STATE OF ALABAMA DEPARTMENT OF REVENUE,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. INC. 86-231
LFC, INC. 232 Oxmoor Road, Suite 1003 Birmingham, AL 35209,	§ §	
Taxpayer.	§	

ORDER

This case involves a preliminary assessment of income tax entered by the Revenue Department (Department) against LFC, Inc. (Taxpayer) for the fiscal year ending September 30, 1984. A hearing was conducted in the matter by the Administrative Law Division of the Department on August 6, 1987. Mr. Grant McDonald, CPA, appeared on behalf of the Taxpayer. Assistant counsel Mark Griffin was present and represented the Department. Based on the evidence submitted by the parties, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

The issue to be decided is whether the Taxpayer realized a taxable gain on the transfer of appreciated property (a partnership interest) to a shareholder in redemption of the shareholder's stock. The relevant facts are undisputed.

Big B Food Systems (partnership) is a limited partnership, with a general partner and two limited partners. The Taxpayer is one of the limited partners and at the time of its incorporation owned a forty-five percent interest in the partnership.

On February 20, 1984, the Taxpayer transferred fifty percent of its remaining partnership interest to one of its two remaining shareholders in exchange for all of the shareholder's stock in the Taxpayer. At the time of the exchange, the fair market value of the partnership interest exceeded the Taxpayer's adjusted basis in the partnership interest by the amount of $18,846.00.

On its federal return for the period in question, the Taxpayer reported a gain of $18,846.00 on the transfer of the partnership interest. No gain was reported by the Taxpayer on its Alabama return. That is, because the Alabama return started with the federal net income amount as reported by the Taxpayer on its federal return, which included the $18,846.00 as income, the Taxpayer deducted or adjusted downward the net income figure so as to remove the $18,846.00 from income on its Alabama return.

CONCLUSIONS OF LAW

Code of Ala. 1975, §40-18-34 defines "gross income" relative to corporations to be the same as is applied to individuals at Code of Ala. 1975, §40-18-14. Section 40-18-14 defines the term broadly to include, among other items, all gains, profits, etc. derived from dealings in property.

Code of Ala. 1975, §40-18-7 provides that the amount realized from the sale or other disposition of property, other than money plus the fair market value of any property, other than money, received. Code of Ala. 1975, §40-18-8 governs the recognition of any gain and provides a general rule that the entire gain upon the sale or exchange of property shall be recognized. The remaining subsections of §40-18-8 provide exceptions to the general rule, and subsection (m), which was enacted in 1985 and became effective for tax years beginning after December 31, 1984, reads as follows:

> (m) Taxability of corporation on distribution. - The amount of gain recognized by a corporation on the distribution of its stock, rights to acquire its stock, or property shall be determined in accordance with 26 U.S.C. 311 (relating to taxability of corporations on distributions), as in effect from time to time.

26 U.S.C.A. §311 is title "Taxability of corporation on distribution" and provides a general rule, with exceptions stated therein, that no gain or loss shall be recognized by a corporation on the distribution, with respect to its stock, of any property. However, one of the exceptions is §311(d), which provides that if a corporation uses appreciated property to redeem its stock, then the corporation must recognize a gain equal to the excess of the property's fair market value over its adjusted basis in the hands of the corporation.

The Department argues that §40-18-8(m), and thus 26 U.S.C.A. 311, is inapplicable because it became effective under Alabama law subsequent to the tax year in question. Thus, the Department contends that the general rule of taxability set out in §40-18-8(a) should govern and that thereunder the entire gain derived by the Taxpayer from the property/stock exchange should be recognized.

The Taxpayer argues that the transaction in question would have resulted in a taxable gain under §311 had that section been applicable in Alabama for the subject period. However, because §40-18-8(m) was enacted after the tax year in dispute, the Taxpayer contends that the general rule of federal law should apply which holds that a transfer of appreciated property to a shareholder with respect to his stock is non-taxable, citing General Utilities and Operating Co. v. Helvring, 296 U.S. 200, 56 S.Ct. 185.

Upon consideration, it is determined that the Department's position is correct. To begin, because §40-18-8(m) became effective subsequent to the year in question, it is inapplicable and need not be considered. Also, no basis can be found for the Taxpayer's argument that no gain should be recognized on the exchange by a corporation of appreciated property in redemption of its stock. A more correct statement of the rule referred to by the Taxpayer, and set out in the cited General Utilities and Operating Co. case, is that the mere distribution of appreciated property to its shareholders is not taxable. The purpose behind §311 was to codify that general rule. Honigman v. C.I.R., 466 F.2d 69; Grede Foundries, Inc. v. U.S., 202 F. Supp. 263. However, as stated, §311(d) provides that a gain should be recognized if appreciated property is distributed in exchange for the corporation's stock. Thus, there is a distinction between a simple distribution of property by a corporation to its shareholders (non-taxable), as opposed to an exchange of property by a corporation in redemption of its stock (taxable).

In any case, the gain resulting from the transaction in question is clearly taxable under Alabama law. Section 40-18-14 governs and broadly defines "gross income" to include gains from any dealing in property. Section 40-18-8 provides that the entire gain upon the sale or exchange of property shall be recognized. There is no dispute that a gain of $18,846.00 was realized on the transaction in issue, which, based on the above, must be recognized as taxable by the Taxpayer in the tax year in question.

The above considered, the Revenue Department is hereby directed to make final the preliminary assessment in issue as entered, with additional interest as required by statute.

Done this 18th day of September, 1987.

BILL THOMPSON
Chief Administrative Law Judge