REPORT #870

TAX SECTION

New York State Bar Association

Letter on Proposed Proposed Amendments to IRC § 1374

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New York State Bar Association

March 1, 1996

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Department of the Treasury
Room 3064, Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Proposed Amendments to IRC § 1374

Dear Glen:

We are concerned that a provision contained in President Clinton's balanced budget proposal could have harsh and unintended consequences for RICs, REITs, S corporations and other pass-through entities that unintentionally lose pass-through status and thereafter re-elect such status.[1] The provision could effectively require such entities to immediately recognize all of their gain from appreciated assets and pay corporate-level tax thereon (as well as shareholder-level tax, in the case of an S corporation). We suggest modification of the proposal so that a pass-through entity that (1) unintentionally ceases to qualify for pass-through status and (2) re-qualifies[2] at the earliest possible time will not be required to recognize net built-in gain on its assets, under Section 1374 or 337(d) of the Internal Revenue Code (the "Code"), upon re-qualification. We

[1] David P. Hariton participated substantially in the preparation of this letter. This letter's narrow point concerning the proposal to repeal Section 1374 should not be construed as support for the repealer itself.

[2] In the case of a re-electing S corporation, the shareholder tax should also be excused.

note that the Internal Revenue Service previously provided analogous relief for RICS.[3]

Section 1374 of the Code effectively imposes corporate-level tax on the net built-in gain of a C corporation that elects to become an S corporation when the relevant asset is disposed of if, but only if, the asset is disposed of within ten years of the commencement of S status. Under the President's proposal, the rules of Section 1374 would be changed to provide that a large C corporation (i.e., stock value over $5 million) that elects S status would be treated as having liquidated, with tax being imposed at both the corporate level (under Section 336) and the shareholder level (under Section 331).[4] In a February 22 press release, the Treasury Department clarified that corporate level gain, but not shareholder level gain, would be triggered by a large C corporation's conversion to RIC or REIT status. For convenience, we sometimes refer to the tax treatment that would be provided by the proposal as “deemed liquidation/sale treatment.”

More specifically, in Notice 88-19,[5] the Internal Revenue Service announced its intention to promulgate regulations under Section 337(d) of the Code to prevent the avoidance of corporate-level tax with respect to the net built-in gain of a C corporation that elected to become a RIC or a REIT. Notice 88-19 stated that in such a case, the regulations would require the C corporation to recognize any net built-in gain that would have been realized if the C corporation had liquidated immediately before the taxable year in which it qualified to be taxed as a RIC or a REIT.[6] Notice 88-19 further stated, however, that the regulations would permit a RIC or REIT required to recognize gain under Section 337(d) to elect instead to be subject to rules similar to the rules of Section

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[3] See Notice 88-96, 1988-2 C.B. 420.

[4] See Section 208 of the President's Deficit Reduction and Balanced Budget Proposal, reprinted as House Doc. No. 104-160, Pt. 2, 104th Cong., 2d Sess. (1996).

[5] 1988-1 C.B. 486.

[6] Notice 88-19 did not address other pass-thru entities, such as REMICs.

1374 of the Code.[7] According to the February 22 press release, such relief would be eliminated, and a large C corporation electing RIC or REIT status would be immediately taxed on its net built in gain. Thus, if the proposal is enacted, a RIC, REIT, S corporation or other pass-through entity that ceases to meet the requirements for pass-through status, and thereafter re-elects such status, would be subject to deemed liquidation/sale treatment.

We think the imposition of this significant tax burden on an entity that unintentionally loses pass-through status and thereafter re-qualifies for the same will significantly reduce the utility of the Code's pass-through vehicles. The qualification requirements for the various pass-through entities are in many cases subject to both factual and legal uncertainties. It seems likely that if relief is not provided, entities that lose pass-through status will often be reluctant to incur the tax cost of re-electing; leading to additional pressure on, and litigation over, the sometimes subtle factual and legal issues that can determine qualification for pass-through status.[8]

We think that the burden of recognizing all corporate-level gain (as well as shareholder gain, in the case of an S corporation) represents too great a penalty for the unintended and temporary loss of pass-through status. We therefore recommend that the proposed deemed liquidation/sale treatment be modified to exclude such cases. We note that three subsidiary issues then arise in implementing such relief: (1) How much time can elapse between termination of pass-through status and re-election? (2) What reasons, if any, for loss of pass-through status should prevent relief from the deemed liquidation tax? (3) What is the proper treatment of gains accruing prior to re-election?

With regard to the first issue, a RIC that

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[7] Shortly after the issuance of Notice 88-19, the Service announced a relief measure for RICs, indicating that a RIC that failed to qualify as a RIC for a single taxable year would not be required to recognize gain under Section 337(d) when it re-qualifies. Notice 88-96, supra.

[8] Disqualification also can result from temporary circumstances outside the entity's control. For example, we understand that the October 1987 market break led to the disqualification of a number of RICs.

ceases to qualify as such may re-elect RIC status at any time, with no waiting period. REITs and S corporations that lose pass-through status generally must allow five years to elapse before re-electing such status, with relief from the five-year delay requirement available in some circumstances.[9] While the issue of permissible delay in re-electing could be affected by the decision as to how to treat accrued gains (discussed below), our judgment is that the relief should be available if the entity re-elects pass-through status by the later of (i) a reasonable time following discovery of its non-qualified status or (ii) the first date permitted by law for re-election. We do not think that the failure to obtain relief from the five-year waiting period for REITs and S corporations should affect the liability for tax arising from the deemed liquidation/sale upon re-qualification.

With regard to the second issue, we think relief from deemed liquidation/sale treatment should be available in any case where termination of pass-through status is not intentional (provided, of course, that re-qualification is timely).[10] For a publicly-held RIC or REIT we would define intentional to mean pursuant to a determination of the entity's board of directors (or its equivalent, such as a trustee) to terminate pass-through status. Thus, the failure of a corporate officer to comply with statutory requirements leading to disqualification would not be regarded as intentional unless the officer was acting at the specific direction of the entity's board of directors (or its equivalent).[11] We think a narrower

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9 Section 856(g)(3), (4) (REITs); Section 1362(g) (S corporations). A REMIC that loses such status generally may not re-elect REMIC status, although relief may be obtained under Section 860D(b)(2)(B).

10 Although Notice 88-96, supra, did not do so, we think a strong case can be made for affording the relief suggested herein if the entity fails to qualify for pass-through status in the first instance.

11 For a privately-held entity, a bright-line standard for unintentional termination probably would not work; in such cases, we would suggest an analysis of all relevant facts and circumstances. Such analysis should, in our judgment, take into account whether meaningful benefits were expected to be derived from the termination, including both tax and non-tax benefits. Where meaningful benefits are expected, we would treat termination as presumptively intentional.

rule, such as one that operated by reference to an inadvertent failure to comply, would not be adequate.[12] In many cases, unintended disqualification might stem from an intentional act based on a completely mistaken understanding of the law, or an arguably intentional failure to comply with a ministerial requirement (such as a REIT's failure to send annual mailings to its shareholders under Reg. § 1.857-8). Even if such actions cannot be classified as inadvertent, we think the burden of deemed liquidation/sale treatment is significantly disproportionate to any such failure to satisfy the requirements for pass-through status.

With regard to the third issue, several alternatives are available as to the treatment of built-in gain on re-election: First, continue to apply the present rules of Section 1374 to re-qualifying RICs, REITs and S corporations, i.e., impose corporate- level tax on assets disposed of within ten years following re-election, with no distinction being drawn between gain accruing before and after termination of the prior election. Second, following the approach of Notice 88-96, take no account of pre-re-election gain for RICs or other entities that re-elect such status after not more than one year of C status. Third, value the entity's assets at the time pass-through status terminates, and apply the current Section 1374 regime to net gain accruing while the entity was a C corporation (necessitating a second valuation of the entity’s assets when pass-through status re-commences). Fourth, in recognition of the inadvertant nature of the error that led to disqualification, impose no corporate-level tax on built-in gain in connection with requalification, but require a distribution of all earnings and profits derived during C corporation status.[13] Fifth, impose the current Section 1374 regime to built-in gain with respect to assets acquired during the period after termination of pass-through status and prior to re-election; but

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12 See Section 1362(f); see also Rev. Rul. 86-110, 1986-2 C.B. 150, 151 (transfer of S corporation shares to an ineligible trust held inadvertent; transfer made in reliance on opinion of counsel as to trust’s eligible status).

13 RICs and REITs would already be subject to such a requirement by Sections 852(a)(2)(B) and 857(a)(3)(B).

we recognize that this approach is underinclusive.[14] NO choice is clearly right, at least for all pass-through entities. The mark-to-market approach, while perhaps conceptually sound, introduces difficult valuation issues. The application of current Section 1374 principles, the first approach, may be appropriate for most REITs and S corporations (and would be consistent with their present-law treatment); such treatment may be burdensome for RICs, however, whose assets may be shorter-lived and subject to involuntary disposition (such as by reason of issuer calls of debt securities). Applying a Section 1374 tax to some but not all pass-through entities is also dissatisfying, however. We make no final recommendation on this subject, although we note that the case for imposing a toll-charge for use of pass-through status is significantly weaker in the case of an entity that had at one time qualified for pass-through status (including the payment of any applicable toll-charge) and seeks to re-claim that status promptly after becoming aware of having lost it.

As always, we would be delighted to discuss this matter further with you or members of your staff.

Sincerely

Richard L. Reinhold
Chair

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14 We assume that under any alternative, the deemed liquidation/sale tax (or taxes) would be imposed where the assets of a large C corporation are acquired in a tax-free transaction during the C corporation status of an entity that utilizes the relief we suggest.