

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)(3) 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)(3).

(B) *Taxable income limitation.* The taxable income limitation determined as provided in § 1.1374-2(a)(2) is reduced by an amount equal to the tax imposed under section 857(b)(5), (6), and (7).

(ii) *Loss carryforwards, credits and credit carryforwards.*—(A) *Loss carryforwards.* Consistent with paragraph (b)(1)(i) of this section, net operating loss carryforwards and capital loss carryforwards arising in taxable years for which the corporation that generated the loss was not subject to subchapter M of chapter 1 of the Internal Revenue Code are allowed as a deduction against net recognized built-in gain to the extent allowed under section 1374 and the regulations thereunder. Such loss carryforwards must be used as a deduction against net recognized built-in gain for a taxable year to the greatest extent possible before such losses can be used to reduce other investment company taxable income for purposes of section 852(b) or other real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

(B) *Credits and credit carryforwards.* Consistent with paragraph (b)(1)(i) of this section, minimum tax credits and business credit carryforwards arising in taxable years for which the corporation that generated the credit was not subject to subchapter M of chapter 1 of the Internal Revenue Code are allowed to reduce the tax imposed on net recognized built-in gain under this paragraph (b) to the extent allowed under section 1374 and the regulations thereunder. Such credits and credit carryforwards must be used to reduce the tax imposed under this paragraph (b) on net recognized built-in gain for a taxable year to the greatest extent possible before such credits and credit carryforwards can be used to reduce the tax, if any, on other investment company taxable income for purposes of section 852(b) or on other real estate investment trust taxable income for purposes of section 857(b) for that taxable year.

(iii) *10-year recognition period.* In the case of a conversion transaction that is a qualification of a C corporation as a RIC or REIT, the 10-year recognition period described in section 1374(d)(7) begins on the first day of the RIC's or

REIT's first taxable year. In the case of other conversion transactions, the 10-year recognition period begins on the day the property is acquired by the RIC or REIT.

(3) *Coordination with subchapter M rules.*—(i) *Recognized built-in gains and losses subject to subchapter M.* Recognized built-in gains and losses of a RIC or REIT are included in computing investment company taxable income for purposes of section 852(b)(2), real estate investment trust taxable income for purposes of section 857(b)(2), capital gains for purposes of sections 852(b)(3) and 857(b)(3), gross income derived from sources within any foreign country or possession of the United States for purposes of section 853, and the dividends paid deduction for purposes of sections 852(b)(2)(D), 852(b)(3)(A), 857(b)(2)(B), and 857(b)(3)(A). In computing such income and deduction items, capital loss carryforwards and net operating loss carryforwards that are used by the RIC or REIT to reduce recognized built-in gains are allowed as a deduction, but only to the extent that they are otherwise allowable as a deduction against such income under the Internal Revenue Code (including section 852(b)(2)(B)).

(ii) *Treatment of tax imposed.* The amount of tax imposed under this paragraph (b) on net recognized built-in gain for a taxable year is treated as a loss sustained by the RIC or the REIT during such taxable year. The character of the loss is determined by allocating the tax proportionately (based on recognized built-in gain) among the items of recognized built-in gain included in net recognized built-in gain. With respect to RICs, the tax imposed under this paragraph (b) on net recognized built-in gain is treated as attributable to the portion of the RIC's taxable year occurring after October 31.

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

Example. Section 1374 treatment on REIT election. (i) X, a C corporation that is a calendar-year taxpayer, elects to be taxed as a REIT on its 2004 tax return, which it files on March 15, 2005. As a result, X is a REIT for its 2004 taxable year and is subject to section 1374 treatment under this paragraph (b). X does not elect deemed sale treatment under paragraph (c) of this section. As of the beginning of the 2004 taxable year, X's property consisted of Real Property, which is not section 1221(a)(1) property and which had a fair market value of \$100,000 and an adjusted basis of \$80,000, and \$25,000 cash. X also had accumulated earnings and profits of \$25,000, unrestricted capital loss carryforwards of \$3,000, and unrestricted business credit carryforwards of \$2,000. On

July 1, 2007, X sells Real Property for \$110,000. For its 2007 taxable year, X has no other income or deduction items. Assume the highest corporate tax rate is 35%.

(ii) Upon its election to be taxed as a REIT, X retains its \$80,000 basis in Real Property and its \$25,000 accumulated earnings and profits. X retains its \$3,000 of capital loss carryforwards and its \$2,000 of business credit carryforwards. To satisfy section 857(a)(2)(B), X must distribute \$25,000, an amount equal to its earnings and profits accumulated in non-REIT years, to its shareholders by the end of its 2004 taxable year.

(iii) Upon X's sale of Real Property in 2007, X recognizes gain of \$30,000 (\$110,000—\$80,000). X's recognized built-in gain for purposes of applying section 1374 is \$20,000 (\$100,000 fair market value as of the beginning of X's first taxable year as a REIT—\$80,000 basis). Because X's \$30,000 of net income for the 2007 taxable year exceeds the net recognized built-in gain of \$20,000, the taxable income limitation does not apply. X, therefore, has \$20,000 net recognized built-in gain for the year. Assuming that X has not used its \$3,000 of capital loss carryforwards in a prior taxable year and that their use is allowed under section 1374(b)(2) and § 1.1374-5, X is allowed a \$3,000 deduction against the \$20,000 net recognized built-in gain. X would owe tax of \$5,950 (35% of \$17,000) on its net recognized built-in gain, except that X may use its \$2,000 of business credit carryforwards to reduce the tax, assuming that X has not used the credit carryforwards in a prior taxable year and that their use is allowed under section 1374(b)(3) and § 1.1374-6. Thus, X owes tax of \$3,950 under this paragraph (b).

(iv) For purposes of subchapter M of chapter 1 of the Internal Revenue Code, X's earnings and profits for the year increase by \$26,050 (\$30,000 capital gain on the sale of Real Property—\$3,950 tax under this paragraph (b)). For purposes of section 857(b)(2) and (b)(3), X's net capital gain for the year is \$23,050 (\$30,000 capital gain reduced by \$3,000 capital loss carryforward and further reduced by \$3,950 tax).

(c) *Election of deemed sale treatment.*—(1) *In general.* Paragraph (b) of this section does not apply if the C corporation that qualifies as a RIC or REIT or transfers property to a RIC or REIT makes the election described in paragraph (c)(5) of this section. A C corporation that makes such an election 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 (c)(3) of this section). See paragraph (c)(4) of this section concerning limitations on the use of loss in computing gain. This paragraph (c) 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.