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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9770]

RIN 1545-BN39

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations effecting the repeal of the General Utilities doctrine by the Tax Reform Act of 1986 and preventing abuse of the Protecting Americans from Tax Hikes Act of 2015. The temporary regulations impose corporate level tax on certain transactions in which property of a C corporation becomes the property of a REIT. The temporary regulations affect RICs, REITs, C corporations the property of which becomes the property of a RIC or a REIT, and their shareholders. The text of these temporary regulations also serves as the text of part of the proposed regulations in the related notice of proposed rulemaking (REG-126452-15) set forth in the Proposed Rules section in this issue of the **Federal Register**.

DATES: These regulations are effective **June 7, 2016**.

FOR FURTHER INFORMATION CONTACT: Austin M. Diamond-Jones, (202) 317-5085 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

1. The General Utilities Doctrine, Its Repeal, and Section 337(d)

In general, gain on a sale of appreciated property by a C corporation is taxed to the corporation when the sale occurs and to the shareholders when the proceeds are distributed as dividends. Historically however, a corporation generally could distribute appreciated property to its shareholders without recognition of gain to the corporation under the so-called General Utilities doctrine arising from interpretations of General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). See H.R. Rep. No. 99-841, at 198 (1986) (Conf. Rep.); H.R. Rep. No. 99-426, at 274-75 (1985).

Beginning in 1969, a series of statutory limitations on the General Utilities doctrine were enacted into law. In the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248, 96 Stat. 324, current section 311(b) (originally designated as section 311(d)) was added to the Internal Revenue Code (Code) and required a corporation to recognize gain on appreciated property distributed to a shareholder in redemption of shares. Legislation enacted in 1984 required gain recognition for all non-liquidating distributions. Finally, what remained of the General Utilities doctrine was repealed (General Utilities repeal) by the enactment of subtitle D of title VI of the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085 (the Act), which amended sections 336 and 337 of the Code 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) was added to the Code by section 631(a) of the Act and subsequently amended by section 1006(e)(5)(A)(i) through (ii) of the Technical and Miscellaneous Revenue Act of 1988, Public Law 100-647, 102 Stat. 3342 (the Technical

Amendment). This document contains amendments to 26 CFR part 1 under section 337(d).

Section 337(d) directs the Secretary of the Treasury to prescribe regulations that are necessary or appropriate to carry out the purposes of General Utilities repeal, including “regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including ... part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax exempt entity....” The legislative histories of the Act and the Technical Amendment underscore the broad grant of regulatory authority and Congress’ expectation that the Treasury Department and the IRS would issue or amend regulations as necessary to further the purposes of General Utilities repeal, “includ[ing] rules to require the recognition of gain if appreciated property of a C corporation is transferred to a RIC or a REIT in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation.” H.R. Rep. No. 100-391, at 1199 (1987); see also H.R. Rep. No. 99-841, at 204 (1986) (Conf. Rep.). Section 337(d)(1) specifically refers to ensuring that the purposes of General Utilities repeal are not circumvented through the use of the corporate organization and reorganization provisions of part III, subchapter C, chapter 1 of the Code, which include section 355.

2. Section 355 and the PATH Act

Section 355 generally provides that, if certain requirements are satisfied, a corporation may distribute stock (or stock and securities) of one or more controlled corporations to its shareholders and security holders without the distributing corporation, its shareholders, or its security holders recognizing income, gain, or loss on the

distribution (a section 355 distribution). In the course of enacting certain amendments to section 355 as part of the Omnibus Budget Reconciliation Act of 1990, Public Law 101-508, 104 Stat. 1388, Congress described section 355 as a “limited exception to the repeal of the General Utilities doctrine intended to permit historic shareholders to continue to carry on their historic corporate businesses in separate corporations” and stated that “[t]he present-law provisions granting tax-free treatment at the corporate level are particularly troublesome because they may offer taxpayers an opportunity to avoid the general rule that corporate-level tax is recognized when an asset (including stock of a subsidiary) is disposed of.” 136 Cong. Rec. S15704 (daily ed. Oct 18, 1990).¹ Further, Congress noted that “[t]he bill is not intended to limit in any way the continuing Treasury Department authority to issue regulations to prevent the avoidance of the repeal of the General Utilities doctrine through any provision of law or regulations, including section 355.” Id. at S15705.

On December 18, 2015, the President signed into law the Protecting Americans Against Tax Hikes Act of 2015 (PATH Act), enacted as Division Q of the Consolidated Appropriations Act, 2016, Public Law 114-113, 129 Stat. 2422. Section 311(a) and (b) of the PATH Act added to the Code sections 355(h) and 856(c)(8), respectively. Section 355(h)(1) of the Code provides that section 355 shall not apply to a distribution if either the distributing corporation or the controlled corporation is a REIT. Section 355(h)(2) provides exceptions permitting a REIT to distribute the stock of another REIT or of a taxable REIT subsidiary under certain conditions. Section 856(c)(8) provides

¹ The bill that resulted in Public Law 101-508, S.3209, was brought to the floor without printing a formal report, and language from the various committees to consider the bill was printed in the Congressional Record at the request of Senator Sasser to complete the legislative record.

that a corporation may not elect REIT status during the ten-year period following a section 355 distribution if such corporation was the distributing corporation or the controlled corporation in that distribution. Section 311(c) of the PATH Act provides that sections 355(h) and 856(c)(8) apply to distributions on or after December 7, 2015, but do not apply to any distribution pursuant to a transaction described in a ruling request initially submitted to the IRS on or before such date, which request has not been withdrawn and with respect to which a ruling has not been issued or denied in its entirety as of such date.

3. Prior Regulations

In certain cases, General Utilities repeal could be circumvented if property of a C corporation becomes the property of a RIC or a REIT (converted property) by a transfer of the converted property from a C corporation to a RIC or a REIT or by the qualification of the C corporation as a RIC or a REIT (either, a conversion transaction). A conversion transaction could result in elimination of the corporate level of gain in the converted property, including gain from the sale of the property, because RICs and REITs generally are not subject to tax on income that is distributed to their shareholders.

The Treasury Department and the IRS issued Notice 88-19 (1988-1 C.B. 486) on February 4, 1988. Notice 88-19 announced the IRS's intention to promulgate regulations providing that a C corporation engaging in a conversion transaction would be treated, for all federal income tax purposes, as if it had sold all of its assets at their respective fair market values (deemed sale treatment) and immediately liquidated, unless the C corporation elected to be subject to tax under section 1374 with respect to

the C corporation property (section 1374 treatment). If elected, section 1374 treatment would subject the RIC or REIT to corporate-level taxation on the built-in gain recognized during the ten-year period following the conversion transaction on the converted property. Temporary regulations under §1.337(d)-5T (TD 8872) and a notice of proposed rulemaking cross-referencing the temporary regulations (REG-209135-88) were published in the **Federal Register** (65 FR 5775, 65 FR 5805) on February 7, 2000, and reflected the principles set forth in Notice 88-19.

Additional temporary regulations under §§1.337(d)-6T and 1.337(d)-7T (TD 8975) and a notice of proposed rulemaking cross-referencing the temporary regulations (REG-142299-01 and REG-209135-88) were published in the **Federal Register** (67 FR 8, 67 FR 28) on January 2, 2002. The proposed regulations cross-referencing §§1.337(d)-5T through -7T, with modifications, were adopted on March 18, 2003 (TD 9047), and published as final regulations in the **Federal Register** (68 FR 12817).

4. Current Regulations

The final regulations in §1.337(d)-6 apply to conversion transactions occurring on or after June 10, 1987, and before January 2, 2002, and provide that a C corporation engaging in such a conversion transaction is subject to deemed sale treatment unless the C corporation elects section 1374 treatment with respect to the converted property. The final regulations in §1.337(d)-7 apply to conversion transactions occurring on or after January 2, 2002, and provide that the RIC or the REIT owning the property after the conversion transaction is subject to section 1374 treatment unless the C corporation engaging in a conversion transaction elects deemed sale treatment with respect to the converted property.

In response to concerns expressed by commentators (described subsequently), the Treasury Department and the IRS published in the **Federal Register** (77 FR 22516) on April 16, 2012, a notice of proposed rulemaking (REG-139991-08) proposing amendments to §1.337(d)-7. These amendments (the 2013 amendments) were adopted as final regulations (TD 9626) and were published in the **Federal Register** (78 FR 46805) on August 2, 2013.

The 2013 amendments address two principal areas of concern. First, the 2013 amendments provide an exception from the general rule subjecting the RIC or the REIT to section 1374 treatment in the case of a transfer of property by a C corporation to a RIC or a REIT to the extent the transfer qualifies for nonrecognition treatment under section 1031 (relating to like-kind exchanges) or section 1033 (relating to involuntary conversions). The Treasury Department and the IRS did not extend this treatment to all exchanged basis transactions, such as exchanges that would otherwise qualify for nonrecognition treatment under section 351 of the Code, out of concern that such an exception could create opportunities to avoid corporate-level tax on built-in gains. Second, the 2013 amendments provide an exception for conversion transactions in which the C corporation that owned the converted property is a tax-exempt entity to the extent that gain would not be subject to tax if a deemed sale election were made. In such circumstances, the C corporation is not required to make a deemed sale election, and the RIC or the REIT is not subject to section 1374 treatment.

5. Notice 2015-59 and Revenue Procedure 2015-43

Congress, the Treasury Department, and the IRS are aware of transactions in which a C corporation that does not qualify as a REIT distributes the stock of a

controlled corporation in a transaction intended to qualify under section 355 so that either the distributing corporation or the controlled corporation can qualify as a REIT. In many cases, a C corporation that owns both assets qualifying as real estate assets for purposes of part II, subchapter M, chapter 1 of the Code (REIT-qualifying assets) and assets that do not so qualify (non-qualifying assets) transfers either the REIT-qualifying assets or the non-qualifying assets to a controlled corporation in exchange for its stock and then distributes the controlled corporation stock to its shareholders. Before or after the distribution, the corporation holding the REIT-qualifying assets elects REIT status. If the transaction satisfies the requirements of sections 368(a)(1)(D), 355, and 361, no gain is recognized on either the transfer of assets by the distributing corporation to the controlled corporation or the distribution of the controlled corporation stock to the shareholders of the distributing corporation.

Prior to the enactment of the PATH Act, the IRS issued Notice 2015-59 (2015-40 I.R.B. 467) and Revenue Procedure 2015-43 (2015-40 I.R.B. 495) on September 14, 2015, in part to respond to the transactions described in the preceding paragraph. Revenue Procedure 2015-43 provides that the IRS will not ordinarily issue a ruling relating to the qualification under section 355 and related provisions of a distribution in certain circumstances in which property owned by the distributing corporation or the controlled corporation becomes the property of a RIC or a REIT. Notice 2015-59 states that such transactions “may circumvent the purposes of Code provisions intended to repeal the Supreme Court's decision” in General Utilities, such as section 337(d). The Notice also requested comments with respect to the facts and circumstances relevant to whether such transactions circumvent the purposes of General Utilities repeal. The

Treasury Department and the IRS are aware of informal commentary, but no formal comments have been received.

Explanation of Provisions

The Treasury Department and the IRS believe that section 1374 treatment imposes an appropriate regime for recognizing built-in gain for many conversion transactions. The Treasury Department and the IRS are concerned, however, that section 1374 treatment may not adequately implement the purposes of General Utilities repeal if a taxpayer effects a tax-free separation of REIT-qualifying assets from non-qualifying assets in a section 355 distribution (the related section 355 distribution) and the REIT-qualifying assets become the assets of a REIT. After such transactions, gain on the assets held by the REIT may not be taxed at the corporate level because such gain is unlikely to be recognized within the recognition period during which the REIT is subject to section 1374 treatment under the final regulations in §1.337(d)-7. In contrast, without a section 355 distribution, a taxpayer generally could not separate REIT-qualifying assets from non-qualifying assets and cause one corporation to hold the REIT-qualifying assets and another corporation to hold the non-qualifying assets except by means of a sale or exchange to which section 1001 applies or a distribution to which section 311(b) applies.

Moreover, the REIT and its shareholders may realize the benefit of appreciation on converted property without a transaction subject to section 1374 treatment or otherwise taxable at the corporate level. For example, a REIT that distributes rental income on appreciated converted property to its shareholders may be entitled to a dividends paid deduction under section 562 and, therefore, effectively does not pay

income tax at the REIT level on that income, which in many cases will reflect the appreciation in the value of the property. Additionally, if the lessee is a C corporation (such as the other party to the section 355 distribution), the rental deductions reduce the C corporation's taxable income. In such circumstances, the Treasury Department and the IRS have determined that section 355 does not serve as a "limited exception to General Utilities repeal intended to enable historic shareholders to carry on their historic businesses in separate corporations" but rather creates an "opportunity to avoid the general rule that corporate-level tax is recognized when an asset . . . is disposed of." 136 Cong. Rec. S15704.

Section 311 of the PATH Act addresses some of the concerns just described. However, the Treasury Department and the IRS are concerned that some variations of the transactions previously described may continue to be used to circumvent the purposes of section 311 of the PATH Act. In particular, there is concern that corporations affiliated with the distributing corporation or the controlled corporation could be used to circumvent the Congressional policy implemented through section 311 of the PATH Act. The Treasury Department and the IRS thus have determined that temporary regulations are necessary to prevent abuses of sections 355(h) and 856(c)(8) and to further the purposes of General Utilities repeal.

Therefore, the Treasury Department and the IRS are issuing these temporary regulations providing that a C corporation engaging in a conversion transaction involving a REIT within the ten-year period following a related section 355 distribution is treated as making an election to recognize gain and loss as if it had sold all of the converted property to an unrelated party at fair market value on the deemed sale date

(as defined in §1.337(d)-7(c)(3)). Section 1374 treatment is accordingly not available in these cases as an alternative to recognizing any gain with respect to the converted property on the deemed sale date.

The temporary regulations also provide that a REIT that is a party to a section 355 distribution occurring within the ten-year period following a conversion transaction for which a deemed sale election has not been made recognizes any remaining unrecognized built-in gains and losses resulting from the conversion transaction (after taking into account the impact of section 1374 in the interim period, as described subsequently).

For the taxable year in which the related section 355 distribution occurs, the REIT's net recognized built-in gain is the amount of its net unrealized built-in gain limitation (as defined in §1.1374-2(a)(3)) for such taxable year. For this purpose, the limitations in §1.1374-2(a)(1) and (2) do not apply because the net unrealized built-in gain limitation generally achieves the effect of a deemed sale election, adjusted for prior recognized built-in gains and recognized built-in losses. As a result, the temporary regulations cause the REIT to recognize any built-in gains or losses attributable to time periods in which the REIT was a C corporation while ensuring that gains and losses recognized in previous taxable years during the recognition period on which taxes have been paid are accounted for appropriately. The temporary regulations provide an appropriate increase to the basis of the converted property held by the REIT.

Consistent with section 311 of the PATH Act, the temporary regulations contain two exceptions. First, the temporary regulations do not apply if both the distributing corporation and the controlled corporation are REITs immediately after the date of the

section 355 distribution and at all times during the two years thereafter. Second, the temporary regulations also do not apply to certain section 355 distributions in which the distributing corporation is a REIT and the controlled corporation is a taxable REIT subsidiary. In addition, and consistent with the effective date in section 311(c) of the PATH Act, the temporary regulations under §1.337(d)-7T(f) do not apply to distributions pursuant to a transaction described in a ruling request initially submitted to the IRS on or before December 7, 2015, which request has not been withdrawn and with respect to which a ruling has not been issued or denied in its entirety as of December 7, 2015.

To prevent avoidance, these temporary regulations apply to predecessors and successors of the distributing corporation or the controlled corporation and to all members of the separate affiliated group, within the meaning of section 355(b)(3)(B), of which the distributing corporation or the controlled corporation are members.

Predecessors and successors include corporations that succeed to and take into account items described in section 381(c) of the distributing corporation or the controlled corporation, and corporations having such items to which the distributing corporation or the controlled corporation succeed and take into account.

The temporary regulations also make a clarifying amendment to the generally applicable rules of §1.337(d)-7 in response to section 127 of the PATH Act, which amended Code section 1374(d)(7) to provide that the term “recognition period” means the 5-year period beginning with the first day of the first taxable year for which a corporation was an S corporation. The temporary regulations replace the term “10-year recognition period” with the new defined term “recognition period” and clarify that the recognition period is no longer determined by reference to section 1374(d)(7), but is the

ten-year period beginning on the first day of the RIC or the REIT's first taxable year (in the case of a conversion transaction that is a qualification of a C corporation as a RIC or a REIT) or on the date the property is acquired by the RIC or the REIT. As a result, after **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, §1.337(d)-7 will no longer be affected by section 127 of the PATH Act, which amended section 1374(d)(7) of the Code to shorten the length of the recognition period from 10 years to 5 years with respect to C corporations that elect to be, or transfer property to, S corporations.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13653. Therefore, a regulatory impact assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (APA) (5 U.S.C. chapter 5) does not apply to these regulations because good cause exists under section 553(b)(3)(B) of the APA to dispense with notice and public comment because doing so would be contrary to the public interest. These temporary regulations are necessary to prevent abuse of section 311 of the PATH Act through certain section 355 distributions that would contradict the intent of Congress. These temporary regulations are also

necessary to update existing regulations under §1.337(d)-7 to delink the determination of the recognition period from the rules of section 1374(d)(7) modified by the enactment of section 127 of the PATH Act. Accordingly, good cause exists for dispensing with notice and public comment pursuant to section 553(b) of the APA. In addition, pursuant to 26 U.S.C. 7805(b)(3) and section 553(d)(3) of the APA, the requirements in section 553(d) of the APA for a delayed effective date are inapplicable to the temporary regulations necessary to prevent abuse of section 311 of the PATH Act. 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 the Proposed Rules section in this issue of the **Federal Register**.

Pursuant to section 7805(f) of the Internal Revenue 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 Austin M. Diamond-Jones, Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements

Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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)-7T also issued under 26 U.S.C. 337(d) and 355(h).

* * * * *

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

1. Revising paragraph (a)(1) and adding paragraphs (a)(2)(vi) and (vii).
2. In paragraph (b)(1)(ii), removing the language “10-year recognition period” and adding “recognition period” in its place wherever it appears.
3. Revising paragraph (b)(2)(iii).
4. Redesignating paragraph (b)(4) as paragraph (b)(5) and adding a new paragraph (b)(4).
5. Revising paragraph (c)(1).
6. Redesignating paragraph (c)(6) as paragraph (c)(7) and adding a new paragraph (c)(6).
7. In paragraph (d)(2)(iii), removing the language “10-year recognition period” and adding “recognition period” in its place wherever it appears.
8. Redesignating paragraph (f) as paragraph (g) and adding a new paragraph (f).
9. In newly redesignated paragraph (g)(1), removing the language “(f)(2)” and adding “(g)(2)” in its place.
10. Revising newly redesignated paragraph (g)(2).

The additions and revisions read as follows:

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

(a) General rule. (1) [Reserved]. For further guidance, see §1.337(d)-7T(a)(1).

(2) * * *

(vi) through (vii) [Reserved]. For further guidance, see §1.337(d)-7T(a)(2)(vi)

through (vii).

(b) * * *

(2) * * *

(iii) [Reserved]. For further guidance, see §1.337(d)-7T(b)(2)(iii).

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(4) [Reserved]. For further guidance, see §1.337(d)-7T(b)(4).

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(c) Election of deemed sale treatment. (1) [Reserved]. For further guidance, see §1.337(d)-7T(c)(1).

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(6) [Reserved]. For further guidance, see §1.337(d)-7T(c)(6).

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(f) [Reserved]. For further guidance, see §1.337(d)-7T(f).

(g) * * *

(2) Special rules--(i) Conversion transactions occurring on or after August 2, 2013 and certain prior conversion transactions. Paragraphs (a)(2)(i) through (v), (d)(1), (d)(3), (d)(4), and (e) of this section apply to conversion transactions that occur on or after August 2, 2013. However, taxpayers may apply paragraphs (a)(2)(i) through (v), (d)(1), (d)(3), (d)(4), and (e) of this section to conversion transactions that occurred

before August 2, 2013. For conversion transactions that occurred on or after January 2, 2002 and before August 2, 2013, see §1.337(d)-7 as contained in 26 CFR part 1 in effect on April 1, 2013.

(ii) through (iii) [Reserved]. For further guidance, see §1.337(d)-7T(g)(2)(ii) through (iii).

Par. 3. Section 1.337(d)-7T is added to read as follows:

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

(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 §1.337(d)-7(a)(2)(i)) becomes the property of a RIC or a REIT in a conversion transaction (as defined in §1.337(d)-7(a)(2)(ii)), then section 1374 treatment will apply as described in §1.337(d)-7(b) and paragraph (b) of this section, unless the C corporation elects, or is treated as electing, deemed sale treatment with respect to the conversion transaction as provided in §1.337(d)-7(c) and paragraph (c) of this section. See §1.337(d)-7(d) for exceptions to this paragraph (a).

(2)(i) through (v) [Reserved]. For further guidance, see §1.337(d)-7(a)(2)(i) through (v).

(vi) Section 355 distribution. The term section 355 distribution means any distribution to which section 355 (or so much of section 356 as relates to section 355) applies, including a distribution on which the distributing corporation recognizes gain pursuant to sections 355(d) or 355(e).

(vii) Converted property. The term converted property means property owned by a C corporation that becomes the property of a RIC or a REIT.

(b)(1) through (2)(ii) [Reserved]. For further guidance, see §1.337(d)-7(b)(1) through (2)(ii).

(iii) Recognition period. For purposes of applying the rules of section 1374 and the regulations thereunder, as modified by §1.337(d)-7(b) and paragraph (b) of this section, the term recognition period means the 10-year period beginning--

(A) In the case of a conversion transaction that is a qualification of a C corporation as a RIC or a REIT, on the first day of the RIC's or the REIT's first taxable year; and

(B) In the case of other conversion transactions, on the day the property is acquired by the RIC or the REIT.

(3) [Reserved]. For further guidance, see §1.337(d)-7(b)(3).

(4) Section 355 distribution following a conversion transaction--(i) In general. If a REIT is described in paragraph (f)(1) of this section and the related section 355 distribution (as defined in paragraph (f)(1)(i) of this section) follows a conversion transaction, then for the taxable year in which the related section 355 distribution occurs, §1.1374-2(a)(1) and (2) (as modified by §1.337(d)-7(b)(2)(i)) do not apply, and the REIT's net recognized built-in gain for such taxable year is the amount of its net unrealized built-in gain limitation (as defined in §1.1374-2(a)(3)) for such taxable year.

(ii) Basis adjustment--(A) In general. If a REIT recognizes gain under paragraph (b)(4)(i) of this section, the aggregate basis of the converted property held by the REIT at the end of the taxable year in which the related section 355 distribution occurs shall be increased by an amount equal to the amount of gain so recognized, increased by the amount of the REIT's recognized built-in loss for such taxable year, and reduced by the

amount of the REIT's recognized built-in gain and recognized built-in gain carryover for such taxable year.

(B) Allocation of basis increase. The aggregate increase in basis by reason of paragraph (b)(4)(ii)(A) of this section shall be allocated among the converted property in proportion to their respective built-in gains on the date of the conversion transaction.

(5) [Reserved]. For further guidance, see §1.337(d)-7(b)(5).

(c) Election of deemed sale treatment--(1) In general. Section 1.337(d)-7(b) and paragraph (b) of this section do not apply if the C corporation that qualifies as a RIC or a REIT or transfers property to a RIC or a REIT makes the election described in §1.337(d)-7(c)(5) or is treated as making such election under paragraph (c)(6) of this section. A C corporation that makes, or is treated as making, 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 §1.337(d)-7(c)(3)). See §1.337(d)-7(c)(4) concerning limitations on the use of loss in computing gain. Section 1.337(d)-7(c) and this paragraph (c) do not apply if their 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) through (5) [Reserved]. For further guidance, see §1.337(d)-7(c)(2) through (5).

(6) Conversion transaction following a section 355 distribution. A C corporation described in paragraph (f)(1) of this section is treated as having made the election under §1.337(d)-7(c)(5) with respect to a conversion transaction if the conversion

transaction occurs following the related section 355 distribution (as defined in paragraph (f)(1)(i) of this section) and the C corporation has not made such election.

(7) through (e) [Reserved]. For further guidance, see §1.337(d)-7(c)(7) through (e).

(f) Conversion transaction preceding or following a section 355 distribution--(1) In general. A C corporation or a REIT is described in this paragraph (f)(1) if--

(i) The C corporation or the REIT engages in a conversion transaction involving a REIT during the twenty-year period beginning on the date that is ten years before the date of a section 355 distribution (the related section 355 distribution); and

(ii) The C corporation or the REIT engaging in the related section 355 distribution is either--

(A) The distributing corporation or the controlled corporation, as those terms are defined in section 355(a)(1); or

(B) A member of the separate affiliated group (as defined in section 355(b)(3)(B)) of the distributing corporation or the controlled corporation.

(2) Predecessors and successors. For purposes of this paragraph (f), any reference to a controlled corporation or a distributing corporation includes a reference to any predecessor or successor of such corporation. Predecessors and successors include corporations which succeed to and take into account items described in section 381(c) of the distributing corporation or the controlled corporation, and corporations having such items to which the distributing corporation or the controlled corporation succeeded and took into account.

(3) Exclusion of certain conversion transactions. A C corporation or a REIT is not described in paragraph (f)(1) of this section if--

(i) The distributing corporation and the controlled corporation are both REITs immediately after the related section 355 distribution (including by reason of elections under section 856(c)(1) made after the related section 355 distribution that are effective before the related section 355 distribution) and at all times during the two years thereafter;

(ii) Section 355(h)(1) does not apply to the related section 355 distribution by reason of section 355(h)(2)(B); or

(iii) The related section 355 distribution is described in a ruling request referred to in section 311(c) of Division Q of the Consolidated Appropriations Act, 2016, Public Law 114-113, 129 Stat. 2422.

(g) Effective/Applicability date. (1) [Reserved]. For further guidance, see §1.337(d)-7(g)(1).

(2) Special rules. (i) [Reserved]. For further guidance, see §1.337(d)-7(g)(2)(i).

(ii) Conversion transactions occurring on or after **June 7, 2016**. Paragraphs (a)(1), (a)(2)(vi) and (vii), (b)(4), (c)(1), (c)(6), and (f) of this section apply to conversion transactions occurring on or after **June 7, 2016** and to conversion transactions and related section 355 distributions for which the conversion transaction occurs before, and the related section 355 distribution occurs on or after, **June 7, 2016**. For conversion transactions that occurred on or after January 2, 2002 and before **June 7, 2016**, see §1.337(d)-7 as contained in 26 CFR part 1 in effect on April 1, 2016.

(iii) Recognition period. Paragraphs (b)(1)(ii), (b)(2)(iii), and (d)(2)(iii) of this section applies to conversion transactions that occur on or after **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. For conversion transactions that occurred on or after January 2, 2002 and before **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, see §1.337(d)-7 as contained in 26 CFR part 1 in effect on April 1, 2016.

(h) Expiration date. The applicability of this section expires on **June 7, 2019**.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: May 11, 2016.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

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