



Section of Taxation

10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682
E-mail: tax@abanet.org

May 1, 2008

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Final Regulations Under Section 337(d) Relating to Conversion Transactions

Dear Commissioner Shulman:

Enclosed are comments concerning final regulations under section 337(d) relating to conversion transactions. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stanley L. Blend
Chair, Section of Taxation

Enclosures

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service
Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury

CHAIR

Stanley L. Blend
San Antonio, TX

CHAIR-ELECT

William J. Wilkins
Washington, DC

VICE CHAIRS

Administration

Rudolph R. Ramelli
New Orleans, LA

Committee Operations

Elaine K. Church
Washington, DC

Communications

Ellen P. Aprill
Los Angeles, CA

Government Relations

Armando Gomez
Washington, DC

Professional Services

Samuel L. Braunstein
Fairfield, CT

Publications

Louis Mezzullo
Rancho Santa Fe, CA

SECRETARY

Alice G. Abreu
Philadelphia, PA

ASSISTANT SECRETARY

Walter Burford
Atlanta, GA

COUNCIL

*Section Delegates to the
House of Delegates*

Paul J. Sax
San Francisco, CA

Richard M. Lipton
Chicago, IL

Immediate Past Chair

Susan P. Serota
New York, NY

MEMBERS

Christine L. Agnew
Houston, TX

John P. Barrie
New York, NY

Peter P. Blessing
New York, NY

Peter J. Connors
New York, NY

Richard S. Gallagher
Milwaukee, WI

Sharon Stern Gerstman
Buffalo, NY

C. Wells Hall
Charlotte, NC

Helen M. Hubbard
Washington, DC

Kathryn Keneally
New York, NY

Emily A. Parker
Dallas, TX

Priscilla E. Ryan
Chicago, IL

Stephen E. Shay
Boston, MA

Barbara Spudis de Marigny
San Antonio, TX

LIAISON FROM ABA

BOARD OF GOVERNORS

Raymond J. Werner
Chicago, IL

LIAISON FROM ABA

YOUNG LAWYERS DIVISION

Matthew McLaughlin
Gulfport, MS

LIAISON FROM LAW

STUDENT DIVISION

Venay Kumar Puri
Pittsburgh, PA

DIRECTOR

Christine A. Brunswick
Washington, DC

**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
COMMENTS CONCERNING EXCHANGED BASIS TRANSACTIONS AS
“CONVERSION TRANSACTIONS” UNDER REG. §§1.337(d)-6(a)(2)(ii) AND -
7(a)(2)(ii) AND TAX-EXEMPT CORPORATIONS AS “C CORPORATIONS”
UNDER REG. §§1.337(d)-6(a)(2)(i) AND -7(a)(2)(i)**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, the Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jim Sowell, Peter Genz, and Daniel Cullen of the Section’s Real Estate Committee. Substantive contributions were made by Sheldon Elefant of the Section’s Real Estate Committee, Deanna Flores and Keith Lawson of the Section’s Investment Companies Committee, and Jack Cummings of the Section’s Corporate Tax Committee. The Comments were reviewed by Kevin Thomason, Chair of the Section’s Real Estate Committee. The Comments were further reviewed by Joel Zychick of the Section’s Committee on Government Submissions and by Barbara de Marigny, Council Director for the Real Estate Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Persons:

Jim Sowell
Phone: (202) 533-5721
Email: jsowell@kpmg.com

Peter Genz
Phone: (404) 572-4935
Email: pgenz@kslaw.com

Daniel Cullen
Phone: (312) 602-5071
Email: daniel.cullen@bryancave.com

Date: May 1, 2008

EXECUTIVE SUMMARY

On March 13, 2003, the Internal Revenue Service (“Service”) and the Department of the Treasury (“Treasury”) issued final regulations under section 337(d)¹ (the “Final Regulations”) relating to transactions involving the conversion of a C corporation to a real estate investment trust (“REIT”) or a regulated investment company (“RIC”) or the transfer of property from a C corporation to a REIT or RIC (collectively, “conversion transactions”).² The Final Regulations provide alternative regimes for ensuring that the 1986 repeal of the *General Utilities* doctrine is not avoided in connection with such conversion transactions.

These comments address the following two very narrow issues arising under the Final Regulations:

- The first issue involves the definition of a “conversion transaction.” The Final Regulations would appear to include “exchanged basis” transactions within the definition of “conversion transactions.” We believe that this definitional inclusion is not appropriate, and we recommend that the Final Regulations be corrected so that such transactions will not be subject to the Final Regulations.
- The second issue involves the possible treatment of a tax-exempt corporation as a “C corporation” for purposes of the Final Regulations. “C corporation” is the term describing the party that, upon undertaking a “conversion transaction,” will be subject to the Final Regulations. We believe that, with one exception, the inclusion of tax-exempt corporations within the definition of a “C corporation” for this purpose is not appropriate. We recommend that the Final Regulations be corrected to properly coordinate the results under the Final Regulations with the principles of Reg. §1.337(d)-4, relating to transfers of assets by taxable corporations to tax-exempt entities.

¹ All references to sections herein are references to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise expressly stated herein, and references to regulations are to the Treasury Regulations issued under the Code.

² 68 Fed. Reg. 12817-01 (2003).

DISCUSSION

I. Background

The Tax Reform Act of 1986 (the “1986 Act”) effectively repealed the *General Utilities* doctrine. Prior to its repeal, the *General Utilities* doctrine provided a common law and statutory exception (under the pre-1987 version of sections 336(a) and 337) to the general principle that the income and gains of a C corporation are subject to two levels of tax (first, at the corporate level when recognized and, second, at the shareholder level when distributed). The exception generally allowed a corporation to liquidate without paying a corporate level tax on the net unrealized gains in its appreciated assets.

The 1986 Act repealed the *General Utilities* doctrine by amending sections 336 and 337 to require C corporations (other than certain subsidiaries) to recognize gain upon the distribution of appreciated property in connection with a complete liquidation. The repeal of the *General Utilities* doctrine ensured that the realized, but theretofore unrecognized, gain occurring at the corporate level in such liquidations would be recognized by, and taxable to, the liquidating corporation. To prevent avoidance of this gain recognition in a situation where a C corporation elects S corporation status, Congress enacted section 1374, which provides a tax on certain “built-in gains” of C corporations that make such an election.

In addition, section 337(d) directs the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments effected by the 1986 Act, 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 . . .

On February 4, 1988, the Service issued Notice 88-19 announcing its intention to promulgate regulations under the authority of section 337(d) with respect to transactions or events that result in a REIT or RIC owning property that has a basis determined by reference to the basis of a C corporation in such property (a “carryover basis”). Notice 88-19 indicated that regulations would prevent the avoidance of tax on the net built-in gain of C corporation assets that become assets of a REIT or RIC upon (1) the qualification of a C corporation as a REIT or RIC or (2) the transfer of assets to a REIT or RIC in a “carryover basis transaction.” Where the regulations would apply, under the default rule announced in Notice 88-19, 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. Alternatively, Notice 88-19 provided that immediate gain recognition could be avoided if the transferee REIT or RIC elected to be subject to the rules of section 1374 (by treating the REIT or RIC similarly to a C corporation that elected to become an S corporation). Section 1374 subjects newly electing S corporations to corporate-level taxation on built-in gains from C corporation years, as and when such gains are recognized, during a ten-year period following the conversion from

C corporation to S corporation status. The regulations would not allow the recognition of a net loss.

On February 7, 2000, the Service published Temporary Regulation section 1.337(d)-5T implementing section 337(d) (the “2000 Regulations”). The 2000 Regulations applied

to the net built-in gain of C corporation assets that become assets of a RIC or REIT by –

- (i) the qualification of a C corporation as a RIC or REIT; or
- (ii) the transfer of assets of a C corporation to a RIC or REIT in a transaction in which the basis of such assets are determined by reference to the C corporation’s basis (a carryover basis).³

Subsequently, in January 2002 the Service replaced the 2000 Regulations with Temporary Regulation section 1.337(d)-7T (for transfers after January 1, 2002), and Temporary Regulation section 1.337(d)-6T (for transfers before January 2, 2002) (the “Temporary Regulations”). The Temporary Regulations were further revised, and the Final Regulations were adopted on March 13, 2003.

II. The Definition of a “Conversion Transactions”

Like Notice 88-19, the Final Regulations were intended to police the potential avoidance of the *General Utilities* repeal by imposing the built-in gain rules of section 1374, or immediate gain recognition, on property held by a REIT or RIC that formerly had been held by a C corporation. The description of such transactions, however, was altered from the description which appeared in Notice 88-19 and the 2000 Regulations. Specifically, Regulation sections 1.337(d)-6 and -7 provide that section 1374 treatment or immediate gain recognition will apply with respect to any asset of a C corporation that “becomes property” of a REIT or RIC in a “conversion transaction.”⁴ For this purpose, a “conversion transaction” is defined as “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.”⁵

By eliminating the reference to “carryover basis” in defining the transfers from C corporations to RICs or REITs that are covered by these rules, the Final Regulations greatly expanded the transactions that could be covered by the basic rule. The Final Regulations did, however, provide some limitation by adding an exception for “any

³ Temp. Reg. §1.337(d)-5T(a).

⁴ Reg. §§1.337(d)-6(a)(1) and -7(a)(1). The principle difference between the two regulation sections is that, with respect to conversion transactions, Reg. §1.337(d)-7 imposes the built-in gain rules of section 1374 unless the C corporation elects deemed sale treatment for the property that is the subject of the conversion transaction whereas Reg. §1.337(d)-6 imposes deemed sale treatment on the C corporation unless the RIC or REIT elects section 1374 treatment.

⁵ Reg. §§1.337(d)-6(a)(2)(ii) and -7(a)(2)(ii). The Temporary Regulations defined “conversion transactions” in the same way as the Final Regulations. Temp. Reg. §§1.337(d)-6T(a)(2)(ii) and -7T(a)(2)(ii)

conversion transaction to the extent that gain or loss otherwise is recognized on such conversion transaction.”⁶

A. Problem Created by the Final Regulations

We assume that the elimination of the reference to carryover basis transactions and adoption of the exception from the Final Regulations to the extent of recognized gain was aimed at avoiding duplication of the C corporation-level tax with respect to the same gain in situations where other provisions, such as section 351(b), applied. The change, however, had another impact that likely was unintended. By virtue of the approach taken, the Final Regulations technically apply section 1374 treatment or immediate gain recognition to assets acquired in nonrecognition transfers between a C corporation and a REIT or RIC where the basis of the assets received by the C corporation is determined by reference to the basis of the assets transferred by such C corporation (*i.e.*, “exchanged basis property”).⁷ By way of illustration, where a REIT exchanges real property with a C corporation in an exchange that qualifies for nonrecognition treatment under section 1031 as to the C corporation, the receipt of the C corporation’s property by the REIT would qualify as a “conversion transaction” under the Final Regulations because the REIT acquires property of a C corporation and no gain or loss is recognized by the C corporation on the transfer. Thus, the Final Regulations would seem to require section 1374 treatment or immediate gain recognition with respect to the property acquired by the REIT or RIC.

B. Analysis and Recommendation

We agree that the Final Regulations under section 337(d) should not apply to carryover basis transactions to the extent that gain or loss is recognized with respect to the assets received by the REIT or RIC. If the C corporation recognized some amount of gain in connection with a transfer, the assets should not again be subject to a second layer of tax in the hands of the REIT or RIC on the same amount of gain.

At the same time, we believe it is inappropriate to subject assets received in an exchanged basis transaction to section 1374 treatment or immediate gain recognition under the Final Regulations. In an exchanged basis transaction, the C corporation will be replacing the property that it transfers to the REIT or RIC with property having equivalent basis and built-in gain or loss, so that no amount of gain is escaping a C corporation-level tax. In this situation, there is no “circumvention” of the purposes of *General Utilities* repeal, and the regulatory authority provided under section 337(d) would not appear to extend so far as to permit such transactions to be captured.

⁶ Reg. §§1.337(d)-6(d)(1) and -7(d)(1).

⁷ Section §7701(a)(44) defines “exchanged basis property” for purposes of the Code.

We note that the same comment was made and accepted in connection with the proposed regulations regarding transfers of all, or substantially all, of a C corporation's assets to a tax-exempt entity.⁸ In this regard, the preamble to the Final Regulations stated:

One commentator suggested that the Asset Sale Rule should not apply to a taxable corporation transferring assets to a tax-exempt entity in a like-kind exchange described in section 1031 or an involuntary conversion described in section 1033. In transactions described in these sections, the taxable corporation acquires replacement property that has a basis determined by reference to the basis of the property replaced. Because the built-in appreciation in the transferred asset is preserved in the replacement asset and remains in the hands of a taxable corporation, *General Utilities* repeal is not circumvented in these transactions. Accordingly, the final regulations exclude transactions from the Asset Sale Rule to the extent the transactions qualify for nonrecognition of gain or loss under section 1031 or 1033.⁹

We see no distinction between the transfer of substantially all of a C corporation's assets to a tax-exempt entity in a transaction qualifying under section 1031 and a section 1031 exchange where a C corporation transfers property to a REIT or RIC.

Accordingly, we recommend that transactions involving exchanged basis property be excluded from the definition of a conversion transaction. This result could be readily achieved by defining "conversion transactions" in a manner similar to Regulation section 1.337(d)-7(a)(2)(ii), but excluding transactions where the C corporation receives "exchanged basis property" (as defined under section 7701(a)(44)) in connection with the transaction.

II. Issues Arising in Connection with Treating a Tax-Exempt Corporation as a C Corporation

As described above, the Final Regulations apply with respect to assets transferred by a "C corporation" to a REIT or RIC. For this purpose, the term "C corporation" has the meaning provided in section 1361(a)(2), except that the term does not include a RIC or REIT.¹⁰ Section 1361(a)(2) provides that the term "C corporation" means a corporation which is not an S corporation.

⁸ As discussed below, Reg. §1.337-4 generally requires the C corporation to recognize gain on the transfer of property in such transactions unless the tax-exempt entity would use the property in an activity that generates unrelated business taxable income. See *infra* note 18 and accompanying text.

⁹ T.D. 8802 (preamble).

¹⁰ Reg. §§1.337(d)-6(a)(2)(i) and -7(a)(2)(i). The Temporary Regulations defined "C corporation" in the same way as the Final Regulations. Temp. Reg. §§1.337(d)-6T(a)(2)(i) and -7T(a)(2)(i), but the 2000 Regulations did not define the term "C corporation."

The preamble to the Final Regulations recognized the possibility that a tax-exempt entity could be treated as a C corporation for purposes of the Final Regulations.¹¹ Similarly, subsequent to the promulgation of the Final Regulations, the Service issued Rev. Rul. 2003-69,¹² where, in the context of analyzing qualification for the small partnership exception to the TEFRA rules under section 6231(a)(1)(B), it recognized that an exempt organization under section 501(a) could be a C corporation within the meaning of section 1361(a)(2).¹³

A. Problem Created by the Final Regulations

The vast majority of property transfers by tax-exempt corporations to REITs or RICs do not create the potential for corporate tax avoidance that the Regulations are intended to

¹¹ Specifically, the preamble to the Final Regulations stated:

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 Service 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.

T.D. 9047 (preamble), 68 Fed. Reg. 12817-01 (2003).

¹² 2003-1 C.B. 1118.

¹³ Under Reg. §301.7701-3(c)(1)(v), an eligible entity that is determined to be, or claims to be, exempt from tax under section 501(a) is treated as having made an election to be classified as a corporation. In Rev. Rul. 2003-69, the determination that the tax-exempt entity was properly treated as a C corporation followed from the conclusion that the tax-exempt entity was a "business entity" as defined under Reg. § 301.7701-2(a). A "business entity" is any entity recognized for federal tax purposes and that is not properly classified as a trust or otherwise subject to special treatment under the Code. Not all tax-exempt entities are properly classified as corporations. For example, state and private pension funds may be classified as "trusts" rather than "business entities" that are treated as "C corporations," in which case transfers of assets by such entities to REITs or RICs would not be subject to the Regulations. Cf. PLR 200734018 (May 22, 2007) (foreign pension trust classified as a "trust" under Reg. §301.7701-4); PLR 200508004 (Nov. 10, 2004) (same).

police.¹⁴ For example, there is no potential for avoidance of *General Utilities* repeal where a tax-exempt corporation transfers property to a REIT because the tax-exempt corporation would have been exempt from tax on gain recognized in connection with a sale of such property. This conclusion would seem to be confirmed by, for example, Regulation section 1.337(d)-4, which provides that, where a taxable corporation¹⁵ transfers all or substantially all of its assets to a tax-exempt entity, the taxable corporation must recognize gain or loss immediately before the transfer as if the assets were sold at their fair market values.¹⁶ The justification for this rule is that the tax-exempt entity will

¹⁴ These rules should have little practical effect for RICs, because RICs typically receive assets with an adjusted basis equal to their fair market value. In particular, a transfer of property to a widely-held RIC generally would not qualify for nonrecognition treatment under section 351. However, if a closely-held or newly-formed RIC receives built-in gain assets in a transaction qualifying under section 351, such gains could impact not only the transferor, but also the RIC's current and future shareholders. RICs generally avoid receiving assets with built-in gain due to the tax impact on non-contributing shareholders and fiduciary obligations owed to such shareholders under applicable securities laws. As a result, parties involved in a contribution to a RIC that might qualify under section 351 generally would attempt to restructure such transactions so as to ensure that the adjusted basis of contributed securities is equal to their fair market value or that any built-in gains for such securities are appropriate from a tax and securities law perspective. The gain-recognition election under Reg. § 1.337(d)-7(c) also could serve as a tool for ensuring that gain is recognized on the transfer of assets to a RIC where the contribution might otherwise qualify under section 351.

¹⁵ Reg. § 1.337(d)-4(c)(1) defines a "taxable corporation" as "any corporation that is not a tax-exempt entity as defined in paragraph (c) (2) of this section." Reg. § 1.337(d)-4(c)(2) defines a "tax-exempt entity" as

- (i) any entity that is exempt from tax under section 501(a) or section 529;
- (ii) A charitable remainder annuity trust or charitable remainder unitrust as defined in section 664 (d);
- (iii) The United States, the government of a possession of the United States, a state, the District of Columbia, the government of a foreign country, or a political subdivision of any of the foregoing;
- (iv) An Indian Tribal Government as defined in section 7701(a)(40), a subdivision of an Indian Tribal Government determined in accordance with section 787 1 (d), or an agency or instrumentality of an Indian Tribal Government or subdivision thereof;
- (v) An Indian Tribal Corporation organized under section 17 of the Indian Reorganization Act of 1934, 25 U.S.C. 477, or section 3 of the Oklahoma Welfare Act, 25 U.S.C. 503;
- (vi) An international organization as defined in section 7701(a)(18);
- (vii) An entity any portion of whose income is excluded under section 115; or
- (viii) An entity that would not be taxable under the Internal Revenue Code for reasons substantially similar to those applicable to any entity listed in this paragraph (c)(2) unless otherwise explicitly made exempt from the application of this section by statute or by action of the Commissioner.

¹⁶ Reg. § 1.337(d)-4(a)(1). Although these rules appear to have some focus on whether the tax-exempt entity will be taxable on operating income with respect to the C corporation assets (*see infra* note 18 and accompanying text), the Final Regulations with respect to REITS and RICs appear to be singularly focused on built-in gain with respect to the C corporation's assets. This conclusion follows from the adoption of the section 1374 regime for REITs and RICs, a regime that was considered and rejected for transfers from C corporations to tax-exempt entities. T.D. 8802 (preamble) 63 Fed. Reg. 71591-01 (1999). The section 1374 regime allows a REIT or RIC to acquire the assets of a C corporation, avoid immediate recognition of gain, and hold the assets without subjecting operating income to a C corporation tax, only imposing tax on gain from the sale of converted assets if the assets are sold within ten years of the conversion transaction.

not be subject to tax when it later resells the property, so that failure to trigger gain upon a transfer from the C corporation to the tax-exempt entity would forever eliminate the C corporation-level tax on the gain inherent in the assets transferred. If a transfer of property by a C corporation to a tax-exempt corporation compromises *General Utilities* repeal, then a subsequent transfer of that property by the same tax-exempt corporation to a REIT or RIC should not again compromise *General Utilities* repeal. The only exception to this rule is the case where gain from the sale of property by the tax-exempt corporation would be characterized under section 511 as unrelated business taxable income.

B. Analysis and Recommendation

If the Final Regulations applied only in the context of direct transfers by a tax-exempt corporation to a REIT or RIC, the situation arguably would be manageable, because the tax-exempt corporation could make the gain recognition election under Regulation section 1.337(d)-7(c) or, for conversion transactions that occurred before January 2, 2002, could have defaulted to gain recognition treatment under Regulation section 1.337(d)-6(b). In either such case, the tax-exempt corporation, by virtue of its exempt status, would not be subject to tax on the gain caused to be recognized by the Final Regulations unless the tax under section 511 on unrelated business taxable income applied.¹⁷

But a direct transfer is not the only situation where the Final Regulations can apply. Regulation section 1.337(d)-7(e) provides that the principles of the Final Regulations¹⁸ apply to property transferred by a partnership to a REIT or RIC to the extent of any C corporation partner's distributive share of gain or loss in the transferred property. Where a partnership has one or more C corporations as partners, it is the partnership, not the C corporation partner, that has the option to make the gain recognition election. The partnership is confronted with a paradox where it has, as partners, both taxable and tax-exempt corporations. Here, the partnership is left in a situation where, no matter what it does, its actions will be detrimental to at least one set of its partners.

If the partnership makes the gain recognition election under Regulation section 1.337(d)-7(c), the tax-exempt corporate partners will pay no tax. The taxable C corporation partners are harmed, however, as their gain will be accelerated. If the partnership determines not to make the gain recognition election, the rules of section 1374 will apply imposing section 1374 treatment on the REIT or RIC by reference to the amount of the deemed gain that would be allocated to all C corporation partners, including those that are tax-exempt C corporations. Under these facts, all of the partners are harmed. Any C

The decision with respect to REITs and RICs is logical, given that (1) section 337(d) itself appears to be focused on ensuring that built-in gain does not escape the C corporation-level tax, and (2) most income that represents qualifying income for a REIT or RIC also would not be subject to tax under section 511(a).

¹⁷ From a policy perspective, it would seem preferable not to force a tax-exempt corporation to affirmatively make an election in order to avoid a result that the tax-exempt corporation should not be subject to in the first place.

¹⁸ Temp. Reg. §1.337(d)-7T(e) provided essentially the same rule. Reg. §1.337(d)-6 and Temp. Reg. §1.337(d)-6T do not provide for a rule relating to partnerships with C corporation partners.

corporation tax imposed under section 1374 will reduce the after-tax return of the REIT, which affects all of the partners.

We believe that applying the Final Regulations to a tax-exempt corporation is defensible only in the case where the tax-exempt corporation actually would be subject to tax on a sale of the “converted property” under section 511. Regulation section 1.337(d)-4 effectively subscribes to this concept by providing that its gain recognition rules will not apply where the transferee tax-exempt entity will use the transferred assets in an activity the income from which is subject to tax under section 511(a).¹⁹

Accordingly, we recommend that the Final Regulations be amended to provide that a tax-exempt corporation will be subject to the Final Regulations only to the extent that the corporation would be subject to tax upon a sale of the converted property.²⁰ We believe that this could be accomplished by amending Regulation section 1.337(d)-7(a)(2)(i) so as to reference a “taxable corporation,” as defined in Regulation section 1.337(d)-4(c)(1),²¹ rather than a “C corporation,” as defined in section 1361(a)(2). In addition, we recommend that a proviso be added at the end of that subsection stating that a corporation also would be treated as a taxable corporation to the extent that the corporation would be subject to tax under section 511 if it were to recognize gain on the sale to an unrelated party of the property that is the subject of the conversion transaction.

¹⁹ Reg. §1.337(d)-4(b)(1). That rule would subject the tax-exempt entity to tax upon disposition of the property or ceasing to use the assets in a section 511(a) activity.

²⁰ If a tax-exempt corporation that is a qualified organization within the meaning of section 514(c)(9)(C) (e.g., a section 501(c)(25) organization that is classified as a corporation) disposes of real property that is subject to “acquisition indebtedness,” gain from that sale will be exempt from tax so long as none of the exceptions in section 514(c)(9)(B) apply. Where a partnership has tax-exempt corporate partners that are qualified organizations, a disposition by the partnership of real property subject to such acquisition indebtedness would not give rise to gain that would be taxable to the qualifying organizations so long as the partnership meets one of the requirements set forth in section 514(c)(9)(B)(vi). In most cases, the partnership will avoid subjecting its qualifying organization partners to tax by satisfying the “fractions rule,” as described in section 514(c)(9)(E) and Reg. §1.514(c)-2.

²¹ See *supra* note 14.