Perplexing Temporary Regulations Expand Rules for Taxing C Corporation Built-In Gain for REITs

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The Temporary Regulations extend the recognition period for REIT assets with C corporation gain from five years to ten years and use the PATH Act to impose additional C corporation gain recognition penalties on transactions involving the conversion of a C corporation's assets into assets of a REIT that take place within a 20-year period surrounding a related Section 355 distribution.

The Treasury and the IRS recently released temporary regulations (the Temporary Regulations) under Section 337 that expand the scope of circumstances under which Regulated Investment Companies (RICs), real estate investment trusts (REITs), and their owners are subject to double taxation on unrecognized built-in gain to the extent such gain was accrued while property was held by a corporation subject to tax under Subchapter C of the Code (a C corporation).[1] The Temporary Regulations were issued under the authority of Section 337(d)(1), which empowers Treasury to promulgate regulations to prevent the circumvention of the repeal of the "General Utilities Doctrine"[2] through the use of RICs and REITs. Before its repeal, the General Utilities Doctrine allowed C corporations to distribute property to shareholders without the corporation recognizing any built-in gain in the distributed property. Treasury's mandate under Section 337(d)(1) is to prevent taxpayers from using REITs and RICs to avoid entity-level tax on gain accruing during the period in which property is held by a C corporation (C Corporation Gain).

Under previously-existing regulations, the regime for imposing entity-level tax on the C Corporation Gain of RICs and REITs had been essentially the same as the regime for imposing entity-level tax on the C Corporation Gain of corporations subject to tax under subchapter S of the Code (S corporations) pursuant to Section 1374. Recent legislative changes under the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act)[3]

made two changes generally relevant to the treatment of C Corporation Gain with respect to entities with essentially no entity-level tax, such as S corporations, RICs and REITs. First, the PATH Act permanently reduced the period for which an S corporation has to hold acquired property with C Corporation Gain before it could escape entity-level tax with respect to such C Corporation Gain from ten years to five years. Because previously-applicable regulations addressing the C Corporation Gain inherent in property held by REITs used the rules for S corporations, this change also applied to REITs.[4] The Temporary Regulations run contrary to Congress's trajectory on this matter, increasing the period during which REITs are subject to entity-level tax on C Corporation Gain. Second, the PATH Act limited the circumstances under which REITs, or C corporations interested in becoming REITs, are able to participate in tax-free distributions under Section 355 (Section 355 Distributions). Section 355 Distributions had been a pathway to move assets with C Corporation Gain into REITs in a tax-free manner. The Temporary Regulations further restrict Section 355 Distributions with respect to REITs.

TAXATION OF REITS ON C CORPORATION GAIN

Generally, the various provisions of the Code that exempt certain corporate transactions (Non-Recognition Transactions) from federal income tax apply similarly to S corporations and REITs as they do to C corporations.[5] This presented an issue when, for example, a C corporation would transfer property in a Non-Recognition Transaction to a REIT or an S corporation and the REIT or S corporation would subsequently sell such property in a taxable transaction, because of the difference in the manner in which C corporations, on one hand, and S corporations and REITs, one the other, are taxed.

C corporations are subject to two layers of tax. The C corporation itself is subject to tax on its earnings and, when the C corporation distributes those earnings to its shareholders, the shareholders are subject to tax on the dividends received.[6] S corporations and REITs, however, are generally not subject to C corporation tax. Income and gain earned by an S corporation passes through to the S corporation's shareholders and is taxed at the shareholder level, without the S corporation incurring any entity-level tax.[7] Shareholders are not taxed again when the S corporation's earnings are distributed.[8] REITs are subject to entity-level tax on their earnings, but receive a dividends-paid deduction for earnings that they distribute to their shareholders, essentially wiping out any earnings that would otherwise be taxable at the level of the REIT if such earnings are distributed.[9]

Therefore, if a C corporation is able to transfer appreciated property to an S corporation or to a REIT in a tax-free Non-Recognition Transaction, the S corporation or REIT could subsequently sell the property and avoid entity-level tax on the built-in gain. Section 1374, for S corporations, and regulations under Section 337, for REITs, prevent this situation by imposing entity-level tax on C Corporation Gain accrued while property disposed of by an S corporation or a REIT was held by a C corporation if the disposition occurs within a set period of time after the property is transferred from the C corporation to the S corporation or REIT (the "Recognition Period").

IMPACT OF TEMPORARY REGULATIONS ON RECOGNITION PERIOD

In the 28 years since Treasury guidance was first promulgated under Section 337(d)(1), the Recognition Period for REITs and for S corporations has always been the same,[10] even though the length of such Recognition Period has been changed a number of times.[11] The PATH Act revised Section 1374(d)(7), making the Recognition Period applicable to an S corporation five years.[12] As recognized in the legislative history of the PATH Act, because the regulations applicable to a REIT's Recognition Period at the time of the PATH Act's passage, that change also had the effect of reducing a REIT's Recognition Period for C Corporation Gain to five years.[13] The Temporary Regulations change the regulations applicable to REITs, increasing a REIT's Recognition Period for C Corporation Gain to ten years.[14]

This aspect of the Temporary Regulations is the most troubling and the most perplexing. The perplexing aspect is that, prior to the issuance of the Temporary Regulations, the Recognition Period for S corporations and REITs had always been the same. This made sense because, as the regulations under Section 337(d)(1) explicitly state (both before and after the promulgation of the Temporary Regulations), the purpose of the regulations under

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1 Temp. Reg. 1.337-7T; see also TD 9770, 6/7/16. This article focuses on the impact of the Temporary Regulations on REITs. Hereinafter, only consequences to REITs and their shareholders will be discussed; however, most of the same rules apply with respect to RICs.

2 The "General Utilities Doctrine" is named for the U.S. Supreme Court Case, *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), which held that a C corporation did not recognize taxable income at the corporate level on a distribution of appreciated property to its shareholders. The doctrine was repealed by subtitle D of title VI of the Tax Reform Act of 1986, P.L. 99-514, 10/22/86.

3 The "PATH Act" refers the U.S. House of Representatives amendment to the U.S. Senate amendment to H.R. 2029. Military Construction and Veterans Affairs and Related Agencies Appropriations Act of 2016, which on December 18, 2015, became Public Law No: 114-113.

4 See Joint Committee on Taxation, "Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029" (Rules Committee Print 114-40) (12/17/15) at 43.

5 See Sections 856(a)(3) and 1363(a); see generally Sections 332, 351, and 368.

6 See Sections 11 and 301.

7 Section 1366.

8 Section 1368.

9 Section 857(b).

10 See Notice 88-19, 1988-1 CB 486; TD 8872, 2/7/00; TD 8975, 1/2/02; TD 9047, 3/18/18; TD 9626, 8/2/13.

11 See P.L. 99-514, section 632(a) (ten-year recognition period); P.L. 111-5, section 1251 (seven-year recognition period for 2009 and 2010); P.L. 111-240, section 2014 (five-year recognition period for 2011); P.L. 112-240, section 326 (five-year recognition period for 2012 and 2013); P.L. 113-295, section 138 (five-year recognition period for 2014).

12 PATH Act, section 127.

13 See note 4 *supra*.

14 Temp. Reg. 1.337-7T(b)(2)(iii).

Section 337(d)(1) is to apply the C Corporation Gain rule for S corporations to REITs with the implication being that REITs and S corporations should be treated the same with respect to C Corporation Gain. Specifically, the regulations state that "[i]f property owned by a C corporation becomes the property of a [REIT] in a conversion transaction, then the [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 [Temp. Reg. 1.337-7T(b)], as if the [REIT] were an S corporation."[15] While the existing regulations under Section 337(d)(1) make a few modifications to the way that the rules of Section 1374 are applied to REITs in certain instances, one would expect there to be some logical basis for such modifications.

> **Treasury provides no explanation at all for the reason why it chose to modify the Recognition Period for REITs and de-link it from the Recognition Period for S corporations provided by Section 1374.**

This leads to the troubling aspect of the Temporary Regulations. Specifically, Treasury provides no explanation at all for the reason why it chose to modify the Recognition Period for REITs and de-link it from the Recognition Period for S corporations provided by Section 1374. Although the Preamble to the Temporary Regulations is silent on this issue, a possible explanation for mandating a ten-year Recognition Period for REITs could come from Section 856(c)(8), added by the PATH Act and discussed below. This section prohibits the distributing corporation and the controlled corporation in a tax-free Section 355 Distribution from making a REIT election for ten years after the Section 355 Distribution. However, that provision is specific to Section 355 Distributions, which as discussed below, seem to be viewed by Congress as more problematic in the REIT context. It does not make sense to analogize from a provision that is meant to prevent what, in Congress's view, are problematic transactions to those that, in Congress's view, should not be subject to the same scrutiny, as expressed in the legislative history of the PATH Act, recognizing that a reduction in the statutory Recognition Period applicable to S corporations would result in a similar reduction to the Recognition Period applicable to REITs. This is especially true when, with respect to C Corporation Gain, a transaction such as a C corporation's conversion into a REIT is, as a matter of policy, no different than a C corporation's conversion to an S corporation. The same General Utilities Doctrine issues that apply to a C corporation converting to a REIT and later selling or distributing property with built-in gain apply when the C corporation converts to an S corporation. The historic gain in the value of the C corporation's property becomes subject to only one level of tax after the expiration of the Recognition Period in both instances. This is the reason why the taxation of C Corporation Gain for REITs has been linked, by reference, to the taxation of C Corporation Gain for S corporations for the last 28 years.

IMPACT OF TEMPORARY REGULATIONS ON SECTION 355 DISTRIBUTIONS AND REITS

The major focus of the Temporary Regulations is to further restrict the potential use of tax-free spin-off transactions involving REITs, beyond the restrictions imposed by the PATH Act. The PATH Act restrictions were presumably imposed in response to the concern raised by Treasury and the Service over the ability of C corporations operating active businesses, prior to passage of the PATH Act, to use tax-free spin-offs to separate out their REIT-eligible assets and spin them off into REITs, with no change to business operations, but with substantial tax benefits with respect to the taxation of the income generated by such REIT-eligible assets. Of course, there can be no issue with a C corporation that qualifies to be a REIT electing to become one in order to benefit from the beneficial tax regime applicable to REITs.[16] However, what Congress did not approve of was an operating business separating out its REIT-eligible assets in a tax-free Section 355 Distribution, so that income and gain attributable to those assets could benefit from the REIT tax regime, while the non-REIT operating company continues to use the spun-off assets in the operation of its business.[17] To prevent this result, the PATH Act added two new provisions to the Code, one under Section 355(h) and the other under Section 856(c)(8).

Code Sections Added by the PATH Act

Generally, under Section 355, a "distributing corporation" can distribute the shares of a "controlled corporation" to the distributing corporation's shareholders tax-free. Under Section 355(h), Section 355 does not apply to REITs, unless: (1) both the controlled corporation and the distributing corporation are REITs; or (2) the distributing corporation is a REIT and the controlled corporation is a "taxable REIT subsidiary" (the "TRS Exception"). For the TRS Exception to apply, the REIT must have been a REIT for three years prior to the distribution; the taxable REIT subsidiary (TRS) must have been a TRS for that entire period and the TRS must have been controlled by the REIT during that period. The TRS Exception can also apply in certain circumstances to corporations spun-off by a TRS.

Without more, Section 355(h) could be easily avoided when a dis-

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tributing C corporation spins-off a controlled corporation that is also a C corporation and, subsequently, one of the two elects REIT status. Section 856(c)(8) prevents this by providing that a corporation that is either a distributing corporation or a controlled corporation in a Section 355 Distribution may not elect REIT status for a period of ten years after the Section 355 Distribution. The prohibition also applies to successors of the controlled and/or distributing corporation, although the statute does not define the term successor. Therefore, for example, a corporation cannot circumvent the rule established by Section 355(h) and spin-off its REIT-eligible assets by contributing such assets to a subsidiary corporation, spinning-off the subsidiary corporation using a tax-free Section 355 Distribution, and then causing the spun-off controlled corporation to make a REIT election. Section 856(c)(8) will require the controlled corporation to wait ten years before it can make such an election.

The Temporary Regulations

The Temporary Regulations introduce far more expansive anti-abuse rules that, generally speaking, require either a REIT or a C corporation to recognize C Corporation Gain when a transaction involving the conversion of a C corporation's assets into assets of a REIT as a result of a REIT election or a Non-Recognition Transaction (a "Conversion Transaction") occurs within ten years of a Section 355 Distribution (the "Automatic Gain Recognition Rules"). The Automatic Gain Recognition Rules apply when a C corporation engages in a Conversion Transaction resulting in its assets becoming REIT assets during the 20-year period beginning on the date that is ten years before the date of a Section 355 Distribution (the "Related Section 355 Distribution") and such C corporation or REIT engaged in the Related Section 355 Distribution as either: (1) the distributing corporation; (2) the controlled corporation; or (3) a member of a separate affiliated group (SAG)[18] of the distributing or controlled corporation.[19] For purpose of this rule, predecessors or successors to the distributing or controlled corporation are also included.[20]

The major focus of the Temporary Regulations is to further restrict the potential use of tax-free spin-off transactions involving REITs, beyond the restrictions imposed by the PATH Act.

The Automatic Gain Recognition Rules apply differently depending on the order of the Conversion Transaction and the Related Section 355 Transaction. If a Related Section 355 Distribution occurs prior to a Conversion Transaction, the C corporation engaging in the Conversion Transaction is deemed to elect to treat the Conversion Transaction as a taxable sale, causing the C corporation to recognize the C Corporation Gain as a result of the Conversion Transaction (the "Conversion Post-355 Rule").[21] For example, if a C corporation were to spin-off a subsidiary C corporation and either corporation merges into a REIT in an otherwise tax-free merger with the REIT surviving, the merging C corporation would be required to recognize C Corporation Gain on all of its property. On the other hand, if the Conversion Transaction occurs prior to the Related Section 355 Distribution, the REIT must recognize all of the C Corporation Gain for which the Recognition Period has not lapsed in the year of the Related Section 355 Distribution (the "Conversion Pre-355 Rule"). As discussed in further detail below, it is not readily apparent when the Conversion Pre-355 Rule applies, based on the exceptions to the Automatic Gain Recognition Rules.

The exceptions to the Automatic Gain Recognition Rules apply when: (1) the distributing corporation and the controlled corporation are both REITs immediately after the Related Section 355 Distribution[22] and at all times during the two years thereafter (the "Two-Year Rule") or (2) the TRS Exception applies.[23]

Issues Under the Temporary Regulations

The Temporary Regulations are problematic from both a policy perspective and a practical perspective. On the

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15 Reg. 1.337-7(b)(1).

16 Notice 2015-59, 2015-40 IRB 459.

17 The soundness of this concern is debatable, but having been approved by legislation, for the purpose of this article, it will be used as the analytical guideline.

18 The term "separate affiliated group" means, with respect to any corporation, the affiliated group that would be determined under Section 1504(a) if such corporation were the common parent and Section 1504(b) did not apply. Section 355(b)(3)(B). This generally includes corporations in a chain of ownership, when the ultimate parent of the chain owns, directly or indirectly, 80% or more of the vote and value of each corporation in the chain.

19 Temp. Reg. 1.337(d)-7T(f)(1).

20 Predecessors and successors include corporations that succeed to and take into account items described in Section 381(c) of the distributing corporation or the controlled corporation, and corporations having such items to which the distributing corporation or the controlled corporation succeeded and took into account. Temp. Reg. 1.337(d)-7T(f)(2)

21 Temp. Reg. 1.337-7T(c)(6).

22 This includes REIT elections made after the Related Section 355 Distribution that are effective before the Related Section 355 Distribution.

23 Temp. Reg. 1.337-7T(f)(3). There is also an exception when the Related Section 355 Distribution occurred before 12/7/15 or is described in a ruling request referred to in section 311(c) of Division Q of the Consolidated Appropriations Act, 2016, P.L. 114-113, 12/18/15.

24 TD 9770, 6/8/16 ("The Treasury Department and the IRS believe that section 1374 treatment imposes an appropriate regime for recognizing built-in gain for many conversion transactions. The Treasury Department and the IRS are concerned, however, that section 1374 treatment may not adequately implement the purposes of General Utilities repeal if a taxpayer effects a tax-free separation of REIT-qualifying assets from non-qualifying assets in a section 355 distribution .... Moreover, the REIT and its shareholders may realize the benefit of appreciation on converted property without a transaction subject to section 1374 treatment or otherwise taxable at the corporate level. For example, a REIT that distributes rental income on appreciated converted property to its shareholders may be entitled to a dividends paid deduction under section 562 and, therefore, effectively does not pay income tax at the REIT level on that income, which in many cases will reflect the appreciation in the value of the property.").

policy side, the preamble to the Temporary Regulations provides that the purpose of the Temporary Regulations is not only to prevent C Corporation Gain from escaping double taxation, but also to prevent income from holding or operating assets with C Corporation Gain from escaping double taxation.[24] The second objective appears to grossly overstep congressional intent, as it goes against the policy of allowing C corporations to make REIT elections without immediately recognizing all C Corporation Gain on appreciated assets or being subject to entity-level tax on distributed income generated by such assets. In other words, if the rental income received by a REIT with respect to property with C Corporation Gain should be subject to tax, why would Congress allow a C corporation to convert into a REIT without paying tax on the C Corporation Gain and without being subject to double taxation on the rental income generated by the property with C Corporation Gain? However, setting aside the baffling policy that appears to underpin them, the Temporary Regulations present numerous practical problems.

The Conversion Post-355 Rule. What can be said about the Conversion Post-355 Rule is that it does make sense to a point. Sections 355(h) and 856(c)(8), on their own, would likely not be effective in preventing tax-free REIT spin-offs. For example, the shareholders of a C corporation engaged in an operating business could form a REIT, spin-off REIT-eligible assets in a new C corporation, and then merge the spun-off C corporation into the REIT in a tax-free merger. The Section 355 Distribution of the spun-off corporation would not fall afoul of Section 355(h), because the controlled corporation and the distributing corporation are both C corporations in this case. Section 856(c)(8) would not apply because neither the controlled corporation nor the distributing corporation made REIT elections. However, under the Conversion Post-355 Rule, the spun-off C corporation would be required to recognize gain on its assets when it merges into the REIT. The trouble is that the Conversion Post-355 Rule goes way too far.

Consider a different scenario, in which a C corporation worth $1 billion intends to merge with, and into, an unrelated REIT in a tax-free merger, with the REIT surviving. If nine years prior to the merger, the C corporation had spun-off one of its minor business operations that was worth $100,000, under the Conversion Post-355 Rule, the C corporation would be treated as a distributing corporation engaging in a Conversion Transaction within ten years of a Related 355 Distribution. As a consequence, the C corporation would be required to recognize the built-in gain on all of its assets in the otherwise tax-free merger with the REIT. In such a scenario, it seems absurd to require the C corporation to recognize gain on all of its assets because of a relatively minor transaction that had nothing to do with the Conversion Transaction and that occurred that many years in the past.

As promulgated, the Two-Year Rule creates serious and unnecessary pitfalls for unsuspecting taxpayers.

The Conversion Pre-355 Rule. This rule is quite perplexing. Under the rule, first, there must be a Conversion Transaction so either a C corporation must become a REIT or a REIT must make a tax-free acquisition of C corporation property. Then, within the following ten years, the REIT must engage in a Related Section 355 Distribution. Under Section 355(h), a REIT can be only a distributing corporation or a controlled corporation in a tax-free Section 355 Distribution if the other corporation is either a REIT or a TRS to which the TRS Exception applies. Moreover, a REIT that is a distributing corporation or a controlled corporation is generally exempt from the Automatic Gain Recognition Rules, when the other corporation is a REIT or a TRS to which the TRS Exception applies. Thus, the Conversion Pre-355 Rule appears to apply when, for example, a recently-converted REIT spins-off another REIT and one of the two REITs fails the Two-Year Rule. Another possible scenario in which the Conversion Pre-355 Rule would apply is where a converted REIT is a subsidiary of a corporation (such that it would be a member of the corporation's SAG) and that corporation is spun-off. However, the Two-Year Rule and the application of the Automatic Gain Recognition Rules with respect to SAG members have problems of their own, as described below.

The Two-Year Rule. The Two-Year Rule is essentially an add-on to Section 355(h) which generally prohibits REITs from engaging in Section 355 Distributions, except when both the distributing corporation and the controlled corporation are themselves REITs. The Two-Year Rule adds a requirement that both the distributing corporation and the controlled corporation must remain REITs for at least two years after the Section 355 Distribution, when the Section 355 Distribution occurs within ten years of a Conversion Transaction. No explanation is provided in the preamble to the Treasury Regulations for the addition of the Two-Year Rule.[25]

[25] It is possible that the Two-Year Rule is modeled after the two-year continuity of business enterprise (COBE) requirement set forth under Section 382(c)(1), which has been linked to the COBE requirement for reorganizations under Section 368. See *Berry Petroleum Co.*, 104 TC 584 (1995). This would provide a model for the Two-Year Rule, but it would not explain the reason for imposing it (i.e. the purpose such a COBE-like requirement would serve that would further the objectives of the Temporary Regulations). Furthermore, for a stand-alone Section 355 Distribution, there is no COBE requirement. When a Section 355 Distribution is part of a reorganization under Section 368(a)(1)(D), the regulations under Section 368 impose a COBE requirement for the transaction to be treated as a reorganization. Reg. 1.368-1(d). However, when, for example, a controlled corporation continues to operate and only ceases to be a REIT, COBE is not violated.

As promulgated, the Two-Year Rule creates serious and unnecessary pitfalls for unsuspecting taxpayers. For example, if one year after a Section 355 Distribution involving two REITs (which therefore complies with the requirements of Section 355(h)), the REIT that was the controlled corporation fails to satisfy any of the REIT requirements, then a REIT that was the distributing corporation in the Section 355 Distribution will automatically become subject to entity-level tax on the C Corporation Gain attributable to any property it acquired in a Conversion Transaction within the ten-year period preceding the Section 355 Distribution. This seems to be an unusually harsh result for the REIT that was the distributing corporation in the Section 355 Distribution, especially if it is completely unrelated to the REIT that was the controlled corporation at that time the latter potentially unknowingly breached one of the REIT qualification requirements. Moreover, if the two REITs are completely unrelated, it is not at all apparent how the distributing REIT would be notified of the controlled REIT's failure to continue to qualify as a REIT, requiring the former to potentially recognize C Corporation Gain.

SAG Members. There does not seem to be any good reason to extend the Automatic Gain Recognition Rules to SAG members. By definition, a controlling interest in a SAG member is held by a corporation.[26] As a result, until the SAG member is itself spun-off, no Conversion Transaction would cause the SAG member's assets to escape corporate-level tax.

For example, assume X is an operating corporation, Y is X's wholly owned corporate subsidiary, and Z is Y's wholly owned corporate subsidiary. Assume further that Z holds appreciated real property. In Scenario 1, Z simply sells the real property. Z is subject to corporate-level income tax on the gain from the sale, Z's distribution of such gain to Y and Y's distribution of such gain to X would be tax-free, assuming the dividends received deduction applies,[27] and X's shareholders would be subject to tax when the gain is distributed to them as a dividend.

In Scenario 2, (i) X corporation spins-off Y corporation in a Section 355 Distribution; (ii) Y corporation merges Z corporation into a REIT in exchange for shares of the REIT; and (iii) the REIT sells the appreciated property received from Z. Prior to the Temporary Regulations, the tax result would have essentially been the same as Z's sale of the appreciated property in Scenario 1. The REIT would not have been subject to tax on the gain from the sale of the appreciated property to the extent it distributed such gain to Y. However, Y would have been subject to corporate-level tax on the distributed gain, because the distribution from the REIT would not have been eligible for the dividends received deduction.[28] Y's distribution of the gain to Y's shareholders then would have been taxed as dividend income to Y's shareholders. In sum, prior to the Temporary Regulations the net tax result of Scenario 1 and Scenario 2 would essentially have been the same with respect to corporate-level taxation of C Corporation Gain.

26 See note 18, *supra*.
27 See generally Section 243.
28 Section 857(b)(2).

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Nevertheless, the Temporary Regulations will now apply to Scenario 2. Specifically, the Conversion Post-355 Rule will apply when Z is merged into the REIT. This is because Z will be treated as having engaged in a Related Section 355 Distribution as a SAG member of Y. Thereafter, Z will engage in a Conversion Transaction when it merges into the REIT. As a result, the Temporary Regulations will require Z to recognize all built-in gain in its property in a merger with the REIT that would have otherwise been tax-free, whether or not the REIT sells the property. Therefore, contrary to the stated intent of the Temporary Regulation, it appears that the application of the Automatic Gain Recognition Rules to SAG members will likely affect situations in which corporate-level tax would not have been avoided in the first place.

In fairness, it is possible to imagine certain situations in which corporate income tax could have been avoided without an extension of the Automatic Gain Recognition Rules to SAG members. For example, if in Scenario 2 above Y elects to become an S corporation after the spin-off, it could escape corporate income tax on the built-in gain inherent in the property held by Z, absent the Temporary Regulations. In that instance, if the Automatic Gain Recognition Rules had not been extended to SAG members, the REIT would not have been subject to tax on the gain from the sale of the appreciated property to the extent it distributed such gain to Y. Additionally, Y, as an S corporation, would not have been subject to corporate-level tax on the distributed gain. Instead, income and/or gain from the distribution would have been passed through to Y's shareholders, who would not have been subject to tax on the distribution of the gain to them from Y. However, if exceptional circumstances, like the example above, are the target of the extension of the Automatic Gain Recognition Rules to SAG members, such extension should more narrowly apply to these types of situations that Treasury deems abusive.

A further point to note with respect to the extension of the Automatic Gain Recognition Rules to SAG members is that it can easily be avoided. This is because a SAG member's predecessors and successors are not covered by the rule.[29] In Scenario 2 above, when X distributes the shares of Y and, thereafter, Z merges into a REIT, the Conversion Post-355 Rule applies because Z, as a SAG member of Y, is treated as engaging in a Related Section 355 Distribution and then engaging in a Conversion Transaction. However, if Z were to merge into a C corporation, V, and then V were to merge into the REIT, the Automatic Gain Recognition Rules would not apply. V's merger with and into the REIT is a Conversion Transaction; however, under the Temporary Regulations, V would not be deemed to have engaged in a Related Section 355 Distribution as a SAG member. Although V is a successor to Z and Z engaged in a Section 355 Distribution (as a member of Y's SAG), the Automatic Gain Recognition Rules do not treat successors of a SAG member that engaged in a Section 355 Distribution as corporations that engaged in such Section 355 Distribution.

CONCLUSION

The Temporary Regulations impose new restrictive rules on REITs and taxpayers that engage in transactions with REITs with respect to the recognition of entity-level tax on C Corporation Gain. The Temporary Regulations extend the Recognition Period for REIT assets with C Corporation Gain from five years to ten years, so that for the first time in 28 years, the Recognition Period for REITs is different than the Recognition Period for S corporations. Treasury offers no explanation to distinguish REITs and S corporations in this regard, even though the same rules essentially generally apply to both with respect to the recognition of C Corporation Gain. The Temporary Regulations also use the PATH Act as a jumping off point to impose additional, aggressive C Corporation Gain recognition penalties on Conversion Transactions taking place within a 20-year period surrounding a Related Section 355 Distribution. What this means is that even potentially insignificant, temporally-distant Section 355 Distributions can have catastrophic effects on C corporations that have converted, or are planning to convert, into REITs, and on reorganizations and other Non-Recognition Transactions that involve REITs and C corporations, even when such transactions are between unrelated parties dealing at arm's length. Consequently, practitioners will have to be extra vigilant in their due diligence and in drafting agreements for Non-Recognition Transactions involving REITs to make certain that even minor transactions that are within the 20-year collar surrounding a REIT/C corporation Non-Recognition Transaction will not result in unforeseen entity-level tax liability.

Although there is some merit in Treasury's and the Service's interest in implementing regulations to support recent changes made under the PATH Act and to prevent the avoidance of some of the rules enacted thereby, Treasury and the Service should take a hard look at these Temporary Regulations, in order to align them with the intent of the provisions in the PATH Act and tailor them to implement the policies of the PATH Act without creating potentially disastrous pitfalls for REITs and C corporations transacting with REITs. Hopefully, Treasury and the Service will better explain their reasoning with respect to the specific rules imposed in the Temporary Regulations instead of justifying the rules with sweeping general statements about the General Utilities Doctrine. ●

NOTES

29 See note 20, *supra*, and accompanying text.