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General Utilities Repeal and Charitable Contributions

by Robert W. Wood • San Francisco

Should a corporation face gain recognition upon giving appreciated assets to an unrelated charity? Should an organization converting from taxable to tax-exempt status trigger gain recognition? These questions require some deep thinking, and some might say reach to the core of *General Utilities* repeal a fundamental change in the corporate tax system that was effected way back in 1986.

Still, these questions were at the forefront of a recent debate at a regulation hearing concerning the proposed Section 337(d) regulations. Section 337(d) was one of those "intent" provisions, giving the Treasury Secretary authority to prescribe regulations that might be necessary to carry out the purposes of the repeal of the *General Utilities* doctrine. Along with a few other statements, there was even a mention in the legislative history that these might include rules to trigger the recognition of gain if appreciated property of a C corporation was transferred to a tax-exempt entity in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation.

This unfortunate turn of phrase (but fortunate at least for the IRS), gave rise to the release of proposed regulations attempting to address this problem.

Taxing Charity?

The proposed regulations (Reg-209121-89) generally require that a taxable corporation must recognize gain or loss on a transaction in which that corporation transfers its assets to a tax-exempt entity. The same would be true for the conversion of a taxable corporation to a tax-exempt one. The transfer of assets to a charity would be treated under these proposed rules as a sale for the fair market value of the assets. Interestingly, transferred assets that would be used in an activity that produces unrelated business income are excluded from this rather harsh treatment.

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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% 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 transferred assets 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 transferred assets that are used by the tax-exempt entity in an activity the income from which is subject to the unrelated business income 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.

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Converting to Tax-Exempt Status

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 thereof 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

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avoiding the gain or loss recognition rule of these regulations.

Losses Disallowed

The proposed regulations disallow the recognition of loss if assets are acquired by the taxable corporation in a Section 351 transaction or by a contribution to capital, or if assets are distributed by the taxable corporation to a shareholder, with a principal purpose of recognizing losses loss by the taxable corporation on the transfer of its assets to a tax-exempt entity (a so-called loss limitation rule). For example, this 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.

Definitions and Such

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 organizations 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).

Quite apart from the seeming inequity of a corporation being taxed on a transfer of assets to a charity, there has been considerable focus in certain industries on the conversion of a taxable corporation to a tax-exempt entity. Such a conversion will be treated as a transfer by the taxable corporation to a new entity, even though no actual transfer of assets occurs. However, there at least a few exceptions to this conversion treatment.

These exceptions provide relief to corporations that: (1) need a brief start-up period to establish tax-exempt status; and (2) corporations that lose their tax-exempt status. Still, an anti-abuse rule is intended to prevent a taxable corporation that acquires assets from another corporation and then changes its status from using these exceptions. This anti-abuse rule is meant to apply where such an event occurs for the purpose of avoiding recognition of gain or loss on the transfer of the assets.

The proposed rules are coupled with loss disallowance rules as well. Under the proposed regulations, losses are disallowed if the assets are acquired by a taxable corporation in a Section 351 transaction or as a contribution to capital. Likewise, losses are disallowed if the corporation distributes assets to a shareholder for the purpose of recognizing a corporate loss upon the transfer of the assets to a tax-exempt entity. The proposed regulations cross-reference principals of Section 336(d)(2), which govern such loss recognition attempts.

Conclusion

These new Section 337(d) regulations are proposed to be applicable to transfers of assets that occur 30 days after publication of final regulations in the Federal Register. So there is certainly some time before which one could expect these rules to kick in. Still, the recent hearing on the proposed regulations

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does not appear to have moved Treasury a great deal. The basic concept, after all, dates way back to the 1986 Tax Reform Act—and the repeal of our old friend the *General Utilities* rule. ■