

AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

# BDO KNOWS:

## FEDERAL TAX



### SUBJECT

## FINAL REGULATIONS ISSUED CONFORMING REIT BUILT-IN-GAIN RECOGNITION PERIOD TO FIVE YEAR RECOGNITION PERIOD, APPLICABLE TO S CORPORATIONS

### SUMMARY

On January 17, 2017, the Treasury Department issued final regulations (T.D. 9810) that conform the built-in-gain recognition period for real estate investment trusts ("REITs") and regulated investment companies ("RICs") to five years, the same period for S corporations. The regulations issued under Code Section 337(d) provide for a five-year built-in-gain recognition period during which a REIT or RIC may be subject to corporate-level tax on certain dispositions of property acquired from a C corporation in a conversion transaction. The final regulations adopt, with modifications, a portion of the temporary regulations published on June 8, 2016 (TD 9770).

Treasury Regulation Section 1.337(d)-7 generally provides that if a C corporation property becomes property of a REIT or a RIC through either the C corporation's conversion to such an entity or the C corporation's transferring of assets to a REIT or RIC, the REIT or RIC will be subject to built-in-gains tax under IRC Section 1374 on the property. This recognition period rule does not apply if the C corporation transferor makes a deemed sale election to recognize gain or loss as if it sold the property to an unrelated person at the fair market value of such property at the time of conversion or transfer. Historically, the built-in-gain recognition period was 10 years.

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## DETAILS

In December 2015, Congress enacted the Protecting Americans Tax Act (“PATH”) which permanently set the built-in-gain recognition period under IRC Section 1374(d)(7) for C corporations becoming or merging into S corporations at 5 years. Since 2008 and prior to the PATH Act, the standard 10-year recognition period had been reduced annually to 5 years in extenders bills. Legislative history demonstrated and acknowledged that the built-in-gain recognition period had consistently been the same between S corporations, REITs and RICs. As a result, the Joint Committee on Taxation’s technical explanation of the PATH Act confirmed that the new 5-year recognition period applied to REITs and RICs as well as S corporations.

On June 8, 2016, Treasury issued temporary regulations, and proposed regulations cross referencing the temporary regulations, under IRC Section 337(d) and announced that the built-in-gain recognition period for REITs and RICs would revert to 10 years for REIT conversions and acquisitions occurring on or after August 8, 2016. These temporary regulations also called for deemed sale treatment, without the ability to elect IRC Section 1374 treatment for any C corporation that engages in a conversion transaction within 10 years of a tax free spin off. This deemed treatment applied to any situation in which a C corporation converted to REIT or RIC status, for which there was no private letter ruling submission prior to December 7, 2015, or spin offs that occurred prior to the change. These proposed regulations therefore seemingly overruled Congress and reinstated the 10-year recognition period rule.

The Treasury Department and the IRS received one written comment after the issuance of the temporary regulations. The comment requested a public hearing, and such hearing was held on November 9, 2016. The comment requested that the temporary and the proposed regulations with respect to the recognition period be immediately withdrawn and the recognition period with respect to REITs and RICs be defined with reference to the recognition period of IRC Section 1374(d)(7), which is currently a 5-year period as a result of the PATH Act. The comment asserted that the recognition period applicable to REITs and RICs as provided in the temporary and proposed regulations was not consistent with Congress’s intent in the PATH Act and prior administrative guidance. After the public hearing, a Treasury official stated that “we anticipate issuing final regulations that would modify the recognition period for REITs and RICs to confirm to the 5-year period that applies to S corporations.”

On January 17, 2017, the Treasury issued the final regulations under IRC Section 337(d). The regulations provide that the term “recognition period” means the recognition period as described in IRC Section 1374(d)(7), the 5-year period, beginning on the first day of the REIT or RIC’s taxable year, in the case of an election to be taxed as such, and in the case of other conversion transactions, on the day the REIT or RIC acquires the property. It should be noted that the final regulations do not address the “Automatic Deemed Sale Rule.” The preamble to the regulations indicates that the Treasury Department and the IRS continue to study this and other issues addressed in the temporary and proposed regulations, including other issues raised by comments. Comments are still being taken on these issues.

Based on the effective date as outlined in the final regulations, the regulations were to be effective and apply prospectively from February 18, 2017, 30 days after the publication of the regulations in the Federal Register, but taxpayers may choose to apply the definition of recognition period in the final regulations instead of the 10-year period as contained in the temporary regulations, for all conversion transaction or property acquisitions occurring on or after August 8, 2016, and on or before February 18, 2017. However, it should be noted that since the regulations are effective 30 days after publication, the final regulations are subject to the Presidential regulatory freeze that was issued on January 22, 2017. Under this freeze, regulations that have been published in the Office of the Federal Register but have not taken effect are subject to a 60-day postponement.

## BDO INSIGHTS

The final regulations are consistent with the intent of Congress to keep the built-in-gain recognition period for REITs and RICs the same as S corporations, which has historically been the case.

There does not appear to be policy concerns that would result in modification of the regulations as a result of the regulatory freeze. However, it should be noted that the effective date is subject to the freeze and must be taken in consideration.

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