

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Part 1**

[TD 9626]

RIN 1545-B184

Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs]**AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Final regulations.

SUMMARY: This document contains final regulations under section 337(d) of the Internal Revenue Code. These regulations provide guidance concerning certain transfers of property from a C corporation to a Regulated Investment Company (RIC) or a Real Estate Investment Trust (REIT). These regulations will affect the parties to such transactions.

DATES: *Effective Date:* These regulations are effective on August 2, 2013.

Applicability Date: For date of applicability, see § 1.337(d)-7(f)(2).

FOR FURTHER INFORMATION CONTACT: Grid Glycer (202) 622-7530 or Maury Passman (202) 622-7750 with respect to the corporate issues, and David H. Kirk (202) 622-3060 with respect to the partnership issues (not toll-free numbers).

SUPPLEMENTARY INFORMATION:**Background**

This document contains an amendment to 26 CFR Part 1. On April 16, 2012, a notice of proposed rulemaking (NPRM) concerning certain transfers of property (converted property) from a C corporation to a RIC or a REIT was published in the **Federal Register** (REG-139991-08; 77 FR 22516). One written comment was received and no public hearing was requested or held. This Treasury Decision adopts the proposed regulations with the changes discussed in this preamble.

Explanation and Summary of Comments

Section 1.337(d)-7 generally provides (in paragraphs (a) and (b)(1)) that if property of a C corporation (the C corporation transferor) becomes the property of a RIC or REIT by the qualification of that C corporation as a RIC or REIT or by the transfer of assets of that C corporation to a RIC or REIT (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 section 1374 and the underlying regulations (the general rule). The general rule, however, does not apply if the C corporation transferor makes a “deemed sale election” provided for under § 1.337(d)-7(c) to recognize gain and loss as if it sold the converted property to an unrelated person at fair market value.

The NPRM proposed to amend § 1.337(d)-7 to provide two exceptions from the general rule. First, the general rule would not apply to the extent that the conversion transaction qualifies for nonrecognition treatment under either section 1031 (relating to like-kind exchanges) or section 1033 (relating to involuntary conversions) (the exchange exception). Second, a conversion transaction in which the C corporation that owned the converted property is a tax-exempt entity (within the meaning of § 1.337(d)-4(c)(2)) would not be subject to the general rule if the tax-exempt entity would not be subject to tax (such as under the unrelated business income tax rules of section 511) on gain resulting from a deemed sale election had such an election been made under § 1.337(d)-7(c)(5) (the tax-exempt exception).

The commenter requested clarification regarding the application of the tax-exempt exception. The IRS and Treasury Department recognize that it may be unclear whether the tax-exempt exception applies to a transaction in which some of the gain resulting from a deemed sale election would be subject to tax if such an election were made, and some of the resulting gain would not be subject to tax. For example, if a tax-exempt entity transferred an asset to a REIT and a portion of the gain resulting from a deemed sale election would be subject to tax under section 511, it may be unclear whether the tax-exempt exception applies to the portion of the gain that would be exempt from tax under section 501(a). Under one interpretation of the proposed regulations, the tax-exempt exception would not apply to any of the gain, including the portion that would be exempt from tax under section 501(a), because a portion of the gain would be subject to tax under section 511.

As noted in the NPRM, the IRS and Treasury Department believe that the general rule should not apply to transfers by tax-exempt entities to the extent that resulting gain (if any) would not be subject to tax under some Code provision were a deemed sale election made. Accordingly, the final regulations clarify that the general rule does not apply to a conversion transaction in which the C corporation that owned the

converted property is a tax-exempt entity to the extent that gain would not be subject to tax under Title 26 of the United States Code if a deemed sale election were made. Thus, in the example described, the tax-exempt exception applies to the extent the deemed sale gain with respect to the converted property would be exempt from tax under section 501(a) because that portion of the gain would not be subject to tax under any Code provision had a deemed sale election been made. This is the case even though the tax-exempt exception does not apply to the extent the deemed sale gain with respect to the converted property would be subject to tax under section 511. This clarification is made in a new paragraph in § 1.337(d)-7(d).

The commenter also requested clarification that the exchange exception applies to certain multi-party like-kind exchanges of property involving intermediaries, including “reverse like-kind exchanges” in which the replacement property is acquired before the relinquished property is transferred. The IRS and Treasury Department believe that the language of the exchange exception is sufficiently clear and operates to exclude from the general rule any realized gain that is not recognized by reason of either section 1031 or 1033, regardless of the specific transactional form. Accordingly, the IRS and Treasury Department do not believe that any change to the NPRM is necessary on this issue.

In addition, the commenter requested that a new exception to the general rule be added to address the fact pattern in which a REIT purchases appreciated property from a C corporation for cash or other consideration equal to the property's fair market value. According to the commenter, if the REIT does not have a continuing relationship with the C corporation, the REIT would have no way of knowing the extent to which the C corporation might not recognize any gain, whether pursuant to section 1031, 1033, or some other Code provision. Because the REIT's basis in property purchased in an arm's length transaction generally is its cost, the REIT should generally not have any built-in gain in the converted property. Thus, the commenter suggested that this fact pattern should never give rise to a conversion transaction.

The IRS and Treasury Department agree with the commenter that a RIC or REIT that purchases property in an arm's length transaction from a C corporation for an amount of cash equal to the property's fair market value should have a cost basis equal to fair market value. Thus, if the RIC or REIT

subsequently were to sell the property at a gain during the recognition period, the RIC or REIT should be able to establish that the gain recognized is not built-in gain within the meaning of section 1374(d)(3). Accordingly, the IRS and Treasury Department do not believe that any change to the NPRM is necessary on this issue.

Finally, as suggested by the commenter, a reference in § 1.337(d)-7(d)(1) of the NPRM is corrected to refer to section 1033(a)(2) instead of section 1033(b).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these regulations would not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations do not create additional obligations for, or impose an economic impact on, small entities. Instead, these regulations provide an additional exception to the current regulations, and thus have a more limited application to all businesses, including small businesses, than the current regulations. Therefore, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business, and no comments were received.

Drafting Information

The principal authors of these regulations are Grid Glycer and Maury Passman of the Office of Associate Chief Counsel (Corporate). Other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *
Section 1.337(d)-7 is also issued under 26 U.S.C. 337(d) * * *

■ **Par. 2.** Section 1.337(d)-7 is amended by:

- 1. Revising paragraphs (a)(2), (d)(1), (e), and (f).
- 2. Adding paragraphs (d)(3) and (d)(4).
The revisions and addition read as follows:

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

(a) * * *

(2) *Definitions.* For purposes of this section:

(i) *C corporation.* The term *C corporation* has the meaning provided in section 1361(a)(2) except that the term does not include a RIC or a REIT.

(ii) *Conversion transaction.* 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.

(iii) *RIC.* The term *RIC* means a regulated investment company within the meaning of section 851(a).

(iv) *REIT.* The term *REIT* means a real estate investment trust within the meaning of section 856(a).

(v) *S corporation.* The term *S corporation* has the meaning provided in section 1361(a)(1).

* * * * *

(d) *Exceptions*—(1) *Gain otherwise recognized.* Paragraph (a)(1) of this section does not apply to any conversion transaction to the extent that gain or loss otherwise is recognized on such conversion transaction by the C corporation that either qualifies as a RIC or a REIT or that transfers property to a RIC or REIT. See, for example, sections 311(b), 336(a), 351(b), 351(e), 356, 357(c), 367, 368(a)(2)(F), 1001, 1031(b), and 1033(a)(2).

* * * * *

(3) *Special rules for like-kind exchanges and involuntary conversions.*—(i) *In general.* Paragraph (a)(1) of this section does not apply to a conversion transaction to the extent that a C corporation transfers property with a built-in gain to a RIC or REIT, and the C corporation's gain is not recognized by reason of either section 1031 or 1033.

(ii) *Clarification regarding exchanged property previously subject to section 1374 treatment.* Notwithstanding paragraph (d)(3)(i) of this section, if, in a transaction described in paragraph (d)(3)(i) of this section, a RIC or REIT surrenders property that was subject to section 1374 treatment immediately prior to the transaction, the rules of

section 1374(d)(6) will apply to continue section 1374 treatment to the replacement property acquired by the RIC or REIT in the transaction.

(iii) *Examples.* The rules of this paragraph (d)(3) are illustrated by the following examples. In each of the examples, X is a REIT, Y is a C corporation, and X and Y are not related.

Example 1. Section 1031(a) exchange. (i) *Facts.* X owned a building that it leased for commercial use (Property A). Y owned a building leased for commercial use (Property B). On January 1, Year 3, Y transferred Property B to X in exchange for Property A in a nonrecognition transaction under section 1031(a). Immediately before the exchange, Properties A and B each had a value of \$100, X had an adjusted basis of \$60 in Property A, Y had an adjusted basis of \$70 in Property B, and X was not subject to section 1374 treatment with respect to Property A.

(ii) *Analysis.* The transfer of property (Property B) by Y (a C corporation) to X (a REIT) is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section. The conversion transaction is a nonrecognition transaction under section 1031(a) as to Y; thus, Y does not recognize any of its \$30 gain. Therefore, the conversion transaction is not subject to paragraph (a)(1) of this section by reason of paragraph (d)(3)(i) of this section.

Example 2. Section 1031(a) exchange of section 1374 property. (i) *Facts.* The facts are the same as in *Example 1*, except that X had acquired Property A in a conversion transaction in Year 2, and immediately before the Year 3 exchange X was subject to section 1374 treatment with respect to \$25 of net built-in gain in Property A.

(ii) *Analysis.* The Year 3 transfer of Property B by Y to X is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section. The conversion transaction is a nonrecognition transaction under section 1031(a) as to Y; thus, Y does not recognize any of its \$30 gain. Therefore, the Year 3 transfer is not subject to paragraph (a)(1) of this section by reason of paragraph (d)(3)(i) of this section. However, X had been subject to section 1374 treatment with respect to \$25 of net built-in gain in Property A immediately before the Year 3 transfer, and X's basis in Property B is determined (in whole or in part) by reference to its adjusted basis in Property A. Accordingly, the rules of section 1374(d)(6) apply and X is subject to section 1374 treatment on Property B with respect to the \$25 net built-in gain. See paragraph (d)(3)(ii) of this section.

Example 3. Section 1031(b) exchange. (i) *Facts.* The facts are the same as in *Example 1*, except that immediately before the Year 3 exchange Property A had a value of \$92, and X transferred Property A and \$8 to Y in exchange for Property B in a nonrecognition transaction under section 1031(b).

(ii) *Analysis.* The transfer of Property B by Y to X is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section. Pursuant to section 1031(b), Y recognizes \$8 of its gain. Paragraph (a)(1) of this section does not apply to the transaction to the

extent of the \$8 gain recognized by Y by reason of paragraph (d)(1) of this section, or to the extent of the \$22 gain realized but not recognized by Y by reason of paragraph (d)(3)(i) of this section.

Example 4. Section 1033(a) involuntary conversion of property held by a C corporation transferor. (i) *Facts.* Y owned uninsured, improved property (Property 1) that was involuntarily converted (within the meaning of section 1033(a)) in a fire. Y sold Property 1 for \$100 to X, which owned an adjacent property and wanted Property 1 for use as a parking lot. Y had a \$70 basis in Property 1 immediately before the sale. Y elected to defer gain recognition under section 1033(a)(2), and purchased qualifying replacement property (Property 2) for \$100 from an unrelated party prior to the expiration of the period described in section 1033(a)(2)(B).

(ii) *Analysis.* The transfer of Property 1 by Y to X is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section. The conversion transaction (combined with Y's purchase of Property 2) is a nonrecognition transaction under section 1033(a) as to Y; thus, Y does not recognize any of its \$30 gain. Therefore, the conversion transaction is not subject to paragraph (a)(1) of this section by reason of paragraph (d)(3)(i) of this section.

Example 5. Section 1033(a) involuntary conversion of property held by a REIT. (i) *Facts.* X owned property (Property 1). On January 1, Year 2, Property 1 had a fair market value of \$100 and a basis of \$70, and X was not subject to section 1374 treatment with respect to Property 1. On that date, when Property 1 was under a threat of condemnation, X sold Property 1 to an unrelated party for \$100 (First Transaction). X elected to defer gain recognition under section 1033(a)(2), and purchased qualifying replacement property (Property 2) for \$100 from Y (Second Transaction) prior to the expiration of the period described in section 1033(a)(2)(B).

(ii) *Analysis.* The transfer of Property 2 by Y to X in the Second Transaction is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section. The Second Transaction (combined with the First Transaction) is a nonrecognition transaction under section 1033(a) as to X, but not as to Y. Assume no nonrecognition provision applied to Y; thus, Y recognized gain or loss on its sale of Property 2 in the Second Transaction, and the Second Transaction is not subject to paragraph (a)(1) of this section by reason of paragraph (d)(1) of this section.

(4) *Special rule if C corporation is a tax-exempt entity.* Paragraph (a)(1) of this section does not apply to a conversion transaction in which the C corporation that owned the converted property is a tax-exempt entity described in § 1.337(d)-4(c)(2) to the extent that gain (if any) would not be subject to tax under Title 26 of the United States Code if a deemed sale election under paragraph (c)(5) of this section were made.

(e) *Special rule for partnerships—(1) In general.* The principles of this section

apply to property transferred by a partnership to a RIC or REIT to the extent of any gain or loss in the converted property that would be allocated directly or indirectly, through one or more partnerships, to a C corporation if the partnership 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). 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 paragraph (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.

(2) *Example; Transfer by partnership of property to REIT.* (i) *Facts.* PRS, a partnership for Federal income tax purposes, has three partners: TE, a C corporation (within the meaning of paragraph (a)(2)(i) of this section) that is also a tax-exempt entity (within the meaning of § 1.337(d)-4(c)(2)), owns 50 percent of the capital and profits of PRS; A, an individual, owns 30 percent of the capital and profits of PRS; and Y, a C corporation (within the meaning of paragraph (a)(2)(i) of this section), owns the remaining 20 percent. PRS owns a building that it leases for commercial use (Property 1). On January 1, Year 2, when PRS has an adjusted basis in Property 1 of \$100 and Property 1 has a fair market value of \$500, PRS transfers Property 1 to X, a REIT, in exchange for stock of X in an exchange described in section 351. PRS does not elect deemed sale treatment under paragraph (c) of this section. TE would not be subject to tax with respect to any gain that would be allocated to it if PRS had sold Property 1 to an unrelated party at fair market value.

(ii) *Analysis.* The transfer of Property 1 by PRS to X is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section to the extent of any gain or loss that would be allocated to any C corporation partner if PRS sold Property 1 at fair market value to an unrelated party on the deemed sale date. TE and Y are C corporations, but A is not a C corporation within the meaning of paragraph (a)(2)(i) of this section. Therefore, the transfer of Property 1 by PRS to X is a conversion transaction within the meaning of paragraph (a)(2)(ii) of this section to the extent of the gain in Property 1 that would be allocated to TE and Y. Pursuant to paragraph (d)(4) of this section, paragraph (a)(1) of this section does not apply to the extent of the gain that would be allocated to TE if PRS had sold Property 1 to an unrelated party at fair market value on the deemed sale

date. If PRS were to sell Property 1 to an unrelated party at fair market value on the deemed sale date, PRS would allocate \$80 of built-in gain to Y. Thus, X is subject to section 1374 treatment on Property 1 with respect to \$80 of built-in gain.

(f) *Effective/Applicability date—(1) In general.* Except as provided in paragraph (f)(2) of this section, 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.

(2) *Special rule.* Paragraphs (a)(2), (d)(1), (d)(3), (d)(4), and (e) of this section apply to conversion transactions that occur on or after August 2, 2013. However, taxpayers may apply paragraphs (a)(2), (d)(1), (d)(3), (d)(4), and (e) of this section to conversion transactions that occurred before August 2, 2013. For conversion transactions that occurred on or after January 2, 2002 and before August 2, 2013, see § 1.337(d)-7 as contained in 26 CFR part 1 in effect on April 1, 2013.

Beth Tucker,
Deputy Commissioner for Services and Enforcement.

Approved: June 25, 2013.

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9627]

RIN 1545-BL04

Mixed Straddles; Straddle-by-Straddle Identification Under Section 1092(b)(2)(A)(i)(I)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains guidance for those taxpayers electing to establish a mixed straddle using straddle-by-straddle identification. These temporary regulations explain how to account for unrealized gain or loss on a position held by a taxpayer prior to the time the taxpayer establishes a mixed straddle using straddle-by-straddle identification. The text of these temporary regulations also serves as the text of the proposed regulations (REG-112815-12) set forth