Notice of Proposed Rulemaking and Notice of Public Hearing

Certain Asset Transfers to a Tax-Exempt Entity

REG–209121–89

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Notice of proposed rulemaking and notice of public hearing

SUMMARY: This document contains proposed regulations. The proposed regulations effectuate provisions of the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. The proposed regulations generally affect a taxable corporation that transfers all or substantially all of its assets to a tax-exempt entity or converts from a taxable corporation to a tax-exempt entity, and generally require the taxable corporation to recognize gain or loss in such a transaction.

DATES: Written comments must be received by April 15, 1997. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for May 6, 1997, at 10 a.m. must be submitted by April 15, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–209121–89), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–209121–89), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave. NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Stephen R. Cleary (202) 622–7530; concerning submissions and the hearing, Evangelista Lee, (202) 622–7180, (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to the repeal of the *General Utilities* doctrine in the Tax Reform Act of 1986. Under the *General Utilities* doctrine, which took its name from *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), corporations were not required to recognize gain or loss when they distributed appreciated or depreciated property to their shareholders. The *General Utilities* doctrine applied to distributions of property in complete liquidation, certain sales of property that were in connection with a complete liquidation, and nonliquidating distributions of property. It was codified in former sections 311, 336, and 337 of the Internal Revenue Code of 1954.

The *General Utilities* doctrine was an exception to the general rule that income earned by a corporation is taxed twice, once to the corporation when the income is earned and a second time to the corporation's shareholders when the earnings are distributed. The *General Utilities* doctrine generally permitted the permanent elimination of corporate-level tax on the disposition of appreciated assets because the transferee received a fair market value basis in the assets and the corporation generally did not recognize any gain. Thus, the appreciated assets left corporate solution without any corporate-level tax having been paid.

Beginning in 1969, the scope of the *General Utilities* doctrine was restricted by a series of amendments (initially relating to nonliquidating distributions governed by section 311), until ultimately the *General Utilities* doctrine was repealed, with limited exceptions, in the Tax Reform Act of 1986. Sections 336 and 337 were amended to generally require corporations to recognize gain or loss when appreciated or depreciated property is distributed in complete liquidation or sold in connection with a complete liquidation.

Section 337(a) provides one of the limited exceptions from the repeal of the *General Utilities* doctrine by allowing a subsidiary to liquidate into its 80-percent distributee (a corporation meeting the stock ownership requirements of section 332(b) in the liquidating corporation) without recognizing gain or loss.

The 80-percent distributee takes a carryover basis in the distributed property. However, under section 337(b)(2), this nonrecognition exception generally does not apply if the 80-percent distributee is a tax-exempt entity.

The Tax Reform Act of 1986 added section 337(d), directing the Secretary to prescribe regulations as may be necessary to carry out the purposes of the repeal of the *General Utilities d*octrine. The legislative history of the Tax Reform Act of 1986 indicates that the *General Utilities* doctrine was repealed because it tended to undermine the corporate income tax by allowing appreciated property to leave corporate solution without imposition of a corporate level tax. H.R. Rep. No. 99–426, 99th Cong., 1st Sess. 282 (1985). The Technical and Miscellaneous Revenue Act of 1988 amended section 337(d) to specify that the section authorizes regulations to ''ensure that these purposes shall not be circumvented . . . through the use of a . . . tax-exempt entity.'' The legislative history concerning the 1988 amendment to section 337(d) explains:

> The bill also clarifies in connection with the built-in gain provisions of the Act that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to carry out those provisions . . . . For example, this includes rules to require the recognition of gain if appreciated property of a C corporation is transferred to a . . . tax-exempt entity [footnote 32] in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation.
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> [footnote 32] The Act generally requires recognition of gain if a C corporation transfers appreciated assets to a tax exempt entity in a section 332 liquidation. See Code section 337(b)(2).

S. Rep. No. 145, 100th Cong., 2d Sess. 66 (1988).

Explanation of Provision

An acquisition by a tax-exempt entity of all or substantially all of the assets of a taxable corporation or a change in status of a taxable corporation to a tax-exempt entity, like a liquidation into an 80-percent tax-exempt distributee that is taxable under section 337(b)(2), could eliminate the corporate level tax on the appreciation in the taxable corporation's assets. Accordingly, the proposed regulations apply rules similar to section 337(b)(2) to these transactions. The proposed regulations generally do not affect the tax treatment of the taxable corporation's shareholders or the availability of any charitable contribution deduction.

The proposed regulations provide that a taxable corporation that transfers all or substantially all of its assets to one or more tax-exempt entities is required to recognize gain or loss as if the assets transferred were sold at their fair market values. Like section 337(b)(2), the proposed regulations provide that no gain or loss will be recognized on any of the assets transferred that are used by the tax-exempt entity in an activity the income from which is subject to the unrelated business tax under section 511(a). However, gain on such assets will later be recognized as unrelated business taxable income if the tax-exempt entity disposes of the assets or ceases to use the assets in an unrelated trade or business activity.

The proposed regulations generally treat a taxable corporation that changes its status to a tax-exempt entity as having transferred all of its assets to a tax-exempt entity immediately before the change in status becomes effective, irrespective of whether an actual transfer of the assets has occurred. For this purpose, if a state, a political subdivision thereof, or an entity any portion of whose income is excluded from gross income under section 115, acquires the stock of a taxable corporation and thereafter any of the taxable corporation's income is excluded from gross income under section 115, the taxable corporation will be treated as if it transferred all of its assets to a tax-exempt entity immediately before the stock acquisition.

Certain exceptions are provided to the change in status rule for organizations that are tax-exempt or are seeking tax-exempt status under section 501(a). These exceptions provide relief for corporations needing a brief start-up period to establish their tax-exempt status and for those that temporarily lose their tax-exempt status. Under the proposed regulations, the change in status rule does not apply to a corporation that is tax-exempt within three taxable years of the taxable year of its formation, or to a corporation that regains its tax-exempt status within three years after either a final adverse adjudication on its tax-exempt status or filing a tax return as a taxable corporation. The change in status rule also does not apply to an organization that before publication of these proposed regulations was exempt or unsuccessfully applied for exemption, if the organization is tax-exempt within three years after the date of publication of final regulations. An organization that files for recognition of its exempt status during one of the three-year periods will be deemed to have or regain tax-exempt status if the application ultimately results in recognition as of a date during the three-year period. An anti-abuse rule makes all these exceptions unavailable to a taxable corporation that acquires all or substantially all of the assets of another taxable corporation and then changes its status with a principal purpose of avoiding the gain or loss recognition rule made applicable by these regulations.

The proposed regulations disallow the recognition of loss if assets are acquired by the taxable corporation in a section 351 transaction or a contribution to capital, or if assets are distributed by the taxable corporation to a shareholder, with a principal purpose to recognize loss by the taxable corporation on the transfer of its assets to a tax-exempt entity (loss limitation rule). For example, the loss limitation rule may apply if (a) a loss asset is contributed to a taxable corporation and then is transferred with substantially all of the taxable corporation's assets to a tax-exempt entity; (b) loss assets not constituting substantially all of a taxable corporation's assets are contributed to a new subsidiary and then the new subsidiary transfers the loss assets which are its only assets to a tax-exempt entity, or (c) assets are distributed by a taxable corporation to its parent and then the taxable corporation transfers loss assets now constituting substantially all of its assets to a tax-exempt entity. For purposes of the loss limitation rule, the principles of section 336(d)(2) apply.

Under the proposed regulations, a ''taxable corporation'' is any corporation that is not a tax-exempt entity as defined in the proposed regulations. Thus, taxable corporations include all S corporations whether or not subject to tax on built-in gain under section 1374. After the repeal of the *General Utilities* doctrine, an S corporation like a C corporation is required to recognize gain or loss when it liquidates. This gain or loss passes through to the S corporation's shareholders under section 1366. The proposed regulations parallel this treatment.

Under the proposed regulations, a ''tax-exempt entity'' includes organiza-

tions exempt from tax under section 501, section 527, section 528, or section 529; Federal, state, and local governments; Indian tribal governments and federally chartered Indian tribal corporations; foreign governments and international organizations; and entities any portion of whose income is excluded from gross income under section 115. The term does not, however, include a cooperative described in section 521, paralleling the exception to section 337(b)(2).

A transaction conveying all or substantially all of the assets of a taxable corporation to an Indian tribal government or a corporation organized under section 17 of the Indian Reorganization Act (IRA) or section 3 of the Oklahoma Welfare Act (OWA) will be covered by these regulations. Rev. Rul. 94–16, 1994–1 C.B. 19, held that an unincorporated Indian tribe or a corporation organized under section 17 of the IRA is not subject to federal income tax, but a corporation wholly owned by an Indian tribe and organized under state law is subject to federal income tax. Rev. Rul. 94–65, 1994–2 C.B. 14, held that a corporation organized under section 3 of the OWA also was not subject to federal income tax. In that ruling, the Service announced that an Indian tribe seeking to dissolve a corporation organized under state law and organize into a federally chartered corporation (corporation organized under either section 17 of the IRA or section 3 of the OWA) will be granted relief under section 7805(b) of the Code upon application for such relief provided it demonstrates to the Service that it has acted reasonably and in good faith to achieve the dissolution and organization. The relief described in that ruling applied to taxes on income earned after September 30, 1994, by a corporation organized by an Indian tribe under state law from income earned within the boundaries of the reservation (including gain or loss properly allocable to such activities from the sale or exchange of assets). The Service intends to provide similar relief from tax resulting from any gain or loss recognized under the rules provided in these regulations. The relief will be available to state law corporations wholly owned by Indian tribes that have acted reasonably and in good faith to dissolve and reorganize as federally chartered corporations.

Proposed Effective Date

These regulations are proposed to be applicable to transfers of assets as described in the regulations occurring after the date that is 30 days after publication in the Federal Register of these regulations as final regulations, unless the transfer is pursuant to a written agreement which is (subject to customary conditions) binding on or before the date that is 30 days after publication in the Federal Register of these regulations as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. Chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Tuesday, May 6, 1997, at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Service Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by April 15, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 15, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Stephen R. Cleary of the Office of Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

PART I—INCOME TAXES

Paragraph 1. The authority citation for 26 CFR Part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.337(d)–4 also issued under 26 U.S.C. 337. * * *

Par. 2. Section 1.337(d)–4 is added to read as follows:

§ 1.337(d)–4 Taxable to tax-exempt.

(a) *Gain or loss recognition*—(1) *General rule.* If a taxable corporation transfers all or substantially all of its assets to one or more tax-exempt entities, the taxable corporation must recognize gain or loss immediately before the transfer as if the assets transferred were sold at their fair market values. But see section 267 and paragraph (d) of this section concerning limitations on the recognition of loss.

(2) *Change in corporation's tax status treated as asset transfer.* Except as provided in paragraph (a)(3) of this section, a taxable corporation's change in status to a tax-exempt entity will be treated as if it transferred all of its assets to a tax-exempt entity immediately before the change in status becomes effective in a transaction to which paragraph (a)(1) of this section applies. For purposes of this paragraph (a), if a state, a political subdivision thereof, or an entity any portion of whose income is excluded from gross income under section 115, acquires the stock of a taxable corporation and thereafter any of the taxable corporation's

income is excluded from gross income under section 115, the taxable corporation will be treated as if it transferred all of its assets to a tax-exempt entity immediately before the stock acquisition.

(3) *Exceptions for certain changes in status*— (i) *To whom available.* Paragraph (a)(2) of this section does not apply to the following corporations—

(A) A corporation previously exempt under section 501(a) which regains its tax-exempt status under section 501(a) within three years from the later of a final adverse adjudication on the corporation's tax exempt status, or the filing by the corporation, or by the Secretary or his delegate under section 6020(b), of a federal income tax return of the type filed by a taxable corporation;

(B) A newly-formed corporation that is tax-exempt under section 501(a) within three taxable years from the end of the taxable year in which it was formed;

(C) A corporation previously exempt under section 501(a) or that applied for but did not receive recognition of exemption under section 501(a), before January 15, 1997, if such corporation is tax-exempt under section 501(a) within three years from the date of publication of these regulations in the Federal Register as final regulations.

(ii) *Application for recognition.* An organization is deemed to have or regain tax-exempt status within one of the three-year periods described in paragraph (a)(3)(i) of this section if it files an application for recognition of exemption with the Commissioner within the three-year period and the application either results in a determination by the Commissioner or a final adjudication that the organization is tax-exempt under section 501(a) during any part of the three-year period. The preceding sentence does not require the filing of an application for recognition of exemption by any organization not otherwise required, such as by § 1.501(a)–1, § 1.505(c)–1T, and § 1.508–1(a), to apply for recognition of exemption.

(iii) *Anti-abuse rule.* This paragraph (a)(3) does not apply to a corporation that, with a principal purpose of avoiding the application of paragraphs (a)(1) and (a)(2) of this section, acquires all or substantially all of the assets of another taxable corporation and then changes its status to that of a tax-exempt entity.

(4) *Related transactions.* This section applies to any series of related transactions having an effect similar to any of the transactions to which this section applies.

(b) *Exceptions.* Paragraph (a) of this section does not apply to—

(1) Any assets transferred to a tax-exempt entity if the assets are used in an activity the income from which is subject to tax under section 511(a). However, if assets on which no gain or loss was recognized by reason of the preceding sentence are disposed of by the tax-exempt entity, then, notwithstanding any other provision of law, any gain (not in excess of the amount not recognized by reason of the preceding sentence) shall be included in the tax-exempt entity's unrelated business taxable income. If the tax-exempt entity ceases to use the assets in an activity the income from which is subject to tax under section 511(a), the entity will be treated for purposes of this subparagraph as having disposed of the assets on the date of the cessation;

(2) Any transfer of assets to the extent gain or loss otherwise is recognized by the taxable corporation on the transfer. See, for example, sections 336, 337(b)(2), 367, and 1001;

(3) Any forfeiture of a taxable corporation's assets in a criminal or civil action to the United States, the government of a possession of the United States, a state, the District of Columbia, the government of a foreign country, or a political subdivision of any of the foregoing; or any expropriation of a taxable corporation's assets by the government of a foreign country; and

(4) Any transfer of assets to a cooperative described in section 521.

(c) *Definitions.* For purposes of this section—

(1) *Taxable corporation.* A *taxable corporation* is any corporation that is not a tax-exempt entity as defined in paragraph (c)(2) of this section.

(2) *Tax-exempt entity.* A *tax-exempt entity* is—

(i) Any entity that is exempt from tax under section 501(a), section 527, section 528, or section 529;

(ii) A charitable remainder annuity trust or charitable remainder unitrust as defined in section 664(d);

(iii) The United States, the government of a possession of the United States, a state, the District of Columbia, the government of a foreign country, or a political subdivision of any of the foregoing;

(iv) An Indian Tribal Government as defined in section 7701(a)(40), a subdivision of an Indian tribal government determined in accordance with section 7871(d), or an agency or instrumentality of an Indian tribal government or subdivision thereof;

(v) An Indian Tribal Corporation organized under section 17 of the Indian Reorganization Act of 1934, 25 U.S.C. 477, or section 3 of the Oklahoma Welfare Act, 25 U.S.C. 503;

(vi) An international organization as defined in section 7701(a)(18);

(vii) An entity any portion of whose income is excluded under section 115; or

(viii) An entity that would not be taxable under the Internal Revenue Code for reasons substantially similar to those applicable to any entity listed in this paragraph (c)(2) unless otherwise explicitly made exempt from the application of this section by statute or by action of the Commissioner.

(3) *Substantially all.* The term *substantially all* has the same meaning as under section 368(a)(1)(C).

(d) *Loss limitation rule.* For purposes of determining the amount of loss recognized by a taxable corporation on the transfer of its assets to a tax-exempt entity under paragraph (a) of this section, if assets are acquired by the taxable corporation in a transaction to which section 351 applied or as a contribution to capital, or assets are distributed from the taxable corporation to a shareholder or another member of the taxable corporation's affiliated group, and in either case as part of a plan a principal purpose of which is to recognize loss by the taxable corporation on the transfer of its assets to the tax-exempt entity, the losses recognized by the taxable corporation on the assets transferred to the tax-exempt entity will be disallowed. For purposes of the preceding sentence, the principles of section 336(d)(2) apply.

(e) *Effective date.* This section is applicable to transfers of assets as described in paragraph (a) of this section occurring after the date that is 30 days after publication in the Federal Register of these regulations as final regulations, unless the transfer is pursuant to a written agreement which is (subject to customary conditions) binding on or before the date that is 30 days after

publication in the Federal Register of these regulations as final regulations.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 10, 1997, 8:45 a.m., and published in the issue of the Federal Register for January 15, 1997, 62 F.R. 2064)