



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-113943-17]

RIN 1545-BO01

Certain Transfers of Property to Real Estate Investment Trusts [REITs]

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking and notice of proposed rulemaking.

SUMMARY: This document withdraws a portion of a notice of proposed rulemaking published in the Proposed Rules section of the **Federal Register** on June 8, 2016. If adopted, the proposed rules would have provided guidance for transactions in which property of a C corporation becomes the property of a REIT following certain corporate distributions of controlled corporation stock. This document also contains a notice of proposed rulemaking that provides revised guidance on the same subject. These proposed regulations would affect REITs, C corporations the property of which becomes property of a REIT, and their respective shareholders.

DATES: Comments and requests for a public hearing must be received by **[INSERT DATE 45 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-113943-17), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8

a.m. and 4 p.m. to CC:PA:LPD:PR (REG-113943-17), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224 or sent electronically via the Federal eRulemaking Portal at <http://www.regulations.gov/> (IRS REG-113943-17).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Austin Diamond-Jones, (202) 317-5363; concerning the submission of comments or to request a public hearing, Regina Johnson, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION

Background

This document contains proposed amendments to 26 CFR part 1 under section 337(d) of the Internal Revenue Code (Code).

On June 8, 2016, the Department of the Treasury (Treasury Department) and the IRS published temporary regulations (TD 9770) under section 337(d) (Temporary Regulations) in the **Federal Register** (81 FR 36793) concerning certain transfers of property to regulated investment companies (RICs) and real estate investment trusts (REITs). A notice of proposed rulemaking (REG-126452-15) was published in the **Federal Register** (81 FR 36816) on the same day (2016 Proposed Regulations). The text of the Temporary Regulations served as the text for part of the 2016 Proposed Regulations, which also included an amendment not addressed in the Temporary Regulations. A correction to the Temporary Regulations was published in the **Federal Register** (81 FR 41800) on June 28, 2016.

The Treasury Department and the IRS received one written comment and a letter addressed to the Secretary of the Treasury (Secretary) by the Chairmen and Ranking

Members of the Ways and Means Committee of the U.S. House of Representatives and the Finance Committee of the U.S. Senate in response to the 2016 Proposed Regulations. The comment requested a public hearing, and a hearing was held on November 9, 2016.

After consideration of the letter, the written comment, and the comments made at the public hearing, the Treasury Department and the IRS adopted the 2016 Proposed Regulations, in part, in final regulations (TD 9810) published in the **Federal Register** (82 FR 5387) on January 18, 2017 (Final Regulations). The Final Regulations adopted a definition of the term “recognition period” that is consistent with that used in section 1374(d) relating to S corporations. The Final Regulations amended and removed the corresponding provisions in the Temporary Regulations and indicated that the Treasury Department and the IRS would continue to study other issues addressed in the Temporary Regulations and the 2016 Proposed Regulations.

Executive Order 13789 (E.O. 13789), issued on April 21, 2017, instructed the Secretary to review all significant tax regulations issued on or after January 1, 2016, and to take concrete action to alleviate the burdens of regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the federal tax laws; or (iii) exceed the statutory authority of the IRS. E.O. 13789 further instructed the Secretary to submit to the President within 60 days an interim report identifying regulations that meet these criteria.

Notice 2017-38 (2017-30 I.R.B. 147 (July 24, 2017)) included the Temporary Regulations in a list of eight regulations identified by the Secretary in the interim report as meeting at least one of the first two criteria specified in E.O. 13789. In particular,

Notice 2017-38 mentioned a concern raised by commenters that the Temporary Regulations “could result in over-inclusion of gain in some cases, particularly where a large corporation acquires a small corporation that engaged in a Section 355 spinoff and the large corporation subsequently makes a REIT election.” See *also* Executive Order 13789--Second Report to the President on Identifying and Reducing Tax Regulatory Burdens (Second Report), 82 FR 48013 (October 16, 2017) (stating that the Treasury Department and the IRS “agree that the temporary regulations may produce inappropriate results in some cases”). The Treasury Department and the IRS received three written comments in response to Notice 2017-38 and the Second Report that addressed the Temporary Regulations and the 2016 Proposed Regulations.

Explanation of Provisions

I. Gain Recognized by Successor Corporations

Pursuant to §1.337(d)-7(c)(6) of the 2016 Proposed Regulations, if a C corporation is the distributing corporation or the controlled corporation in a “related section 355 distribution” (within the meaning of proposed §1.337(d)-7(f)(1)(i)), and the C corporation or its successor (within the meaning of proposed §1.337(d)-7(f)(2)) engages in a conversion transaction (as defined in §1.337(d)-7(a)(2)(ii)) involving a REIT, the C corporation or its successor will be treated as making a deemed sale election (within the meaning of proposed §1.337(d)-7(c)). Commenters suggested that application of proposed §1.337(d)-7(c)(6) to successors (within the meaning of proposed §1.337(d)-7(f)(2)) could result in recognition of gain greatly in excess of the amount that would have been recognized if the distributing corporation or the controlled corporation had directly engaged in a conversion transaction.

To illustrate the issue, consider the following example (Example One): Each of Distributing and Acquiring is a C corporation, and each holds real estate assets with \$1 billion fair market value and \$0 adjusted basis. Distributing and Acquiring are unrelated. Distributing owns 100 percent of the stock of Controlled, which holds assets with \$20 million fair market value and \$0 adjusted basis. In Year 1, Distributing distributes the stock of Controlled in a section 355 distribution (as defined in proposed §1.337(d)-7(a)(2)(vi)). In Year 3, Acquiring acquires Controlled in a transaction in which Acquiring becomes a successor of Controlled (within the meaning of proposed §1.337(d)-7(f)(2)). At that time, Acquiring has no plan to convert to a REIT. No asset held by Distributing, Controlled, or Acquiring appreciates or depreciates in value between Year 1 and Year 9. In Year 9, Acquiring merges into a REIT and does not make a deemed sale election under §1.337(d)-7(c)(5).

As a successor to Controlled, Acquiring itself was ineligible to make a REIT election until Year 11. Section 856(c)(8). However, the merger of Acquiring into a REIT is not addressed by section 856(c)(8). On the other hand, if Acquiring were not a successor to a distributing corporation or a controlled corporation, its assets would be subject to section 1374 treatment upon the merger (unless Acquiring actually made a deemed sale election).

Because Acquiring is a successor to a controlled corporation and engages in a conversion transaction within ten years of a related section 355 distribution, the 2016 Proposed Regulations would treat Acquiring as making a deemed sale election and require Acquiring to recognize \$1.02 billion gain (\$1.02 billion fair market value less \$0 adjusted bases of all its property at the time of the merger). This gain would greatly

exceed the \$20 million gain (\$20 million fair market value less \$0 adjusted basis) Controlled would have recognized if Acquiring had been a REIT when it acquired Controlled's converted property. The Treasury Department and the IRS agree with the commenters that this result is inappropriate.

To address the concern described in the previous paragraph, the Treasury Department and the IRS propose adopting a new limitation to the general rule in newly proposed §1.337(d)-7(c)(6)(i) (the general rule) (which is the same as the general rule in the 2016 Proposed Regulations). As a result of the limitation, gain immediately recognized by a C corporation engaging in a section 355 distribution and a later conversion transaction will be limited to gain on property traceable to the section 355 distribution.

The limitation is based on a comment received and would be available to a distributing corporation or a controlled corporation (and a successor) that engages in a conversion transaction within the ten-year period following a related section 355 distribution. The limitation would provide that, if a C corporation is treated as making a deemed sale election but has not actually made such an election, the C corporation would be treated as making the election only with respect to its distribution property. "Distribution property" would be defined as property owned by a distributing corporation or a controlled corporation or a member of the separate affiliated group of the distributing corporation or the controlled corporation (SAG member) immediately after a section 355 distribution, and other property the basis of which is determined, directly or indirectly, in whole or in part, by reference to that property. However, no formulation of the step transaction doctrine will be used to determine whether property acquired after

the distribution is distribution property. The C corporation's property that is not distribution property would be subject to section 1374 treatment under §1.337(d)-7(b) instead of deemed sale treatment under §1.337(d)-7(c)(6). In general, the C corporation must establish that any particular property is not distribution property. However, property with built-in loss as of the date of the conversion transaction will be presumed to not be distribution property unless the C corporation establishes that it owned such property immediately after the related section 355 distribution.

To illustrate the limitation, consider the following example (Example Two): Distributing is a C corporation that owns 100 percent of the stock of Controlled. In Year 1, Distributing distributes the stock of Controlled in a section 355 distribution. At the time of the section 355 distribution, Controlled has one asset (Asset 1) with \$5 million fair market value and \$0 adjusted basis. In Year 2, Controlled purchases a second asset (Asset 2), which has \$1 million fair market value and \$1 million adjusted basis. In Year 5, Controlled engages in a conversion transaction when it merges into a REIT in a transaction described in section 368(a)(1). At the time of the merger, Asset 1 has \$5.5 million fair market value, and Asset 2 has \$1.1 million fair market value. The adjusted bases of Asset 1 and Asset 2 are both unchanged.

If the limitation is available and Controlled does not make a deemed sale election, Controlled would be treated as making a deemed sale election only with respect to Asset 1 (and not Asset 2) because Asset 1 was held by Controlled immediately after the related section 355 distribution and is therefore distribution property. Because Controlled can establish that it did not own Asset 2 immediately after the related section 355 distribution (and the basis of Asset 2 was not determined,

directly or indirectly, in whole or in part, by reference to the basis of an asset held by Controlled immediately after the related section 355 distribution in Year 1), Asset 2 is not distribution property, and Controlled will not be treated as electing deemed sale treatment with respect to Asset 2. Accordingly, Controlled would recognize \$5.5 million gain on Asset 1 (\$5.5 million fair market value less \$0 adjusted basis), and the REIT would be subject to section 1374 treatment with respect to Asset 2 and its \$0.1 million built-in gain.

However, if Controlled had elected deemed sale treatment or was unable to establish that Asset 2 was not distribution property, then all of its assets that became converted property, rather than only the distribution property, would be treated as sold upon Controlled's merger into a REIT in Year 5. Controlled would recognize \$5.6 million gain (\$5.5 million gain on Asset 1 (\$5.5 million fair market value less \$0 adjusted basis at the time of the merger) and \$0.1 million gain on Asset 2 (\$1.1 million fair market value less \$1 million adjusted basis at the time of the merger)). Neither Asset 1 nor Asset 2 would be subject to section 1374 treatment.

As a result of the combination of the general rule and the limitation, a C corporation that engages in a section 355 distribution and a later conversion transaction recognizes immediate gain only on property that is traceable to the section 355 distribution. Application of the limitation could cause a single conversion transaction to result in some property being subject to deemed sale treatment and other property being subject to section 1374 treatment. However, the Treasury Department and the IRS have determined that this approach is administrable by both taxpayers and the IRS and that it satisfies the concerns expressed by E.O. 13789, Notice 2017-38,

and the Second Report. Because application of the limitation results in only property held immediately after the related section 355 distribution being subject to deemed sale treatment, the property of a successor to the distributing corporation, the controlled corporation, or a SAG member will not be subject to deemed sale treatment unless such property is distribution property from a related section 355 distribution involving the successor.

A commenter suggested an approach pursuant to which distribution property subject to deemed sale treatment as a result of the general rule could be deemed to be sold for its fair market value at the time of the related section 355 distribution. However, the commenter stated that this approach “may be objectionable given [E.O. 13789’s] focus on reducing complexity and taxpayer burdens in Treasury regulations,” because it would require taxpayers to perform a valuation of their assets at the time of a related section 355 distribution and to keep records of the valuation in case the taxpayer engages in a later conversion transaction. In the commenter’s view, this valuation and record keeping would be burdensome and result in administrative difficulties for both taxpayers and the IRS. The Treasury Department and the IRS agree.

In addition, section 1374 treatment would need to be applied to post-distribution appreciation to prevent it from inappropriately escaping corporate-level taxation. As a result, an individual asset that is distribution property would be subject to deemed sale treatment on the gain inherent in the asset at the time of the related section 355 distribution, and to section 1374 treatment on the appreciation in such asset after the post-distribution period. This result further increases the burdens and administrative difficulties imposed by the alternative approach. Because this approach is inconsistent

with the goal of reducing administrative burdens described in E.O. 13789 and reflected in Notice 2017-38 and the Second Report, the Treasury Department and the IRS decline to adopt this approach.

II. Predecessors and Successors of SAG Members

The Treasury Department and the IRS are aware of certain situations in which the predecessor or successor to a SAG member would not itself be a SAG member immediately before or after, respectively, the transaction giving rise to the predecessor-successor relationship. To prevent avoidance, the proposed regulations would expand the rule of proposed §1.337(d)-7(f)(2) so that references to a member of the separate affiliated group of the distributing corporation or the controlled corporation include references to any successor of such member.

III. Additional Comments

A commenter described an example similar to the following example (Example Three): Distributing is a C corporation that holds real estate assets with \$1 billion fair market value and \$0 adjusted basis. Distributing owns 100 percent of the stock of Controlled, which holds assets with \$100,000 fair market value and \$0 adjusted basis. In Year 1, Distributing distributes the stock of Controlled in a section 355 distribution. In Year 10, Distributing merges into a REIT.

Under the 2016 Proposed Regulations, Distributing would have been treated as making a deemed sale election as a result of engaging in a conversion transaction (the merger) during the ten-year period following a section 355 distribution. Accordingly, Distributing would have recognized \$1 billion gain as a result of being treated as selling all of its real estate assets. The commenter argued that requiring a C corporation to

recognize the built-in gain on assets worth \$1 billion because of a distribution of assets worth \$100,000 in an earlier year “seems absurd.” The Treasury Department and the IRS disagree. Section 856(c)(8), which was added by section 311 of 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, prevents the distributing corporation, the controlled corporation, and any successor to the distributing corporation or the controlled corporation from electing REIT status for ten years following a section 355 distribution. Section 856(c)(8) applies regardless of any disparity in size between the distributing corporation and the controlled corporation. The commenter did not identify any reason a merger into a REIT should be treated more favorably than a conversion to a REIT. Accordingly, the Treasury Department and the IRS have determined that application of the 2016 Proposed Regulations in the hypothetical presented by the commenter is consistent with the intent of Congress expressed by the PATH Act. The newly proposed regulations would not change this rule.

The Treasury Department and the IRS continue to study the Temporary Regulations and the 2016 Proposed Regulations, including issues raised by the comments, and welcome further comments on those issues.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter

6), it is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. These proposed regulations would affect transactions in which property of a C corporation becomes the property of a REIT following a section 355 distribution of controlled C corporation stock. Generally, these section 355 distributions involve publicly traded C corporations, which typically are not small entities as defined by the Regulatory Flexibility Act. Transactions in which the property of such C corporation becomes the property of a REIT generally involve the transfer of all of the assets of the C corporation. Therefore, the transferee REIT likely also would not be a small entity, as defined by the Regulatory Flexibility Act. As a result, this certification is based on the conclusion that these proposed regulations would primarily affect large C corporations and REITs that have substantial numbers of shareholders. Therefore, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Statement of Availability of IRS Documents

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

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as

prescribed in this preamble under the “Addresses” heading. The Treasury Department and the IRS request comments on all aspect of the proposed rules. In particular, the Treasury Department and the IRS are requesting comments whether further guidance is necessary regarding how taxpayers should be permitted to establish whether property is or is not distribution property. All comments will be available at <http://www.regulations.gov> or upon request. A public hearing will be scheduled in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Austin 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

Partial Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805 and 337(d), §§ 1.337(d)-7(c)(6), 1.337(d)-7(f), 1.337(d)-7(g)(2)(ii), and 1.337(d)-7(g)(2)(iv) of the notice of proposed rulemaking that was published in the **Federal Register** on June 8, 2016 (81 FR 36816), are withdrawn.

Proposed Amendments to the Regulations

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

Part 1-- INCOME TAXES

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

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

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Par. 2. Section 1.337(d)-7 is amended by adding paragraph (a)(2)(viii) and revising paragraphs (c)(6), (f), and (g)(2)(ii).

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

(a) * * *

(2) * * *

(viii) Distribution property. The term *distribution property* means--

(A) property owned immediately after a section 355 distribution by the distributing corporation, a controlled corporation (as those terms are defined in section 355(a)(1)), or a member of a separate affiliated group (as defined in section 355(b)(3)(B)) of which the distributing corporation or a controlled corporation is the common parent (but no formulation of the step transaction doctrine will be used to determine whether property acquired after the distribution is distribution property pursuant to this paragraph (a)(2)(viii)(A)), and

(B) property with a basis determined, directly or indirectly, in whole or in part, by reference to property described in paragraph (a)(2)(viii)(A) of this section.

* * * * *

(c) * * *

(6) Conversion transaction following a section 355 distribution--(i) In general.

Except as provided in paragraph (c)(6)(ii) of this section, a C corporation described in paragraph (f)(1) of this section is treated as having made the election under paragraph

(c)(5) of this section 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 an election.

(ii) Limitation. A C corporation treated as having made the election under paragraph (c)(5) of this section as a result of paragraph (c)(6)(i) of this section is not treated as having made the election with respect to property that the taxpayer establishes is not distribution property with respect to the related section 355 distribution. For purposes of this paragraph (c)(6)(ii), any property with an adjusted basis in excess of its fair market value as of the date of the conversion transaction will not be treated as distribution property unless the taxpayer establishes that it owned such asset immediately after the related section 355 distribution. If the limitation applies, then paragraph (b) of this section will apply to the property that is not distribution property with respect to the related section 355 distribution.

* * * * *

(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, a distributing corporation, or a member of the separate affiliated group of a distributing corporation or a controlled 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) * * *

(2) * * *

(ii) Conversion transactions occurring on or after the date these regulations are published in the **Federal Register** as final regulations. Paragraphs (a)(1), (a)(2)(vi), (a)(2)(vii), (a)(2)(viii), (b)(4), (c)(1), (c)(6), and (f) of this section will apply to conversion transactions occurring 30 days after the date these regulations are published in the **Federal Register** as final regulations, 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, the date that is 30 days after the date these regulations are published in the **Federal Register** as final regulations. For conversion transactions that occurred on or after June 7, 2016 and before the date that is 30 days after these regulations are published in the **Federal Register** as final regulations, see §§1.337(d)-7 and 1.337(d)-7T as contained in 26 CFR part 1 in effect on April 1, 2018. However, taxpayers may consistently apply paragraphs (a)(1), (a)(2)(vi), (a)(2)(vii), (a)(2)(viii), (b)(4), (c)(1), (c)(6), and (f) of this section in their entirety for all conversion transactions described in the preceding sentence. 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.

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Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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