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Alert: Tax

Final Regulations Issued on Transfers of Property from a C Corporation to a REIT or RIC

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On August 2, 2013, the Treasury Department published final regulations setting forth the circumstances under which the taxable disposition by an entity taxable as a real estate investment trust (REIT) or regulated investment company (RIC) of property that was formerly owned by a C corporation[1] will be subject to corporate level tax. Unlike C corporations, REITs and RICs are generally not subject to corporate income tax on the disposition of appreciated property. Consequently, Congress authorized Treasury to craft regulations to limit the ability of C corporations to avoid corporate level tax by transferring appreciated property to or becoming a REIT or RIC. The breadth of the regulations, however, may create traps for the unwary.

Consistent with the previously proposed regulations, the final regulations provide that if property of a C corporation becomes the property of a REIT or RIC as a result of the C corporation becoming a REIT or RIC or transferring its property to a REIT or RIC (a conversion transaction), the REIT or RIC could be subject to tax under Section 1374 of the Internal Revenue Code of 1986, as amended (the Code) on the net built-in gain in the property involved in the conversion transaction on the date of such transaction to the extent not recognized by the transferor C corporation. Under Section 1374 of the Code, the REIT or RIC generally would owe tax, at the highest corporate rate, on such net built-in gain if it disposes of the converted property in a taxable transaction within ten years of the date of the conversion transaction.[2] Alternatively, the REIT or RIC is not subject to the built-in gain tax if the transferor C corporation elects to recognize gain as if it sold the converted property to an unrelated party at fair market value on the date of the conversion transaction (a deemed sale election).[3] If a deemed sale election is made, the REIT or RIC takes a fair market value basis in the converted property.

Example

C, a domestic corporation, owns asset A with a basis of $0 and a fair market value of $40. C contributes asset A to a newly formed REIT solely for REIT stock in a transaction that would otherwise be tax free under Section 351 of the Code. Five years later, the REIT sells asset A in a taxable transaction for $100.

No deemed sale election. The REIT takes asset A with a carryover basis of $0 from C, and since C had a basis of $0 in asset A, C would have a basis of $0 in the REIT stock received in the contribution. Since the REIT sold asset A within the ten-year recognition period, it is subject to corporate level tax on the $40 of built-in gain that existed at the time C contributed asset A to the REIT. In addition, the REIT recognizes $100 of gain on the sale, the tax treatment of which is governed by general REIT tax principles. This result surprises some, as the built-in gain on the contributed asset also exists in the $0 basis/$40 fair market value REIT stock received by C in the contribution, and, thus, such gain will eventually be subject to corporate tax. Unlike in the case of a conversion of a corporation to a REIT, Section 1374 principles are arguably an unnecessary trap for the unwary with respect to "conversion transactions" structured as contributions as in this example.

- Deemed sale election. C recognizes $40 of income at the time of the contribution of asset A to the REIT, which equals the gain that it would have recognized if it had sold asset A to an unrelated person for its $40 fair market value at the time of contribution. Since C made a deemed sale election, the REIT takes asset A with a $40 fair market value basis. When the REIT later sells asset A, it is not subject to corporate level tax, but the REIT recognizes $60 of gain on the sale, the tax treatment of which is governed by general REIT tax principles.

Partnerships with Corporate Partners

The regulations apply similar rules to transactions where a partnership transfers property to a REIT or RIC to the extent that any gain or loss on the property would have been allocated to a C corporation if the partnership had sold the property to an unrelated person for fair market value. To prevent the REIT or RIC from being subject to the built-in gain tax, the partnership may also make a deemed sale election. If a deemed sale election is made, the partnership recognizes income in an amount equal to the gain that would have been allocated to its C corporation partners if the converted property had been sold to an unrelated party at fair market value. This income is then allocated to the C corporation partners, but does not increase their capital accounts. Any adjustment to the partnership's basis in the REIT or RIC stock received in the conversion transaction as a result of the deemed sale will be attributed to the C corporation partners, and the principles of Section 743 of the Code shall apply to such basis adjustment.

Example

Partnership XY has two partners: X, a domestic corporation that owns 60 percent of the partnership and Y, an individual that owns 40 percent of the partnership. XY owns asset A with a basis of $0 and fair market value of $200. XY contributes asset A to a newly formed REIT for REIT stock in a transaction that would otherwise be tax free under Section 351 of the Code.[4]

- **No deemed sale election.** Under the final regulations, the REIT would be subject to corporate level tax on the $120 of built-in gain if its sells asset A within the ten-year recognition period because if XY had sold asset A for its $200 fair market value, $120 of the gain would have been allocated to X, a C corporation. Since XY had a basis of $0 in asset A, XY would have a basis of $0 in the REIT stock received in the contribution.
- **Deemed sale election.** XY recognizes $120 of income, which equals the gain that would have been allocated to X had asset A been sold to an unrelated person for its $200 fair market value. All of this gain is allocated to X, but does not increase X's capital account. Due to the gain recognition, XY takes the REIT stock with a basis of $120. This basis adjustment is attributable solely to X, and the principles of Section 743 of the Code will apply to the adjustment.

Exception for Like-Kind Exchanges and Involuntary Conversions

A REIT or RIC will not be subject to the built-in gain tax if the transferor C corporation did not recognize gain in the conversion transaction because it qualified as a like-kind exchange or involuntary conversion. An exception was created for these transactions because the C corporation replaces the property transferred to the REIT or RIC with other property that will have a basis equivalent to the transferred property, so any built-in gain remains subject to corporate level tax.

The preamble to the final regulations clarifies that this exception applies to multiparty like-kind exchanges and to like-kind exchanges where the replacement property is acquired before the relinquished property is transferred.

Exception for Conversion Transactions Involving Tax-Exempt Entities

Additionally, if the C corporation in the conversion transaction is a tax-exempt entity, the REIT or RIC is only subject to the built-in gain tax to the extent that the tax-exempt entity would have been subject to tax (*e.g.*, unrelated business income tax) if it had made a deemed sale election with respect to the conversion transaction. This exception prevents the imposition of corporate level tax in situations where the transferor would not have been subject to corporate level tax on the sale of the property due to its tax-exempt status.

1 For this purpose, a C corporation includes any entity treated as a corporation for federal income tax purposes other than a subchapter S corporation, REIT, or RIC.

2 If the REIT or RIC transfers property that was subject to the built-in gain tax in a carryover basis transaction to another REIT or RIC, the transferee takes the property subject to the potential tax on the net built-in gain, but the ten-year recognition period is reduced to account for the time the property was held by the transferor.

3 If the deemed sale were to result in an overall net loss, however, an election is not permitted.

4 This transaction presents a less conspicuous trap for the unwary than the prior example given that the contributor of the appreciated asset is a partnership and not a corporation, generally associated with the Section 1374 regime.

If you have questions concerning the contents of this Alert, or would like more information about Weil's Tax Group, please speak to your regular contact at Weil, or to:

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