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## Gratuitous Transfer to Related Partnership Not a “Distribution”

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If property is transferred from a corporation to a shareholder for an amount less than its fair market value, the transaction may be treated as a distribution of property for income tax purposes.<sup>1</sup> A transaction treated as a distribution can result in the recognition of taxable income to both the transferor (distributing) corporation and the transferee (distributee) shareholder. In particular, in the case of the corporation, Internal Revenue Code section 311(b) provides that gain shall be recognized as if the property had been sold to the distributee at its fair market value.

Sometimes, a transaction takes a form other than a straightforward sale. For example, a closely held corporation may contribute property to a newly formed partnership in exchange for a partnership interest, while members of the family or group that controls the closely held corporation acquire interests in the partnership for cash. Ordinarily, a contribution of property to the capital of a partnership, in exchange for an interest in the partnership, is a non-taxable transaction. However, if the property transferred by the corporation to the partnership is worth more than the partnership interest received by the corporation in exchange for the property, that circumstance may suggest that the partnership formation may have resulted in a distribution of property from

the corporation to the partner or partners contributing cash (or to their relatives who are shareholders of the corporation) and, thus, in the recognition of taxable gain by the corporation.<sup>2</sup>

In *Cox Enterprises, Inc. v. Commissioner*,<sup>3</sup> a recent Tax Court memorandum decision, the question of whether the corporation was required to recognize gain in such a transaction arose in the context of the taxpayer's motion for summary judgment. The taxpayer conceded, for purposes of the motion, that the fair market value of the property transferred by a corporation to the partnership substantially exceeded the fair market value of the partnership interest received by the corporation in exchange. The court concluded that, notwithstanding this concession, no distribution resulting in taxable gain to the corporation would be considered to have occurred, because there was no evidence that the discrepancy resulted from any intention by the controlling shareholders to cause the corporation to confer a benefit on the other partners.

### ‘Cox Enterprises’

Cox Enterprises, Inc. (“Cox”) was the parent of an affiliated group of corporations that filed consolidated returns for Federal income tax purposes. The corporations were engaged in various newspaper publishing, television broadcasting, cable television, and other businesses. Cox Communications, Inc. (“CCI”), a wholly owned subsidiary of Cox, owned KTVU, Inc. (“KTVU”), which, until September 1, 1993, owned

and operated TV station KTVU (the TV station).

Three trusts (the “shareholder trusts”) formed by James M. Cox for the benefit of his daughters and their descendants collectively owned approximately 98% of the stock of Cox. Specifically, one of the trusts was formed for the benefit of Anne Cox Chambers (Mrs. Chambers), a second trust was formed for the benefit of Barbara Cox Anthony (Mrs. Anthony), and the third trust benefited both daughters. All three trusts named the daughters as income beneficiaries for life, with their descendants being successor income beneficiaries and holding the remainder interests. The daughters were also trustees of the trusts.

The remaining stock of Cox was held by other persons, principally employees of Cox, who were not members of the Cox family.

In 1992, Cox sought advice from McKinsey & Co. regarding the prospects for several of its divisions, including the television broadcast business. McKinsey recommended that Cox retain those of its stations that were affiliated with what were then the major television networks, but that Cox dispose of its two Fox affiliates, one of which was KTVU's TV station. Cox was eventually able to sell one of its Fox affiliates, but, in the context of a rapidly declining market, chose to terminate efforts to sell KTVU's TV station.

Instead, Cox determined that the transfer of the TV station owned by KTVU to a new partnership that would

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be owned by KTVU and by members of the Cox family could accomplish several business objectives, including (i) the reduction of the aggregate investment of Cox in television broadcasting, (ii) making the working capital of KTVU available for other businesses, and (iii) assuring the TV broadcasting executives of Cox that the Cox family had a continuing commitment to the broadcasting business.

To effectuate this transfer, the children of Mrs. Chambers and an entity wholly owned by her formed the ACC Family Partnership (ACC Partnership), and Mrs. Anthony, her children, and entities owned or controlled by them formed the Anthony Family Partnership (BCA Partnership). On August 1, 1993, KTVU, the ACC Partnership, and the BCA Partnership formed KTVU Partnership to acquire the KTVU assets used to operate the TV station.

KTVU became the managing general partner of KTVU Partnership and received, in exchange for its contribution of the KTVU broadcasting assets, a 55% interest in partnership profits up to specified thresholds and 75% of profits in excess of the thresholds. Each of ACC Partnership and BCA Partnership contributed \$27,000,000 in cash to KTVU Partnership and received a 22.5% interest in profits up to the specified thresholds and a 12.5% interest in profits in excess of the thresholds.

The cash amounts contributed by the ACC Partnership and the BCA Partnership were determined in part by reference to an analysis prepared by Arthur Andersen of appropriate marketability and minority interest discounts applicable to the minority interests in KTVU Partnership as of August 1, 1993.

In 1996, the management of Cox determined that mistakes had been made in computing the fair market value of the interest of each of the family partnerships in KTVU Partnership. In particular, the computations had failed to take into account the cash contributions by the family partnerships and the reduced allocations to the family partnerships of profits of KTVU

Partnership in excess of specified thresholds.

The investment banking firm of Furman Selz was engaged to determine whether, in light of these mistakes, there should be an adjustment to the amounts paid by the family partnerships for their interests in KTVU Partnership. Furman Selz ultimately concluded that, as of August 1, 1993, the interest acquired by each family partnership in KTVU Partnership had a fair market value of approximately \$31,000,000. Accordingly, in September, 1996, each family partnership contributed an additional \$4,000,000 to KTVU Partnership.

#### IRS Audit

The IRS concluded that, as of August 1, 1993: the TV station assets contributed to KTVU Partnership had a fair market value of \$300,000,000; the partnership interest received by KTVU in exchange for the assets had a fair market value of \$233,500,000; and the fair market value of the interest of each family partnership in KTVU Partnership was approximately \$34,000,000. The values for the partnership interests in KTVU Partnership were then determined to be increased by reason of the additional cash contributions in 1996 to \$239,500,000 for the interest of KTVU, Inc. and \$34,900,000 for the interest of each of the family partnerships. Accordingly, the IRS issued a notice of deficiency asserting that KTVU, CCI, and Cox should be viewed as having distributed, ultimately to the shareholders of Cox, a partnership interest in KTVU Partnership having a value of \$60,500,000, equal to the alleged difference in value between the station assets transferred and the interest in KTVU Partnership received in exchange.<sup>4</sup> Thus, after taking into account a share of the relatively low tax basis in the property transferred to the partnership, an increase in taxable income of approximately \$56 million was alleged by reason of the constructive distribution.

Cox filed a petition with the Tax Court to contest the deficiency determined by the IRS, and then moved for summary judgment on the issue of

whether gain had to be recognized by Cox in connection with the transfer of assets to KTVU Partnership.

#### Discussion

The court first considered whether there were issues of material fact that precluded rendering a decision on Cox's motion. For purposes of the motion, Cox had conceded the values asserted by the IRS. Moreover, the IRS had failed to identify what additional factual issues needed to be developed or resolved to determine whether the formation of the partnership resulted in a distribution by the corporate transferor. Accordingly, the court concluded that there was no issue of fact that would prevent addressing the summary judgment motion on its merits.

The court noted that it was required to follow pre-1981 cases decided by the Fifth Circuit Court of Appeals that are binding precedent in the Court of Appeals for the Eleventh Circuit, the court to which the Tax Court decision would be subject to appeal. The decision refers in particular to pre-1981 cases such as *Sammons v. Commissioner*<sup>5</sup> as relevant to determining when an intercorporate transfer (that is, a transfer from one corporation to another under common control) constitutes a dividend from the transferor corporation to its shareholder.

Under *Sammons* and other Fifth Circuit and Tax Court case law as summarized in *Cox*, two criteria must be considered: first, whether the transfer is made primarily for the benefit of the shareholder, rather than for a valid business purpose; and, second, whether the distribution causes funds or other property to leave the control of the transferor corporation and permits the shareholder to control such property other than through the transferor.

The *Cox* opinion notes that the Government, in its objection to the summary judgment motion, did not dispute Cox's representations regarding the non-tax motives for the formation of KTVU Partnership. Therefore, the court treated those representations as true.

Taking those representations into account, the court concluded that there

was no evidence that the parties to the transaction and the controlling shareholders acted purposely to cause KTVU to transfer property to the partnership for less than fair market value or to confer on the family partnerships terms that were more favorable than those that would have applied in an arm's length transaction.

To the contrary, the court agreed with the petitioner that such a transfer would have represented a violation of the fiduciary duties of Mrs. Chambers and Mrs. Anthony as directors and shareholders, and concluded, citing *United States v. Byrum*,<sup>6</sup> that it would be improper to find on this record – reflecting non-tax business reasons for formation of the partnership, the use of outside appraisals to determine and later increase the family partnerships' capital

contributions, and fiduciary responsibility constraints imposed on the controlling shareholders as such and as directors and trustees – that the daughters acted with the intention of benefiting the trust beneficiaries at the expense of Cox.<sup>7</sup>

#### Observations

There is often reason for concern, in the context of a transfer of a business or other property to a partnership under common control with the corporate transferor, that the value of the partnership interest received by the corporation is less than the value of the property contributed. The conclusion of the Tax Court in *Cox*, albeit in a memorandum decision, that such a differential will not automatically give rise to a constructive distribution by the corporation to its

shareholder or shareholders, is very welcome.

Taking into account the references in the opinion to the primary purpose test as being applicable under binding (but dated) case law precedent in the Fifth and Eleventh Circuits, however, it is conceivable that the court would have reached a different conclusion had the decision been subject to appeal to a Court of Appeals in a different Circuit. Moreover, in light of the Tax Court's opinion, the IRS is now on notice regarding the sorts of evidence of subjective intent that it may be required to produce under the Fifth Circuit's test, and it can be expected to gather that evidence and to make arguments based on its existence more vigorously in the future. Great caution should therefore be exercised before using *Cox* as authority at the planning stage for any transaction.

<sup>1</sup> See, for example, Reg. § 1.301-1(j).

<sup>2</sup> In the case of other relationships between the corporation and the other partners in the partnership, the transaction might be viewed as a gift, as compensation for services, as repayment of a debt, or otherwise. Cf. Reg. § 1.721-1(b) (discussing the potential consequences if a partner surrenders any part of his right to be repaid his capital contributions).

<sup>3</sup> TC Memo 2009-134 (June 9, 2009).

<sup>4</sup> The IRS asserted, citing *Pope & Talbot, Inc. v. Commissioner*, 162 F.3d 1236 (9<sup>th</sup> Cir. 1999), that the property to be valued in determining the amount of gain recognized by Cox consisted of the assets contributed by KTVU to the partnership. The court in *Cox* resolved the motion for summary judgment without addressing the *amount* of gain.

<sup>5</sup> 472 F.2d 449 (5<sup>th</sup> Cir. 1972), affirming TC Memo 1971-145 (1971).

<sup>6</sup> 408 U.S. 125 (1972).

<sup>7</sup> Cox had argued that, under Code section 704(c), any gain that was associated with the TV station assets would be required to be allocated to KTVU as the contributor of the assets, and that this preempted the application of section 311(b) to any part of that gain. Cox had further argued that no distribution to the shareholder trusts could have occurred because the daughters of Mr. Cox, as controlling trustees of the trusts and as members of the board of directors of Cox, lacked the authority or the power to cause station assets to be transferred by Cox or its subsidiaries for the benefit of anyone else until termination of the trusts. The court did not address these arguments, but ruled in favor of Cox on the ground discussed in text.

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