The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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IRS ISSUES NEW TEMPORARY AND PROPOSED REGULATIONS REGARDING CERTAIN ASSET TRANSFERS TO REGULATED INVESTMENT COMPANIES

[14286] January 4, 2002 TO: ACCOUNTING/TREASURERS COMMITTEE No. 2-02 TAX MEMBERS No. 1-02 RE: IRS ISSUES NEW TEMPORARY AND PROPOSED REGULATIONS REGARDING CERTAIN ASSET TRANSFERS TO REGULATED INVESTMENT COMPANIES The Internal Revenue Service ("IRS") has issued the attached temporary and proposed regulations under section 337(d) of the Internal Revenue Code relating to the proper tax treatment of C corporation assets that become assets of a regulated investment company ("RIC") or a real estate investment trust ("REIT") either by (1) the qualification of the C corporation as a RIC or REIT or (2) the transfer of assets of a C corporation to a RIC or REIT in a carryover basis transaction (a "conversion transaction"). The new regulations implement guidance issued by the IRS in 1988 (IRS Notices 88-19 and 88-96) and prevent the avoidance of corporate-level tax on net built-in gain resulting from conversion transactions.1 The new regulations are intended to replace the temporary and proposed regulations issued by the IRS under section 337(d) on February 7, 2000 (the "2000 regulations").2 As requested by the Institute,3 the following clarifications and changes from the 2000 regulations are incorporated in Treas. Reg. 1.337(d)-6T, which applies to conversion transactions occurring on or after June 10, 1987 and before January 2, 2002,4 and in Treas. Reg. 1.337(d)-7T, which applies to conversion transactions occurring after January 1, 2002: Clarification of Failed RIC Exception – Consistent with Notice 88-96, the 2000 regulations provided an exception to the general recognition rule for any C corporation that (1) immediately prior to qualifying to be taxed as a RIC was subject to tax as a C corporation for a 1 See Institute Memoranda to Tax Members No. 9-88, dated February 12, 1988 and Tax Members No. 47-88, dated August 15, 1988. 2 See Institute Memorandum to Accounting/Treasurers Committee No. 8-00 and Tax Members No. 7-00, dated February 24, 2000. 3 See Institute Memoranda to Accounting/Treasurers Members No. 12-00 and Tax Members No. 18-00, dated June 1, 2000 and Accounting/Treasurers Committee No. 18-00 and Tax Members No. 15-00, dated April 26, 2000. 4 Taxpayers may continue to rely on the 2000 regulations for conversion transactions occurring during this period, although certain rules in Treas. Reg. 1.337(d)-6T must be applied to built-in gain recognized in tax years beginning after January 1, 2002. 2 period not exceeding one taxable year and (2) immediately prior to being subject to tax as a C corporation was subject to tax as a RIC for a period of at least one taxable year. The language used to implement this exception in the 2000 regulations was ambiguous and could have been

interpreted to treat assets acquired by the RIC before the single year of failure as ineligible for the exception. The new regulations eliminate this ambiguity by clarifying that only property acquired during the failure period in a carryover basis transaction is ineligible for the exception. The new regulations also expand the exception to cover REITs and extend the maximum period for loss of RIC or REIT status from one taxable year to two taxable years. Coordination with Subchapter M Rules5 – The 2000 regulations provided that the built- in gain of a RIC or REIT electing section 1374 treatment and the corporate-level tax imposed on such gain are subject to "rules similar to the rules relating to net income from foreclosure property [("NIFP")] of REITs." However, the NIFP rules overlap and are inconsistent with the 1374 rules. As recommended by the Institute, the new regulations state directly the additional rules that are needed to coordinate the rules of section 1374 with subchapter M, in lieu of referring to the NIFP rules. The new regulations permit RICs and REITs to use loss carryforwards and credits and credit carryforwards of the C corporation to reduce net recognized built-in gain and the tax thereon to the extent allowed under section 1374.6 In addition, the new regulations generally preserve the character of recognized built-in gains and losses that have been taxed in accordance with the new regulations.7 The new regulations also provide that an entity-level tax imposed on net recognized built-in gain is treated as a loss that reduces the RIC's or REIT's taxable income and earnings and profits8 and is attributable to the portion of the RIC's taxable year occurring after October 31. Finally, the new regulations clarify that earnings and profits attributable to built-in gain recognized by a RIC or REIT are subchapter M earnings and profits.9 Election of Section 1374 Treatment10 – The 2000 regulations provided that a RIC or REIT makes a section 1374 election by attaching a statement to its Federal income tax return for the first taxable year in which the assets of a C corporation became assets of the RIC or REIT. The 2000 regulations also provided for an "interim period" election where the first taxable year in which the assets of a C corporation became the assets of a RIC or REIT ended after June 10, 1987 and before March 8, 2000. In this case, the 2000 regulations required a RIC or REIT to elect 5 The new regulations provide that a RIC or REIT generally will be subject to tax on net built-in gain under the rules of section 1374 as if the RIC or REIT were an S corporation. 6 A RIC or REIT must use loss carryforwards 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 under section 852(b) or real estate investment trust taxable income under section 857(b) for that taxable year. A similar ordering rule applies to credits and credit carryforwards used to reduce the tax on net recognized built-in gain for a taxable year. 7 For example, recognized built-in gain would retain its character for purposes of computing a RIC's net capital gain that can be distributed to shareholders as a capital gain dividend. 8 The character of the loss attributable to the tax on net recognized built-in gain is determined by allocating the tax proportionately among the items of recognized built-in gain. 9 As explained by the Institute, this clarification was necessary because a RIC or REIT cannot qualify as such under subchapter M if it retains any subchapter C earnings and profits. See Treas. Reg. 1.337(d)-6T(c)(5) (example). 10 Like the 2000 regulations, Treas. Reg. 1.337(d)-6T provides that deemed sale treatment applies to conversion transactions, unless the transferee RIC or REIT elects to be subject to the rules of section 1374. 3 section 1374 treatment with its first Federal income tax return filed after March 8, 2000. As requested by the Institute, the new regulations do not require a RIC or REIT to make a second section 1374 election if the RIC or REIT can demonstrate that it previously has informed the IRS of its intent to make a section 1374 election. The new regulations also permit a RIC or REIT that converted from a C corporation or acquired property with a carryover basis from a C corporation before January 2, 2002 to make a section 1374 election with any Federal income tax return filed by the RIC or REIT on or before March 15, 2003, provided that that the RIC or REIT has

reported consistently with such election for all periods. Finally, the new regulations provide that a RIC or REIT can elect section 1374 treatment for one conversion transaction and not for another conversion transaction in which it participates. Clarification of Deemed Sale Treatment – The 2000 regulations provided that, unless a section 1374 election is made, a C corporation engaging in a conversion transaction is "treated for all purposes, including recognition of net built-in gain, as if it had sold all of its assets at their respective fair market values on the deemed liquidation date . . . and immediately liquidated." The new regulations eliminate the "deemed liquidation" construct and clarify that a C corporation is treated as having sold only that property actually transferred to the RIC or REIT. The new regulations also clarify that a shareholder-level tax is not imposed as a result of the conversion transaction. Pursuant to Treas. Reg. 1.337(d)-7T, the following additional clarifications and changes apply to conversion transactions occurring after January 1, 2002: Reversal of Default Rule under Section 1374 – Under Treas. Reg. 1.337(d)-7T(a), section 1374 treatment applies unless the C corporation elects deemed sale treatment. This reverses the "default" rule that applies under the 2000 regulations and Treas. Reg. 1.337(d)-6T. Anti-Stuffing Rule – Treas. Reg. 1.337(d)-7T(c)(4) contains an "anti-stuffing" rule to discourage taxpayers electing deemed sale treatment from attempting to decrease net gains by "stuffing" loss property into a C corporation prior to a conversion transaction. Partnership Transactions – Treas. Reg. 1.337(d)-7T(e) adopts an "aggregate" approach to partnership taxation. As a result, transfers of property by a partnership to a RIC or REIT are subject to the new regulations to the extent of any C corporation partner's proportionate share of the transferred property. ACTION REQUESTED: Comments on the new regulations are due to the Internal Revenue Service by April 2, 2002. Please contact the undersigned (dflores@ici.org or 202/371-5436) with your comments, if any, on the new regulations. Deanna J. Flores Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 14286, or call the ICI Library at (202) 326-8304 and request the attachment for memo 14286.
