000, unrestricted net operating loss carryforwards of $3,000, and unrestricted business credit carryforwards of $2,000. On July 1, 2007, X sells Real Property for $110,000. For its 1997 taxable year, X has net income other than recognized built-in gain. Assume the highest corporate tax rate is 35%.

(ii) Upon its election to be taxed as a REIT, X retains its $80,000 basis in Real Property and its $25,000 accumulated earnings and profits. X retains its $3,000 of net operating loss carryforwards and its $2,000 of business credit carryforwards. To satisfy section 857(a)(2)(B), X must distribute $25,000, an amount equal to its earnings and profits accumulated in non-REIT years, to its shareholders by the end of its 2004 taxable year.

(iii) Upon X's sale of Real Property in 2007, X recognizes gain of $30,000 ($110,000 - $80,000). X's recognized built-in gain for purposes of applying section 1374 is $20,000 ($100,000 fair market value as of the beginning of X's first taxable year as a REIT - $80,000 basis). Because X has net income other than recognized built-in gain for its 2007 taxable year, the taxable income limitation does not apply. X, therefore, has $20,000 net recognized built-in gain for the year. Assuming that X has not used its $3,000 of net operating loss carryforwards in a prior taxable year and that their use is allowed under section 1374(b)(2) and § 1.1374–5, X is allowed a $3,000 deduction against the $20,000 net recognized built-in gain. X would owe tax of $5,950 (35% of $17,000) on its net recognized built-in gain, except that X may use its $2,000 of business credit carryforwards to reduce the tax, assuming that X has not used the credit carryforwards in a prior taxable year and that their use is allowed under section 1374(b)(3) and § 1.1374–6. Thus, X owes tax of $3,950 under this paragraph (b). For purposes of subchapter M, X's earnings and profits for the year increase by $26,050 ($30,000 capital gain on the sale of Real Property - $3,950 tax under this paragraph (b)).

(iv) To compute X's net capital gain for purposes of section 857(b)(3) for the taxable year, the $20,000 of net recognized built-in gain less the $3,950 of tax imposed on that gain is added to X's capital gain (or loss), if any, that is not recognized built-in gain (or loss).

(c) *Election of deemed sale treatment*—(1) *In general*. Paragraph (b) of this section does not apply if the C corporation that qualifies as a RIC or REIT or transfers property to a RIC or REIT makes the election described in paragraph (c)(5) of this section. A C corporation that makes such an election recognizes gain and loss as if it 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). See paragraph (c)(4) of this section concerning limitations on the use of loss in computing gain. This paragraph (c) does not apply if its application would result in the recognition of a net loss. For this purpose, *net loss* is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.

(2) *Basis adjustment*. If a corporation recognizes a net gain under paragraph (c)(1) of this section, then the converted property has a basis in the hands of the RIC or REIT equal to the fair market value of such property on the deemed sale date.

(3) *Deemed sale date*—(i) *RIC or REIT qualifications*. If the conversion transaction is a qualification of a C corporation as a RIC or REIT, then the deemed sale date is the end of the last day of the C corporation's last taxable year before the first taxable year in which it qualifies to be taxed as a RIC or REIT.

(ii) *Other conversion transactions*. If the conversion transaction is a transfer of property owned by a C corporation to a RIC or REIT, then the deemed sale date is the end of the day before the day of the transfer.

(4) *Anti-stuffing rule*. A C corporation must disregard converted property in computing gain or loss recognized on the conversion transaction under this paragraph (c), if—

(i) The converted property was acquired by the C corporation in a transaction to which section 351 applied or as a contribution to capital;

(ii) Such converted property had an adjusted basis immediately after its acquisition by the C corporation in excess of its fair market value on the date of acquisition; and

(iii) The acquisition of such converted property 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. For purposes of this paragraph (c)(4), the principles of section 336(d)(2) apply.

(5) *Making the deemed sale election*. A C corporation makes the deemed sale election with the following statement: "[Insert name and employer identification number of electing corporation] elects deemed sale treatment under § 1.337(d)–7T(c) with respect to its property that was converted to property of, or transferred to, a RIC or REIT, [insert name and employer identification number of the RIC or REIT, if different from the name and employer identification number of the C corporation]." This statement must be attached to the Federal income tax return of the C corporation for the taxable year in which the deemed sale occurs. An election under this paragraph (c) is irrevocable.

(6) *Examples*. The rules of this paragraph (c) are illustrated by the following examples:

Example 1. Deemed sale treatment on merger into RIC. (i) X, a calendar-year taxpayer, has qualified as a RIC since January 1, 2001. On May 31, 2004, Y, a C corporation and calendar-year taxpayer, transfers all of its property to X in a transaction that qualifies as a reorganization under section 368(a)(1)(C). As a result of the transfer, Y would be subject to section 1374 treatment under paragraph (b) of this section but for its timely election of deemed sale treatment under this paragraph (c). As a result of such election, Y is subject to deemed sale treatment on its tax return for the short taxable year ending May 31, 2004. On May 31, 2004, Y's only assets are Capital Asset, which has a fair market value of $100,000 and a basis of $40,000 as of the end of May 30, 2004, and $50,000 cash. Y also has an unrestricted net operating loss carryforward of $12,000 and accumulated earnings and profits of $50,000. Y has no taxable income for the short taxable year ending May 31, 2004, other than gain recognized under this paragraph (c). In 2007, X sells Capital Asset for $110,000. Assume the applicable corporate tax rate is 35%.

(ii) Under this paragraph (c), Y is treated as if it sold the converted property (Capital Asset and $50,000 cash) at fair market value on May 30, 2004, recognizing $60,000 of gain ($150,000 amount realized - $90,000 basis). Y must report the gain on its tax return for the short taxable year ending May 31, 2004. Y may offset this gain with its $12,000 net operating loss carryforward and will pay tax of $16,800 (35% of $48,000).

(iii) Under section 381, X succeeds to Y's accumulated earnings and profits. Y's accumulated earnings and profits of $50,000 increase by $60,000 and decrease by $16,800 as a result of the deemed sale. Thus, the aggregate amount of subchapter C earnings and profits that must be distributed to satisfy section 852(a)(2)(B) is $93,200 ($50,000 + $60,000 - $16,800). X's basis in Capital Asset is $100,000. On X's sale of Capital Asset in 2007, X recognizes $10,000 of gain which is taken into account in computing X's net capital gain for purposes of section 852(b)(3).

Example 2. Loss limitation. (i) Assume the facts are the same as those described in *Example 1*, but that, prior to the reorganization, a shareholder of Y contributed to Y a capital asset, Capital Asset 2, which has a fair market value of $10,000 and a basis of $20,000, in a section 351 transaction.

(ii) Assuming that Y's acquisition of Capital Asset 2 was made pursuant to a plan a principal purpose of which was to reduce the amount of gain that Y would recognize in connection with the conversion transaction, Capital Asset 2 would be disregarded in computing the amount of Y's net gain on 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. See, for example, sections 336, 351(b), 356, 357(c), 367, and 1001.

(2) *Re-election of RIC or REIT status*—(i) *Generally*. Except as provided in paragraphs (d)(2)(ii) and (d)(2)(iii) of this section, paragraph (a)(1) of this section does not apply to any corporation that—

(A) Immediately prior to qualifying to be taxed as a RIC or REIT was subject to tax as a C corporation for a period not exceeding two taxable years; and

(B) Immediately prior to being subject to tax as a C corporation was subject to tax as a RIC or REIT for a period of at least one taxable year.

(ii) *Property acquired from another corporation while a C corporation*. The exception described in paragraph (d)(2)(i) of this section does not apply to property acquired by the corporation while it was subject to tax as a C corporation from another corporation (whether or not a C corporation) in a transaction that results in the acquirer's basis in the property being determined by reference to a C corporation's basis in the property.

(iii) *RICs and REITs previously subject to section 1374 treatment*. If the RIC or REIT had property subject to paragraph (b) of this section before the RIC or REIT became subject to tax as a C corporation as described in paragraph (d)(2)(i) of this section, then paragraph (b) of this section applies to the RIC or REIT upon its requalification as a RIC or REIT, except that the 10-year recognition period with respect to such property is reduced by the portion of the 10-year recognition period that expired before the RIC or REIT became subject to tax as a C corporation and by the period of time that the corporation was subject to tax as a C corporation.

(e) *Special rule for partnerships*. The principles of this section apply to property transferred by a partnership to a RIC or REIT to the extent of any C corporation partner's proportionate share of the transferred property. For example, if a C corporation owns a 20 percent interest in a partnership and that partnership contributes an asset to a REIT in a section 351 transaction, then the partnership shall be treated as a C corporation with respect to 20 percent of the asset contributed to the REIT. If the partnership were to elect deemed sale treatment under paragraph (c) of this section with respect to such transfer, then any gain recognized by the partnership on the deemed sale must be specially allocated to the C corporation partner.

(f) *Effective date*. 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)–5T and § 1.337(d)–6T. This section expires on December 31, 2004.

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In § 602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR Part or section where identified and described	Current OMB control No.
* * * * *	
1.337(d)–6T	1545–1672
1.337(d)–7T	1545-1672
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 20, 2001.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 31, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 2, 2002, 67 F.R. 8)