

NAREIT Alert Important Industry Updates from NAREIT

Tax Report 2017-1 [Treas. Reg. § 1.337\(d\)-7](#) and [Temp. Treas. Reg. § 1.337\(d\)-7T](#)

Compendium References:

6.01 Distributions—Generally

7.03 - Taxation of REITs - Built in Gains

9.00 Reorganizations

On Jan. 17, 2017, the Treasury Department issued [final regulations](#) confirming that the built-in gain recognition period for REITs and regulated investment companies (RICs) is the same as that applicable to S corporations, *i.e.*, five years. If an S corporation (or REIT or RIC) disposes of former C corporation assets originally acquired as a result of conversion or in certain carryover basis transactions with built-in gain (BIG) during the BIG recognition period, it is liable for an entity-level tax on the BIG.

By way of background, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), enacted on Dec. 18, 2015, generally prevents tax-free spin-offs of REITs by C corporations after Dec. 7, 2015. However, the PATH Act allows REITs to spin off other REITs and taxable REIT subsidiaries (TRSs) held for at least three years on a tax-free basis. In addition, the PATH Act grandfathered companies from the spin-off rule if they had a pending IRS ruling request on Dec. 7, 2015. Separately, effective for taxable years beginning after Dec. 31, 2014, the PATH Act reduced the BIG recognition period to five years. Because the REIT built-in gain period is based upon the S corporation BIG period, the REIT BIG period also was reduced to five years.

On June 8, 2016, the IRS issued [final and temporary regulations](#) and [proposed regulations](#) (collectively, the Regulations). Effective for sales of former C corporation BIG property acquired by a REIT after Aug. 8, 2016, the Regulations imposed a 10-year BIG period for REITs (REIT conversions or acquisitions by REITs of C corporation BIG property prior to Aug. 8, 2016 remained subject to the 5-year PATH Act rule). Additionally, the Regulations imposed corporate-level tax on any BIG of a C corporation that is acquired by, or makes an election to be, a REIT (generally, a conversion transaction) during the twenty-year period beginning on the date that is ten years before the date of a section 355 spin-off (the Automatic Deemed Sale Rule).

Pursuant to a [correction](#) issued on June 28, 2016, the latter provision will apply only to spin-offs completed after Dec. 7, 2015. The Regulations contain exceptions consistent with the PATH Act regarding distributions by REITs of other REITs, TRSs, and with regard to companies that had a pending ruling request on Dec. 7, 2015.

On July 19, 2016, NAREIT submitted [comments](#) in response to the Regulations. Further, on Oct. 18, 2016, the Chairmen and the Ranking Members of the House Ways & Means and Senate Finance Committee sent a [letter](#) to then Treasury Secretary Lew that stated their belief that Congress intended that REITs and RICs use the same 5-year BIG recognition period as S corporations, and they asked the Treasury Department to amend the regulations to reflect such legislative intent. Tony Edwards of NAREIT also testified at the Nov. 9, 2016 Treasury and IRS hearing on the Regulations.

The final regulations issued Jan. 17, 2017 provide that the term "recognition period" means the recognition period described in section 1374(d)(7) (that is, a 5-year period), beginning on the first day of a REIT or RIC's taxable year (in the case of a REIT/RIC election) and, in the case of other conversion transactions, on the day the RIC or the REIT acquires the property. Although the final regulations will apply prospectively to conversion transactions after Feb. 17, 2017, taxpayers may choose to apply the 5-year recognition period, instead of the 10-year recognition period in the temporary regulations, to conversion transactions occurring on or after Aug. 8, 2016, and on or before Feb. 17, 2017.

Additionally, the Jan. 17 final regulations are narrowly focused on the REIT/RIC recognition period and do not address the Automatic Deemed Sale Rule. The preamble to these regulations states that "[t]he Treasury Department and the IRS continue to study the other issues addressed in the temporary regulations and the proposed regulations, including other issues raised by the comment, and welcome further comment on those issues."

On Jan. 20, 2017, the White House released [a memorandum](#) ordering a freeze on regulatory actions. Among other actions, the memorandum orders agencies to temporarily postpone for 60 days the effective date of regulations that have been published in the Federal Register but are not yet effective." Although these final regulations are effective for transactions occurring after the publication Jan. 20 memorandum, the preamble to the regulations specifically states "[t]hese regulations are effective January 18, 2017." The effect of the Administration's Jan. 20 memorandum on these regulations is not yet clear.

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