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Proposed regulations: Transfers of property to REITs

The U.S. Treasury Department and IRS today released for publication in the Federal Register proposed regulations (REG-113943-17) concerning certain transfers of property to real estate investment trusts (REITs).

The [proposed regulations](#) [PDF 238 KB] provide guidance for transactions when property of a C corporation becomes the property of a REIT following certain corporate distributions of controlled corporation stock.

Background

The proposed regulations would modify certain aspects of temporary regulations published on June 8, 2016, under section 337(d). Sections 355(h) and 856(c)(8), enacted in late 2015 by Pub. L. No. 114-113 (the "PATH Act"), together place limitations on tax-free spin offs where, following the spin-off, one, but not both, entities are taxable as REITs.

The temporary regulations were intended to complement these provisions, and provided in part that if a C corporation is either the "distributing" or "controlled" corporation in a section 355 distribution, and the C corporation engages in a "conversion transaction" (generally, a REIT conversion or a transfer of property from the C corporation to a REIT) during the 10-year period that follows the section 355 distribution, the C corporation is treated as having made the deemed-sale election with respect to the conversion transaction. For this purpose, any reference to a distributing corporation or a controlled corporation includes a reference to any predecessor or successor of such corporation.

Some commentators expressed concern with this approach, on grounds that requiring the corporation engaging in the conversion transaction to recognize gain in respect of all of its assets, not only those that it held at the time of the tax-free spin-off, would lead to the triggering of an excessive amount of gain and therefore inappropriate results.

Example

By way of illustration, assume that Distributing owns Controlled, which holds assets with \$20 million fair market value and \$0 adjusted basis, and distributes Controlled in Year 1 in a section 355 distribution. Acquiring is a C corporation and holds real estate assets with \$1 billion fair market value and \$0 adjusted basis. Acquiring acquires Controlled in Year 3 in a transaction in which

Acquiring becomes a successor of Controlled. In Year 9, Acquiring merges into a REIT and does not make a deemed-sale election. As a "successor" to Controlled, the 2016 regulations would treat Acquiring as making a deemed-sale election and would require Acquiring to recognize a gain on all its property at the time of the merger (instead of the property of Controlled traceable to the section 355 transaction).

Proposed regulations

To address this concern, the proposed regulations would limit the automatic deemed-sale election to "distribution property," which is 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) 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. The C corporation's property that is not considered distribution property generally would be subject to normal treatment under section 337(d) and its regulations.

It is worth noting that while the property subject to the automatic deemed-sale election is limited to property traceable to the section 355 distribution, the amount of the gain recognized is not limited to the "built-in gain" in those assets determined as of the time of the section 355 distribution.

Effective date

As a general matter, the proposed regulations would be applicable to conversion transactions "occurring 30 days after" the date that the regulations are published as final regulations in the Federal Register (presumably, this is intended to cover conversion transactions occurring on or after 30 days the date that the regulations are published as final regulations). Taxpayers are permitted to "consistently apply" the proposed regulations for all conversion transactions that occurred on or after June 7, 2016 and before the 30 days following the date of publication in the Federal Register of final regulations).

Comments and requests for a public hearing must be received by 45 days after publication in the Federal Register, which is scheduled for March 26, 2019.

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