

Client Alert

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Treasury Expands Scope of REIT Spin-Off Rules in New Regulations

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On June 7, the Treasury Department released temporary regulations (the “Temporary Regulations”)¹ that expand the types of spinoff transactions subject to the rules under Section 337(d)² requiring gain recognition where either the distributing or distributed corporation elects to be treated as a real estate investment trust (REIT). The Regulations also modify the built-in gain rules applicable to REIT conversions.

BACKGROUND

The Protecting Americans from Tax Hikes Act (“PATH Act”) was signed into law last December. The PATH Act introduced rules that eliminated tax-free treatment under Section 355 for REIT spinoffs, except in certain transactions where one REIT spins off another REIT or where a REIT spins off a taxable REIT subsidiary (TRS). These rules also prohibit the distributing or distributed corporation from electing REIT status within 10 years of a spinoff. Congress viewed such REIT spinoffs as an inappropriate means of removing assets from corporate solution without incurring a corporate-level tax on gain from those assets, and the provisions within the PATH Act were meant as a means to counteract this perceived abuse.

The PATH Act was meant to bolster the current regime under the Section 337 regulations and Section 1374 dealing with REIT “conversion transactions.” Treas. Reg. 1.337(d)-6 provides that a C corporation engaging in a REIT conversion transaction is treated as if it had sold all its assets at their respective fair market values and immediately liquidated, unless a Section 1374 election is made. Section 1374 subjects a REIT or a regulated investment company (RIC) to corporate-level taxation on built-in gain in its assets at the time of a conversion transaction that are recognized by the REIT on a sale of such assets during the five -year period following the conversion transaction.

Recently, Treasury expressed concerns that the existing legal regime is still not sufficient to prevent the use of REITs and spinoffs to avoid the corporate-level tax.³ For example, a C corporation could effect a tax-free separation of REIT-qualifying assets from nonqualifying assets in a spinoff followed by an acquisition by a REIT of the qualifying assets through a tax-free reorganization. Treasury has commented that, though Section 1374 imposes an appropriate regime for recognizing built-in gain for many conversion transactions, it may be

¹ T.D. 9770.

² Section 337(d), enacted by Congress in 1986, directs the Treasury to prescribe regulations to carry out the purposes of the repeal of the *General Utilities* doctrine. That doctrine, which arose from *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), generally provided that a corporation recognized no gain or loss on distribution of appreciated property to its shareholders. All section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

³ T.D. 9770.

Client Alert

insufficient in transactions similar to that discussed above, because gain is unlikely to be recognized within the five-year recognition period during which the REIT is subject to Section 1374. As a result, even after the PATH Act, the previously described transaction might allow a taxpayer to separate REIT-qualifying assets from nonqualifying assets in a tax-free manner and avoid the Section 1374 built-in gains tax by waiting five years to dispose of the real estate.

THE TEMPORARY REGULATIONS

The Temporary Regulations effectively expand the PATH Act restrictions on REIT spinoffs. In an effort to combat the perceived abuse described above, using the authority under Section 337(d), the Temporary Regulations impose a corporate-level tax on any built-in gains of a C corporation that engages in a spinoff in which either the distributing or distributed corporation is acquired by a REIT or otherwise engages in a conversion transaction within the 10-year period following the spinoff. As noted above, before the Temporary Regulations, taxpayers engaging in such transactions could elect to be subject to Section 1374's built-in gain-recognition regime rather than immediately recognizing gain. The Temporary Regulations contain exceptions consistent with those of the PATH Act; namely, the Temporary Regulations do not apply if both distributing and controlled corporations are REITs or a REIT distributes its TRS.

Additionally, while the PATH Act reduced the Section 1374 built-in gain period from 10 years to five years, the Temporary Regulations decouple the gain-recognition period from Section 1374 and provide that period will still be 10 years for transfers from C corporations to REITs or RICs in a conversion transaction, even in situations where there had been no prior spinoff.

Proposed Regulations⁴ that accompany the Temporary Regulations also include a modification to the definition of "converted property" that would treat as converted property any property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of property owned by a C corporation that becomes the property of a RIC or a REIT.

The Temporary Regulations are effective June 7, 2016. However, this effective date could be misleading, since these rules seem to indicate that a conversion transaction today could taint a spinoff that happened 10 years ago. Comments on the Proposed Regulations and requests for a public hearing are requested by August 7, 2016.

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⁴ REG-126452-15.

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