Comments on Proposed Regulations Section 1.337(d)-5
and Temporary Regulation Section 1.337(d)-5T

Date: April 2000

This report sets forth comments of the individual members of the Real Estate and Regulated
Investment Companies Committees of the Section of Taxation of the American Bar Association
with respect to Proposed Regulation Section 1.337(d)-5 (the "Proposed Regulations") and
Temporary Regulation Section 1.337(d)-5T (the "Temporary Regulations") (collectively, the
"Regulations") governing certain transfers of assets from Subchapter C corporations to, and
qualification of Subchapter C corporations as, a regulated investment company ("RIC") or a real
estate investment trust ("REIT").

These comments are the individual views of the members of the Section of Taxation who
prepared them and do not represent the position of the Section of Taxation or the American Bar
Association.

Primary responsibility was exercised by Morris L. Kramer and J. Ronald Shiff. These comments
were reviewed by Steven D. Conlon for the Committee on Government Submissions and by
Council Director Stanley Louis Blend.

Although the members of the Section of Taxation who participated in preparing these comments
may have clients who would be affected by the federal income tax principles addressed, or have
advised clients on the application of these principles, no such member (or the firm or
organization to which such member belongs) has been engaged by a client to make a
government submission with respect to, or otherwise to influence the development or outcome
of, the specific subject matter of these comments.

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The comments concern Proposed Regulation Section 1.337(d)-5 and Temporary Regulation Section 1.337(d)-5T which are intended to implement Notice 88-19. The Regulations govern the tax consequences of an election by a Subchapter C Corporation of Regulated Investment Company (RIC) or Real Estate Investment Trust (REIT) status and carry-over basis transfers of assets from a Subchapter C Corporation to a RIC or a REIT. The comments address twelve specific concerns with the Regulation.

1. The Regulation covers more situations than those contemplated by Congress in that it applies to transactions in which there is no avoidance of corporate level tax. Conversely, the Regulation does not appear to cover transactions with Subchapter S Corporations which hold built-in gain assets.

2. The Regulation includes a blanket loss disallowance rule which appears to be beyond the result contemplated by Congress.

3. The Regulation sets up an exception for RICs without setting up a parallel exception for REITs.
4. The Regulation appears to provide for a different determination of net built-in gain than that provided in Code Section 1374.

5. The Regulation includes a rule which converts capital gain into ordinary income.

6. The Regulation does not address the use of net operating loss, capital loss and business credit carryovers in connection with the recognition of built-in gains.

7. The Regulation is unclear with respect to all of the tax effects of the deemed liquidation contemplated by the Regulation.

8. The Regulation calls for taxpayers who have already made an election in good faith to re-elect in order to qualify for favorable tax treatment.

9. The Regulation is premised on a tax result which is opposite the normal result under Section 1374 setting up a trap for the unwary.

10. The Regulation needs to clarify the length of the built-in gain recognition period with respect to transactions with Subchapter S Corporations.

11. The Regulation needs to be clarified to address earnings and profits implications of transactions governed by it.

12. The Regulation needs to be clarified to insure that the taxable income of RICs and REITs is properly determined for regular tax and excise tax purposes.

For the reasons set forth above, we believe the Regulation is flawed and should be revised. Since the Regulation is already effective, we recommend the Regulation be withdrawn and modified as discussed herein. Alternatively, we recommend the Regulation, once revised, be made retroactively effective.

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**Background**

This report sets forth comments of the individual members of the Real Estate and Regulated Investment Companies Committees of the Section of Taxation of the American Bar Association with respect to Proposed Regulation Section 1.337(d)-5 (the "Proposed Regulations") and Temporary Regulation Section 1.337(d)-5T (the "Temporary Regulations") (collectively, the "Regulations") governing certain transfers of assets from Subchapter C corporations to, and qualification of Subchapter C corporations as, a regulated investment company ("RIC") or a real estate investment trust ("REIT"). The Regulations are intended to implement Notice 88-19, 1988-1 C.B.486, which announced that regulations would be issued for such transactions occurring on or after June 10, 1987.

The Regulations provide that when a Subchapter C corporation either (a) elects to be taxed as a RIC or a REIT, or (b) transfers assets to a RIC or a REIT in a carryover basis transaction, the C Corporation is treated as if it sold all of its assets at their respective fair market values and immediately liquidated. In lieu of such treatment, the Regulations permit the RIC or REIT to elect to be subject to tax under rules similar to those of Internal Revenue Code (the "Code") Section 1374. That Section, which applies to Subchapter S corporations, generally requires that
net built-in gains be taxed only to the extent such net built-in gains are recognized within a ten year period following the date a Subchapter C corporation elects to be taxed as an S Corporation or the date Subchapter C assets are acquired by an S corporation in a carryover basis transaction. If an election is made under the Regulation, the Subchapter C corporation is not deemed to have sold its assets, there is no current recognition of gain, and there is no deemed liquidation. Upon the sale of a built-in gain asset during the recognition period, the RIC or REIT would pay a corporate level tax on the gain at the highest corporate rates.

Code Section 337(d) was enacted as part of the Tax Reform Act of 1986 (the "1986 Act") in connection with the repeal of the General Utilities Doctrine. That Section was amended by the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"). As amended, Section 337(d) directed the IRS to:

…prescribe such regulations as may be necessary or appropriate to carry out the [repeal of the General Utilities Doctrine] including —

(1) regulations to insure that such purposes should not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this sub-chapter) or through the use of a regulated investment company, real estate investment trust, or tax exempt entity…" (Emphasis added.)

Prior to amendment by the 1988 Act, Section 337(d) did not include the highlighted language regarding regulated investment companies and real estate investment trusts. Accordingly, the legislative history with respect to the 1986 Act makes no reference to avoidance of the General Utilities Doctrine by electing RIC or REIT status or the acquisition of Subchapter C assets by a RIC or REIT in a carryover basis transaction.

The General Explanation of the Tax Reform Act of 1986 prepared by the Joint Committee of Taxation (which was published on May 4, 1987) included the following explanation of Section 337(d):

The repeal of the General Utilities doctrine is designed to require the corporate level recognition of gain on a corporation’s sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context. Congress expected the Treasury Department to issue, or to amend, regulations to insure that the purpose of the new provisions (including new subchapter S built-in gains provisions) is not circumvented through the use of any other provision, including the consolidated return regulations or the tax-free reorganization provisions of the Code (part III of subchapter C) or through the use of other pass-through entities such as regulated investment companies (RICs) or real estate investment trusts (REITs). For example, this would include rules to require recognition of gain if appreciated property of a C corporation is transferred to a RIC or REIT in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation. (Emphasis added.)

As discussed below, we believe that there are serious flaws in the Regulations as drafted and suggest that the Regulations be withdrawn and re-issued after revision to address the issues discussed herein.

1. **Scope of the Regulations**

The grant of regulatory authority in Code Section 337(d) is limited to situations in which taxpayers avoid "corporate level tax on the built-in appreciation." Unfortunately, the Regulations extend well beyond the concern addressed by Congress. Regulation Section 1.337(d)-5T(a)(1)
provides that it applies to any transfer of assets of a Subchapter C corporation to a RIC or a REIT in a carryover basis transaction. Thus, the Regulations would apply to an incorporation under Section 351. However, in that instance, there has been no elimination of tax at the corporate level. The transferor corporation will recognize gain when it sells or distributes the stock of the RIC or REIT formed in the Section 351 transaction. Similarly, the Regulations would also cover the situation in which a Subchapter C corporation merges a subsidiary into a RIC or a REIT in exchange for stock. Such a transaction would be a tax free reorganization under Code Section 368 with the acquiring corporation taking the assets with a carryover basis. Nevertheless, since the parent of the target is itself a Subchapter C corporation, gain from the sale of the RIC or REIT stock would be subject to tax at the corporate level. If the Regulation applies, the transaction would be treated as a deemed sale of assets so that corporate level tax would be paid twice-- once on the deemed sale of the target’s assets and the second time when the Subchapter C parent sells the RIC or REIT shares. Clearly, such a result is beyond what was contemplated by Congress in enacting Section 337(d).

Moreover, the Regulations do not appear to address the situation of a Subchapter S corporation which was previously a C corporation. The S corporation could have built-in gain assets which were then transferred to the RIC or REIT. In such a transaction, the assets should continue to be subject to built-in gains tax for the remainder of the built-in gain period which began when the corporation elected S status or acquired the assets from a C corporation in a reorganization.

Recommendation

Paragraph (a)(1) of the Regulation should be revised to provide that the Regulation only applies to:

1. an election by a Subchapter C corporation to be taxed as a RIC or REIT, but only to the extent that the shares of such corporation are not owned, directly or indirectly, by Subchapter C corporations,
2. a tax-free reorganization by a Subchapter C corporation into a RIC or REIT, but only to the extent that the shares of the target corporation are not owned, directly or indirectly, by Subchapter C corporations,
3. an election by a Subchapter S corporation which has built-in-gain assets under §1374 to be taxed as a RIC or a REIT,
4. a tax-free reorganization of a Subchapter S corporation which has built-in-gain assets under Section 1374 into a RIC or a REIT.

2. Loss Disallowance Rule

Notice 88-19 and Regulation Section 1.337(d)-5T(a)(4) provide that a corporation which makes a RIC or a REIT election or transfers its assets to a RIC or REIT in a carryover basis transaction may not recognize any loss. The blanket loss disallowance rule is at odds with Section 1374 which expressly allows S Corporations to offset built-in gains and losses. The blanket rule is also inconsistent with the provisions of Section 336. A corporation which liquidates under that Section is allowed to recognize loss subject to certain specific limitations. The same result should occur in the context of a deemed liquidation under the Regulations. The current rule is a trap for the unwary. A well advised taxpayer would actually liquidate the C corporation and then contribute the assets to a REIT rather than engage in a transaction which results in a "deemed liquidation" without allowing the corporation to recognize its losses. Nothing in the legislature history suggests that Congress intended a worse result for a corporation making a RIC or REIT election than one making an S election.

Recommendation
Paragraph (a)(4) of the Regulations should be deleted to eliminate the loss disallowance rule.

3. Exception for Re-Election of RIC and REIT Status

Paragraph (a)(6) of the Regulations provides that the general gain recognition rule applies only to a limited extent with respect to a C corporation which is re-electing RIC status after satisfying the one year waiting period before making such re-election. A similar rule should apply to a C corporation which is re-electing REIT status. We do not believe Congress expressed any intent to treat RICs and REITs differently in connection with such a transaction.

Recommendation

Paragraph (a)(6) of the Regulations should be revised to provide an identical exception for a corporation which is re-electing REIT status.

4. Determination of Net Built-In Gain

The Regulations provide that net built-in gain is the excess of the aggregate gains (and including items of income) over aggregate losses. We do not believe the Regulations should specify which items of income are included in such calculation and whether items of deduction are included in the calculation of losses. The language in the Temporary Regulations differs from the definition provided in Code Section 1374(d) as well as Regulation Section 1.1374-3. To the extent that the rules applicable to RICs or REITs differ from those applicable to S corporations, the Regulations should specifically identify those differences. Nevertheless, we do not believe there are any situations where differing treatment can be justified. A Subchapter C corporation which makes an S election and one which makes a RIC or REIT election are not fundamentally different. In both cases Congress has seen fit to permit pass through treatment. Accordingly, if an asset would constitute a built-in gain or built-in loss asset under Section 1374 for an S corporation, it should also constitute such an asset under the Regulations for a RIC or REIT. Moreover, if an asset would not constitute a built-in gain asset or built-in loss asset under Section 1374, the same result should occur under the Regulations for a RIC or REIT.

Recommendation

Paragraph (a)(2) of the Regulations should be modified to provide that the definition of built-in-gain, built-in-loss, net built-in-gain and net built-in-loss are the same as those contained in §1374(d).

5. Character of Gain

The Regulations, incorporating language from Notice 88-19, provide that built-in gains are subject to rules similar to the rules relating to net income from foreclosure property of REITs. At the time the notice was issued, there was no difference in the rates applicable to capital gains and ordinary income. Moreover, the concept of income from foreclosure property does not exist in the provisions of Subchapter M governing RICs. Thus, the language in Notice 88-19 appeared to be included so as to insure that the recognition of built-in gains would not result in prohibited transaction for a REIT. It did not appear to be a vehicle for changing the character of gain. Nothing in the legislative history surrounding the 1986 Act or the 1988 Act indicated that Congress intended that recognized or built in gains (net of corporate level tax) would always be taxable as ordinary income. Under Section 1374 recognized built-in gains (net of corporate level tax) retain their character for purposes of the shareholder level tax.

Recommendation
Paragraph (b)(1) of the Regulations should be revised to state that any built-in gain which is recognized retains its character as ordinary income or capital gain both for the purposes of the corporate level built-in gain tax and for the pass through to the shareholders of the RIC or the REIT.

6. Use of Net Operating Loss Carryovers, Capital Loss Carryovers and Business Credit Carryovers

Code Section 1374(b) specifically provides that a corporation’s net operating loss and capital loss carryovers may be used against built-in gain recognized by the corporation following an S election. It also permits business credit carryovers to offset built-in gain tax.

Recommendation

A new Paragraph should be added to the Regulations to explicitly provide for similar carryover rules with respect to RICs and REITs which recognize built-in gain.

7. Clarification of the Effect of Deemed Liquidation

The Regulations need clarification regarding the deemed sale of assets by the C corporation as a result of the acquisition of the assets by the RIC or REIT. Paragraph (a)(3) of the Regulation States:

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

That language implies that shareholder level tax is imposed although neither Notice 88-19 nor the preamble to the Regulations make any mention of a shareholder level tax in this context. To the extent that the RIC or REIT acquires the assets in a tax-free reorganization, the shareholders of the target should not be subjected to a corporate level tax. Similarly, under the principles of Section 1374, the election of RIC or REIT status should not result in the current taxation of the shareholders. The imposition of an immediate shareholder level tax is inconsistent with the purposes of Section 337(d), which is to prevent the avoidance of the corporate level tax which would otherwise be payable. Nothing in the legislative history suggested that Congress intended to accelerate the shareholder level tax in any such transaction.

Recommendation

Paragraph (a)(3) of the Regulations should be modified to provide that in the case of a deemed liquidation under §337(d) the corporation is treated as if it sold all of its assets in a taxable transaction for their fair market values but that there is no shareholder level gain recognition as a result of such deemed liquidation.

8. Validity of Prior Elections

The Regulations state that a RIC or a REIT makes a Section 1374 election by attaching a statement, signed and in the form prescribed by the Regulations, to its federal income tax return for the first taxable year in which the assets of the C corporation became assets of the RIC or REIT. A special rule provides for cases where the first such taxable year ends after June 10, 1987 but before March 8, 2000. In that case, the election may be filed with the first federal
income tax return filed after March 8, 2000. We understand that this rule was a pro-taxpayer rule designed to allow taxpayers to make a Section 1374 election retroactively. It should not be interpreted as requiring a RIC or a REIT to re-file an election which was filed in a prior year even if such election did not literally comply with the requirements of the Temporary Regulations. Such a requirement could result in taxpayers attempting to whipsaw the Treasury by a RIC or a REIT intentionally failing to re-elect under the Temporary Regulations. In that case, the RIC or REIT could take the position that its prior treatment was erroneous and that it has a step up in basis in the assets. More importantly, the statue of limitations for the former C corporation’s final return may have expired.

**Recommendation**

Paragraph (c) of the Regulations should be revised to eliminate the requirement that corporations which have previously filed an election to be treated under rules similar to §1374 file a new election.

**9. Default Rule**

Notice 87-19 and the Regulations start from the premise that the election of RIC or REIT status or the acquisition of built-in gain assets in a carryover basis transaction by a RIC or a REIT should be a taxable transaction unless an election is made. That is exactly the opposite of the statutory scheme under Section 1374. A C corporation which makes an S election does not immediately recognize gain. Rather, corporate level tax is imposed only if and when net gain is recognized during the built-in gain recognition period. The default rule in this context should be the same. If there is an election, it should be one permitting the taxpayer to treat the transaction as a taxable sale of assets. Moreover, any such election should be required to be a joint election of the target and the acquiring RIC or REIT. Without the requirement of a joint election, the parties could take differing positions to the detriment of the Treasury.

**Recommendation**

Paragraph (a)(3) and (b)(1) of the Regulations should be modified to provide that §1374 type treatment will result in all cases unless both the RIC or REIT (as the case may be) and the Subchapter C or Subchapter S corporation (as the case may be) jointly elect to have the transaction treated as a taxable sale of assets.

**10. Built-In Gain Recognition Period**

As noted above, in the context of an election to become a RIC or a REIT, or a tax free reorganization of a Subchapter C corporation into a RIC or a REIT, the built-in gain recognition period should be a full ten years from the effective date of the election or the date or the reorganization. However, in the context of an election by a Subchapter S corporation to become a RIC or a REIT or a reorganization involving a Subchapter S corporation, the built-in gain recognition period should be reduced by that portion of the ten year period under Section 1374 which occurred prior to the RIC or REIT election or reorganization.

**Recommendation**

Paragraph (b)(2) of the Regulations should be modified to specifically provide that in the case of an election of RIC or REIT status by a Subchapter S corporation or a reorganization involving a Subchapter S corporation, the built-in-gain recognition period is reduced by the portion of the ten year built-in-gain recognition under §1374 which occurred prior to the RIC or REIT election or reorganization.
11. Clarification of Earnings and Profits Issues

The Regulations are silent on earnings and profits issues in connection with transactions governed by the Regulations. If the C Corporation recognizes gain on the deemed sale of assets and is deemed to liquidate, there should not be any earnings and profits for the RIC or REIT to inherit. Alternatively, if gain is deferred under rules similar to Section 1374, the recognition of built-in gain would generate Subchapter M earnings and profits.

Recommendation

A new paragraph should be added to the Regulations to expressly provide for such results so that the Regulations coordinate seamlessly with Code Sections 852(a) and 856(a) as well as Regulations Sections 1.852-12 and 1.856-11.

12. Determination of RIC Taxable Income and REIT Taxable Income

The Regulations are also silent as to the determination of RIC taxable income and REIT taxable income.

Recommendation

A new paragraph should be added to the Regulations to clarify that for the purposes of Sections 852 and 857, taxable income includes net recognized built-in gains less the corporate level tax on such built-in gains. Similar clarification is needed for the purposes of determining taxable income for the purposes of the excise taxes imposed under Sections 4981 and 4982.

Conclusion

For the reasons set forth above, we believe the Regulation is flawed and should be revised. Since the Regulation is already effective, we recommend the Regulation be withdrawn and modified as discussed herein. Alternatively, we recommend the Regulation, once revised, be made retroactively effective.