How Much Gain Would a REIT Defer if a REIT Could Defer Gain?

By Ameek Ashok Ponda

Ameek Ashok Ponda

Ameek Ashok Ponda is a tax partner in Sullivan & Worcester LLP's Boston office, an adjunct professor with the Boston University Law School Graduate Tax Program, and a lecturer on law at Harvard Law School. He gratefully acknowledges the assistance of Benjamin Bray, David B. Casten, Paul W. Decker, Jonathan B. Dubitzky, Joseph X. Donovan, Christopher M. Flanagan, David O. Kahn, David H. Kaplan, Robert J. LeDuc, and Sarah D. Wellings.

When a C corporation converts or is otherwise absorbed into a real estate investment trust, its deferred intercompany gains are needlessly restored into income on the final C corporation income tax return. A more sensible rule would be to permit continued deferral with the REIT as the appropriate successor and repository of deferred gains. That is, a REIT would defer as much deferred gain as a REIT could defer if a REIT could defer deferred gain.

Real estate investment trusts in recent years have been much lauded in the press.[1] Not only are they a domestic success, they have also become increasingly international by accepting non-U.S. investors and by making investments abroad.[2]

REITs were not always so widespread. When they were created in 1960, REITs were envisioned as permitting small investors access to the same kinds of real estate investment opportunities that large, sophisticated investors could access directly.[3] But it took decades to realize that expansive vision: A REIT was not listed on the New York Stock Exchange until 1965; entities organized under local law as corporations could not become REITs until 1976; and a REIT first reached an equity market capitalization in excess of $1 billion only in 1991.[4] During those formative years, REITs were sometimes viewed as the province of only the very sophisticated.[5]

It should be no surprise, however, that REITs evolved from patrician to pedestrian. Under U.S.

---

[1] *See, e.g.*, Allen Kenney, ''Ten Years Into the Mainstream,'' *Real Estate Investment Today* (Sept.-Oct. 2011); *Real Estate Investment Today Anniversary Issue* (Nov.-Dec. 2010) (REIT industry celebrates its 50th anniversary); Anton Troianovski, ''REITs Going Global to Find Deals,'' *The Wall Street Journal*, Nov. 10, 2010; Robert Manor, ''U.S. Real Estate Expertise Helps Lead International Developments: REITs on the Rise,'' *Chicago Tribune*, Apr. 25, 2008; Renuka Rayasam, ''Going Global With REITs,'' *U.S. News & World Report*, July 26, 2007.

[2] *See, e.g.*, Ameek Ashok Ponda, ''REITs Abroad,'' *Practising Law Institute's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* (2006-2008); Ponda, ''Foreign Pension Plans Investing in Shares of a U.S. REIT,'' *Tax Notes*, Mar. 24, 1997, p. 1593, *Doc 97-8309*, or *97 TNT 56-55*.

[3] H.R. Rep. No. 87-2020. Congress wanted ''small investors [through the use of REITs to] secure advantages normally available only to those with larger resources.'' *Id.*

[4] National Association of Real Estate Investment Trusts, ''REIT Industry Timeline: Celebrating 50 Years of REITs and NAREIT,'' *available at* http://www.reit.com/timeline/timeline.php.

[5] *See, e.g.*, comments by Mark A. Ferguson and Charles O. Lorensen of George, Ferguson & Lorensen, Charleston, W.Va., on proposed partnership antiabuse rule (July 22, 1994), *Doc 94-6705*, *94 TNT 142-39* (''West Virginia is not the Mecca of tax planning. We would not know an UPREIT if we saw one. However, we should be able to know a partnership if we see one''). Speaking of Mecca, REITs are now so mainstream that they meaningfully intersect with *sharia* and with financial markets concerned with *sharia* compliance, particularly outside the United States. *See, e.g.*, Nicole C. O'Neal, ''The Development of Islamic Finance in America: The Future of Islamic Real Estate Investment Trusts,'' 44 *Real Prop., Trust, & Est. L.J.* 279 (2009); Min Hun Fong, ''Malaysia's Axis to List World's Largest Sharia REIT,'' Reuters (Mar. 11, 2011); P.R. Venkat, ''IPO Twist: REIT Obeys Islamic Law,'' *The Wall Street Journal Asia*, Oct. 13, 2010 (''Once floated, Sabana REIT is expected to be the largest certified Shariah-compliant REIT in the world''). *Cf.* Jeremy Harding, ''Islam and the Armies of Mammon,'' 31 *London Review of Books* 19, 22 (May 14, 2009) (''Sharia-compliance is a profitable conversation between Islam and the armies of mammon . . . ; advocates of sharia-compliant products are not afraid to lift ideas — and instruments — from the repertoire of Western finance and graft them onto Islamic principles'').

federal income tax law, there are essentially only two tax-efficient entities for investing in rental real estate: a partnership (or limited liability company) taxed as a partnership under subchapter K, and a corporation (or corporate trust) taxed as a REIT under subchapter M.[6]

In general, the partnership model offers more flexibility in matters of organization, operations, and distributions, whereas a REIT is more constrained in those matters and thus is not always suitable. For example, a REIT is taxed punitively on its income from dealer transactions and so is unsuited for build-to-sell deals or other situations in which the investments will either be held for only a short time or frequently sold.[7] Also, a REIT generally cannot be majority held, directly or indirectly, by five or fewer individuals and their families.[8] Further, a REIT cannot pass foreign tax credits through to its owners, whereas a partnership or LLC taxed under subchapter K can, so a REIT will typically be eclipsed by a partnership or LLC when the bulk of the vehicle's investments are outside the United States.[9] Finally, a REIT cannot pass losses through to its owners on a current basis, but a partnership or LLC taxed under subchapter K can, and thus a partnership or LLC will be preferable to a REIT when planning contemplates the current use of tax losses by one or more of the entity's owners.[10]

However, a REIT can shield tax-exempt investors from possible unrelated business income tax exposure if they invest in real estate — particularly leveraged real estate — directly or indirectly through an entity taxed under subchapter K.[11] Also, a REIT serves as a state income tax blocker at the investor level in that it typically pays no state income taxes on account of a dividends paid deduction, and a REIT shareholder pays tax on her dividends from the REIT only in her state of residence[12] — that is, states where the REIT's properties are located have typically ceded source taxation of the REIT's income to the states where the REIT's shareholders reside.[13] To receive some of the best benefits of both subchapter K and subchapter M, it is common for a REIT to invest in a partnership (for example, the so-called UPREIT and DownREIT models) or for a partnership to invest through a captive REIT.[14]

It is now also common for a REIT to acquire a C corporation so that the REIT succeeds to the C corporation's tax attributes under section 381, including asset tax bases and accumulated earnings and profits.[15] That transaction may take one of two basic forms. Either the REIT acquires the C corporation in an asset reorganization under section 368(a)(1)(A), (C), or (D),[16] or the REIT acquires the C corporation through a taxable stock purchase that is immediately followed by a deemed section 332

---

[6]*Compare* sections 701-777 *with* sections 856-860 (both regimes generally involve no entity-level income taxation, but rather a single level of taxation at the investor level, which for the REIT regime is achieved through a dividends paid deduction). In conformity with that federal treatment, both the subchapter K and REIT regimes generally also avoid entity-level state income taxation. For the REIT regime, that is typically because state taxable income generally uses federal taxable income (and the associated dividends paid deduction) as the starting point. *See, e.g.*, Fla. Stat. section 220.13(2)(e); N.J. Rev. Stat. sections 54A:2-2 and 54A:5-4; *Corporate Property Investors v. Division of Taxation*, 664 A.2d 1281 (N.J. Super. Ct. App. Div. 1995); Pa. Stat. Ann. section 7306. Less common, but also possible, is for an S corporation to be a pooled vehicle for the ownership of rental real estate. *See* sections 1361-1379 for the provisions governing the taxation of S corporations generally. Among the drawbacks of an S corporation as the real estate pooled vehicle are: (1) S corporations that were once C corporations may have a limited ability to earn passive rental income, since too much passive income may result in a federal entity-level penalty tax as well as termination of S corporation status (sections 1362(d)(3) and 1375); (2) some states impose entity-level income taxes on S corporation income (*e.g.*, Mass. G.L., ch. 63, section 32D); (3) compared with the subchapters K and M models, the S corporation is severely limited in the number and type of investors that may participate (sections 856, 1361, and 7704); and (4) unlike the subchapter K model, the S corporation cannot give its owners tax basis for entity-level indebtedness, which precludes the possibility of debt-financed tax deductions for the entity's owners (sections 704(d), 752, 1366(d), and 1367).

[7]*See* section 857(b)(6).

[8]*See generally* sections 542(a)(2), 544, 856(a)(6), 856(g), 856(h), 856(k), and 857(f).

[9]*See* section 702; *cf.* section 853 (regulated investment company passthrough of foreign tax credits, but no analogous provision for REITs in sections 856-860). *See* Ponda, ''REITs Abroad,'' *supra* note 2, at para. I(F) (discussing current law and OECD proposals on this point).

[10]*Compare* sections 465, 469, 704, and 752 *with* section 857.

[11]*See generally* sections 316, 511-515, and 856(h)(3)(C)-(E); Rev. Rul. 66-106, 1966-1 C.B. 151.

[12]*See supra* note 6. In contrast, a nonresident investor in a partnership is typically taxed by the states in which the partnership owns real estate. *See, e.g.*, N.J. Rev. Stat. section 54A:5-4 and N.J. Admin. Code section 18:35-1.3(b)(2); Pa. Stat. Ann. sections 7301(k) and 7308 and Pa. Code section 107.2.

[13]*Cf.* Multistate Tax Commission, ''Proposed Model Statute for Taxation of Captive Real Estate Investment Trusts,'' section A (Jan. 3, 2008) (''This statute shall not be interpreted as precluding the right of a state to tax the income earned by any type of real estate investment trust as source income in computing net income by measures including, but not limited to, the disallowance of, or required add back of, the dividends paid deduction otherwise allowed by federal law'').

[14]*See generally* Practising Law Institute, 10th annual Real Estate Tax Forum.

[15]*See generally* sections 334, 362, and 381. Generally, a REIT acquires a C corporation only if the target assets mostly comprise interests in real property. *See, e.g.*, Paul W. Decker, Ameek Ashok Ponda, and Jonathan Stein, ''Toward a Workable Definition of REIT Health Facility,'' *Tax Notes*, Dec. 5, 2011, p. 1231, at 1247 n.95, *Doc 2011-22825*, or *2011 TNT 234-9*.

[16]*See generally* sections 361, 368, and 381(a)(2).

liquidation of the C corporation into the REIT.[17] In both of those situations, the acquiring REIT must distribute the inherited C corporation E&P before the close of the REIT's tax year,[18] and the REIT's disposition within a specified number of years, generally 10 years, of the assets inherited from the C corporation will be subject to a built-in gains tax (imported from section 1374).[19]

These two principal tax issues apply to a REIT's acquisition of a C corporation consolidated group in much the same way as they do to a REIT's acquisition of a stand-alone C corporation. On the parent corporation's acquisition by the REIT, the members of the consolidated group are treated as liquidating or otherwise being absorbed into the REIT — the liquidations presumably beginning with the bottom tier of the consolidated group, proceeding upward tier by tier to the parent, and culminating in the parent's liquidation or reorganization into the REIT.[20] Each of the liquidations is typically governed by section 332, so on the parent's liquidation or reorganization into the REIT, the following takes place: Each member's asset tax bases carry over to

---

[17]Absent a taxable REIT subsidiary election on IRS Form 8875, a REIT's acquisition of all the stock of a C corporation will be deemed to be followed by a liquidation of the target C corporation for income tax purposes. *See generally* sections 332, 334, 337, 381(a)(1), 856(i), and 856(l); Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2). *Cf.* reg. section 1.1361-4(a)(2).

[18]*See* sections 316, 561, 857(a)(2), and 857(d); reg. section 1.857-11. This distribution requirement is typically addressed by one or both of the following approaches. First, the target C corporation could be contractually required to distribute most or all of its E&P to its shareholders before acquisition, such that little or no accumulated E&P carries over to the REIT under section 381. *See, e.g.*, LTR 9717036, *Doc 97-11636*, *97 TNT 81-21*, and LTR 9813004, *Doc 98-10454*, *98 TNT 60-15* (pre-acquisition dividend distributions). Second, the target C corporation's accumulated E&P that remains undistributed and thus carries over to the REIT must be distributed by the REIT to its shareholders before the close of the REIT's tax year, either via the REIT's regularly scheduled distributions or, if necessary, as part of another, special distribution occasioned by the REIT's need to distribute both the inherited, additional E&P as well as its REIT earnings for the tax year.

[19]*See* sections 337(d) and 1374; reg. section 1.337(d)-7; and prop. reg. section 1.337(d)-7. For dispositions in 2009 and 2010, a REIT's recognition period was reduced from 10 to seven years, so, for example, a REIT's 2010 disposition of built-in gain assets acquired from a C corporation in 2002 was exempted under that special dispensation. For dispositions in 2011, a REIT's recognition period was reduced from 10 to five years. *See* section 1374(d)(7)(B); LTR 201202014, *Doc 2012-754*, *2012 TNT 10-37* (confirming application of the section 1374(d)(7)(B) reduced recognition periods for REITs). Now that the concept of a reduced recognition period has gained currency, it is quite possible that future legislation will bring similar special dispensations.

[20]*See* reg. section 1.1361-4(b)(2) (although a taxpayer may specify a different order, the default rule is that liquidations begin at the lowest tier and proceed upward so that the acquired C corporation parent is liquidated last); *but cf.* reg. section 301.7701-3(g)(3)(iii) (although a taxpayer may specify a different order, the default rule is that liquidations begin at the highest tier and proceed downward). In determining the order of liquidations when a REIT acquires a C corporation consolidated group, the qualified REIT subsidiary rules of section 856(i) are nearly identical to the qualified subchapter S subsidiary rules of section 1361(b)(3), so reg. section 1.1361-4(b)(2) should generally govern in the section 856(i) context absent any express contrary authority. *See* Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 104th Congress," JCS-12-96, at 120-121 (Dec. 18, 1996), *Doc 96-32501*, *96 TNT 246-1*. The principal concerns with the ordering of tax-free liquidations is that the bottom-up approach eliminates adverse tax issues that may arise with a top-down approach, including the possible triggering of excess loss accounts under reg. section 1.1502-19 and the possible segregation of loss carryovers, credits, and other tax attributes on a member-by-member basis for purposes of sections 337(d) and 1374 built-in gains tax. *See generally* reg. sections 1.337(d)-7, 1.1374-8, and 1.1502-19; *but cf. United Dominion Industries Inc. v. United States*, 532 U.S. 822 (2001), *Doc 2001-15742*, *2001 TNT 108-14* (consolidated group has a single, groupwide, consolidated net operating loss carryover that is not to be segregated among members unless rules so provide); ILM 201033031, *Doc 2010-18552*, *2010 TNT 162-19*, ILM 200714017, *Doc 2007-8967*, *2007 TNT 68-16* (affirming and applying *United Dominion*'s unified view of consolidated NOL carryovers); and TAM 200447037, *Doc 2004-22217*, *2004 TNT 225-24* (for purposes of the section 384 built-in gain recognition regime, *United Dominion*'s unified view of consolidated NOLs applies). For a more detailed description of those potentially adverse results in a top-down liquidation approach, see T.D. 8869, 2000-1 C.B. 498, 501-502 (Section 1374 and Excess Loss Accounts), *Doc 2000-2452*, *2000 TNT 14-5*; American Institute of Certified Public Accountants, "Comments on Proposed Regulations Under Sections 1361 and 1362 Relating to S Corporations and Their Subsidiaries" (Nov. 10, 1998), *Doc 98-33579*, *98 TNT 223-35* (see Specific Comments — Detail, Comment I(E), regarding section 1374 as applied in tiered situations); American Bar Association Section of Taxation, "Comments on Proposed Regulations Under Section 1361(b)(3) on the Treatment of Corporate Subsidiaries of S Corporations" (Aug. 17, 1999), *Doc 1999-27802*, *1999 TNT 165-27* (see Issues for Consolidating Groups Electing S Corporation and QSub Status, regarding excess loss accounts as applied in tiered situations). REIT precedents suggest that a bottom-up approach is indeed applied under section 856(i), because applicable private rulings do not explicitly find triggered excess loss accounts or segregated sections 337(d) and 1374 tax attributes. *See, e.g.*, LTR 200702028, *Doc 2007-1028*, *2007 TNT 10-28* (no opinion expressed regarding excess loss accounts under reg. section 1.1502-19); LTR 9808011, *Doc 98-6711*, *98 TNT 35-59*, as supplemented by LTR 9823030, *Doc 98-17940*, *98 TNT 109-59* (no excess loss accounts triggered under reg. section 1.1502-19); LTR 9717036 (section 332 liquidations of target and its subsidiaries, but without any discussion of ordering or effect on excess loss accounts or sections 337(d) and 1374 tax attributes); LTR 9625024, *Doc 96-18284*, *96 TNT 123-47* (parent elects REIT status); LTR 9421034, *94 TNT 104-33* (same); LTR 9330022, *93 TNT 160-46* (same); LTR 9307018, *93 TNT 42-44* (same); LTR 9205030, *92 TNT 26-35* (same); LTR 9124041, *91 TNT 130-82* (same); and LTR 9051043, *90 TNT 260-84* (same). Also, parties seeking greater certainty that bottom-up liquidation treatment applies can have the target C corporation parent, a few days before liquidation or reorganization into the REIT acquirer, convert its lower-tier subsidiaries into LLCs that are disregarded entities for federal income tax purposes.

the REIT,[21] and the group's consolidated accumulated E&P (as well as each member's separate accumulated E&P, if any, accrued before joining the consolidated group) also carry over to the REIT.[22]

Those two principal tax issues are well understood by market participants and are routinely accommodated in REIT acquisitions of C corporations.[23] For example, an E&P study is usually commissioned so that the REIT can measure and meet its distribution obligation by the close of its calendar tax year. As for the built-in gain exposure during the recognition period following the acquisition (typically 10 years), the acquiring REIT may defer recognition of those gains through deferral strategies such as section 1031 like-kind exchanges.[24]

But lurking in the consolidated return rules may be an unpleasant surprise for a REIT that acquires C corporations. Reg. sections 1.1502-13(d) and 1.1502-13(j)(6) require that the target include in income on its final C corporation tax return all its deferred intercompany gains.[25] The principal concern with this acceleration rule is the obvious one: The accelerated gains increase the final year's taxable income, and the associated increase in tax liability creates a drag on the economics of the deal. Another undesirable side effect is that the additional taxable income (net of taxes) increases the C corporation's E&P that the REIT will inherit and then must distribute before the close of its tax year.[26]

This acceleration rule is especially pernicious because it applies in situations when the REIT acquirer may not otherwise expect deferred intercompany gains, such as (1) when a stand-alone C corporation target, as the last surviving member of a consolidated group, is the repository of deferred intercompany gains from the former consolidated group,[27] and (2) when an acquired C corporation consolidated group, as a successor through mergers and acquisitions activity, is the repository of deferred intercompany gains from former consolidated groups that it acquired.[28] In essence, deferred intercompany gains that were established many

---

[21]Sections 334(b) and 362(b). In special circumstances in which a REIT acquires a consolidated group's foreign C corporation subsidiaries with aggregate built-in losses, and those foreign subsidiaries are actually liquidated under section 332 or deemed liquidated under sections 332 and 856(i), the REIT could receive fair market value for its tax basis in assets rather than the higher carryover basis. Sections 334(b)(1)(B) and 362(e)(1).

[22]Sections 381(c)(2) and 857(d); reg. sections 1.381(c)(2)-1 and 1.1502-33. The target group's current E&P does not carry over separately to the REIT as current E&P; instead it is added to the target group's accumulated E&P and carries over to the REIT in that form. *See, e.g.*, reg. section 1.381(c)(2)-1(a)(7), Example 1. Also, because of the so-called hovering deficit rule, both a positive accumulated E&P account and a negative one could carry over from the target group to the REIT. *See* reg. sections 1.381(c)(2)-1(b)(2), Example 2, and 1.1502-33(e). In that case, the REIT must distribute to its shareholders the full amount of the positive account before the close of the REIT's tax year. *See supra* note 18.

[23]There may well be other key tax issues in a transaction in which a C corporation is absorbed into a REIT, particularly concerns about the ongoing REIT qualification of the acquired assets and gross income. For example, an open question is whether a properly designated hedge of the C corporation under section 1221 and reg. section 1.1221-2 automatically becomes a section 856(c)(5)(G)(i) hedge of the REIT upon the C corporation's absorption into the REIT, or whether instead some form of new, additional designation is needed because the hedge was not inside a REIT when the original identification was made. This can be a significant concern for an acquiring REIT because implicitly leveraged financial products like swaps can produce large and volatile amounts of gross income. *See generally* Ponda, ''Economic Inconsistencies in the Taxation of Currency Swaps,'' *Tax Notes*, Dec. 28, 1992, p. 1795.

[24]Section 1374(d)(6). For some current planning issues in like-kind exchanges, see David W. Hesford, David J. Nagle, and Ameek Ashok Ponda, ''Mirror, Mirror: Identifying Property in a Reverse Like-Kind Exchange,'' *Tax Notes*, July 5, 2010, p. 45, *Doc 2010-12239*, or *2010 TNT 128-7*. The section 1374 built-in gain regime also applies to some income and loss items that are recognized during or after the applicable recognition period but that relate back as built-in gain or loss items. They can include accrued items of cash method taxpayers, section 267(a)(2) and section 404(a)(5) deductions, section 481(a) adjustments, and installment gains. *See generally* section 1374(d)(5) and reg. section 1.1374-4. Of course, those items are not subject to the section

(Footnote continued in next column.)

1374 built-in gain regime when that result is inappropriate. For example, a change in depreciation classification resulting from a change in use is not considered a change of accounting method in the first place, so it does not result in a section 481(a) adjustment that is taxable under section 1374. *See* reg. sections 1.168(i)-4(f) and 1.446-1(e)(2)(ii)(d)(3)(ii). Also, section 1374 does not apply to a section 481(a) adjustment occasioned by a REIT changing from a prior proper method used by a predecessor C corporation to a new proper method, because the adjustment does not relate to items attributable to the C corporation period. *See* reg. sections 1.446-1(e)(2)(ii)(d)(5)(iii), 1.1374-4(b)(1)-(2), 1.1374-4(b)(3), Example 4, and 1.1374-4(d); *MMC Corp. v. Commissioner*, T.C. Memo. 2007-354, *Doc 2007-26341*, *2007 TNT 231-13*, *aff'd*, 551 F.3d 1218 (10th Cir. 2009), *Doc 2009-905*, *2009 TNT 10-13*.

[25]This result was confirmed in TAM 200247002, *Doc 2002-25982*, *2002 TNT 227-67*, in which, on an S election, all deferred intercompany gains were accelerated into income on the consolidated group's final C corporation tax return. *See also* LTR 200702028 (issues reserved), *supra* note 20. Deferred intercompany losses continue to be deferred under section 267(f) and reg. section 1.267(f)-1. Similar to the rule for deferred intercompany gains, there is a comparable recapture rule for dual consolidated losses on the final C corporation tax return. *See generally* reg. section 1.1503(d)-6(e)(1)(vii).

[26]*See supra* notes 18 and 22. In some circumstances, a REIT in a later tax year can purge C corporation E&P that was unknowingly accumulated in an earlier tax year. *See* section 852(e) and reg. section 1.857-11(c).

[27]Reg. section 1.1502-13(j)(6). *See also* TAM 200247002, *supra* note 25. *Cf.* LTR 200850015, *Doc 2008-26175*, *2008 TNT 241-27*.

[28]Reg. sections 1.1502-13(j)(5) and 1.1502-13(j)(9), Example 5.

years ago and remained dormant through successive acquisitions of one C corporation by another are finally accelerated into income on the REIT's acquisition of its C corporation target.[29]

The purpose of the deferred intercompany gain regime is to keep track, within a consolidated group, of the amount and location of gains and losses (and for older deferred transactions, also their character and source), so that the consolidated group is not unduly advantaged or disadvantaged through intercompany transactions.[30] While preserving the amount and location of gains and losses (and for older deferred transactions, character and source too), the deferred intercompany regime recognizes that accelerating the timing of an amount of gain or loss would be inappropriate until either the asset or an affected member has left the group, and thus there is typically no acceleration of gain or loss until such an event occurs.[31]

However, with a C corporation group's absorption into a REIT, there is no principled reason the deferred intercompany gains should be accelerated into income on the group's final C corporation tax return. It is widely recognized and accepted that the toll charge for a C corporation group's absorption into a REIT is the 10-year built-in gains tax of sections 337(d) and 1374. The added burden of immediately accelerating deferred intercompany gains into income furthers neither the toll charge principles of sections 337(d) and 1374 nor the deferred intercompany amount and location preservation principles of the consolidated return regulations. Indeed, the current acceleration rule seems mostly the result of applying the statute's technical language in an unnecessarily adverse manner rather than of a conscious tax policy decision.[32] Further, workable deferred intercompany regimes have been and can be constructed in which a surviving REIT (or S corporation) is the sole continuing repository of deferred intercompany items.[33]

Accordingly, a more sensible regime would permit a REIT to continue as the C corporation group's

[29]Ordinary due diligence may not reveal whether a C corporation consolidated group has dormant, deferred intercompany gains or losses that will be accelerated into income upon absorption into a REIT, particularly if the deferred gain or loss was first established in a prior C corporation consolidated group that is several generations of M&A activity removed from the current C corporation consolidated group. Perhaps the most telling sign of deferred intercompany gains or losses is an asset with a state income tax basis that differs from its federal income tax basis, a feature that often results from a state not adhering to the federal regime for deferred intercompany items. *See generally* Joseph X. Donovan, "What Is the Corporate Tax Basis in Massachusetts?" *State Tax Notes*, Apr. 9, 2007, p. 97, at 104-105. Of course, it can be criminal to ignore, or attempt to undo, the acceleration of deferred intercompany gains into taxable income. *See, e.g.*, Stephen Taub, "Former Tyco Man Gets Three Years," CFO.com (Nov. 30, 2006), *available at* http://www.cfo.com/article.cfm/8369609; U.S. District Court for the Southern District of Florida (West Palm Beach), Criminal Docket for Case No. 9:06-cr-80132-DMM-1, Document 15, "Transcript of Plea Proceedings," pp. 10-14, and Document 18, "Joint Objection to Presentence Investigation Report" (by backdating a rescission agreement, the defendant attempted to undo an intercompany gain transaction that would in a later tax year be accelerated into taxable income).

[30]Reg. section 1.1502-13(a)(1)-(2). Although the consolidated group may be viewed as a single corporation for some purposes under current tax law (*e.g.*, character and source), the amount and location of gains and losses within a consolidated group must still be separately tracked to give proper effect to various consolidated return provisions, including the separate return limitation year rules, the subsidiary stock basis adjustment rules, the E&P rules, and the rules for allocating losses to members leaving the consolidated group. *See generally* reg. sections 1.1502-13, 1.1502-15, 1.1502-21, 1.1502-32, 1.1502-33, and 1.1502-79. Under prior regulations (which are still generally effective for deferred transactions that occurred in tax years that commenced before July 12, 1995), not just amount and location but also character and source were generally determined on a separate-member basis. Prior reg. sections 1.1502-13(c)(4) and 1.1502-13(m) (1994); reg. section 1.1502-13(l) (current regulations generally effective for transactions that occur in tax years beginning on or after July 12, 1995). For a thoughtful discussion of these matters, see Notice 94-49, 1994-1 C.B. 358, *Doc 94-3769*, *94 TNT 69-1*.

[31]Reg. sections 1.267(f)-1(c) and 1.1502-13(c)-(d) (matching and acceleration rules).

[32]Reg. section 1.1502-13(j)(6) is presumably an overly technical interpretation of section 1504(b), which excludes some corporations (such as S corporations and REITs) from membership in a consolidated group. But section 1504(b) addresses the very different issue of which corporations are properly includable in the consolidated group in the first place, and it should not answer which corporation may be the continuing repository of deferred items. *See, e.g.*, reg. section 1.1502-13(j)(6) (stand-alone C corporation, which could never have constituted a consolidated group in the first place, is nevertheless successor to the consolidated group's deferred intercompany gains and losses); TAM 200247002, *supra* note 25 (same).

[33]Indeed, the prior deferred intercompany regulations sometimes permitted, and the current deferral regime for 50 percent-controlled group losses require, the surviving S corporation or REIT to be the sole continuing repository of the old consolidated group's deferred intercompany items, *i.e.*, continued deferral (rather than acceleration) is often permitted or required. *See* prior reg. section 1.1502-13(c)(6), 1.1502-13(f)(1)(iii), 1.1502-13(f)(2)(i)(a), 1.1502-13(f)(2)(ii)(b), 1.1502-13T(c), 1.1502-13T(f), and 1.1502-13T(k) (1994) (no acceleration event on common parent converting to S or REIT status, or being acquired by an S corporation or REIT in some section 368 reorganizations); section 267(f) and reg. section 1.267(f)-1 (deferred intercompany regime for losses among members of 50-percent-controlled groups; those controlled groups include S corporations and REITs, including as the stand-alone sole repository of deferred intercompany losses through the reg. section 1.267(f)-1(b)(3) expansion of reg. section 1.1502-13(j)(6) beyond stand-alone C corporations); ILM 200931043, *Doc 2009-17447*, *2009 TNT 146-19* (deferred intercompany loss and continued deferral when a REIT is the controlled group's buying member).

successor when applying the reg. section 1.1502-13 deferred intercompany regime.[34] If any deferred intercompany gains or losses are restored into income as recognized built-in gains or losses during the applicable built-in gain/loss recognition period of sections 337(d) and 1374 — typically 10 years in duration — those could be subjected to the entity-level tax at that time.[35]

So how much deferred gain would a REIT defer if a REIT could defer deferred gain? A REIT would defer as much deferred gain as a REIT could defer if a REIT could defer deferred gain.

[34]This change could be accomplished, for example, through the expansion of reg. section 1.1502-13(j)(6) to successor, standalone S corporations and REITs, much as reg. section 1.267(f)-1(b)(3) applies now for deferred intercompany losses.

[35]*Cf.* Notice 90-27, sections 1 and 2, 1990-1 C.B. 336 (for deferred intercompany gains that are restored into income during the applicable recognition period upon the disposal of the intercompany asset outside the affiliated group, those restored gains are considered recognized built-in gains that are within the applicable section 382(h) or section 384 recognition period). With a new rule of continued deferral for deferred intercompany gains that is symmetric to the current rule of continued deferral for deferred intercompany losses, both deferred intercompany gains and deferred intercompany losses at the end of the C corporation group's final tax year should enter into the computation of reg. section 1.1374-3 net unrealized built-in gain. Further, if those deferred intercompany items are restored into income upon the disposal of the intercompany asset during the recognition period, the restored gains and losses would then enter into the computations of recognized built-in gains and losses (reg. section 1.1374-4(a)) and net recognized built-in gain (reg. section 1.1374-2(a)). *See generally* section 1374(d)(5); *cf*. reg. section 1.1374-4(b)-(h) (regarding income and loss items recognized during or after the recognition period but that relate back as built-in gain or loss items). Although current law on this point is sparse, deferred intercompany gains or losses that are restored into income as part of depreciation matching — as opposed to the matching or acceleration that applies when the subject asset or an affected member leaves the group — presumably do not enter into the computation of recognized built-in gain or loss because there has been no actual disposition of the intercompany asset for section 1374 purposes, but only a routine restored gain or loss to offset the routine exhaustion of incremental or decremental depreciable tax basis that arose from the intercompany transaction. Reg. sections 1.267(f)-1(c), 1.1374-4(a), 1.1502-13(c)(1)-(6), 1.1502-13(c)(7)(ii), examples 1 and 4, and 1.1502-13(d); and Rev. Rul. 2001-50, 2001-2 C.B. 343, *Doc 2001-25846*, *2001 TNT 196-19*; *see also* reg. sections 1.861-9T(g)(2)(iv) and 1.861-11T(c) and Notice 89-91, 1989-2 C.B. 408 (under a "single corporation" theory, the tax bases of assets in allocating interest expense between domestic and foreign sources is determined without regard to the increment or decrement from deferred intercompany gain or loss transactions).