INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Team Manager

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer	=
State X	=
Product	=
v	=
w	=
x	=
y	=
z	=

Year 1 =

Date 1 =

Date 2 =

ISSUE:

Whether Taxpayer’s gain under § 311(b) of the Internal Revenue Code on the transfer of assets to newly-formed limited partnerships, followed by the pro rata distribution of the limited partnership interests to its shareholders, is determined as if Taxpayer sold the assets in their entirety for their fair market value, or by reference to the value of the individual limited partnership interests received by the shareholders?

CONCLUSION:

Taxpayer's gain under § 311(b) of the Internal Revenue Code is to be determined as if Taxpayer had sold the assets at their fair market value on the date of the distribution.

FACTS:

Taxpayer is a State X corporation that manufactures and sells Product. Taxpayer manufactures Product in v plants located throughout the southern portion of State X.

In Year 1, Taxpayer and its shareholders determined that it would be advantageous to transfer Taxpayer’s manufacturing operations to various limited partnerships. On Date 1, Taxpayer formed w limited partnerships (the “Limited Partnerships”). The shareholders of Taxpayer contributed cash to the Limited Partnerships as operating capital. Taxpayer contributed the real estate and improvements, inventory, additional operating capital, accounts receivable, and accounts payable associated with each of its plants to the Limited Partnerships (the “Assets”).

Taxpayer did not contribute the rolling stock, administrative assets, and administrative staff associated with its plants to the Limited Partnerships (“Retained Assets”).

On Date 2, Taxpayer distributed the interests in the Limited Partnerships (the “Interests”) to its shareholders pro rata while retaining the general partnership interest of each of the Limited Partnerships (the “Distribution”).

Taxpayer obtained appraisals of the Interests for purposes of reporting gain on the Distribution. The valuation in the appraisal was based on the value of the businesses underlying the Interests, discounted by x percent because the Interests are minority interests and discounted by y percent because there is no public market for the Interests. Taxpayer and the agent have stipulated that the undiscounted fair market value of the Interests is $z.

Taxpayer and the examining agent are in agreement that the governing provision of the Internal Revenue Code for the transaction is § 311(b). Taxpayer and the agent do not agree, however, on what property must be valued for purposes of determining gain under § 311(b) on the Distribution. The agent asserts that the business assets transferred to the Limited Partnerships are the property distributed for purposes of § 311(b). Taxpayer's position is that the property distributed for purposes of § 311(b) is the unmarketable, minority limited partnership interests, the value of which should reflect their minority position and lack of marketability.

LAW AND ANALYSIS:

Section 311(b)(1) of the Code provides that if a corporation distributes appreciated (in the hands of the distributing corporation) property to a shareholder, the corporation must recognize gain as if the property had been sold to the distributee shareholder at its fair market value.

We agree with the examining agent that, for purposes of determining gain on the Distribution under § 311(b), the business assets transferred to the Limited Partnerships constitute the distributed property. The controlling law in this area is found in Pope & Talbot, Inc. v. Comm'r, 104 T.C. 574 (1995), aff'd, 162 F.3d 1236 (9th Cir. 1999). The question in Pope & Talbot was the same question presented in the instant case. In Pope & Talbot, a corporation transferred property (the "Washington Properties") to a newly-created limited partnership. The partnership then distributed its partnership interests pro rata to the corporation's shareholders. The interests were traded on the Pacific Stock Exchange. The taxpayer and the Service disagreed over the determination of the taxpayer's gain on the distribution. The taxpayer argued that its gain should be determined by aggregating the value of all the individual partnership units, while the Service contended that the gain should be calculated by treating the property transferred to the limited partnership as if it had been sold by the corporation in its entirety on the date of the distribution, without regard for the value of the individual partnership interests received by each shareholder. Pope & Talbot 162 F.3d at 1238.

The Tax Court framed the issue in terms of what property is to be valued for purposes of § 311(d): the entire property interest leaving corporate solution or the fractional interests received by the shareholders. After analyzing the legislative history of § 311(d) (the predecessor to § 311(b)), the court found that the purpose of the section is to tax the appreciation in value that occurs while the distributing corporation holds the property. The court noted that if it adopted the taxpayer's position, the taxpayer would escape taxation of the gain in the Washington Properties attributable to appreciation during the period in which the corporation held the properties. Accordingly, the court ruled in favor of the Service's position. 104 T.C. 574 (1995).

The Ninth Circuit affirmed the Tax Court's decision, holding that the plain meaning of § 311 requires that the gain recognized by the distributing corporation be valued as if the corporation had sold the assets distributed at the time of the distribution. See 162 F.3d at 1239. Section 311(d) was designed to codify the repeal of the doctrine of General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), and required corporations to recognize gain when they distribute appreciated property to shareholders. Id.

The Tax Reform Act of 1986, Pub. L. No. 99-51, sec. 631(c), 100 Stat. 2272, which redesignated subsection (d) of § 311 as subsection (b), modified the language describing how gain would be recognized.[1] The former language stated gain would be recognized by the distributing corporation "as if the property distributed had been sold at the time of the distribution." The new language states that gain is recognized "as if such property were sold to the distributee at its fair market value." Taxpayer seeks to distinguish the instant case from Pope & Talbot on the ground that the decision in Pope & Talbot was based on the former language.

Taxpayer argues that the Tax Court and Ninth Circuit in Pope & Talbot would have decided that case differently under the new language of the 1986 Act. This argument, however, attributes undue importance to the language change and ignores the Tax Court's own discussion of the change. The taxpayer in Pope & Talbot advanced an argument similar to the one made by Taxpayer now. The Pope & Talbot taxpayer argued that the language change, as well as other language in § 311, indicated that the

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[1] Before the Tax Reform Act of 1986, Pub. L. 99-51, sec. 631(c), 100 Stat. 2272, sec. 311(d) read as follows:

(d) Distributions of appreciated property

(1) In general. –If–

(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and

(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation *in an amount equal to such excess as if the property distributed had been sold at the time of the distribution.*

The Tax Reform Act of 1986, redesignated and amended sec. 311(d)(1) as follows:

(b) Distributions of appreciated property

(1) In general. –If–

(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and

(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation *as if such property were sold to the distributee at its fair market value.*

focus of the statute is on what is received by the individual shareholders and not on what is distributed. The court dismissed this argument. In doing so, the court observed that the only reason for the language change was to conform the language of § 311(b) to that of § 336(a), citing the legislative history. See Pope & Talbot, 104 T.C. at 582 (citing H. Conf. Rept. No. 99-841, at II-198 (1986), 1986-3 C.B. (Vol. 4) 1, 198: "the Act generally conforms the treatment of nonliquidating distributions with liquidating distributions."). After our own review of the legislative history of the 1986 Act, we agree with the Tax Court that the language change was not substantive. Moreover, if we attributed the meaning to the language change that Taxpayer proposes, we would have to disregard Congress' stated objectives in enacting § 311(b) and its predecessor, because Taxpayer's position would avoid recognition of the full amount of the Assets' inherent gain realized in the Distribution. See 104 T.C. at 578-79; 162 F.3d at 1239-40. Therefore, Taxpayer's gain under §311(b) must be determined with reference to the value of the Assets, not the value of the Interests.

Taxpayer also seeks to distinguish the instant case from Pope & Talbot on the basis that Pope & Talbot never received nor distributed partnership interests, while Taxpayer received the Interests and distributed them to its shareholders. This, however, is a distinction without a difference. Section 311, like §§ 301 and 302, applies to distributions by a corporation to its shareholders in their capacity as shareholders of the corporation. The shareholders of Pope & Talbot received the distribution of the limited partnership interests in proportion to and because of their shareholdings in Pope & Talbot. It does not matter for Federal tax purposes whether those interests were transferred directly from Pope & Talbot or through conduit entities; the courts still treated Pope & Talbot as if it distributed the interests directly to its shareholders. See 104 T.C. 574 n.5 ("it is clear that a conveyance of property to a partnership on behalf of a shareholder falls within the ambit of sec. 311(d)(1).") In this regard, the facts of the instant case and those of Pope & Talbot are essentially identical.

The taxpayer in Pope & Talbot argued that § 311 must be read symmetrically with §§ 301 and 302. In other words, the "fair market value" of property distributed by the corporation must equal the "fair market value" of property received by the shareholders. The Ninth Circuit ruled that symmetry between the provisions was not required, stating:

> However, if the corporation distributes one form of property and the shareholders receive another, there is no "symmetry." That was the case here. The corporation did not distribute gold coins to shareholders who received gold coins. The corporation distributed the Washington Properties to the Partnership, and the shareholders received individual limited partnership interests. We conclude that the tax court used the proper methodology to determine the fair market value of the distributed property.

162 F.3d at 1240.

Taxpayer contends that the Ninth Circuit's decision on the symmetry question turned on the fact that Pope & Talbot did not directly distribute the partnership interests to its shareholders (but through a conduit entity). Based on this interpretation of the court's reasoning, Taxpayer asserts that if its case were before the Ninth Circuit, the court would rule in Taxpayer's favor.

We disagree. As already discussed, the courts treated Pope & Talbot as having distributed the partnership interests to its shareholders, so, in this regard, there is no factual distinction between the instant case and Pope & Talbot for Federal tax purposes. The point made by the Ninth Circuit was that, for Federal tax purposes, Pope & Talbot distributed something different (the Washington Properties) than what its shareholders received (the limited partnership interests). Taxpayer is in no different a situation. For Federal tax purposes, Taxpayer is treated as distributing something different (the Assets) than what its shareholders received (the Interests). Further, the Ninth Circuit explicitly stated that there was no symmetry requirement between § 311(d) and §§ 301 or 302. 162 F.3d at 1240 ("We disagree with [Pope & Talbot's argument that section 311(d)(1) must be read symmetrically with 26 U.S.C. sections 301 and 302.]"). Therefore, in this regard, we find nothing in the Ninth Circuit's opinion that indicates Taxpayer's case should be decided differently than Pope & Talbot.

For similar reasons, we disagree with Taxpayer's argument that its retention of the general partnership interest is a significant distinction from Pope & Talbot. In Pope & Talbot, the general partnership interest in the limited partnership was transferred to two other corporations controlled by Pope & Talbot's principal shareholders. We see no reason, and Taxpayer has not suggested any reason, why Federal tax treatment would turn on whether the general partnership interest was held by Pope & Talbot or by a corporation controlled by Pope & Talbot's principal shareholders.

Taxpayer also seeks to distinguish Pope & Talbot by pointing out that Taxpayer did not contribute Retained Assets to the Limited Partnerships, while Pope & Talbot, Taxpayer asserts, transferred 100 percent of the Washington Properties to the limited partnership. Although the facts set forth in the Pope & Talbot decisions state that Pope & Talbot transferred all of the Washington Properties, we do not find any indication that it transferred all of its business, including administrative staff and administrative assets, to the limited partnership, as Taxpayer asserts. In any event, this factual matter is unimportant, because even assuming the facts of Pope & Talbot are as Taxpayer asserts, Taxpayer's point does not bear on the essential question before us. Whether or not certain assets are retained does not alter the application of § 311(b) to the Distribution, nor is it determinative of whether we must look to the Assets or the Interests in determining the value of the Distribution.

Taxpayer further points out that Pope & Talbot was a Subchapter C corporation, while Taxpayer is a Subchapter S corporation. Asserting that avoidance of double taxation was the main concern of the Pope & Talbot courts, Taxpayer claims such concerns are not applicable here because "S" corporations are subject to only a single level of taxation. As we read the opinions, however, double taxation was not the concern of the Pope & Talbot courts. Rather the Tax Court and Ninth Circuit were concerned about taxation of the appreciation occurring while properties were held by Pope & Talbot. If Taxpayer's position were adopted, the full amount of gain attributable to appreciation during the time Taxpayer held the Assets would not be taxed. While we recognize that Taxpayer is a Subchapter S corporation and does not itself pay tax on the gain, § 311(b) and the holding of Pope & Talbot require that Taxpayer recognize gain on the appreciation of the Assets while Taxpayer held them. Thus, Subchapter S status is irrelevant to the question before us.

Taxpayer also cites South Tulsa Pathology Laboratory, Inc. v. Comm'r, 188 T.C. 84 (2002). In South Tulsa, the taxpayer, a corporation, sought to sell a portion of its business without recognizing gain. To this end, the taxpayer dropped the business assets it desired to sell into a controlled corporation, and spun that corporation off to its shareholders in a transaction purported to qualify under § 355. Pursuant to a prearranged sale, the shareholders sold all of the controlled corporation's stock to a third party. The taxpayer argued that if section 311(b) applied to the distribution, then the value of property distributed should be determined by the value of the controlled corporation's assets the day before the distribution, and not the amount for which the shareholders sold their shares. The court ruled that the spinoff failed to qualify under § 355 and that the distribution of the stock was subject to § 311(b). In applying § 311(b), the court rejected the taxpayer's position on valuation, finding that the sale price of the stock was the best evidence of the fair market value of the property distributed.

We find South Tulsa inapposite to the instant case for the same reasons that the South Tulsa court found Pope & Talbot inapplicable to its facts. The taxpayer in South Tulsa relied on Pope & Talbot in arguing that its § 311(b) gain should be determined with reference to the controlled corporation's assets rather than the value of the stock distributed. The South Tulsa court distinguished Pope & Talbot stating that the question presented in Pope & Talbot was what property interest had to be valued for purposes of §311, while the question in South Tulsa was not one of what had to be valued, but how it was to be valued. For the same reason South Tulsa does not apply to the instant case. Here the question is, as it was in Pope & Talbot, what to value, not how to value it.

Taxpayer cites Estate of Lee v. Comm'r, 69 T.C. 860 (1978) and Revenue Ruling 93-12, 1993-1 C.B. 202, in the estate and gift tax area, for the proposition that gifts made by a donor to multiple donees cannot be aggregated for purposes of determining the fair market value of the property subject to gift tax at the donor level. These authorities are not relevant to the question before us because they address the issue of whether to aggregate donated stock interests for purposes of valuation (i.e., applying a minority discount or blockage factor). However, the question here is whether to value the § 311(b) gain with reference to the assets contributed or with reference to the aggregate of the individual partnership interests. Or, as the Pope & Talbot court said it, the question is not *how* to value the distributed property, but *what* to value for purposes of

§ 311(b). Having decided that the Assets should be valued to determine Taxpayer’s § 311(b) gain, the question of whether Taxpayer would aggregate Interests or not is irrelevant.

For the reasons stated above, we conclude that Taxpayer’s gain under § 311(b) is to be determined as if Taxpayer sold the Assets at their fair market value on the date of the distribution.

CAVEATS:

It should be noted that this technical advice addresses only the § 311 distribution issue presented. This technical advice does not address any tax characterizations or consequences that may arise under Subchapter S or Subchapter K of the Internal Revenue Code. In addition, we do not address the tax treatment of the dividends received by Taxpayer's shareholders as a result of the Distribution.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.