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Book 1 of 3 Books

Examination Number 7761

Subject of Examination
Corporate Tax

Date of Examination
5-2-02

NORTHWESTERN SCHOOL OF LAW

LEWIS & CLARK COLLEGE

EXAMINATION BOOK

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Parco (P) was an asset deal in acquiring Tarco (T). Pursuant to 61(a)(3) and 1001, T is required to report gain or loss on each asset sold.

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Under 1060, the purchase price $300K ($280K cash + $20K assumption to T's liability) must be allocated to each of the asset sold. If P and T has a mutual agreement as to the allocation, which is a recommended practice in reality, otherwise, P and T has to go out to appraise every and each asset, the allocation will be based on the agreement. If there is no such an agreement, T needs to use the general allocation rules under 1060. This is basically a residual method allocation. The first step is to identify the assets in each class; The second step is to allocate the purchase prize to each asset according to their FMV but no more

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than their FMV. The last step will be calculating gain or loss based on the allocation and their respective basis.

With regard to covenant not to compete, the purchase price is allocated to such covenant first because this allocation will be subject to one level of tax on Jen and Justic's tax returns. Here, FMV of 2 of the covenants is $40K, with $20K each. Assuming the basis in the covenants is 0; thus, Jen and Justin will each recognize a gain of $20K. This is ordinary income. Another issue involved here is that whether Jen or Justin can ~~or cannot~~ compete ~~carry out the covenant~~. Here, Jen seems to ~~be~~ able to compete ~~carry out~~ based on her active involvement in T's business. Her share of allocation $20K seems to be fine. But Justin was only an outside accountant in T; if there is no possible

way that Justic will compete, then the Service will come out to argue that Justin's $20K allocation to his covenant not to compete is not effective. As a result, the Service will impose a double penalty tax on that $20K allocation

After allocating $40K to covenants not to compete, the remaining ($260K) from the purchase price ($300K). will allocate to each class of assets ~~based on the Regs~~ pursuant to relavant regulations. In this case, the class I includes cash and account receivables; ~~class~~ There is no class II assets, which usually include investment securities; class III assets include the inventory, equipment, and the land. Each of these assets will get an amount equal, but no more, than, their respective FMV from the purchase price. ~~class~~ There are no class IV, V, VI assets in this case. After

the above allocation, the remaining purchase prise, if any, will go to the last class — Class VII assets; in this case, they are customers lists and good-will, each of which will get a share based on their FMV; if not enough to cover both of their FMV, then the remaining shares of amount will be allocated between them base on a ratio determined by their FMV.

After the above allocation, each asset will get an ~~share~~ amount equal (in some cases, may be less than) to their respective FMV. Based on these allocation and each asset's adjusted basis, we may calculate each assets gain or loss. and T has to pay taxes on those gain and deduct losses. in the meantime. The gain or loss resulted from the accounts receivable, inventory, customers list and good will will be

ordinary gain or loss. The gain or loss resulted from the land will be capital if the land is a capital asset under 1231. If there is any gain from the ~~[illegible]~~ equipment, ~~this~~ gain will ~~probably~~ be ordinary income under the 1245 recapture provisions. The loss from the equipment will be capital loss.

In this case, without calculating ~~each~~ gain or loss from each asset, T will recognize an overall gain of \$135K: [total amount of allocation ~~receive~~ from the purchase price ~~\$260~~ less \$40 allocated to covenant not to compete, thus (\$260K) ~~minus~~ ~~ove~~ overall basis in all assets (\$125K)]. For ~~this~~ character of gain, please see the preceeding paragraph.

When T liquidates, distributing $280K cash to both shareholders Jen and Justin. On the T corp. level, there is no gain or loss recognized by distributing cash under 336(a). After the liquidation, T stock is cancelled; and T is effectively dissolved. T's e&p account and other tax characteristics disappear with the corp.; The reason for e&p's dissappearance is that those amount is theretically incorporated in T's assets, thus, reflected in P's purchase price. and T has already paid tax on the gains from those assets.

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On shareholder Jen and Justin level, since each of them ~~will realized a gain of $90K~~ owns 50% of T's stocks. Each will get half ($140) of the cash ~~distribution~~ distributed ($280). Each of them will realize a gain of $90K under 311 ($140 amount received − ~~stock~~ basis in

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each of their stock $50K). The gain will be considered as capital gain from the sale and exchange of stock. If they have held the stock for over 1-y, the gain will get more favorable rate for LTCG. Notice that T's e&p account is not relevant in determining Jen and Justin's gain under 311. After the liquidation, T's e&p and other tax attributes will disappear.

Last, the buyer P's tax consequences are as follows. After P's acquiring assets from T, P will get a cost basis in each of the assets pursuant to 1012. Here, P's purchase price is $300K ($280K + $20K assumption of liability). This purchase price once again will be allocated to each of the asset based on a residual allocation method as discussed above. Thus, at least, we know the 2 covenants.

not to compete will get a basis of $40K. The rest of the assets will get a basis equal to (or in some case less than) their respective FMV. Notice, that P may amortize the cost spend on the goodwill, and the convenants not to compete over a 15-year period. pursuant to §197. Congress passed §197 in order to take some tension out between P and T when they decide how much to allocate to each of the assets.

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Book 2 of 3 Books

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Question 2

[A]. First, applying the stock attribution rules of 318. Andrea own 100 shares before the redemption (50 by herself, 50 attribut to her from her son under 318(a). Her ownership percentage is 100/150 (total shares outstanding), resulting at 66.6%. After redemption, A still owns 25 directly and 50 through her son under 318(a): Thus, A's ownership percentage after the redemption is 75/125 outstanding, resulting at 60%.

Now, the tax consequences of the redemption. First, since there is no indication of "genuine business contraction" of XYZ, so §302(d)(4) partial liquidation safe harbor does not apply here. Second, since A still owns 25 shares directly by herself, the 302(d)(3) "complete termination" safe harbor does not apply, either. Thus, we don't have to worry about A files with the IRS a waiver of family attribution under 302(c).

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Third, this is also not a "substantially disportionate redemption" under 302(d)(2). because A still owns 60% of the voting stock, directly and indirectly through her son; thus, this does not meet 302(d)(2) threshold test of owning less than 50% of voting common after the redemption.

Forth, this is also not a 302(d)(1) safe harbor because it is essentially equivalent to dividends. Immediately before redemption, A owns, directly and indirectly, 66.6% of voting stocks; immediately after redemption, A owns, directly and indirectly, 60% of the voting common. thus, A still controls the corp. XYZ. There is no substantial change in A's controlling power. Thus, it is an essentially ~~equivalent to~~ dividends redemption.

Therefore, this redemption will be treated as a dividend

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distributed to A, not a sale or exchange of her redeemed shares.

The tax consequences on A by receiving $50K cash as divident from XYZ. is as follows. First, XYZ has a current e&p deficit of $360K. Based on the Reg., this deficit will be allocated to each distribution based on the number of days that has passed at the time of the distribution. Since A's distribution (here redemption of her stock) happens on 7-1-02. half of the deficit, thus, $180K, will be used to offset any accumulated e&p of XYZ. Since XYZ has accumulate e&p as of start of 2002 of $200K, the available e&p for A's distribution is $20K ($200K accumulated − $180K deficit) as of July 1-2002.

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The entire distribution of $50K cash (in redeeming A's

25 shares) will be taxed to the extent of e&p, that is,

$20K under 301(c)(1); Thus, A will report an ordinary

income of $20K for taxable year of 2004. The excess

of the distribution over the e&p, that is, $30K, will first

go to reduce the basis (under 301(c)(2)). Here, A's basis in her stock

is told to be $35K. Thus, this basis will be reduced to

$5K ($35K − $30K excess from the e&p). If after

reducing the A's stock basis to 0, there is still remaining

from the distribution; this remaining amount will be treated

as capital gain under 301(c)(3). But this does not happen

in A's case.

Now, A's basis in her remaining 25 shares

is $5K. Since A is not completely redeemed, all this

basis will go to her remaining 25 shares. If A is

completely redeemed, her basis will shift to the stock basis of those shareholders from which she may be attributed any shares under 318(a); in this case, it's her son Barry.

On the corporate level, there is no gain or loss by distributing the cash of $150K. XYZ cannot take a deduction of this amount, either. Since this distribution already used up all XYZ's positive accumulated e&p, it's amount is zero now. As to the current e&p deficit, since A's distribution used half $180K of that deficit; there is a remain $180K deficit in XYZ's current e&p account. Even if there is further distribution, in the year 2012, the $180K e&p deficit is not relevant because there is no positive accumulated e&p to offset. Those further distributions will all be return of basis in

stock with any remaining to be capital gain for the distributee. The $180K current e&p deficit will not be wasted if not used; it will carry over for purpose of calculating e&p in future years.

[B] Before redemption, Ed(E) owns 50 shares out of 150 shares of XYZ outstanding stock, thus, E has a control of about 33.3% of XYZ. Immediately after redemption, E owns 50 shares out of 125 shares outstanding, thus, E has a control of 40% over XYZ. After the redemption, there is about 6.7% increase in E's control right over XYZ.

Since E has been a minority shareholder before the redemption and E continues to be a minority shareholder after the redemption. The 6.7% increase in his control

right is really not that significant. The dynamics of the corporation remains the same before & after redemption. That is, E still needs to combine either with A or Barry (B) in order to meaningfully exersise his shares of control.

In addition, E did not take out any assets out of the corporation; even though, the relatively relationship among the 3 shareholders has changed a little bit after the redemption, XYZ does not issue any more stocks to any of the shareholders.

In consideration of the above, there should be no tax consequenses to E from the redemption of A's stock.

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