Taxable Spinoffs May Now Carry Greater Tax Liabilities

by Robert W. Wood • San Francisco

Although taxpayers would typically prefer a tax-free distribution of stock under Section 355, there are a variety of circumstances in which a

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taxable distribution may either be attractive, or at least not unattractive. It may be impossible for the transaction to qualify as a tax-free spinoff for any one of a number of reasons, or it may actually be desirable for the transaction to be structured in a taxable fashion. Either way, it will become necessary to determine precisely what the tax is. One would think that would be easy. A recent Tax Court case suggests otherwise.

In *Pope & Talbot, Inc. v. Commissioner*, 104 T.C. No. 29 (1995), the taxpayer was a publicly held corporation in the timber, land development and resort businesses in Washington state. In October of 1995, the board of directors and shareholders adopted a plan of distribution calling for the transfer of assets of certain businesses to Pope Resources, a newly formed limited partnership. The partnership had two Delaware corporations as managing general partner and standby general partner, respectively. These two corporate partners initially were owned equally by two of the principal shareholders. Under the plan, one corporation was to receive partnership units when Pope & Talbot transferred the Washington properties to the partnership. This corporate general partner was then to make a pro rata distribution of partnership units to the Pope & Talbot shareholders.

In late 1985, pursuant to the plan, Pope & Talbot transferred its Washington timberlands to the partnership subject to a substantial and newly-acquired loan. Also transferred were the land development and resort businesses, and $1.5 million in cash. Pursuant to the plan, the general partner issued partnership units to each holder of record of Pope & Talbot stock, with each shareholder receiving one partnership unit for every five shares of common stock held.

Big Question

The issue in the case was how to value the property distributed to the shareholders. There was no dispute about the facts, nor even about the taxability of the distribution. After all, the common shareholders of Pope & Talbot wound up receiving partnership interests in a partnership holding some of the assets previously held by Pope & Talbot. The question was how much these partnership units should be worth. The taxpayer (Pope & Talbot) argued that the fair market value of the property distributed should be determined by reference to the value of the partnership units received by each shareholder. That sounds sensible. On the other hand, the IRS contended that under Section 311(d), the fair market value of the property distributed had to be determined as if the property had been sold in its entirety.

Although one might have thought that such a question would have been resolved long ago, the Tax Court in its opinion acknowledged that this was an issue of first impression, requiring the court to determine just what property interest must be valued for purposes of Section 311(d). Is it: (1) the entire property interest which is being taken out of corporate solution; or (2) the fractional interests received by the shareholders? The Tax Court acknowledged that both parties relied on purportedly clearly statutory language. The Tax Court, however, noted that it found the statutory language uncertain and therefore had to resort to rifling through the legislative history.

Age-Old Provision

Section 311(d) dates to the Tax Reform Act of 1969, designed in large part to tax corporations on their use of appreciated property in stock redemptions. The legislative history suggests that using appreciated property in this fashion should be treated essentially as if the property had been sold. Subsequently, Section 311(d) was amended to cover more circumstances than mere redemptions.

The Tax Court concluded that the purpose underlying Section 311(d) was to tax the appreciation in value that occurred during the time the distributing corporation held the property, thus preventing the corporation from avoiding tax on the inherent gain by distributing that property to its shareholders.

The precise method of valuation was significant. Under the taxpayer's theory, the property distributed to the shareholders (the partnership interests) had a value of $40,325,775. The government, on the other hand, argued that the appropriate value was $115,610,385. The Tax Court assumed for purposes of rendering its decision that these valuation figures were accurate. Why the difference? In the one case, one looks at the fair

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market value of the partnership interests; in the other, one looks at the fair market value of the underlying property.

Plain Meaning

The taxpayer argued with some cogency that for purposes of symmetry between Sections 301, 302 and 311(d), the fair market value of the property distributed by a corporation must be the same as the fair market value of the property received by its shareholders. Section 301 provides that the amount of a distribution of property by a corporation with respect to its stock (to a non-corporate distributee) is the amount of money received, plus the fair market value of the other property received. Under Section 302, a redemption is either treated as an exchange or as a distribution of property. If the redemption is treated as an exchange, the amount realized is the sum of any money received plus the fair market value of property received.

The court was unmoved by this symmetry argument, noting in fact, that the taxpayer might be proving too much. For example, if a taxpayer were allowed to determine its gain under Section 311(d)(1) based on the lower value of the partnership units distributed, and the partnership were to sell the distributed property at full fair market value, the shareholders would recognize the full fair market value of the property as income (the value of the partnership units plus their portion of partnership gain attributable to the appreciation that occurred while the property was in corporate solution). Were this to occur, though, the corporate taxpayer (Pope & Talbot) would escape recognizing gain on the Washington properties prior to their distribution. This, according to the Tax Court, is what Section 311(d)(1) was designed to prevent.

There is a good deal of rhetoric in the case about the purported plain meaning of the statute. The taxpayer argued that Section 311(d)(1) requires distributions of property to be valued by reference to the property received by each shareholder. The court, however, agreed with the government that such a view would effectively frustrate the purpose of Section 311(d)(1). Nonetheless, I think the taxpayer's argument about statutory language had some force. Section 311 was amended in 1986 to change the phrase "as if the property distributed had been sold at the time of the distribution" to "as if such property were sold to the distributee at its fair market value."

The court was unpersuaded that this seeming focus on the distributee should be interpreted to let a significant amount of appreciation at the corporate level escape taxation. After a lengthy discussion of congressional intent (from which probably either interpretation could be justified), the court held firmly that the taxpayer's gain on the distribution of the Washington properties had to be determined as if the taxpayer had sold its interest in the Washington properties at fair market value on the date of the distribution.

How Much Is It Worth?

The *Pope & Talbot* case may be particularly disturbing if one looks at the disparity in numbers between the IRS' and the taxpayer's value. The difference between the trading value of the partnership interests and the value of the underlying properties in this case was enormous (about $75 million difference). These valuation figures were not disputed by the court, although one wonders whether there could be another round of such discussions. However one reads the *Pope & Talbot* case (which certainly may not be the last word on this subject), it is obvious that the case's harsh treatment of the value of distributions makes such taxable spins substantially more expensive. ■

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