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A Surprise REIT Election Ruling

CCA 201446019

Summary

A recent Chief Counsel Advice treated a REIT election for a disregarded LLC as causing a potential Section 351 exchange before the current owner bought the LLC, but Section 351 did not apply because the prior shareholder lost control over whether the LLC might make a REIT election. While not exactly a trap for the unwary, this is a very surprising result.

Facts

On April 1, 2010 (the dates approximate what happened), Failed Bank transferred REMIC securities to its new wholly owned disregarded LLC. Six months later on October 1, 2010, the FSLIC closed the Failed Bank, and Buyer Bank acquired the Failed Bank's assets and liabilities under a purchase and assumption agreement. The P&A was entered into after the LLC was created. On a return filed in 2011 for the April 1 – December 31, 2010, year of the LLC, Buyer Bank caused the LLC to make a REIT election, effective as of the first date the LLC had existed. The REIT claimed for that year a bad debt loss on the REMIC securities and applied a Section 382 proration to determine the amount of the deduction.

Upon examination of the REIT return, the IRS agent asserted that Buyer Bank could not obtain the benefit of a bad debt deduction under an anti-abuse rule in Section 597, part of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), because the FSLIC had provided support to Buyer Bank. The chief counsel's office (FIP) issued a Chief Counsel Advice suggesting two ways the loss could be denied. First, it agreed that the anti-abuse rule prevented Buyer Bank from claiming the loss in the LLC owned by it and said that the tax items of the LLC prior to the actual acquisition on October 1 should remain with Failed Bank.

Second, even if the REIT election was effective and a deemed Section 351 exchange occurred on April 1, 2010, the basis of the REMIC securities would be stepped down to value under Section 362(e). CCA 201441014.

A month and a half later, the chief counsel (corporate) issued a supplemental CCA 201446019. It stated that the better view was that no Section 351 exchange occurred between Failed Bank and the LLC because Failed Bank did not control the LLC/REIT immediately after the exchange for the REMIC securities. It reasoned that under Reg. 301.7701-3(c)(1)(v)(B), the retroactive REIT election was treated as an incorporation of the REMIC securities on April 1, 2010.

Although Failed Bank was not then under a binding commitment to sell the LLC, Failed Bank should be deemed to have relinquished the right to determine whether to keep the shares. The CCA further stated that the deemed relinquishment was analogous to having a binding commitment to sell the shares to the buyer that ultimately did buy the LLC and convert it to a corporation retroactively. As a result, Section 351 could not have applied to the deemed incorporation of the REIT because Failed Bank did not control it immediately after the exchange of the REMIC securities. Therefore, the REIT took the REMIC securities with a low cost basis, not under Section 362(e), but under Section 1012.

Analysis

This is a most unusual and evidently unique ruling. There are a few prior rulings using the same terminology about relinquishing the right to keep the stock, but they are in the context of a prior commitment to transfer the stock. Here, Failed Bank relinquished that right simply by virtue of transferring the interests in a disregarded LLC that had REITable assets to a buyer that might make a REIT election.

The unusual feature is that the second CCA did not dispute the conversion of the LLC to REIT status as of April 1, 2010. Presumably, that removed the assets from Failed Bank's ownership as of that date and made it a REIT shareholder. Failed Bank did not have to join in the incorporation election because the cited regulation only deems an election to check the box.

In contrast, the same thing cannot happen with a simply retroactive checking of the box because Reg. 301.7701-3(c)(2)(ii) requires the owners at the effective date to sign the election.

But S corporation elections can be made by the fifteenth day of the third month, retroactive to the first of the year. When the electing entity is an eligible entity, it too is deemed to make a check the box election as of the first of the year, and evidently the requirement that owners at that date join the election also does not apply.

In both of these cases, prior owners who had no idea they were engaging in Section 351 exchanges, much less failed Section 351 exchanges, will be doing so before they sell their equity to the new owner. In most cases, the slightly accelerated gain or loss recognized will be the same as would be recognized on the sale of the LLC interest, so the seller may not care. In fact, the seller might be happy if the assets produce income in the interim because the income will not fall on its return.

However, a buyer thinking it will get a carryover built-in loss may be disappointed, as in the case of these chief counsel advices.

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