

Section 1374.—Tax Imposed on Certain Built-In Gains

26 CFR 1.1374–8: Section 1374(d)(8) transactions.

T.D. 9170

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Section 1374 Effective Dates

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: These temporary regulations provide guidance concerning the applicability of section 1374 to S corporations that acquire assets in carryover basis transactions from C corporations on or after December 27, 1994, and to certain corporations that terminate S corporation status and later elect again to become S corporations. The text of the temporary regulations also serves as the text of the proposed regulations (REG–139683–04) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective December 22, 2004.

Applicability Date: Section 1.1374–8T applies to any transaction described in section 1374(d)(8) that occurs on or after December 27, 1994. Section 1.1374–10T applies for taxable years beginning after December 22, 2004. The applicability of §1.1374(d)–8T and §1.1374(d)–10T will expire on or before December 20, 2007.

FOR FURTHER INFORMATION CONTACT: Stephen R. Cleary, (202) 622–7750, (not a toll-free number).

Background and Explanation of Provisions

1. Section 1374 and its Effective Dates

Under the *General Utilities* doctrine, see *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), a C corporation, in certain cases, could distribute appreciated assets to its shareholders or sell appreciated assets without recognizing gain. Section 1374 of the Internal Revenue Code of 1986 (Code), amended in the Tax Reform Act of 1986 (TRA) as part of the repeal of the *General Utilities* doctrine, prevents a corporation from circumventing *General Utilities* repeal by converting to S corporation status before distributing appreciated assets to its shareholders or selling appreciated assets.

Section 1374 generally imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that it held on the date it converted from a C corporation to an S corporation. This tax is imposed on built-in gain recognized during the 10-year period beginning on the first day the corporation is an S corporation. Section 1374(d)(8), which was added by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that it acquired in a carryover basis transaction from a C corporation for the 10-year recognition period beginning on the day of the carryover basis transaction.

Under section 1374(d)(9), which also was added by TAMRA, any reference in section 1374 to the first taxable year the corporation was an S corporation is a reference to the first taxable year it was an S corporation pursuant to its most recent S corporation election under section 1362.

Section 1019 of TAMRA states that, except as otherwise provided, any amendments made by TAMRA are effective as if included in the provision of TRA to which such amendment relates.

The current version of section 1374 replaced a prior version of section 1374 that generally only taxed income or gain recognized within the three year period following the date the corporation converted from C to S status. Section 633 of TRA,

as amended by TAMRA, provides the effective dates of the current version of section 1374. Specifically, section 633(b)(1) of TRA, as amended by TAMRA, provides that the amendments to section 1374 apply to taxable years beginning after December 31, 1986, but only in cases where the return for the taxable year is filed pursuant to an S election made after December 31, 1986. Section 633(d)(8) of TRA, as amended by TAMRA, provides a transition rule granting a limited postponement of the above effective date for "qualified corporations", which are certain small corporations as defined in that section. Under the transition rule, if a C corporation that is a qualified corporation makes an election to be an S corporation under section 1362 before January 1, 1989, then it is subject to former section 1374 for dispositions of long-term capital gain assets and current section 1374 for dispositions of short-term capital gain assets and ordinary income assets, without regard to whether such corporation is completely liquidated.

2. Section 1374(d)(8)

As discussed above, the general effective date of current section 1374, which is contained in section 633(b)(1) of the TRA, as amended by TAMRA, provides that current section 1374 applies to tax years beginning after December 31, 1986, but only in cases where the return for the taxable year is filed pursuant to an S election made after December 31, 1986. In TAMRA, Congress added subsection (d)(8) to section 1374, and provided that the provision was effective as if included in TRA.

Section 1.1374-8 provides regulations interpreting section 1374(d)(8). Example 1 of §1.1374-8(d) applies section 1374(d)(8) to a merger of a C corporation into an S corporation that elected S status before the effective date of TRA amendments, as further amended by TAMRA, to section 1374. Section 1.1374-10(a) provides that §1.1374-8 applies for taxable years ending on or after December 27, 1994, but only in cases where the corporation's tax return is filed pursuant to an S election *or* a section 1374(d)(8) transaction occurring after December 27, 1994 (emphasis added).

Despite the provisions of §1.1374-8 and the effective date provisions of §1.1374-10, the IRS understands that

some taxpayers contend that section 1374(d)(8) does not apply to carryover basis transfers from C corporations to S corporations that filed S elections before January 1, 1987, because the provisions in TAMRA that added section 1374(d)(8) indicated that the amendment was effective only if the return for the taxable year was filed pursuant to an S election made after December 31, 1986.

Section 337(d)(1) authorizes the Secretary to prescribe regulations to prevent the circumvention of the purposes of the repeal of the *General Utilities* doctrine through the use of any provision of law or regulations. The Treasury Department and the IRS believe that these temporary regulations are necessary to implement *General Utilities* repeal to prevent the use of corporations with pre-1987 S elections as a method for C corporations to transfer appreciated assets out of C corporation solution without gain recognition. Accordingly, these regulations confirm that section 1374(d)(8) applies to any transaction described in that section that occurs on or after December 27, 1994, the effective date of §1.1374-8, regardless of the date of the S corporation's election under section 1362.

3. Revocation and Re-election of S Corporation Status

As discussed above, section 633(d)(8) of TRA, as amended by TAMRA, provides a transition rule granting a limited postponement of the general effective date of current section 1374 for qualified corporations that make an election to be an S corporation under section 1362 before January 1, 1989. In *Colorado Gas Compression, Inc. v. Commissioner*, 366 F.3d 863 (10th Cir. 2004), *reversing and remanding* 116 T.C. 1 (2001), a qualified corporation eligible for the special transition rule elected S corporation status on February 1, 1988 (before the extended effective date of January 1, 1989), revoked S status on December 1, 1989, and subsequently re-elected S status effective on January 1, 1994. During the years 1994 through 1996, the taxpayer sold assets. The Tax Court held that such sales were subject to current section 1374, and that the transition rule did not preclude the application of current section 1374 because the taxpayer's most recent S election was

made after 1989. The Tax Court concluded that section 1374(d)(9) requires that the 1994 election, the taxpayer's most recent election, be the election considered for effective date purposes. The Tenth Circuit reversed the Tax Court, holding that, because the 1988 election was made before the extended effective date, the corporation was exempt from current section 1374 despite the intervening revocation of S status.

The Treasury Department and the IRS believe that the Tenth Circuit's holding is inconsistent with the legislative history and underlying policy of section 633 of TRA, as amended by TAMRA, and believe the Tax Court was correct in holding that a corporation's most recent S election must have been made before the deadline of the transition rule (*i.e.*, before January 1, 1989) in order for the corporation to be entitled to the benefit of the transition rule. As indicated above, section 337(d)(1) authorizes the Secretary to prescribe regulations to prevent the circumvention of the purposes of the repeal of the *General Utilities* doctrine through the use of any provision of law or regulations. The Treasury Department and the IRS believe that these temporary regulations are necessary to implement *General Utilities* repeal to prevent avoidance of corporate level tax on appreciation in the assets of a C corporation attributable to periods after the extended effective date of January 1, 1989. Accordingly, these regulations provide that the transition rule regarding qualified corporations in section 633(d)(8) of TRA, as amended by TAMRA, applies only if the corporation's most recent S election was made before January 1, 1989. Although these regulations apply to built-in gain recognized in taxable years beginning after December 22, 2004, the IRS will continue to assert this position for prior taxable years.

In summary, the temporary regulations provide that (1) section 1374(d)(8) applies to any transaction described in that section that occurs on or after December 27, 1994, regardless of the date of the S corporation's election under section 1362, and (2) for purposes of section 633(d)(8) of TRA, as amended by TAMRA, a corporation's most recent S election, not an earlier election that has been revoked or terminated, determines whether or not it is subject to current section 1374.

Special Analyses

It has been determined that this temporary regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to §1.1374-8T(a)(2) of these regulations. With respect to §1.1374-10T(c) of these regulations, it has been determined, pursuant to 5 U.S.C. 553(b)(B), that it would be contrary to the public interest to issue the regulations with notice and public procedure and, pursuant to 5 U.S.C. 553(d)(3), that good cause exists to dispense with a delayed effective date. The regulations are necessary to provide immediate guidance to taxpayers with respect to the application of the transition rule regarding qualified corporations in section 633(d)(8) of TRA, as amended by TAMRA, and, accordingly, with respect to the application of current section 1374 to asset dispositions which occur during taxable years beginning after December 22, 2004. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analysis section of the Notice of Proposed Rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these temporary regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Stephen R. Cleary of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury and the IRS participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

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

Section 1.1374-8T also issued under 26 U.S.C. 337(d) and 1374(e).* * *

Section 1.1374-10T also issued under 26 U.S.C. 337(d) and 1374(e).* * *

Par. 2. Section 1.1374-8 is amended by redesignating paragraph (a) as paragraph (a)(1) and adding paragraph (a)(2) to read as follows:

§1.1374-8 Section 1374(d)(8) transactions.

(a)(1) * * *

(2) (Reserved) For further guidance, see §1.1374-8T(a)(2).

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Par. 3. Section 1.1374-8T is added to read as follows:

§1.1374-8T Section 1374(d)(8) transactions (temporary).

(a)(1) (Reserved) For further guidance, see §1.1374-8(a).

(2) Section 1374(d)(8) applies to any section 1374(d)(8) transaction, as defined in paragraph (a)(1) of this regulation, that occurs on or after December 27, 1994, without regard to the date of the corporation's election to be an S corporation under section 1362.

(b) through (d) (Reserved) For further guidance, see §1.1374-8(b) through (d).

Par. 4. Section 1.1374-10 is amended by adding paragraph (c) to read as follows:

§1.1374-10 Effective date and additional rules.

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(c) (Reserved) For further guidance, see §1.1374-10T(c).

Par. 5. Section 1.1374-10T is added to read as follows:

§ 1.1374-10T Effective date and additional rules (temporary).

(a) through (b)(4) (Reserved) For further guidance, see § 1.1374-10(a) through (b)(4).

(c) *Revocation and re-election of S corporation status*—(1) *In general.* For purposes of section 633(d)(8) of the Tax Reform Act of 1986, as amended, any reference to an election to be an S corporation under section 1362 shall be treated as a reference to the corporation's most recent election to be an S corporation under

section 1362. This paragraph (c) applies for taxable years beginning after December 22, 2004, without regard to the date of the corporation's most recent election to be an S corporation under section 1362.

(2) *Example.* The following example illustrates the rules of this paragraph (c):

Example. (i) On February 1, 1988, X, a C corporation that is a qualified corporation under section 633(d) of the Tax Reform Act of 1986, as amended, elects to be an S corporation under section 1362. On December 1, 1989, X revokes its S status and becomes a C corporation. On January 1, 2004, X again elects to be an S corporation under section 1362. X disposes of assets in 2006, 2007, and 2008, recognizing gain.

(ii) X is not eligible for treatment under the transition rule of section 633(d)(8) of the Tax Reform Act of 1986, as amended, with respect to these assets. Accordingly, X is subject to section 1374, as amended by the Tax Reform Act of 1986 and TAMRA, and the 10-year recognition period begins on January 1, 2004.

(iii) To the extent the gain that X recognizes on the asset sales in 2006, 2007, and 2008 reflects built-in gain inherent in such assets in X's hands on January 1, 2004, such gain is subject to tax under section 1374 as amended by the Tax Reform Act of 1986 and TAMRA.

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

Approved December 15, 2004.

Gregory F. Jenner,
Acting Assistant of the Treasury.

(Filed by the Office of the Federal Register on December 21, 2004, 8:45 a.m., and published in the issue of the Federal Register for December 22, 2004, 69 F.R. 76612)