April 26, 2000

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service, Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Jonathan Talisman, Esq.
Acting Assistant Secretary (Tax Policy)
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1500 Pennsylvania Avenue, N.W.
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Dear Commissioner Rossotti and Mr. Talisman:

This letter[1] sets forth the comments of the Tax Section of the New York State Bar Association regarding the recently issued temporary and proposed regulations (T.D. 8872) on asset transfers from a C corporation to, or the qualification of a C corporation as, a regulated investment company (a "RIC") or a real estate investment trust (a "REIT"). The regulations generally follow the guidance set forth in Notice 88-19, 1988-1 C.B. 486, pursuant to which the Internal Revenue Service announced its intention to promulgate regulations under the authority of Section 337(d) of the Code[2] with respect to transactions or events that result in the ownership of assets formerly held by a C corporation by a RIC or REIT with basis determined by reference to the corporation's basis (a carryover basis), or the qualification of a C corporation as a RIC or REIT. The temporary and proposed

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1 This letter was prepared by the Committee on Pass-Through Entities. The principal drafter of this letter was Janet B. Korins, with substantial assistance from Paul R. Wysocki. Helpful comments were received from William B. Brannan, Dale S. Collinson and Robert A. Jacobs.

2 All section references are to the Internal Revenue Code of 1986, as amended (the "Code").

regulations provide that when a C corporation qualifies to be taxed as a RIC or REIT, or transfers assets to a RIC or REIT in a transaction that would otherwise be a carryover basis transaction, the C corporation is treated as if it sold all of its assets at their respective fair market values and immediately liquidated, requiring the C corporation to recognize any resulting net built-in gain. This rule does not apply if its application would result in the recognition of net built-in loss. The deemed sale of assets and recognition of gain can be avoided if the RIC or REIT elects to be subject to tax under the rules of Section 1374 of the Code. Those rules apply to S corporations and generally tax net built-in gain only to the extent recognized by reason of a disposition within a ten-year recognition period.

We have the following suggestions and observations with respect to the regulations:

1. **Section 1374 Elections and Default Rules.** The regulations provide that a RIC or REIT makes a Section 1374 election by attaching a statement, signed and in the form prescribed by the regulation, to the Federal income tax return for the first taxable year in which the assets of the C corporation become assets of the RIC or REIT. Under a special rule, in cases where such first taxable year ends after June 10, 1987 but before March 8, 2000, the Section 1374 election "may" be filed with the first Federal income tax return filed after March 8, 2000.

As a preliminary matter, it is worth noting that the stakes are quite high for a RIC or REIT making a Section 1374 election. Absent a valid election, deemed asset sale treatment will apply, resulting in a potentially substantial corporate-level tax. The RIC or REIT would generally be liable for any unpaid corporate taxes by operation of law pursuant to a merger or upon conversion from C corporation to RIC or REIT status. In addition, as mentioned in Section Five below, a deemed asset sale might increase the C corporation earnings and profits inherited by the RIC or REIT, which it would have to distribute to maintain its status. Because of these harsh results, a RIC or REIT will generally want to fall within the Section 1374 regime and will only very rarely want to be subject to the tax on built-in gains. It is therefore important to have a simple and clear procedure for obtaining Section 1374 treatment.

A number of suggestions follow from these observations. First, with respect to prior years, a Section 1374 election should be respected even if it did not comply with all of the literal requirements of the temporary regulations. The temporary regulations have raised some concern that RICs and REITs need to refile prior Section 1374 elections under the special rule permitting such elections to be made retroactively. This concern arises because the temporary regulations require the prior election statement to contain very specific language, including a reference to a specific section of the temporary regulation itself. We do not believe the regulations should (or were intended to) create any uncertainty about the validity of a prior, good faith

election. The regulations therefore should state explicitly that a Section 1374 election for prior years will be respected if a RIC or REIT indicated its intention to make such an election on its tax return for the first taxable year in which it acquired assets of a C corporation or qualified as a RIC or REIT, or otherwise indicated to the Internal Revenue Service its intention to defer the built-in gain by the date of filing of such tax return. This formulation of the rule would also eliminate the possibility that a taxpayer will try to repudiate a prior attempt to make a Section 1374 election and "whipsaw" the government by claiming deemed asset sale treatment and a stepped-up asset basis after the statute of limitations has expired for collection of the corresponding corporate-level tax.

Under the foregoing approach, deemed asset sale treatment for prior years will apply only if the taxpayer's intention to make a Section 1374 election was not clear. We think this will be the unusual case. However, the taxpayer would still have the opportunity to make a retroactive Section 1374 election under the regulations. We believe it would be appropriate to provide that a taxpayer would not be permitted to make a retroactive Section 1374 election if it indicated a contrary intention on any of its prior tax returns (for example, by showing the acquired assets as having a stepped up basis as of the date of acquisition), because such a taxpayer would be deemed to have opted out of Section 1374 treatment and that decision should be irrevocable.

Second, for periods after the effective date of the final regulations, we recommend that the "default rule" be the reverse of the rule set forth in the temporary regulations. In other words, a taxpayer would affirmatively elect to be subject to deemed asset sale treatment and, absent such an election, Section 1374 would apply. Under this approach, the default rule of gain deferral will be consistent with the typical taxpayer's expectations. It would be appropriate to require the C corporation to join in an election out of Section 1374 treatment, or to otherwise take steps to ensure that the corporate-level tax is paid. Although we recommend elective asset sale treatment on a going-forward basis, we believe the existing elective Section 1374 regime should remain in effect for periods prior to the issuance of final regulations, because the rules set forth in Notice 88-19 and the temporary regulations should not be changed retroactively.

2. **Definition and Calculation of Net Built-in Gain.** The regulations define net built-in gain as "the excess of aggregate gains (including items of income) over aggregate losses." This definition applies only in the unusual case where gain is recognized upon a deemed asset sale. We suggest clarification of which items of income are included in the calculation of gains and whether items of deduction would similarly be included in the calculation of losses. In addition, the regulatory language differs from the definition of net unrealized built-in gain under Section 1374(d) and Treasury Regulation Section 1.1374-3. If the rules applicable

to RICs or REITs are intended to differ from those rules, the regulations should say so explicitly.

3. **Exception for Re-election of RIC Status.** The regulations provide that the general rule of gain recognition does not apply to a C corporation that is re-electing RIC status after being subject to tax as a C corporation for no more than one year. However, that exception applies "only to assets acquired by the corporation during the year when it was subject to tax as a C corporation in a transaction that does not result in its basis in the asset being determined by reference to a corporate transferor's basis."

The exception is based on Notice 88-96, 1988-2 C.B. 420, which was issued in response to taxpayer concerns following the release of Notice 88-19. Notice 88-96 stated that the regulations under Section 337(d) would provide that a previously qualifying RIC that failed to meet the requirements of the RIC tax provisions for a single taxable year would not be required to recognize net built-in gain upon requalification. The Notice further stated that the exception to gain recognition would not apply to any asset acquired during the C corporation year from another corporation in a carryover basis transaction.

In contrast to Notice 88-96, the regulations at least arguably require a re-electing RIC to pay the tax on built-in gains with respect to assets previously held by the RIC upon its conversion to C corporation status. Consistent with the Notice, we believe such assets should not be subject to gain recognition and the regulations should so clarify. An alternative approach would tax only the appreciation that occurred during the C corporation period, but that approach would be inconsistent with Notice 88-96.

We also recommend that consideration be given to applying the exception from gain recognition even if the C corporation period is longer than one year. A re-electing RIC may have more than one C corporation year even if it re-elects RIC status on the earliest possible date after discovery of an inadvertent disqualification. Consideration should be given to (i) extending the re-election period to a period longer than one year, without taxing any of the appreciation accruing during the C corporation years, or (ii) extending the re-election period but also imposing the built-in gain regime to the appreciation accruing during the extended C corporation period. Although we do not recommend any particular approach, we do suggest

that a more generous rule would be appropriate, particularly in cases of inadvertent disqualification and prompt re-election of RIC status.[3]

Finally, we recommend that any rule that is adopted for RICs should also apply to REITs. While valuation issues may be more difficult for the type of assets typically held by a REIT, compared with the type of assets held by a RIC, those issues do not justify the exclusion of REITs from the benefits of this provision.

4. **Treatment of Net Built-In Gain Similar to Income From Foreclosure Property.** The temporary regulations, like Notice 88-19, state that the built-in gains of electing RICs and REITs, and the corporate-level tax imposed on such gains, "are subject to rules similar to the rules relating to net income from foreclosure property of REITs. See sections 857(a)(1)(A)(ii) and 857(b)(2)(B),(D) and (E)." That statement does not make clear whether built-in gains are treated like foreclosure income for all purposes, or solely for purposes of the cited Code sections (dealing with the REIT distribution requirements and the tax on real estate investment trust taxable income). We believe the latter alternative is the correct result, and the final regulations should so provide. As an example, although income from foreclosure property is generally treated as qualifying REIT income under Section 856(c)(2) and (c)(3), we believe the determination of whether built-in gains are qualifying income is appropriately based on whether gain from the sale of the underlying property would so qualify, without reference to the rules governing foreclosure property.

5. **Impact of Deemed Liquidation.** The regulations should clarify the impact of the deemed liquidation following the deemed sale of assets by a C corporation prior to the acquisition of such assets by a RIC or REIT. Notice 88-19 stated that the regulations under Section 337(d) would not affect the characterization for tax purposes of, or the treatment of parties to, any transaction to which they apply. For example, shareholders of a C corporation who received RIC shares in a "C" reorganization would not recognize gain or loss solely because under the regulations the C corporation would be subject to corporate-level taxation. In contrast, the temporary regulations state that, absent a Section 1374 election, the C corporation is treated as having sold its assets and liquidated "for all purposes,"

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[3] We discussed similar issues in our 1996 report on the legislative proposal to repeal Section 1374. We generally recommended that, if Section 1374 were repealed, pass-through entities such as RICs and REITs that unintentionally ceased to qualify for pass-through status should be entitled to relief from the tax on built-in gains upon requalification, if they requalified on the earliest possible date after discovery of disqualification.

suggesting that a shareholder-level tax might be imposed on the deemed liquidation. The regulations should be clarified to follow Notice 88-19 and eliminate this uncertainty.

In addition, it is unclear what purpose, if any, is served by the deemed liquidation. The purpose of the regulations is to prevent the avoidance of corporate-level tax, and that purpose is adequately addressed by the recognition of built-in gain upon a deemed asset sale. If the deemed liquidation were eliminated, the asset sale would function as a mark-to-market regime. Under this approach, the C corporation would remain in existence, and the rules generally applicable to tax-free transactions would otherwise apply. For example, corporate attributes such as net operating losses and earnings and profits would carry over to the RIC or REIT under Section 381. This treatment is consistent with Notice 88-19, which stated that the regulations would not affect the characterization of transactions to which they applied.

On the other hand, the C corporation could be treated as liquidating and then reincorporating, or as selling its assets to a new corporation and then liquidating. In either case, the tax consequences of the transaction would be affected. For example, corporate attributes would not carry over to the RIC or REIT, and the C corporation would presumably be entitled to deduct previously capitalized organizational expenses upon the deemed liquidation.[4]

Although we do not recommend either of these approaches as the correct result as a policy matter, practitioners in this area generally believe the first approach to be the current state of the law, in part in reliance on the language in Notice 88-19. Under that approach, the deemed liquidation serves no purpose and should be eliminated. We recommend that these issues be carefully considered and clarified in the final regulations.

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[4] *See, e.g.*, *Kingsford Co. v. Commissioner*, 41 T.C. 646 (1964) , *acq.*, 1964-2 C.B. 6.

As always, we would be delighted to discuss these issues with you or members of your staff.

Very truly yours,

Robert H. Scarborough

cc: Stuart L. Brown
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CC:DOM:CORP:R[REG-209135-88]