Section 337.—Nonrecognition for Property Distributed to Parent in Complete Liquidation of Subsidiary

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

T.D. 9047

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs]

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that apply to certain transactions or events that result in a Regulated Investment Company [RIC] or a Real Estate Investment Trust [REIT] owning property that has a basis determined by reference to a C corporation's basis in the property. These regulations affect RICs, REITs, and C corporations and clarify the tax treatment of transfers of C corporation property to a RIC or REIT.

DATES: *Effective Date:* These regulations are effective March 18, 2003.

Applicability Dates: For dates of applicability, see §§1.337(d)–5(d), 1.337(d)–6(e) and 1.337(d)–7(f).

FOR FURTHER INFORMATION CONTACT: Jennifer D. Sledge, (202) 622–7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1672. This information is required to obtain a benefit, *i.e.*, to elect to recognize gain as if the C corporation had sold the property at fair market value or to elect section 1374 treatment.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent is 30 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224, and to the **Office of Management and Budget**, ATTN: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR part 1. On February 7, 2000, temporary regulations (T.D. 8872, 2000–1 C.B. 639 [65 FR 5775]) (the 2000 temporary regulations) relating to certain transactions or events that result in a RIC or REIT owning property that has a basis determined by reference to a C corporation's basis in the property were published in the **Federal Register**. A notice of proposed rulemaking (REG–209135–88, 2000–1 C.B.

681 [65 FR 5805]) cross-referencing the temporary regulations was published in the **Federal Register** for the same day. The 2000 temporary regulations were intended to carry out the purposes of the repeal of the *General Utilities* doctrine as enacted in the Tax Reform Act of 1986 (the 1986 Act) (Public Law 99–514, 100 Stat. 2085), as amended by the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100–647, 102 Stat. 3342).

The 1986 Act amended sections 336 and 337 to require corporations to recognize gain or loss on the distribution of property in connection with complete liquidations other than certain subsidiary liquidations. Section 337(d) directs the Secretary to prescribe regulations as may be necessary to carry out the purposes of the *General Utilities* repeal, including rules to "ensure that such purposes may not be circumvented . . . through the use of a regulated investment company, a real estate investment trust, or tax-exempt entity . . . ."

The 2000 temporary regulations also reflected the principles set forth in Notice 88–19, 1988–1 C.B. 486, in which the IRS announced its intention to promulgate regulations under the authority of section 337(d) with respect to transactions or events that result in a RIC or REIT owning property that has a basis determined by reference to a C corporation's basis (a carryover basis). Notice 88–19 provided that the regulations would apply with respect to the net built-in gain of C corporation assets that become assets of a RIC or REIT by the qualification of a C corporation as a RIC or REIT or by the transfer of assets of a C corporation to a RIC or REIT (a conversion transaction). The notice further provided that, where the regulations apply, the C corporation would be treated, for all purposes, as if it had sold all of its assets at their respective fair market values and immediately liquidated. The notice provided, however, that the regulations would not allow the recognition of a net loss and that immediate gain recognition could be avoided if the C corporation that qualified as a RIC or REIT or the transferee RIC or REIT, as the case may have been, elected to be subject to tax under section 1374 with respect to the C corporation property. Notice 88–19 also indicated that the regulations would apply retroactively to June 10, 1987.

A public hearing on the cross-referenced notice of proposed rulemaking was held on May 10, 2000. Written or electronic comments responding to the notice of proposed rulemaking were received. After consideration of these comments, Treasury and the IRS decided to issue two new sets of temporary regulations. On January 2, 2002, temporary regulations (T.D. 8975, 2002–1 C.B. 379 [67 FR 8]) (the 2002 temporary regulations) were published in the **Federal Register**. The regulations under §1.337(d)–6T apply to conversion transactions occurring on or after June 10, 1987, and before January 2, 2002, and the regulations under §1.337(d)–7T apply to conversion transactions occurring on or after January 2, 2002. A notice of proposed rulemaking (REG–142299–01 and REG–209135–88, 2002–1 C.B. 418 [67 FR 48]) cross-referencing the temporary regulations was published in the **Federal Register** for the same day.

The regulations under §1.337(d)–6T provide that, if property of a C corporation that is not a RIC or REIT becomes the property of a RIC or REIT in a conversion transaction, then the C corporation is subject to deemed sale treatment, unless the RIC or REIT elects to be subject to section 1374 treatment. Thus, the C corporation generally recognizes gain and loss as if it sold the property converted to RIC or REIT property or transferred to the RIC or REIT (the converted property) to an unrelated party at fair market value immediately before the conversion transaction. If the C corporation recognizes net gain on the deemed sale, then the basis of the converted property in the hands of the RIC or REIT is adjusted to its fair market value immediately before the conversion transaction. The regulations under §1.337(d)–6T do not permit a C corporation to recognize a net loss on the deemed sale. Where there is a net loss, the C corporation recognizes no gain or loss on the deemed sale, and the C corporation's basis in the converted property carries over to the RIC or REIT.

The regulations under §1.337(d)–7T provide that, if property of a C corporation that is not a RIC or REIT becomes the property of a RIC or REIT in a conversion transaction, then the RIC or REIT will be subject to tax on the net built-in gain in the converted property under the rules of section 1374 and the regulations thereunder, unless the C corporation that qualifies as a RIC or REIT or transfers property to a RIC or REIT elects deemed sale treatment. In most other respects, the regulations under §1.337(d)–7T follow the regulations under §1.337(d)–6T.

No public hearing was requested or held on the 2002 temporary regulations. Written or electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as amended (the final regulations) by this Treasury decision, and the corresponding temporary regulations are removed. The revisions are discussed below.

Explanation and Summary of Comments

This preamble first discusses a change in the time for making the section 1374 election under §1.337(d)–6. This preamble then discusses the clarification of the rules concerning the use of loss carryforwards, credits and credit carryforwards found in the regulations under both §1.337(d)–6 and §1.337(d)–7. Finally, this preamble discusses the clarification of certain issues related to the special rule for partnerships found in §1.337(d)–7.

Time for Making Section 1374 Election under §1.337(d)–6

As explained above, the regulations under §1.337(d)–6T provide that, if property of a C corporation that is not a RIC or REIT becomes the property of a RIC or REIT in a conversion transaction, then the C corporation is subject to deemed sale treatment, unless the RIC or REIT elects to be subject to section 1374 treatment. Under §1.337(d)–6T(c)(4)(ii), the section 1374 election may be filed by the RIC or REIT with any federal income tax return filed by the RIC or REIT on or before March 15, 2003, provided that the RIC or REIT has reported consistently with such election for all periods. Commentators expressed concern that, in the case of a conversion transaction occurring on January 1, 2002 (the last date of applicability of §1.337(d)–6T), the time limit for making a section 1374 election could preclude a RIC or REIT from extending the due date of its federal income tax return beyond March 15, 2003. In response to this comment, the final regula-

tions under §1.337(d)–6 extend the time for making the section 1374 election to September 15, 2003.

Use of Loss Carryforwards, Credits and Credit Carryforwards

Under the 2002 temporary regulations, recognized built-in gains and recognized built-in losses that have been taxed in accordance with these regulations are treated like other gains and losses of RICs and REITs that are not subject to tax under these regulations. Thus, they 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), net capital gain 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 addition, consistent with section 1374, the 2002 temporary regulations generally allow RICs and REITs to use loss carryforwards and credits and credit carryforwards arising in taxable years for which the corporation that generated the attribute was a C corporation (and not a RIC or REIT) to reduce net recognized built-in gain and the tax thereon, subject to the limitations imposed by sections 1374(b)(2) and (b)(3) and §§1.1374–5 and 1.1374–6. The 2002 temporary regulations also provide an ordering rule for applying loss carryforwards, credits, and credit carryforwards to reduce net recognized built-in gain (and the tax thereon) and RIC or REIT taxable income (and the tax thereon). Under this ordering rule, loss carryforwards of a RIC or REIT must be used to reduce net recognized built-in gain for a taxable year to the greatest extent possible before such losses can be used to reduce investment company taxable income for purposes of section 852(b) or real estate investment trust taxable income for purposes of section 857(b). A similar rule applies to the use of credits and credit carryforwards.

A commentator asked whether the use of loss carryforwards, credits and credit carryforwards for purposes of section 1374 affected the use of loss carryforwards, credits and credit carryforwards for purposes of subchapter M. In response to this comment, the final regulations under §§1.337(d)–6 and 1.337(d)–7 clarify that the use of loss carryforwards, credits and credit carryforwards for purposes of the section 1374 tax does not change the extent to which such loss carryforwards, credits and credit carryforwards can be used for purposes of subchapter M.

Special Rule for Partnerships under §1.337(d)–7

Section §1.337(d)–7T applies to property transferred by a partnership to a RIC or REIT to the extent of any C corporation partner's proportionate share of the transferred property (the partnership rule). The regulations state that, if the partnership elects deemed sale treatment with respect to such transfer, then any gain recognized by the partnership on the deemed sale must be specially allocated to the C corporation partner.

In response to comments, the regulations have been revised to clarify that the principles of section 704(b) and (c) apply in determining the C corporation partner's share of the transferred property. As revised, the regulations provide that the principles of these regulations 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. The following sections highlight other specific comments received with respect to this rule.

Partnerships with Multiple Corporate Partners

A commentator expressed concern that the partnership rule does not specify whether the C corporation partner or the partnership is considered the transferor for purposes of making the deemed sale election. Further, the commentator asserted that in the case of a partnership with multiple corporate partners, each corporate partner should be allowed to make (or not make) a deemed sale election.

Treasury and the IRS believe that requiring each corporate partner to make a deemed sale election would be inconsistent with section 703(b) (which generally requires that elections be made at the partnership level) and would create unnecessary administrative complexity. Therefore, the final regulations under §1.337(d)–7 retain the rule under section 703(b) that the deemed sale election is made at the partnership level.

Contribution of Loss Assets by Partnership

Under the partnership rule, if a partnership were to elect deemed sale treatment under §1.337(d)–7T, any gain recognized by the partnership on the deemed sale is allocated to the C corporation partner. A commentator expressed concern that if the contribution by the partnership to a RIC or REIT includes multiple assets, the deemed sale may generate losses on certain assets and gain on others even though there is an overall net built-in gain. The commentator suggested that losses recognized by the partnership must also be allocated to the C corporation partner.

Under §1.337(d)–7T, when a partnership elects deemed sale treatment, only net gains are recognized. If a net gain is recognized, the C corporation partner will receive the benefit of offsetting losses (as a result of the reduction in net gain). The final regulations under §1.337(d)–7 have been modified to clarify that the gain allocated to the C corporation partner on a deemed sale transaction is the C corporation partner's distributive share of the net gain in the assets transferred to the RIC or REIT by the partnership.

Allocation of Gain or Loss on Subsequent Sale of RIC or REIT Stock

Under section 358, a partnership that elects deemed sale treatment under §1.337(d)–7T(c) with respect to a conversion transaction increases its basis in the RIC or REIT stock by the net gain recognized on such transaction. A commentator suggested that the C corporation partner should be allowed to use this basis increase to offset any gain or loss recognized by the partnership on the eventual sale of the RIC or REIT stock.

Treasury and the IRS agree with this comment. Accordingly, the final regulations under §1.337(d)–7 provide that any adjustment to the basis of the RIC or REIT stock held by the partnership as a result of electing deemed sale treatment will constitute an adjustment to the basis of that stock with respect to the C corporation partner only.

Partnerships with Tax-Exempt Partners

A commentator expressed concern that the partnership rule in §1.337(d)–7T may have an unintended punitive effect when the C corporation partner is a tax-exempt entity. Tax-exempt entities that are partners in a partnership that holds debt financed property are subject to tax under the unrelated business income tax (UBIT) rules unless certain criteria are satisfied. One of these criteria (the fractions rule) requires that: (1) the tax-exempt partner's share of overall partnership income for any tax year is no greater than its smallest share of partnership loss in any tax year; and (2) each allocation with respect to the partnership has substantial economic effect within the meaning of section 704(b)(2). The commentator expressed concern that the special allocation of gain to the tax-exempt partner that is required by §1.337(d)–7T when the partnership makes a deemed sale election may violate the fractions rule, tainting all income from the partnership for UBIT purposes.

In response to this comment, Treasury and the IRS have amended the regulations under section 514 to provide that allocations that are mandated by statute or regulation (other than subchapter K of chapter 1 of the Internal Revenue Code and the regulations thereunder) are not considered for purposes of determining qualification under the fractions rule. This rule applies to partnership allocations made in taxable years beginning on or after January 1, 2002.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these final regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Jennifer D. Sledge of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury Department and the IRS participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for "Section 1.337(d)–5T", "Section 1.337(d)–6T", and "Section 1.337(d)–7T" and adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.337(d)–5 also issued under 26 U.S.C. 337.

Section 1.337(d)–6 also issued under 26 U.S.C. 337.

Section 1.337(d)–7 also issued under 26 U.S.C. 337. * * *

§1.337(d)–5T [Redesignated as §1.337(d)–5]

Par. 2. Section 1.337(d)–5T is redesignated as §1.337(d)–5 and the language "(temporary)" is removed from the end of the section heading.

Par. 3. Newly designated §1.337(d)–5 is amended as follows:

1. In paragraph (b)(3), first sentence, the reference to "§1.337(d)–5T(b)" is removed and "paragraph (b) of this section" is added in its place.

2. In paragraph (d), third sentence, the references to "§1.337(d)–5T(b)(1)" and "§1.337(d)–6T" are removed and "paragraph (b)(1) of this section" and "§1.337(d)–6" are added in their places, respectively.

3. In paragraph (d), fourth sentence, the reference to "§1.337(d)–6T" is removed and "§1.337(d)–6" is added in its place.

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

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

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

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

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

(ii) *Conversion transaction.* For purposes of this section, the term *conversion transaction* means the qualification of a C corporation as a RIC or REIT or the transfer of property owned by a C corporation to a RIC or REIT.

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

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

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

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

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

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

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

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

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

(c) *Election of section 1374 treatment*—(1) *In general*—(i) *Property owned by a C corporation that becomes property of a RIC or REIT.* Paragraph (b) of this section does not apply if the RIC or REIT that was formerly a C corporation or that acquired property from a C corporation makes the election described in paragraph (c)(4) of this section. A RIC or REIT that makes such an election will be subject to tax on the net built-in gain in the converted property under the rules of section 1374 and the regulations thereunder, as modified by this paragraph (c), as if the RIC or REIT were an S corporation.

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

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

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

(*2*) Where the tax under section 857(b)(5) is computed by reference to section 857(b)(5)(B), the amount of a REIT's recognized built-in gain that is subject to tax under section 857(b)(5) is the tax imposed by section 857(b)(5) multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in section 856(c)(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 sections 857(b)(5), (6), and (7).

(ii) *Loss carryforwards, credits and credit carryforwards* —(A) *Loss carryforwards.* Consistent with paragraph (c)(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 (c)(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 (c) 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 (c) 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 invest-

ment 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 (c) 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 (c) on net recognized built-in gain is treated as attributable to the portion of the RIC's taxable year occurring after October 31.

(4) *Making the section 1374 election*—(i) *In general.* A RIC or REIT makes a section 1374 election with the following statement: "[Insert name and employer identification number of electing RIC or REIT] elects under §1.337–6(c) to be subject to the rules of section 1374 and the regulations thereunder with respect to its property that formerly was held by a C corporation, [insert name and employer identification number of the C corporation, if different from name and employer identification number of the RIC or REIT]." However, a RIC or REIT need not file an election under this paragraph (c), but will be deemed to have made such an election if it can demonstrate that it informed the Internal Revenue Service prior to January 2, 2002, of its intent to make a section 1374 election. An election under this paragraph (c) is irrevocable.

(ii) *Time for making the election.* An election under this paragraph (c) may be filed by the RIC or REIT with any federal income tax return filed by the RIC or REIT on or before September 15, 2003, provided that the RIC or REIT has reported consistently with such election for all periods.

(5) *Example.* The rules of this paragraph (c) 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 1994 tax return, which it files on March 15, 1995. As a result, X is a REIT for its 1994 taxable year and would be subject to deemed sale treatment under paragraph (b) of this section but for X's timely election of section 1374 treatment under this paragraph (c). X chooses not to rely on §1.337(d)–5. As of the beginning of the 1994 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, 1997, X sells Real Property for $110,000. For its 1997 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 1994 taxable year.

(iii) Upon X's sale of Real Property in 1997, 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 1997 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 this 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 (c).

(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 (c)). 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).

(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 (c) 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 (c) of this section applies to the RIC or REIT upon its requali-

fication 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) *Effective date.* This section applies to conversion transactions that occur on or after June 10, 1987, and before January 2, 2002. In lieu of applying this section, taxpayers generally may apply §1.337(d)–5 to determine the tax consequences (for all taxable years) of any conversion transaction that occurs on or after June 10, 1987, and before January 2, 2002, except that RICs and REITs that are subject to section 1374 treatment with respect to a conversion transaction may not rely on §1.337(d)–5(b)(1), but must apply paragraphs (c)(1)(i), (c)(2)(i), (c)(2)(ii), and (c)(3) of this section, with respect to built-in gains and losses recognized in taxable years beginning on or after January 2, 2002. Taxpayers are not prevented from relying on §1.337(d)–5 merely because they elect section 1374 treatment in the manner described in paragraph (c)(4) of this section instead of in the manner described in §1.337(d)–5(b)(3) and (c). For conversion transactions that occur on or after January 2, 2002, see §1.337(d)–7.

§1.337(d)–6T [Removed]

Par. 5. Section 1.337(d)–6T is removed.

Par. 6. Section 1.337(d)–7 is added to read as follows:

§1.337(d)–7 Tax on property owned by a C corporation that becomes property of a RIC or REIT.

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

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

(ii) *Conversion transaction.* For purposes of this section, the term *conversion transaction* means the qualification of a C corporation as a RIC or REIT or the transfer of property owned by a C corporation to a RIC or REIT.

(b) *Section 1374 treatment*—(1) *In general*—(i) *Property owned by a C corporation that becomes property of a RIC or REIT.* If property owned by a C corporation becomes the property of a RIC or REIT in a conversion transaction, then the RIC or REIT will be subject to tax on the net built-in gain in the converted property under the rules of section 1374 and the regulations thereunder, as modified by this paragraph (b), as if the RIC or REIT were an S corporation.

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

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

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

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

(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.

(f) *Effective date.* This section applies to conversion transactions that occur on or after January 2, 2002. For conversion transactions that occurred on or after June 10, 1987, and before January 2, 2002, see §§1.337(d)–5 and 1.337(d)–6.

§1.337(d)–7T [Removed]

Par. 7. Section 1.337(d)–7T is removed.

Par. 8. In §1.514(c)–2, paragraph (e)(1)(v) is added to read as follows:

§1.514(c)–2 Permitted allocations under section 514(c)(9)(E).

* * * * *

(e) * * *

(1) * * *

(v) Allocations made in taxable years beginning on or after January 1, 2002, that are mandated by statute or regulation other than subchapter K of chapter 1 of the Internal Revenue Code and the regulations thereunder.

* * * * *

Par. 9. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 10. In §602.101, paragraph (b) is amended by removing the entries for "1.337(d)–5T", "1.337(d)–6T", and "1.337–7T" and adding entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR Part or section where identified or described	Current OMB control No.
*****	
1.337(d)–5	1545–1672
1.337(d)–6	1545–1672
1.337(d)–7	1545–1672
*****	

David A. Mader,
Assistant Deputy Commissioner of Internal Revenue.

Approved March 7, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

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