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Report No. 1382
October 10, 2017

The Honorable David Kautter
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Re: *Report No. 1382 on Final, Temporary and Proposed Regulations Under Section 337(d) Relating to Certain Transfers of Property to Regulated Investment Companies and Real Estate Investment Trusts*

Dear Messrs. Kautter, Koskinen and Paul:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report provides comments on final and temporary regulations (the "**2016 Temporary Regulations**") and proposed regulations (the "**2016 Proposed Regulations**" and, together with the 2016 Temporary Regulations, the "**regulations**") issued under Sections 337(d) and 355(h) of the Internal Revenue Code of 1986, as amended, which require corporate-level gain recognition in certain transactions in which property of a C corporation becomes the property of a real estate investment trust (a "**REIT**").

Generally, the 2016 Temporary Regulations apply when a Section 355 distribution occurs within ten years before or after a "conversion transaction" (for this purpose, a transfer from a C corporation to a REIT or a C corporation's election of REIT status) involving the distributing or controlled corporation (or a predecessor, successor or member of the

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separate affiliated group ("**SAG**") of the distributing or controlled corporation). Where the Section 355 distribution precedes the "conversion transaction," the 2016 Temporary Regulations generally treat the corporation transferring property to the REIT as making a "deemed sale election" and recognizing all built-in gain in the transferred assets. Where the conversion transaction precedes the Section 355 distribution, the 2016 Temporary Regulations generally require the REIT, in the year of the distribution, to recognize the remaining built-in gain in its assets attributable to the period when the assets were held by a C corporation (gain the recognition of which would otherwise be deferred, subject to the requirements of Section 1374).

In our view, the regulations in general appropriately focus on restricting transactions that achieve results similar to transactions barred by the Protecting Americans from Tax Hikes Act of 2015 (the "**PATH Act**"), chiefly the merger of a distributing or controlled corporation (or a SAG member of either) with and into a REIT acquiror, which has an effect similar to that of a REIT election by the corporation (which is barred in many circumstances by the PATH Act). However, as discussed in detail in the attached report, and as echoed in the Treasury Department's October 2, 2017 report on identifying and reducing tax regulatory burdens, we believe that the 2016 Temporary Regulations require excessive corporate-level gain recognition in some situations. We recommend an alternative approach that we believe would address this concern and also suggest certain other minor amendments to the regulations.

Below is a brief summary of our principal comments:

A. In the case of a conversion transaction involving a REIT occurring within ten years after a Section 355 distribution, the 2016 Temporary Regulations should be modified to require corporate-level gain recognition solely with respect to built-in gain existing at the time of the distribution and with respect to assets held at the time of the distribution (and possibly "successor assets").

B. The 2016 Temporary Regulations should not apply to certain wholly internal Section 355 distributions subsequent to which the ultimate parent of the distributing and controlled corporations elects REIT status.

C. The definitions of "predecessors" and "successors" in Temporary Regulation Section 1.337(d)-7T(f)(2) should be clarified.

D. The exception in Temporary Regulation Section 1.337(d)-7T(f)(3)(i) (for Section 355 distributions in which the distributing and controlled corporations are REITs immediately after the distribution and remain REITs for two years thereafter) should be amended to match the exception codified in Section 355(h)(2)(A) (which requires only that the distributing and controlled corporations are REITs immediately after

the distribution), or the above temporary regulation should be amended to exempt inadvertent REIT terminations.

E. The definition of "converted property" in the 2016 Proposed Regulations should be adopted, subject to minor clarifications.

F. If the government believes that the regulations may properly permit REIT elections otherwise barred by Section 856(c)(8), at the cost of a toll charge on "converted property," the regulations should clearly state as much.

We appreciate your consideration of our comments. Please let us know if you would like to discuss these matters further or if we can assist you in any other way.

Respectfully submitted,

Michael S. Farber
Chair

Attachment

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Report 1382

New York State Bar Association

Tax Section

Report on Final, Temporary and Proposed Regulations Under Section 337(d) Relating to Certain Transfers of Property to Regulated Investment Companies and Real Estate Investment Trusts

October 10, 2017

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New York State Bar Association

Tax Section

Report on Final, Temporary and Proposed Regulations Under Section 337(d) Relating to Certain Transfers of Property to Regulated Investment Companies and Real Estate Investment Trusts

This report[1] of the Tax Section of the New York State Bar Association (the "**NYSBA**") provides comments on the final and temporary regulations (the "**2016 Temporary Regulations**")[2] and proposed regulations (the "**2016 Proposed Regulations**")[3] issued under Sections 337(d) and 355(h) of the Code, requiring corporate-level gain recognition in certain transactions in which property of a C corporation becomes the property of a real estate investment trust (a "**REIT**") within ten years of a distribution qualifying under Section 355. In the preamble to the 2016 Proposed Regulations, the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**Service**") requested comments with respect to several parts of the 2016 Proposed Regulations (and by extension the 2016 Temporary Regulations), and Notice

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1 The principal drafters of this report are Richard M. Nugent and L. Matthew Waterhouse. Helpful comments were received from William D. Alexander, Daniel Z. Altman, Daniel J. Berger, Andrew H. Braiterman, Patrick M. Cox, Michael S. Farber, Stephen B. Land, Michael T. Mollerus, Deborah L. Paul, Stuart L. Rosow, Michael L. Schler, David R. Sicular and Karen G. Sowell. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or its House of Delegates.

2 Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs]; Final and Temporary Regulations, T.D. 9770, 81 Fed. Reg. 36,793 (June 8, 2016) [hereinafter *2016 Temporary Regulations*]. Unless otherwise indicated, all "**Section**" references are to the Internal Revenue Code of 1986, as amended (the "**Code**"), or the Treasury Department regulations promulgated or proposed thereunder, as the context indicates, all as in effect as of the date of this report.

3 Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs], REG–126452–15, 81 Fed. Reg. 36,816 (June 8, 2016) [hereinafter *2016 Proposed Regulations*].

2017-38 also requested comments with respect to the 2016 Temporary Regulations.[4] In addition, as discussed below, Treasury subsequently issued a report (the "**Treasury Report**"), dated October 2, 2017, stating that it is considering amending the 2016 Temporary Regulations to limit the amount of taxable gain recognized in certain situations.

Part I of this report summarizes our comments on the regulations. Part II provides a summary of Section 337(d), the Protecting Americans from Tax Hikes Act of 2015 (the "**PATH Act**"),[5] and the 2016 Temporary Regulations and 2016 Proposed Regulations. Part III discusses and explains our comments in greater detail.

I. SUMMARY OF COMMENTS

A. In the case of a conversion transaction (defined below) involving a REIT occurring within ten years after a Section 355 distribution, Temporary Regulation Section 1.337(d)-7T(c)(6) at times requires corporate-level recognition of (i) built-in gain in assets not held by a distributing or controlled corporation at the time of a Section 355 distribution and (ii) built-in gain arising after the time of a Section 355 distribution in assets held at the time of that distribution (such additional assets and/or later appreciation, "**additional appreciation**"). We recommend that this provision be amended to disregard additional appreciation and generally require corporate-level gain recognition solely with respect to built-in gain existing at the time of a Section 355 distribution and with respect to assets held at the time of that distribution (and possibly other assets received in exchange for such assets in tax-free carryover basis transactions).

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4 Notice 2017-38, 2017-30 I.R.B. 147.

5 Consolidated Appropriations Act, 2016, Div. Q, Pub. L. 114-113, 129 Stat. 2242 (2015) [hereinafter *PATH Act*].

B. We recommend that the 2016 Temporary Regulations should not apply to certain wholly internal Section 355 distributions subsequent to which the ultimate parent of the distributing and controlled corporations elects REIT status, because these transactions do not implicate the concerns at which the 2016 Temporary Regulations are aimed.

C. We recommend that the definitions of "predecessors" and "successors" in Temporary Regulation Section 1.337(d)-7T(f)(2) be clarified to provide greater certainty regarding when the 2016 Temporary Regulations will require corporate-level gain recognition. We acknowledge that it may be necessary to define these terms by reference to transactions not described in Section 381; if so, the government should also consider including a suitable limitation or limitation(s) on the range of entities that can be treated as predecessors or successors.

D. We recommend amending the exception in Temporary Regulation Section 1.337(d)-7T(f)(3)(i) to match the exception codified in Section 355(h)(2)(A), or narrowing the discrepancy between these authorities by exempting Section 355 distributions in which both the distributing corporation and the controlled corporation are REITs immediately after the distribution, but one or both corporations lose REIT status within two years thereafter and loss of REIT status was not planned at the time of the distribution.

E. We recommend that the definition of "converted property" in the 2016 Proposed Regulations be adopted, subject to minor clarifications.

F. If the 2016 Temporary Regulations are intended to permit REIT elections otherwise barred by Section 856(c)(8), at the cost of a toll charge on "converted property," we suggest that the regulations be amended to clearly provide for such an override.

G. We make no recommendation for or against applying the regulations to regulated investment company ("**RIC**") conversion transactions (defined below) undertaken in proximity to Section 355 distributions.

II. BACKGROUND

A. Background on Section 337(d) & REIT Spinoffs

Section 337(d), enacted as part of the repeal of the *General Utilities*[6] doctrine in the Tax Reform Act of 1986, provides the Secretary of the Treasury with the authority to issue regulations to uphold the purposes of that repeal, including regulations "to ensure that such purposes may not be circumvented . . . through the use of a regulated investment company, real estate investment trust, or tax-exempt entity."[7] Final regulations issued under Section 337(d) in 2003 generally treat appreciated assets of a C corporation acquired by a RIC or REIT in a "**conversion transaction**" (either a transfer from a C corporation to a RIC or REIT or a C corporation's election of RIC or REIT status) in accordance with Section 1374, providing that, if the RIC or REIT disposes of the assets within a set "**recognition period**," the RIC or REIT must

6 *See General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935) (permitting withdrawal of appreciated assets from corporate solution without corporate-level tax).

7 Section 337(d)(1). Section 631(a) of the Tax Reform Act of 1986 enacted Section 337(d) in essentially its current form, but this initial version of the statute did not mention REITs. Tax Reform Act of 1986, § 631(a), Pub. L. 99-514, 100 Stat. 2085, 2271-72 (1986). Congress added the explicit reference to RICs, REITs and tax-exempt entities in 1988. Technical and Miscellaneous Revenue Act of 1988, § 1006(e)(5)(A), Pub. L. 100-647, 102 Stat. 3342, 3400-01 (1988). For a discussion of the history of Section 337(d) within the context of the Tax Reform Act of 1986 and the reasons for the repeal of the *General Utilities* doctrine, see NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON NOTICE 2015-59 AND REVENUE PROCEDURE 2015-43 RELATING TO SUBSTANTIAL INVESTMENT ASSETS, *DE MINIMIS* ACTIVE TRADES OR BUSINESSES AND C-TO-RIC SPIN-OFFS 17-19 (Rep. No. 1342, Apr. 12, 2016) [hereinafter *Notice 2015-59 Report*], *reprinted in* 2016 TNT 71-22 (Apr. 13, 2016). *See also* NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON PROPOSALS FOR TREASURY REGULATIONS UNDER SECTION 337(d) RELATING TO SECTION 355 DISTRIBUTIONS (Rep. No. 638, Dec. 6, 1989), *reprinted in* 90 TNT 9-18 (Jan. 11, 1990) (commenting on Section 337(d) and the possible structure of regulations thereunder relating to Section 355 distributions).

recognize the built-in gain in the assets attributable to the period in which the assets were held by a C corporation ("**C corporation gain**").[8] Under longstanding policy dating back to Notice 88-19,[9] and subject to some changes,[10] when a C corporation transfers property to a RIC or REIT, the C corporation may either (i) elect to recognize all built-in gain in the transferred property as a result of a deemed taxable sale to an unrelated party for fair market value (a "**deemed sale election**") or (ii) transfer the property subject to the Section 1374 rules.[11]

Recently, the government identified the use of a tax-free Section 355 distribution to separate a C corporation's real estate assets into a new REIT (a "**REIT spinoff**") as potentially inappropriate.[12] Most noteworthy were several "Opco-Propco" transactions in which a C corporation holding significant real estate assets contributed those assets to a subsidiary in a Section 368(a)(1)(D) reorganization and spun off the subsidiary tax-free under Section 355, and the subsidiary then elected REIT status.[13] To address this concern, the PATH Act added

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[8] Treas. Reg. § 1.337(d)-7, T.D. 9047, 68 Fed. Reg. 12,817 (Mar. 18, 2003).

[9] 1988-1 C.B. 486.

[10] As promulgated, Notice 88-19 provided that all conversion transactions were treated as deemed sales absent an election of Section 1374 Treatment. *Id.* Regulations issued under Section 337(d) initially provided the same choice. *See* Former Temp. Reg. § 1.337(d)-5T(b), T.D. 9047, 65 Fed. Reg. 5,775, 5,776 (Feb. 7, 2000). However, in response to comments, Treasury and the Service later made Section 1374 treatment the default approach in the absence of an election of deemed sale treatment. Treas. Reg. § 1.337(d)-7(b).

[11] Treas. Reg. § 1.337(d)-7(b)-(c). Section 1374(d)(7) initially applied a ten-year recognition period for RIC, REIT and S corporation property subject to Section 1374 treatment. However, Congress frequently reduced this period and permanently reduced the period to five years in the PATH Act. *PATH Act* § 127(a), 129 Stat. at 3054.

[12] *See* Notice 2015-59, 2015-40 I.R.B. 459, 460 (REIT spinoffs "involve significant concerns relating to the device prohibition, and the business purpose and active trade or business requirements under § 355, as well as the Code provisions intended to repeal the *General Utilities* decision").

[13] *See* Priv. Ltr. Rul. 2013-37-007 (Sept. 13, 2013); Priv. Ltr. Rul. 2014-11-002 (Mar. 14, 2014); Priv. Ltr. Rul. 2014-31-020 (Aug. 1, 2014); Priv. Ltr. Rul. 2014-33-007 (Aug. 15, 2014); Priv. Ltr. Rul.

Sections 856(c)(8) and 355(h), imposing several new restrictions on REIT spinoffs. Section 856(c)(8) generally provides that neither the distributing corporation nor the controlled corporation in a Section 355 distribution (nor any successor corporation of either) may elect REIT status for any taxable year beginning before the end of the ten-year period beginning on the distribution date. Section 355(h) generally provides that Section 355 does not apply to a distribution if either the distributing corporation or the controlled corporation is a REIT.

There are several exceptions to these rules. First, Sections 856(c)(8) and 355(h) do not apply if, immediately after the relevant distribution, both the distributing corporation and the controlled corporation are REITs (the "**REIT-REIT Exception**").[14] Section 355(h) also does not apply to a REIT's distribution of the stock of a taxable REIT subsidiary (a "**TRS**") if certain requirements are satisfied (the "**REIT-TRS Exception**").[15] Finally, Sections 856(c)(8) and 355(h) do not apply to certain distributions for which the taxpayer submitted a private letter ruling request on or prior to December 7, 2015 (the "**PLR Exception**").[16]

2015-28-006 (July 10, 2015); Priv. Ltr. Rul. 2016-07-003 (Feb. 12, 2016); Priv. Ltr. Rul. 2016-37-013 (Sept. 9, 2016).

[14] Section 355(h)(2)(A). We assume that a C corporation with a REIT election that is effective immediately after a Section 355 distribution will in fact be treated as a REIT immediately after such distribution for purposes of the REIT-REIT Exception. *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015 264 n.896 (Rep. No. JCS-1-16, Mar. 2016). The 2016 Temporary Regulations appear to endorse this view, as Temporary Regulation Section 1.337(d)-7T(f)(3)(i) refers to a situation in which "[t]he distributing corporation and the controlled corporation are both REITs immediately after the related section 355 distribution (including by reason of elections under section 856(c)(1) made after the related section 355 distribution that are effective before the related section 355 distribution)".

[15] Section 355(h)(2)(B).

[16] *PATH Act* § 311(c), 129 Stat. at 3091.

B. Background on 2016 Temporary & Proposed Regulations

1. *Regulations*

In June 2016, Treasury and the Service published the 2016 Temporary Regulations in the Federal Register. The preamble to these regulations expresses concern with a transaction, ostensibly permitted under the PATH Act, in which "a taxpayer effects a tax-free separation of REIT-qualifying assets from non-qualifying assets in a section 355 distribution . . . and the REIT-qualifying assets become the assets of a REIT."[17] While Section 355(h) now bars a tax-free REIT spinoff, the PATH Act, by its terms, may not affect a pre-existing REIT's acquisition of the distributing corporation or the controlled corporation in a Section 355 distribution. Specifically, Section 355(h) may not apply because neither distributing nor controlled would be a REIT, and Section 856(c)(8) may not apply because no party to the Section 355 distribution would make a REIT election.

The preamble to the 2016 Temporary Regulations states that such a transaction may circumvent the repeal of the *General Utilities* doctrine, noting that Section 355 may allow a tax-free separation of assets that otherwise could not occur, Section 1374 may prevent or delay the imposition of corporate-level tax on the C corporation gain in the REIT-qualifying assets, and/or the taxpayer may enjoy the benefit of the C corporation gain prior to the imposition of any corporate-level tax, *e.g.*, through higher rental income attributable to appreciation in the value of the REIT-qualifying assets.[18] In addition, the preamble stated that taxpayers may be

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[17] *2016 Temporary Regulations*, 81 Fed. Reg. at 36,795.

[18] *Id.* at 36,795-96.

circumventing the PATH Act's objectives through variations of such a transaction, including through the use of the distributing or controlled corporation's affiliates.[19]

In response to these concerns, the 2016 Temporary Regulations impose several restrictions on conversion transactions occurring within ten years of a Section 355 distribution (including a distribution in which the distributing corporation recognizes gain under Section 355(d) or Section 355(e)). The 2016 Temporary Regulations generally apply where (i) a C corporation or REIT engages in a conversion transaction involving a REIT during the twenty-year period beginning ten years before the date of a Section 355 distribution (the "**related Section 355 distribution**") and (ii) the C corporation or the REIT engaging in the related Section 355 distribution is either (A) the distributing corporation or the controlled corporation or (B) a member of the distributing corporation's or the controlled corporation's separate affiliated group as defined in Section 355(b)(3)(B) (such a group, a "**SAG**," and the combination of clauses (i) and (ii), a "**Spin-Conversion Nexus**").[20] Spin-Conversion Nexuses do not include (i) distributions in which the distributing corporation and the controlled corporation are both REITs immediately after the distribution and remain so at all times during the two years thereafter, (ii) distributions to which the REIT-TRS Exception applies, and (iii) distributions to which the PLR Exception applies.[21]

For purposes of Temporary Regulation Section 1.337(d)-7T(f), references to the distributing corporation and the controlled corporation include references to their predecessors

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[19] *Id.* at 36,796.

[20] Temp. Reg. § 1.337(d)-7T(f)(1).

[21] Temp. Reg. § 1.337(d)-7T(f)(3). In addition, a subsequent correction to the 2016 Temporary Regulations amended subsection (f)(3)(iii) thereof to exempt Section 355 distributions occurring prior to December 7, 2015. Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs], T.D. 9770, 81 Fed. Reg. 41,800 (June 28, 2016).

and successors. The 2016 Temporary Regulations specifically note that predecessors and successors "include corporations which succeed to and take into account items described in section 381(c) of the distributing corporation or the controlled corporation, and corporations having such items to which the distributing corporation or the controlled corporation succeeded and took into account."[22]

If a Spin-Conversion Nexus exists and the conversion transaction occurs after the related Section 355 distribution, the 2016 Temporary Regulations treat the C corporation involved in the conversion transaction as making the deemed sale election described in Treasury Regulation Section 1.337(d)-7(c)(5) for the conversion transaction, requiring the C corporation to recognize all built-in gain in property transferred to the REIT.[23] Conversely, if such conversion transaction occurs before the related Section 355 distribution, the regulations generally require the REIT, in the year of the distribution, to recognize the remaining built-in C corporation gain in its assets.[24]

On the same date the 2016 Temporary Regulations were published, the government also published the 2016 Proposed Regulations, which largely cross-reference the 2016 Temporary Regulations, but also would expand the definition of the term "**converted property**" (property owned by a C corporation that becomes property of a RIC or REIT), which is used throughout Treasury Regulation Section 1.337(d)-7, to include property the basis of which is determined by reference to the basis of property owned by a C corporation that becomes property of a RIC or REIT. The 2016 Proposed Regulations seek comments on all aspects of the 2016 Proposed

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[22] Temp. Reg. § 1.337(d)-7T(f)(2). Unlike the distributing and controlled corporations, it appears that other SAG members cannot have predecessors or successors for purposes of the 2016 Temporary Regulations. *See* Temp. Reg. § 1.337(d)-7T(f)(1)(ii)(B), (f)(2).

[23] Temp. Reg. § 1.337(d)-7T(c)(6).

[24] Temp. Reg. § 1.337(d)-7T(b)(4).

Regulations (and by extension the 2016 Temporary Regulations), and in particular (i) the scope of the terms “predecessors” and “successors” and (ii) whether the 2016 Proposed Regulations should apply to a RIC (as well as a REIT) conversion transaction that is coupled with a Section 355 distribution.[25]

2. *Subsequent Developments*

As initially promulgated, the 2016 Temporary Regulations increased the recognition period for RIC and REIT assets subject to Section 1374 treatment to ten years,[26] overriding a lower five-year period established by Congress in the PATH Act.[27] Prior to the 2016 Temporary Regulations, REITs, RICs and S corporations had used the same recognition period.[28] In October 2016, the chairs and ranking members of the House Ways and Means Committee and the Senate Finance Committee urged the Treasury Secretary to modify the 2016 Temporary Regulations in order to subject REITs and RICs to the same five-year recognition period applicable to S corporations under the PATH Act.[29] In January 2017, Treasury and the Service published an amendment to the regulations implementing the recommended change.[30]

In April 2017, President Trump signed Executive Order 13789 instructing Treasury to review all “significant tax regulations” issued on or after January 1, 2016, and to identify in an

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[25] *2016 Proposed Regulations*, 81 Fed. Reg. at 36,817.

[26] Former Temp. Reg. § 1.337(d)-7T(b)(2)(iii), T.D. 9770, 81 Fed. Reg. 36,793, 36,797 (June 8, 2016).

[27] Section 1374(d)(7).

[28] *See*, *e.g.*, Former Temp. Reg. § 1.337(d)-5T(b)(2), T.D. 9047, 65 Fed. Reg. 5,775, 5,776 (Feb. 7, 2000) (providing for use by RICs and REITs of ten-year recognition period described in Section 1374(d)(7)).

[29] Letter from Representative Kevin Brady, Senator Orrin Hatch, Representative Sander Levin & Senator Ron Wyden to Treasury Secretary Jacob Lew (Oct. 18, 2016) (published in *Taxwriters Seek Changes to Regs on Transfers to REITs, RICs*, 2016 TNT 202-24 (Oct. 19, 2016)).

[30] Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs], T.D. 9810, 82 Fed. Reg. 5,387 (Jan. 18, 2017).

interim report those that (i) impose an undue financial burden on U.S. taxpayers, (ii) add undue complexity to the federal tax laws, or (iii) exceed the Service's statutory authority.[31] In June 2017, Treasury issued an interim report in the form of Notice 2017-38, which identified the 2016 Temporary Regulations (along with seven other regulations) as either (i) imposing an undue financial burden on U.S. taxpayers or (ii) adding undue complexity to the federal tax laws.[32] Finally, the recently issued Treasury Report states that Treasury is considering amending the 2016 Temporary Regulations to limit "the potential taxable gain recognized in situations in which, because of the application of the predecessor and successor rule in Regulation Section 1.337(d)-7T(f)(2), gain recognition is required in excess of the amount that would have been recognized if a party to a spin-off had directly transferred assets to a REIT."[33] The Treasury Report also indicates that the government is considering "other technical changes" to the 2016 Temporary Regulations.[34]

III. COMMENTS

We appreciate the government's efforts in the 2016 Temporary Regulations to police the repeal of the *General Utilities* doctrine and to close perceived gaps in the "REIT spinoff" provisions of the PATH Act, and we acknowledge the concerns underlying the regulations. However, we respectfully submit that the regulations may require excessive corporate-level gain recognition in certain cases and that certain portions of the regulations would benefit from the minor amendments and clarifications discussed herein. Accordingly, we recommend several

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[31] *See* Exec. Order No. 13,789, 82 Fed. Reg. 19,317 (Apr. 26, 2017).

[32] Notice 2017-38, 2017-30 I.R.B. 147.

[33] U.S. DEPARTMENT OF THE TREASURY, SECOND REPORT TO THE PRESIDENT ON IDENTIFYING AND REDUCING TAX REGULATORY BURDENS: EXECUTIVE ORDER 13,789 (2017).

[34] *Id.*

modifications that we believe would improve the regulations while allowing Treasury and the Service to preserve the objectives of *General Utilities* repeal and the PATH Act.[35]

A. Post-Distribution Additional Appreciation

As currently drafted, Temporary Regulation Section 1.337(d)-7T(c)(6) requires the distributing or controlled corporation in a Section 355 distribution (either, the "**spin party**"),[36] or any successor to a spin party, to recognize all the built-in gain in assets transferred to a REIT in a conversion transaction (the "**later conversion transaction**") effected within ten years of the Section 355 distribution. Because the PATH Act prohibits a distributing or controlled corporation from making a REIT election within ten years of a Section 355 distribution, we generally agree that it is appropriate to restrict other methods of transferring the property of a distributing or controlled corporation to a REIT without the imposition of corporate-level tax within ten years of a Section 355 distribution. However, as drafted in the 2016 Temporary Regulations, this requirement can magnify the amount of gain subject to corporate-level tax beyond the gain present in the spin party's assets at the time of the related Section 355 distribution. For instance, (i) the assets of the spin party could appreciate in value after the related Section 355 distribution but prior to the later conversion transaction, (ii) the spin party could issue debt or equity after the related Section 355 distribution in order to acquire additional assets prior to the later conversion transaction, or (iii) the spin party could be acquired by a C

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35 We generally assume in this report that none of the transactions occurring subsequent to a putative Section 355 distribution would cause the distribution to fail to satisfy Section 355.

36 Both the distributing corporation and the controlled corporation could engage in later conversion transactions, making both "spin parties." In addition, the 2016 Temporary Regulations can apply to members of the SAG of the distributing corporation or controlled corporation. Temp. Reg. § 1.337(d)-7T(f)(1)(ii)(B). For sake of simplicity, the discussion in this Part III.A assumes that either distributing or controlled (but not both) engages in a later conversion transaction, and that the spin party is distributing or controlled itself and not a SAG member.

corporation in a Section 381 transaction after the related Section 355 distribution but prior to the later conversion transaction, potentially causing that acquiror to be treated as a successor of the spin party and denying Section 1374 treatment to that acquiror's assets if the acquiror engages in a later conversion transaction.[37]

We have considered several possible approaches, described below, that the 2016 Temporary Regulations could take in these situations. On balance, we recommend that the regulations adopt an approach that limits the amount of corporate-level gain subject to recognition at the time of a spin party's later conversion transaction to the built-in gain existing as of the date of the related Section 355 distribution in the spin party's assets held at the time of the related Section 355 distribution.[38] We believe that this recommendation is in accord with the

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[37] Temporary Regulation Section 1.337(d)-7T(b)(4), which addresses conversions prior to a Section 355 distribution, can also require corporate-level gain recognition in arguably inappropriate scenarios. Consider the following example. In Year 1, corporation R1 elects REIT status, and its assets become subject to Section 1374 treatment. In Year 2, unrelated REIT R2, which also holds some assets subject to Section 1374 treatment, acquires R1 in a Section 368(a)(1)(A) reorganization. In Year 3, R2 contributes some of its assets (not acquired from R1) to a controlled corporation and distributes the stock of controlled in a distribution intended to qualify under Sections 355 and 368(a)(1)(D), with controlled immediately electing REIT status. In Year 4, controlled inadvertently loses REIT status. Because controlled did not retain REIT status for two years after the distribution, the distribution is not described in Temporary Regulation Section 1.337(d)-7T(f)(3)(i). Temporary Regulation Section 1.337(d)-7T(b)(4) would presumably apply to R2 because of its participation in a Section 355 distribution within ten years of a conversion transaction and would require R2 to recognize its built-in C corporation gain in all of its assets subject to Section 1374 treatment, including the R1 assets involved in the initial conversion. Because the assets of R1 remain in a single company and have not been separated by a Section 355 distribution, it is not clear why the 2016 Temporary Regulations should deny Section 1374 treatment to those assets.

[38] As described below, we acknowledge that in some cases it may be appropriate to apply the same treatment to assets not held at the time of a Section 355 distribution if those assets are received in exchange for assets held at the time of the Section 355 distribution in a tax-free carryover basis transaction ("**successor assets**"). As mentioned above, the 2016 Temporary Regulations propose an analogous change to the definition of "converted property" under Treasury Regulation Section 1.337(d)-7. *See* Prop. Reg. § 1.337(d)-7(a)(2)(vii); *see also* Section 1374(d)(6) (treating an asset the basis of which is determined, in whole or in part, by reference to the basis of an asset subject to Section 1374 treatment as subject to Section 1374 treatment itself).

concerns and potential revisions described in the Treasury Report.[39] In addition, because of the complexity of the 2016 Temporary Regulations, including by virtue of the inclusion of predecessor and successor rules, it would be helpful if the government added several examples illustrating the application of the regulations.[40]

1. *Current Approach*

The approach adopted in the 2016 Temporary Regulations (the "**Current Approach**") requires recognition of all the built-in gain in all the assets held by the spin party (or its successor) at the time of the later conversion transaction regardless of when or how those assets were acquired. The government presumably selected this approach because it is relatively simple to apply and does not appear to require that the spin party engage in any additional valuations of its assets (presumably, because the spin party's assets would otherwise become subject to Section 1374 treatment, one of the parties to the conversion transaction would already need to value the spin party's transferred assets as of that time). On the other hand, this approach can lead to situations in which there is only a very small built-in gain existing at the time of the Section 355 distribution but a much larger built-in gain required to be recognized at the time of a later conversion transaction.

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[39] Specifically, the Treasury Report stated that the 2016 Temporary Regulations require excessive gain recognition when a smaller corporation that was party to a Section 355 distribution merges into a larger corporation in a tax-free reorganization and the larger corporation makes a REIT election following such distribution, and indicated that the government was considering potential revisions to the regulations that would "substantially reduce the immediately taxed gain of the larger corporation by limiting gain recognition to the assets of the smaller corporation." Treasury Report, at 9. We believe that this concern is essentially the same concern as that described in Part III.A of this report, and that our recommended approach, described in Part III.A.2 below, would achieve the result contemplated by the Treasury Report.

[40] We note by way of comparison that the temporary regulations on predecessors and successors under Section 355(e) (the "**-8T Regulations**") include 11 examples. *See* Temp. Reg. § 1.355-8T(h).

For example, assume that a distributing corporation D spins off a controlled corporation C in a Section 355 distribution, and C (or its successor) subsequently either holds additional assets not involved in the distribution,[41] and/or the assets held at the time of the distribution thereafter appreciate in value. It is not clear how the denial of Section 1374 treatment to this additional appreciation, which holds no connection to the related Section 355 distribution, addresses the concerns listed in the preamble to the 2016 Temporary Regulations: (i) use of Section 355 to separate REIT-qualifying assets that subsequently become property of a REIT and (ii) avoidance of the PATH Act. Requiring corporate-level gain recognition with respect to all additional appreciation also significantly limits the longstanding policy of allowing Section 1374 treatment for C corporation assets transferred to REITs. Finally, such a result is arguably inequitable, especially if an acquisition of C is followed by one or more acquisition(s) of C's acquiror(s), leaving the final acquiror with only an attenuated connection to C.

2. *Recommended Spin-Focused Approach*

Because the Current Approach may cause inappropriate overinclusions of gain and may abridge to an inappropriate degree the longstanding policy of allowing REITs to receive Section 1374 treatment for assets acquired from C corporations, we recommend that Treasury and the

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[41] As mentioned above, additional assets could become relevant in several different ways. For instance, C or its successor could obtain debt or equity financing and use the proceeds to acquire additional assets, or C could issue its own equity as consideration in an acquisition. At the time of C's (or its successor's) later conversion transaction, Temporary Regulation Section 1.337(d)-7T(c)(6) would require recognition of the built-in gain in all of these assets. In the alternative (or additionally), C could merge with a larger acquiror A in a transaction qualifying as a Section 368(a)(1)(A) reorganization. Under Section 381, A would succeed to and take into account C's tax items. Accordingly, Temporary Regulation Section 1.337(d)-7T(f)(2) would treat A as the successor of C, and any reference in Temporary Regulation Section 1.337(d)-7T(f) that applied to C would also apply to A. If A subsequently engaged in a later conversion transaction, the 2016 Temporary Regulations would require A, as C's successor, to recognize the built-in gain in all of its converted property. Temp. Reg. § 1.337(d)-7T(c)(6). *See* Part III.F, *infra* (discussing overlap between Section 856(c)(8) and Temporary Regulation Section 1.337(d)-7T(f)).

Service adopt a different approach (the "**Spin-Focused Approach**"). The Spin-Focused Approach would limit the amount of gain recognized under Temporary Regulation Section 1.337(d)-7T(c)(6) to the gain in the spin party's assets at the time of the related Section 355 distribution and would disregard for purposes of the deemed sale election any future appreciation in those assets, and any future acquisition of other assets or of the spin party, that occurs prior to the later conversion transaction. If challenged, the taxpayer, of course, would have the burden of demonstrating an accurate valuation of assets held at the time of the related Section 355 distribution as well as an accurate tracing of those assets. If the taxpayer could not meet this burden of proof on audit (or elected not to perform any valuation or keep records, perhaps to save on expenses), we believe that the government could reasonably apply the Current Approach and treat all of the assets of the spin party (or its successor) as subject to corporate-level gain recognition based on their values at the time of the later conversion transaction.

Under the Spin-Focused Approach, if the amount of built-in gain in the spin party's assets declined between the date of the related Section 355 distribution and the later conversion date (*e.g.*, a wasting asset), the spin party would recognize only the amount of built-in gain that exists at the time of the later conversion transaction.[42] In addition, where a spin party disposed

[42] Put differently, under the Spin-Focused Approach, a spin party could recognize no more built-in gain than the lesser of (i) its built-in gain at the time of the related Section 355 distribution in its assets held at that time (and, potentially, successor assets thereof) and (ii) its built-in gain at the time of the later conversion transaction in its assets held at the time of the related Section 355 distribution (and, potentially, successor assets thereof). For example, assume that a distributing corporation spun off a controlled corporation C in a Section 355 distribution, and C held, among other assets, asset A1 with a built-in gain of $50 at the time of the spinoff. Shortly after the spinoff, at a time when the value of A1 had declined in value so that it had only a $20 built-in gain, C merged into a REIT acquiror in a transaction qualifying as a Section 368(a)(1)(A) reorganization. Under the Spin-Focused Approach, upon its deemed sale election, C would recognize $20 (not $50) of built-in gain on A1's deemed sale. We also considered whether it would be more appropriate to require C in a fact pattern like this one to recognize the entire $50 of built-in gain in existence at the time of the spinoff, but ultimately decided against that idea. We believe that the limitation

of an asset held at the time of the related Section 355 distribution in a taxable transaction prior to the later conversion transaction, the Spin-Focused Approach would limit the amount of gain subject to corporate-level recognition to the built-in gain measured at the time of the disposition, and no further tracing would be required.[43] In all cases, the Spin-Focused Approach would track built-in gain on an asset-by-asset basis.[44]

This approach presents several advantages over the Current Approach. Because no amount of additional appreciation would become subject to corporate-level gain recognition, the Spin-Focused Approach would eliminate the inappropriate magnification of gain that may occur under the Current Approach. For instance, if a distributing corporation spun off a controlled corporation C in a Section 355 distribution, and C later merged into a much larger acquiror A, and then A merged into a REIT acquiror that held other assets subject to Section 1374 treatment, the Spin-Focused Approach would limit the amount of gain subject to corporate-level recognition under Temporary Regulation Section 1.337(d)-7T(c)(6) to the gain present in C's

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described here is appropriate because appreciation occurring after a spinoff does not implicate *General Utilities* repeal.

[43] For instance, if C held asset X with $10 of built-in gain at the time of C's related Section 355 distribution, X declined in value by $5 after the distribution, and C sold X for a $5 gain, C would recognize $5 of gain (not the $10 of built-in gain in X at the time of C's distribution). If, by contrast, a spin party exchanged an asset held at the time of a related Section 355 distribution in a tax-free carryover basis transaction prior to its later conversion transaction, we recognize that it may be appropriate for the successor asset(s) received in exchange to become subject to later corporate-level gain recognition.

[44] For example, assume that a controlled corporation C held assets Y1, Y2 and Y3 at the time of a Section 355 distribution, each of which had $10 of built-in gain. After the distribution, C sold Y1 and recognized $10 of gain. Subsequently, Y2 and Y3 each appreciated by $5 and therefore each held $15 in built-in gain. Then, within ten years of the Section 355 distribution, C merged into a REIT acquiror. Because the Spin-Focused Approach would track built-in gain on an asset-by-asset basis, only $20 of built-in gain in Y2 and Y3 ($10 of built-in gain in Y2 and $10 of built-in gain in Y3, existing in each case at the time of C's Section 355 distribution) would be subject to corporate-level recognition at the time of the later merger, rather than the $30 of built-in gain present in all of C's assets (including Y3) at the time of the Section 355 distribution.

assets held at the time of C's distribution. A's assets would be eligible for Section 1374 treatment, and the REIT acquiror's other Section 1374 assets would retain that treatment.[45]

The Spin-Focused Approach would confine the application of the 2016 Temporary Regulations to assets with a clear connection to a related Section 355 distribution. Indeed, it is not clear why other assets involved in a later conversion transaction should be subject to the regulations. Focusing the 2016 Temporary Regulations only on assets involved in a related Section 355 distribution matches the regulations' focus with the clear congressional focus on avoidance of *General Utilities* repeal through the use of Section 355 and REITs, as evidenced in the PATH Act.

The Spin-Focused Approach has drawbacks, however. It would require distributing and controlled corporations to value each of their assets as of the time of a Section 355 distribution and to keep records of these valuations in case a later conversion transaction occurred.[46] It could be difficult and time-consuming for taxpayers to undertake such a detailed valuation. In addition, it could be difficult for the government to confirm the accuracy of the valuation when

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[45] This approach may also find support in the gain limitation rules contained in the -8T Regulations. For Section 355(e) purposes, the government generally concluded that it was inappropriate to require a distributing corporation to recognize all the built-in gain in its controlled corporation stock if a 50% or greater acquisition occurred with respect to (i) a predecessor of distributing but not distributing itself (or any other predecessor) or (ii) distributing but not the predecessor(s) of distributing. *See* Temp. Reg. § 1.355-8T(e)(2)-(3). *See also* NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON TEMPORARY REGULATIONS DEALING WITH "PREDECESSORS" AND "SUCCESSORS" UNDER SECTION 355(e) (Rep. No. 1370, June 1, 2017), *reprinted in* 2017 TNT 105-27 (June 2, 2017) (discussing the -8T Regulations) [hereinafter *-8T Report*].

[46] Because either distributing or controlled (or both, or any SAG member of either) could engage in conversion transactions after the related Section 355 distribution, both corporations would need to value all of their assets. In addition, a whole-company valuation would not suffice because, under the Spin-Focused approach, it would be necessary to track the built-in gain in each asset in case of a separate transfer.

assessing whether the amount realized upon a later disposition of the assets was attributable to built-in gain at the time of the distribution or subsequent appreciation.

In addition to the above valuation concerns, the Spin-Focused Approach generally would require taxpayers that engage in Section 355 distributions to trace assets held at the time of the distribution, possibly including successor assets, which might be only partially subject to the 2016 Temporary Regulations.[47] These complex and burdensome new requirements raise administrability concerns and may be objectionable given Executive Order 13789's focus on reducing complexity and taxpayer burdens in Treasury regulations and the 2016 Temporary Regulations' inclusion in Notice 2017-38.

Despite these drawbacks, we believe that, on balance, the Spin-Focused Approach would improve the 2016 Temporary Regulations and would address many of the instances of overreaching for which the regulations have received criticism. Accordingly, we recommend that Treasury and the Service amend the 2016 Temporary Regulations to incorporate the Spin-Focused Approach.

3. *Intermediate Approach*

We also considered whether it might be possible to adopt an intermediate approach that would address some of the issues with the Current Approach, but would not require the complex valuation regime necessary under the Spin-Focused Approach. In particular, we considered whether the 2016 Temporary Regulations could require the spin party (or its successor) to recognize built-in gain measured as of the time of the later conversion transaction, but only with

[47] We recognize that, while burdensome, the tracing of assets is already an inherent part of Section 1374 treatment for C corporation assets acquired by a REIT as well as of determining net unrealized built-in gain (or loss) under Section 382(h) for a corporation that has experienced an ownership change. *See* Notice 2003-65, 2003-2 C.B. 747 (discussing "1374 approach" and "338 approach" under Section 382(h)).

respect to assets of the spin party held at the time of the related Section 355 distribution (and, potentially, any successor assets) (the "**Intermediate Approach**").[48] This approach would also place the burden of proof in valuing and tracing assets on the taxpayer and would follow the Spin-Focused Approach with respect to assets that decline in value after a related Section 355 distribution as well as assets disposed of prior to a later conversion transaction.[49]

Because the Intermediate Approach would require recognition of built-in gain measured as of the time of the later conversion transaction, a distributing corporation or controlled corporation would not need to conduct an asset-by-asset valuation as of the time of a related Section 355 distribution, and the government would not need to audit any such valuations. However, distributing corporations and controlled corporations would nonetheless need to trace their assets held as of the date of a Section 355 distribution as they would under the Spin-Focused Approach.

The Intermediate Approach would eliminate some of the inappropriate gain magnification scenarios caused by the Current Approach. For instance, if a controlled corporation C merged into a much larger acquiror A, and then A merged into a REIT acquiror, the Intermediate Approach would require gain recognition only with respect to assets held by C at the time of its Section 355 distribution and would prevent the assets of A and the REIT acquiror from becoming subject to the 2016 Temporary Regulations. However, the Intermediate Approach would require recognition of post-distribution appreciation in C's assets held at the

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[48] As with the Spin-Focused Approach, the gain limitation provisions in Temporary Regulation Section 1.355-8T(e)(2)-(3) arguably support the Intermediate Approach.

[49] *See supra* notes 42 and 43.

time of the distribution, which is inappropriate and which leaves unclear the underlying principle behind the Intermediate Approach.[50]

The Intermediate Approach would also treat certain economically similar situations differently. For instance, if a controlled corporation held an asset worth $10 with a $0 basis at the time of a related Section 355 distribution and the asset appreciated in value to $20 by the time of controlled's later conversion transaction, all of the $20 in built-in gain would be subject to corporate-level tax under Temporary Regulation Section 1.337(d)-7T(c)(6). However, if the controlled corporation sold the asset soon after the related Section 355 distribution, recognized $10 of gain, and then purchased a similar asset, the similar asset's subsequent $10 appreciation would be eligible for Section 1374 treatment after the later conversion transaction (and the taxpayer, therefore, could potentially avoid corporate-level tax on the similar asset's gain).

We do not recommend the Intermediate Approach because it lacks the clear principle of the Spin-Focused Approach, may retain some of the inappropriate outcomes of the Current Approach, and nonetheless seems likely to introduce additional complexity into the 2016 Temporary Regulations.[51]

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[50] We do note the government's specific concern, expressed in the preamble to the 2016 Temporary Regulations, with taxpayers separating appreciated property through Section 355 and then transferring the property to a REIT that receives the benefits of untaxed appreciation in the property through increased rents. *2016 Temporary Regulations*, 81 Fed. Reg. at 36,795-96. However, this concern does not apply to post-distribution appreciation, because the element of separation through Section 355 is missing – the taxpayer has made no attempt to separate the assets experiencing post-distribution appreciation from its other assets.

[51] We also considered the possibility of other alternatives to the Current Approach. For example, we considered whether the 2016 Temporary Regulations should include a "plan"-based limitation similar to that found in Section 355(e), so that a Spin-Conversion Nexus would include only later conversion transactions occurring as part of the same plan as the related Section 355 distribution. However, Congress did not include this limitation in Section 337(d) or the relevant provisions of the PATH Act, and we generally believe that other portions of the Code, such as Section 355(e) and the Section 707 "disguised

B. Certain Wholly Internal Distributions

We suggest that the government consider exempting certain wholly internal distributions from treatment as related Section 355 distributions and from inclusion as part of a Spin-Conversion Nexus. For this purpose, a "wholly internal distribution" could be defined as a Section 355 distribution from one member of an affiliated group (as defined in Section 1504(a), without regard to Section 1504(b)) to another member of the group, not effected in connection with an external distribution or other transfer of assets outside the group, after which, within ten years of the distribution, the group's C corporation parent elects REIT status. For instance, assume that corporation A wholly owns corporation B, B wholly owns corporation C, and B distributes all of C's stock to A in a Section 355 distribution. If, within ten years of the Section 355 distribution, A converts to a REIT, and B and C become disregarded qualified REIT subsidiaries ("**QRSs**") in deemed Section 332 liquidations,[52] the 2016 Temporary Regulations appear to treat the deemed liquidations of B and C as later conversion transactions involving spin parties, and Temporary Regulation Section 1.337(d)-7T(c)(6) would appear to require B and C to recognize all the built-in gain in the assets transferred to A.[53] We think that this narrow category

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sale" rules, are by their terms more susceptible to policing through a plan-based limitation. Accordingly, we do not recommend any plan-based limitation to Treasury Regulation Section 1.337(d)-7T(c)(6).

[52] *See*, *e.g.*, Priv. Ltr. Rul. 2013-45-021 (Nov. 15, 2013). Either B or C (or both) could become a TRS instead, and accordingly would not be involved automatically in a later conversion transaction. However, as long as one of the two corporations (or their successors) transferred assets to A in a later conversion transaction, Temporary Regulation Section 1.337(d)-7T(c)(6) would appear to apply. The exemption recommended above should apply regardless of whether a parent REIT's subsidiaries become TRSs or QRSs.

[53] In addition, because Section 332 liquidations are described in Section 381, A would become the successor to B and C upon their deemed liquidation under Temporary Regulation Section 1.337(d)-7T(f)(2). Under the 2016 Temporary Regulations as currently drafted, A, as the successor of B and C, may be required to recognize the built-in gain in its assets on account of A's conversion to REIT status before A became a successor, because the conversion occurred within ten years after B's distribution of the C stock. This

of distributions does not achieve the same type of separation of REIT-qualifying and non-qualifying assets as an external distribution and does not implicate the concerns behind the 2016 Temporary Regulations and, therefore, suggest that the government consider an exception in these circumstances.

C. Scope of Successor & Predecessor Rules

The 2016 Temporary Regulations do not define "predecessors" and "successors" for purposes of Temporary Regulation Section 1.337(d)-7T(f). Subsection (f)(2) thereof provides that the terms "include corporations which succeed to and take into account items described in section 381(c) of the distributing corporation or the controlled corporation, and corporations having such items to which the distributing corporation or the controlled corporation succeeded and took into account." Because the definitions of these terms significantly affect the scope of the 2016 Temporary Regulations, we recommend that Temporary Regulation Section 1.337(d)-7T(f)(2) clarify the definitions of "predecessors" and "successors."

The -8T Regulations may present a helpful point of comparison. In relevant part, those regulations define a successor to the distributing corporation or controlled corporation as a corporation that receives a transfer of property in a Section 381 transaction,[54] and a predecessor to the controlled corporation as a corporation that transfers property to the controlled corporation

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example also demonstrates how applying the 2016 Temporary Regulations to these types of internal distributions may pose a trap for the unwary. If the steps described above were reversed, and A instead converted to REIT status as a first step, B's subsequent distribution of C's stock at a point in time when B and C were QRSs generally would be disregarded.

54 Temp. Reg. § 1.355-8T(c)(2)(i).

in a Section 381 transaction.[55] For purposes of determining if a corporation is a predecessor of a distributing corporation, those regulations also look beyond Section 381 transactions to certain other transactions in which property is transferred to a distributing corporation and the built-in gain in the transferred property is not recognized in full.[56]

We have previously acknowledged that it may be appropriate, in the context of Section 355(e), to consider some corporations that transfer assets to a distributing corporation in transactions not described in Section 381 to be predecessors of that distributing corporation.[57] Nevertheless, we have also argued that the definition of a predecessor of the distributing corporation in the -8T Regulations may be overbroad in certain respects, and have suggested limiting the definition to transactions in which a potential predecessor becomes a member of the distributing corporation's affiliated group (defined without regard to Section 1504(b)) and making certain other clarifications.[58]

If the government concludes that limiting predecessors and successors to participants in Section 381 transactions does not sufficiently protect the objectives of the 2016 Temporary Regulations, then it might consider requiring that an entity transfer or receive a specified threshold level of assets in order to become a predecessor or successor, respectively.[59] We think

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55 Temp. Reg. § 1.355-8T(c)(1). In addition, this definition considers only Section 381 transactions occurring as part of a cognizable Section 355(e) plan, and applies only for purposes of Temporary Regulation Section 1.355-8T(f). *Id.*

56 Temp. Reg. § 1.355-8T(b)(1)(ii). The regulations also require that the transfer and the failure to recognize all the built-in gain in the transferred property occur as part of a cognizable Section 355(e) plan. *Id.*

57 *See -8T Report*, at 13-17.

58 *See id.*, at 15-18.

59 Several provisions in the Code and the Treasury regulations determine predecessor or successor status by reference to whether a threshold amount of assets, or a threshold portion of a business, is transferred. *See*, *e.g.*, Section 41(f)(3)(A) (credit for increasing research activities); Treas. Reg. § 1.7874-10T(f) (distributions disregarded in determining ownership fraction under inversion rules); Treas. Reg.

that an appropriate limitation or limitation(s) on the definitions of these terms would allow for an adequate balance between preserving the objectives underlying the regulations, on the one hand, and providing taxpayers with certainty regarding which of their assets will be subject to the deemed sale election, on the other.[60]

D. REIT-REIT Exception

Under the 2016 Temporary Regulations, a Spin-Conversion Nexus appears to include some distributions for which the REIT-REIT Exception in the PATH Act is available. Temporary Regulation Section 1.337(d)-7T(f)(3)(i) provides that a distribution cannot be part of a Spin-Conversion Nexus if both the distributing and controlled corporations are REITs immediately after the distribution and at all times during the two years thereafter. The REIT-REIT Exception requires only that both distributing and controlled be REITs immediately after the distribution. Thus, a Section 355 distribution in which both distributing and controlled are REITs immediately after the distribution, but in which one or both lose REIT status at some point in the following two-year period, will qualify for the REIT-REIT Exception but may constitute a Spin-Conversion Nexus. The preamble to the 2016 Temporary Regulations does not explain the reason for this discrepancy.

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§ 1.448-2(d)(3)(i) (nonaccrual-experience method of accounting for certain service providers); Treas. Reg. § 1.585-2(e)(4) (addition to reserve for losses on loans).

[60] The government may wish to consider whether it is appropriate to have potentially multiple levels of predecessors and successors, which would add further complexity and increase the already substantial diligence taxpayers will need to undertake when considering conversion transactions and Section 355 distributions in light of the 2016 Temporary Regulations. The government may also wish to consider whether it is appropriate for the 2016 Temporary Regulations to take account of conversion transactions undertaken by a corporation within ten years of a related Section 355 distribution but before that corporation became a successor of the distributing corporation or controlled corporation in the Section 355 distribution; such conversion transactions arguably have a very limited connection to the Section 355 distribution and do not resemble the transactions with which the preamble to the 2016 Temporary Regulations expressed concern.

In creating the REIT-REIT Exception, Congress allowed a REIT to use a tax-free Section 355 distribution to separate some of its assets, including assets subject to Section 1374 treatment, into a controlled corporation that is (or would become) a REIT. In adopting the additional two-year requirement in Temporary Regulation Section 1.337(d)-7T(f)(3)(i), Treasury and the Service have instead provided that, in some cases, the transaction will result in the imposition of corporate-level tax on the gain in the assets subject to Section 1374 treatment. It is not clear that this regulatory deviation from a very recent expression of congressional intent is appropriate. In addition, we do not see why the small population of REIT-REIT spinoffs in which the distributing corporation and/or the controlled corporation lose REIT status within two years of the distribution should be subject to this additional tax burden in any case. Presumably, many such losses of REIT status will be inadvertent terminations, which already result in a variety of serious tax consequences under the Code.

Accordingly, we recommend that Treasury and the Service either alter Temporary Regulation Section 1.337(d)-7T(f)(3)(i) to exclude any distribution to which the REIT-REIT Exception applies from forming part of a Spin-Conversion Nexus[61] or narrow the discrepancy by exempting situations in which the distributing corporation or the controlled corporation, as applicable, loses REIT status within two years after the distribution and loss of REIT status was not planned at the time of the distribution.[62]

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[61] A revised Temporary Regulation Section 1.337(d)-7T(f)(3)(i) could mirror the language in Temporary Regulation Section 1.337(d)-7T(f)(3)(ii), which prevents any distribution to which the REIT-TRS Exception applies from forming part of a Spin-Conversion Nexus.

[62] *See* Rev. Proc. 2015-43, § 3.01, 2015-40 I.R.B. 467 (applying a "no plan or intention" standard regarding future termination of RIC or REIT status). If the government incorporated this exception in the 2016 Temporary Regulations, we believe that it would be appropriate for the taxpayer to have the burden of proving that a loss of REIT status was not planned at the time of the Section 355 distribution. A plan-based exception could lead to fact-based disputes between taxpayers and the government, but we

E. "Converted Property" Definition in the Proposed Regulations

As described above, the 2016 Proposed Regulations would change the definition of "converted property" to include, in addition to property of a C corporation that becomes property of a RIC or REIT, "any other property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the property owned by a C corporation that becomes the property of a RIC or a REIT."[63] We generally agree with the statement in the preamble to the 2016 Proposed Regulations that such other property presents *General Utilities* repeal issues similar to those with respect to property of a C corporation that becomes property of a RIC or REIT. However, we recommend an appropriate change, such as inserting the words "of a RIC or REIT" after "any other property," to clarify that converted property does not include property held by other corporations (*e.g.*, property of a C corporation that became the property of a REIT and was later contributed by the REIT to its TRS in a Section 351 exchange).[64]

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expect that many taxpayers would memorialize their intent to preserve REIT status in the transaction documents for the related Section 355 distribution and, in truly inadvertent REIT termination scenarios, should be able to produce sufficient evidence that the loss of REIT status was due to unanticipated events.

[63] Prop. Reg. § 1.337(d)-7(a)(2)(vii).

[64] In addition, when the 2016 Proposed Regulations are finalized, we suggest that the final regulations include an example demonstrating the application of Section 1374(d)(6)(B) to "converted property." That provision generally provides in the S corporation context that, with respect to an asset treated as held by an S corporation at the beginning of its first taxable year because its basis is determined by reference to an asset actually held at that time, the amount of gain or loss subject to recognition on account of the successor asset under the Section 1374 rules is based upon the original asset's built-in gain or loss, as applicable, at the beginning of the S corporation's first taxable year. For instance, assume that in the proposed example, a REIT exchanges assets A1 (subject to Section 1374 treatment) and A2 (not subject to Section 1374 treatment, but appreciated) for asset A3 in a tax-free transaction. The example should make clear that, upon the REIT's subsequent disposition of A3 within the recognition period, the REIT is subject to corporate-level tax on the built-in gain in A3 attributable to the built-in C corporation gain in A1, but is not subject to corporate-level tax on the built-in gain in A3 attributable to the built-in gain in A2.

F. Overlap of PATH Act & 2016 Temporary Regulations

In some cases where Section 856(c)(8) bars a REIT election on account of an earlier Section 355 distribution, such a distribution and election, if respected, would also qualify as a Spin-Conversion Nexus subject to the 2016 Temporary Regulations. We assume that the statutory rule in Section 856(c)(8) takes precedence in this overlap situation and prevents the distributing corporation or controlled corporation, as applicable, from making a valid REIT election. If, however, Treasury and the Service have concluded that they have the authority to promulgate regulations allowing a REIT election in this case, at the cost of the "toll charge" imposed by Temporary Regulation Section 1.337(d)-7T(c)(6), we recommend that the government clarify the 2016 Temporary Regulations to make this position explicit.

G. RIC Spinoffs

As previously mentioned, the 2016 Proposed Regulations request comments on whether the regulations should apply to RICs in the same manner that they apply to REITs. On the one hand, we recognize that RICs and REITs have a similar pass-through nature, that the government treated RICs and REITs similarly in Notice 2015-59[65] and Revenue Procedure 2015-43,[66] and that we previously concluded that the use of Section 355 to separate assets of a C corporation that are later acquired by a RIC "exacerbates concerns that Section 355 is not being used for its intended purpose as it suggests that the purpose of the transaction is corporate-level tax avoidance."[67]

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[65] 2015-40 I.R.B. 459.

[66] 2015-40 I.R.B. 467.

[67] *Notice 2015-59 Report*, at 32.

On the other hand, the government explained in the preamble to the 2016 Proposed Regulations that "related section 355 distributions occurring before or after conversion transactions involving RICs do not present the same degree of concern regarding the purposes of *General Utilities* repeal."[68] In the PATH Act, Congress limited the spinoff amendments to REIT spinoffs. We are not aware of many transactions that contemplate the conversion of a company involved in a Section 355 distribution to a RIC.[69] In addition, the modifications to the Section 355 device and active trade or business tests contained in the July 2016 proposed regulations would, if finalized in their current or a similar form, present significant issues for the potential Section 355 qualification of a "C-to-RIC" distribution.[70] Finally, we are cognizant that Executive Order 13789 includes undue complexity and undue burdens on taxpayers as criteria for identifying regulations that warrant review.

Accordingly, because we think that valid arguments can be advanced both for and against extending the Spin-Conversion Nexus rules to RICs, we make no recommendation in this regard.

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68 *2016 Proposed Regulations*, 81 Fed. Reg. at 36,817 (June 8, 2016).

69 *See Notice 2015-59 Report*, at 31 (citing Priv. Ltr. Rul. 2016-05-016 (Jan. 29, 2016)).

70 *See* Guidance Under Section 355 Concerning Device and Active Trade or Business, REG-134016-15, 81 Fed. Reg. 46,004 (July 15, 2016). For our report on these proposed regulations, see NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON PROPOSED REGULATIONS UNDER SECTION 355 CONCERNING THE DEVICE PROHIBITION AND ACTIVE TRADE OR BUSINESS REQUIREMENT (Rep. No. 1356, Oct. 14, 2016), *reprinted in* 2016 TNT 200-62 (Oct. 17, 2016).