

(2) *Basis adjustment.* If a corporation recognizes a net gain under paragraph (c)(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) *Anti-stuffing rule.* A C corporation must disregard converted property in computing gain or loss recognized on the conversion transaction under this paragraph (c), if—

(i) The converted property was acquired by the C corporation in a transaction to which section 351 applied or as a contribution to capital;

(ii) Such converted property had an adjusted basis immediately after its acquisition by the C corporation in excess of its fair market value on the date of acquisition; and

(iii) The acquisition of such converted property by the C corporation was part of a plan a principal purpose of which was to reduce gain recognized by the C corporation in connection with the conversion transaction. For purposes of this paragraph (c)(4), the principles of section 336(d)(2) apply.

(5) *Making the deemed sale election.* A C corporation (or a partnership to which the principles of this section apply under paragraph (e) of this section) makes the deemed sale election with the following statement: “[Insert name and employer identification number of electing corporation or partnership] elects deemed sale treatment under § 1.337(d)-7(c) with respect to its property that was converted to property of, or transferred to, a RIC or REIT, [insert name and employer identification number of the RIC or REIT, if different from the name and employer identification number of the C corporation or partnership].” This statement must be attached to the Federal income tax return of the C corporation or partnership for the taxable year in which the deemed sale occurs. An election under this paragraph (c) is irrevocable.

(6) *Examples.* The rules of this paragraph (c) are illustrated by the following examples:

*Example 1. Deemed sale treatment on merger into RIC.* (i) X, a calendar-year taxpayer, has qualified as a RIC since January 1, 2001. On May 31, 2004, 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). As a result of the transfer, Y would be subject to section 1374 treatment under paragraph (b) of this section but for its timely election of deemed sale treatment under this paragraph (c). As a result of such election, Y is subject to deemed sale treatment on its tax return for the short taxable year ending May 31, 2004. On May 31, 2004, 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, 2004, 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, 2004, other than gain recognized under this paragraph (c). In 2007, X sells Capital Asset for \$110,000. Assume the applicable corporate tax rate is 35%.

(ii) Under this paragraph (c), Y is treated as if it sold the converted property (Capital Asset and \$50,000 cash) at fair market value on May 30, 2004, 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, 2004. 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 2007, 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).

*Example 2. Loss limitation.* (i) Assume the facts are the same as those described in *Example 1*, but that, prior to the reorganization, a shareholder of Y contributed to Y a capital asset, Capital Asset 2, which has a fair market value of \$10,000 and a basis of \$20,000, in a section 351 transaction.

(ii) Assuming that Y's acquisition of Capital Asset 2 was made pursuant to a plan a principal purpose of which was to reduce the amount of gain that Y would recognize in connection with the conversion transaction, Capital Asset 2 would be disregarded in computing the amount of Y's net gain on the conversion transaction.

(d) *Exceptions—(1) Gain otherwise recognized.* Paragraph (a) of this section does not apply to any conversion transaction to the extent that gain or loss otherwise is recognized on such

conversion transaction. See, for example, sections 336, 351(b), 351(e), 356, 357(c), 367, 368(a)(2)(F), and 1001.

(2) *Re-election of RIC or REIT status—(i) Generally.* Except as provided in paragraphs (d)(2)(ii) and (iii) of this section, paragraph (a)(1) of this section does not apply to any corporation that—

(A) Immediately prior to qualifying to be taxed as a RIC or REIT was subject to tax as a C corporation for a period not exceeding two taxable years; and

(B) Immediately prior to being subject to tax as a C corporation was subject to tax as a RIC or REIT for a period of at least one taxable year.

(ii) *Property acquired from another corporation while a C corporation.* The exception described in paragraph (d)(2)(i) of this section does not apply to property acquired by the corporation while it was subject to tax as a C corporation from any person in a transaction that results in the acquirer's basis in the property being determined by reference to a C corporation's basis in the property.

(iii) *RICs and REITs previously subject to section 1374 treatment.* If the RIC or REIT had property subject to paragraph (b) of this section before the RIC or REIT became subject to tax as a C corporation as described in paragraph (d)(2)(i) of this section, then paragraph (b) of this section applies to the RIC or REIT upon its requalification as a RIC or REIT, except that the 10-year recognition period with respect to such property is reduced by the portion of the 10-year recognition period that expired before the RIC or REIT became subject to tax as a C corporation and by the period of time that the corporation was subject to tax as a C corporation.

(e) *Special rule for partnerships.* The principles of this section apply to property transferred by a partnership to a RIC or REIT to the extent of any C corporation partner's distributive share of the gain or loss in the transferred property. 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.