

removed and “§ 1.337(d)–6” is added in its place.

4. In paragraph (d), last sentence, the reference to “§ 1.337(d)–7T” is removed and “§ 1.337(d)–7” is added in its place.

Par. 4. Section 1.337(d)–6 is added to read as follows:

§ 1.337(d)–6 New transitional rules imposing tax on property owned by a C corporation that becomes property of a RIC or REIT.

(a) *General rule*—(1) *Property owned by a C corporation that becomes property of a RIC or REIT.* If property owned by a C corporation (as defined in paragraph (a)(2)(i) of this section) becomes the property of a RIC or REIT (the converted property) in a conversion transaction (as defined in paragraph (a)(2)(ii) of this section), then deemed sale treatment will apply as described in paragraph (b) of this section, unless the RIC or REIT elects section 1374 treatment with respect to the conversion transaction as provided in paragraph (c) of this section. See paragraph (d) of this section for exceptions to this paragraph (a).

(2) *Definitions*—(i) *C corporation.* For purposes of this section, the term *C corporation* has the meaning provided in section 1361(a)(2) except that the term does not include a RIC or REIT.

(ii) *Conversion transaction.* For purposes of this section, 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.

(b) *Deemed sale treatment*—(1) *In general.* If property owned by a C corporation becomes the property of a RIC or REIT in a conversion transaction, then the C corporation recognizes gain and loss as if it sold the converted property to an unrelated party at fair market value on the deemed sale date (as defined in paragraph (b)(3) of this section). This paragraph (b) does not apply if its application would result in the recognition of a net loss. For this purpose, *net loss* is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.

(2) *Basis adjustment.* If a corporation recognizes a net gain under paragraph (b)(1) of this section, then the converted property has a basis in the hands of the RIC or REIT equal to the fair market value of such property on the deemed sale date.

(3) *Deemed sale date*—(i) *RIC or REIT qualifications.* If the conversion transaction is a qualification of a C corporation as a RIC or REIT, then the deemed sale date is the end of the last

day of the C corporation's last taxable year before the first taxable year in which it qualifies to be taxed as a RIC or REIT.

(ii) *Other conversion transactions.* If the conversion transaction is a transfer of property owned by a C corporation to a RIC or REIT, then the deemed sale date is the end of the day before the day of the transfer.

(4) *Example.* The rules of this paragraph (b) are illustrated by the following example:

Example. Deemed sale treatment on merger into RIC. (i) X, a calendar-year taxpayer, has qualified as a RIC since January 1, 1991. On May 31, 1994, Y, a C corporation and calendar-year taxpayer, transfers all of its property to X in a transaction that qualifies as a reorganization under section 368(a)(1)(C). X does not elect section 1374 treatment under paragraph (c) of this section and chooses not to rely on § 1.337(d)–5. As a result of the transfer, Y is subject to deemed sale treatment under this paragraph (b) on its tax return for the short taxable year ending May 31, 1994. On May 31, 1994, Y's only assets are Capital Asset, which has a fair market value of \$100,000 and a basis of \$40,000 as of the end of May 30, 1994, and \$50,000 cash. Y also has an unrestricted net operating loss carryforward of \$12,000 and accumulated earnings and profits of \$50,000. Y has no taxable income for the short taxable year ending May 31, 1994, other than gain recognized under this paragraph (b). In 1997, X sells Capital Asset for \$110,000. Assume the applicable corporate tax rate is 35%.

(ii) Under this paragraph (b), Y is treated as if it sold the converted property (Capital Asset and \$50,000 cash) at fair market value on May 30, 1994, recognizing \$60,000 of gain (\$150,000 amount realized—\$90,000 basis). Y must report the gain on its tax return for the short taxable year ending May 31, 1994. Y may offset this gain with its \$12,000 net operating loss carryforward and will pay tax of \$16,800 (35% of \$48,000).

(iii) Under section 381, X succeeds to Y's accumulated earnings and profits. Y's accumulated earnings and profits of \$50,000 increase by \$60,000 and decrease by \$16,800 as a result of the deemed sale. Thus, the aggregate amount of subchapter C earnings and profits that must be distributed to satisfy section 852(a)(2)(B) is \$93,200 (\$50,000 + \$60,000 – \$16,800). X's basis in Capital Asset is \$100,000. On X's sale of Capital Asset in 1997, X recognizes \$10,000 of gain, which is taken into account in computing X's net capital gain for purposes of section 852(b)(3).

(c) *Election of section 1374 treatment*—(1) *In general*—(i) *Property owned by a C corporation that becomes property of a RIC or REIT.* Paragraph (b) of this section does not apply if the RIC or REIT that was formerly a C corporation or that acquired property from a C corporation makes the election described in paragraph (c)(4) of this section. A RIC or REIT that makes such an election will be subject to tax on the

net built-in gain in the converted property under the rules of section 1374 and the regulations thereunder, as modified by this paragraph (c), as if the RIC or REIT were an S corporation.

(ii) *Property subject to the rules of section 1374 owned by a RIC, REIT, or S corporation that becomes property of a RIC or REIT.* If property subject to the rules of section 1374 owned by a RIC, a REIT, or an S corporation (the predecessor) becomes the property of a RIC or REIT (the successor) in a continuation transaction, the rules of section 1374 apply to the successor to the same extent that the predecessor was subject to the rules of section 1374 with respect to such property, and the 10-year recognition period of the successor with respect to such property is reduced by the portion of the 10-year recognition period of the predecessor that expired before the date of the continuation transaction. For this purpose, a continuation transaction means the qualification of the predecessor as a RIC or REIT or the transfer of property from the predecessor to the successor in a transaction in which the successor's basis in the transferred property is determined, in whole or in part, by reference to the predecessor's basis in that property.

(2) *Modification of section 1374 treatment*—(i) *Net recognized built-in gain for REITs*—(A) *Prelimitation amount.* The prelimitation amount determined as provided in § 1.1374–2(a)(1) is reduced by the portion of such amount, if any, that is subject to tax under section 857(b)(4), (5), (6), or (7). For this purpose, the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is computed as follows:

(1) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(A), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is the tax imposed by section 857(b)(5) multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in section 856(c)(2) and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in section 856(c)(2).

(2) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(B), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is