

that are subject to section 1374 treatment with respect to a conversion transaction may not rely on § 1.337(d)-5(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)-5 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)-5(b)(3) and (c). For conversion transactions that occur on or after January 2, 2002, see § 1.337(d)-7.

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§ 1.337(d)-7 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 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 sec-

tion 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 section 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 Internal Revenue 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 other investment company taxable income for purposes of section 852(b) or other 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 para-

graph (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 other investment company taxable income for purposes of section 852(b) or on other 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). In computing such income and deduction items, capital loss carryforwards and net operating loss carryforwards that are used by the RIC or REIT to reduce recognized built-in gains are allowed as a deduction, but only to the extent that they are otherwise allowable as a deduction against such income under the Internal Revenue Code (including section 852(b)(2)(B)).

(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 capital 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 2007 taxable year, X has no other income or deduction items. 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 capital 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's \$30,000 of net income for the 2007 taxable year exceeds the net recognized built-in gain of \$20,000, 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 capital 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).

(iv) For purposes of subchapter M of chapter 1 of the Internal Revenue Code, 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)). For purposes of section 857(b)(2) and (b)(3), X's net capital gain for the year is \$23,050 (\$30,000 capital gain reduced by \$3,000 capital loss carryforward and further reduced by \$3,950 tax).

(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 (or a partnership to which the principles of this section apply under paragraph (e) of this section) makes the deemed sale election with the following statement: “[Insert name and employer identification number of electing corporation or partnership] elects deemed sale treatment under § 1.337(d)-7(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 or partnership].” This statement must be attached to the Federal income tax return of the C corporation or partnership 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%.

(i) 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), 351(e), 356, 357(c), 367, 368(a)(2)(F), 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

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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 any person 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 distributive share of the gain or loss in the transferred property. If the partnership were to elect deemed sale treatment under paragraph (c) of this section in lieu of section 1374 treatment under paragraph (b) of this section with respect to such transfer, then any net gain recognized by the partnership on the deemed sale must be allocated to the C corporation partner, but does not increase the capital account of any partner. Any adjustment to the partnership's basis in the RIC or REIT stock as a result of deemed sale treatment under para-

graph (c) of this section shall constitute an adjustment to the basis of that stock with respect to the C corporation partner only. The principles of section 743 apply to such basis adjustment.

(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)-5 and 1.337(d)-6.

[T.D. 9047, 68 FR 12822, Mar. 18, 2003]

§ 1.338-0 Outline of topics.

This section lists the captions contained in the regulations under section 338 as follows:

§ 1.338-1 General principles; status of old target and new target.

- (a) In general.
 - (1) Deemed transaction.
 - (2) Application of other rules of law.
 - (3) Overview.
- (b) Treatment of target under other provisions of the Internal Revenue Code.
 - (1) General rule for subtitle A.
 - (2) Exceptions for subtitle A.
 - (3) General rule for other provisions of the Internal Revenue Code.
- (c) Anti-abuse rule.
 - (1) In general.
 - (2) Examples.
- (d) Next day rule for post-closing transactions.

§ 1.338-2 Nomenclature and definitions; mechanics of the section 338 election.

- (a) Scope.
- (b) Nomenclature.
- (c) Definitions.
 - (1) Acquisition date.
 - (2) Acquisition date assets.
 - (3) Affiliated group.
 - (4) Common parent.
 - (5) Consistency period.
 - (6) Deemed asset sale.
 - (7) Deemed sale tax consequences.
 - (8) Deemed sale return.
 - (9) Domestic corporation.
 - (10) Old target's final return.
 - (11) Purchasing corporation.
 - (12) Qualified stock purchase.
 - (13) Related persons.
 - (14) Section 338 election.
 - (15) Section 338(h)(10) election.
 - (16) Selling group.
 - (17) Target; old target; new target.
 - (18) Target affiliate.
 - (19) 12-month acquisition period.
- (d) Time and manner of making election.