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NORTHWESTERN SCHOOL OF LAW

LEWIS & CLARK COLLEGE

Book 1 of 2 Books

Examination Number 7434

Subject of Examination Corp. Tax

Date of Examination 5-2-02

EXAMINATION BOOK

Instructions

1. Use a pen with black or blue ink.
2. Do not write in margins under any circumstances.
3. Complete identification data at top right corner of this book. Do not put your name on or in this book. Use your examination number only.
4. Start answer to each question at top of a fresh page unless instructed otherwise by the individual professor.
5. Write only on the front side of the pages in this book unless instructed otherwise by the individual professor. If you need more space, use an additional book(s). If you use additional book(s), complete items in identification space (top right corner) and write Book 2 of 2, etc., in space provided. Insert additional book(s) in book one before turning them in.
6. If you type your examination, use unruled paper. Put your examination number, subject of examination and date of examination on each page and on a cover sheet to be provided. Assemble in page order, place cover on top and staple (or otherwise secure).
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Question 1

This involves an asset sale by Tarco to Parco followed by a liquidation to Jen and Justin. If done properly, the asset sale will result in Tarco paying tax on its gain over its basis in its assets. The asset sail will result in Parco taking a cost basis in the purchased assets. The liquidation will result in Jen and Justin realizing a capitol gain over their basis in their stock.

Tarco's tax results from the asset sale:

Tarco is selling all of its assets, and an over simplification of the tax results is that Tarco will pay tax at its corporait rates on all of the gain. ~~What kind of income will~~

What kind of tax (regular income or capitol gains) will depend on the character ~~of the~~ assets, and Tarco's prior tax handling (deducting etc.) of the property. Capitol assets ~~will~~ like land and equipment, ~~etc.~~ goodwill, customer lists will be treated as capitol gains with the appropriate holding period being from when Tarco acquired them. However, Tarco will ~~may~~ need to pay tax on depreciated equipment and land at the ordinary rates for any Amount realized on those items here up to the amount of depreciation previously taken. The other assets, Accounts receivable, and inventory will produce regular income. Note the liability assumed is additional purchase price.

The amount of tax will depend on the amount of purchase price allocated to each item. This allocation may be done independantly by each

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Tarco and Parco, or they may agree on an allocation. This allocation must be reasonable, and submitted to the IRS by both companies. Tarco will tend to want to allocate more money to capitol assets so as to minimize taxes.

\- Tax results for Parco at time of asset sale:

Parco will not realize any income ~~in~~ at the time of its purchase, however it will receive cost basis ~~(dependant on the~~ in the assets it acquires.

The basis that Parco takes in its newly acquired assets depends on how the purchase price is allocated amoung the assets. Parco will want to make the allocation to allow for the ~~most~~ fastest realization of tax benefits through rapid depreciation or basis recapture. For this reason, assets like accounts receivable and inventory, which will be quickly used up, will be where Parco wants to allocate the purchase price. These assets will allow for quick recapture of basis. Items like land, and Goodwill, and customer lists can be depreciated to ~~re~~ produce tax deductions, but they require a ~~lard~~ long period for depreciation. So, Parco will not want to assign much sale price to these. Equipment is in between depending on its depreciation period.

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Parco will receive deductions for the future from its cost basis, and pay no tax at purchase time.

- Liquidation of Tarco

At the point of tarco's complete liquidation, it's only assets consist of cash, so its liquidation is rather straight forward. By § 331, payments made in complete liquidation are treated as full payment in return for the shares that the share holder has. This means that Jen and Justin will be treated as having sold their shares for the amount of money that was distributed to them, they will pay ~~tax~~ capitol gains tax on the amount they ~~g~~ receive that exceeds their basis. The holding period for ~~#~~ the stock is just from the time of Jen and Justin's acquisition.

Thus, Jen and Justin pay tax on the ~~amount~~ ~~distrib~~ distribution compleating the double tax on corporait income. Tarco pays no tax on this liquidation as no appreciated property was distributed.

- Tax on non compeat agreements.

If the service ~~does~~ accepts that these payments are really for non-competition, only Jen and Justin will be taxed on the non compeat payments. ~~Tax will be paid~~ This will be ordinary income to Jen + Justin, and taxed at ordinary rates. Parco should be able to deduct these payments as a cost of doing business. The overall result is that only Jen + Justin pay a single tax on the non-compeat payments (No tarco tax).

The only potential problem is if the service reclassifies the non-compeat amounts as purchase price rather than non-compeat payments, Given Jen and Justin's unequal input to the business, but equal stock holding, the equal non-compeat payments may be hard to justify.

Whatever income that is reclassified becomes part of the asset purchase price, and must be attached to some asset to produce basis for Parco and gain on sale for Tarco. Reclassified payments would end up in the double tax system.

Because non-compeat agreements produce only single taxation they are beneficial to Target shareholders. Because the non-compeat payments allow for deductions over a relatively short period (here 3 years) they are favorable to purchasers. Therefore, there is great potential for corruption, and the payments will be scrutanized.

Question 2:

A. Andrea will not receive exchange treatment for her redemption, and will have to pay tax as if the payment were a normal distribution.

Andrea's redemption does not meet any of the 4 tests for exchange treatment in §302. Two of the tests are easily not met. Andrea is not releasing all of her own stock, so the complete termination test is not met, and XYZ is not performing a partial liquidation, so the partial liquidation test is not met.

Further, the substantially disproportionate redemption does not apply. The substantially disproportionate redemption requires that a shareholder directly and through attribution have less than 50% of the voting power after the redemption, have less than 80% of their previous voting power, and have less than 80% of their previous holding of all classes of common stock. Attribution requires the shares of one person to be considered owned by another person. One time attribution applies is with family members; individuals are considered as owning the shares of their children, grandchildren, parents, and spouses.

Here, Andrea's son also owns shares. Andrea constructively owns these shares through attribution. Her standing before the redemption is as owner of 100 shares (50 her own + 50 her son's) and after she is owner

of 75 shares (25 her own 50 her son's). The total shares outstanding is 150 before and 125 after, so, Andrea went from owning 2/3 (100/150) to owning 3/5 (75/125). This does not meet the requirement of owning less than 50% after the sale, so the substantialy disproportionate test. Additionaly the 80% tests are not met as 3/5 is 90% of 2/3.

Unforturately for Andrea, not even the not equivilent to a dividend test applies here. To not be equivilent to a dividend, a redemption must result in a meaningful reduction in a share holder's interest. What this means is not entirely clear, but retaining a controling interest or a position in a control group does not qualify. Note that family attribution will generally apply here.

Here, with attribution, after the redemption, Andrea maintains control (3/5 of vote), so the not equivilent to a dividend test does not apply. It is possible that Andrea could get out of the family attribution if she could show discord with her son, but this would not help. Without attribution, Andrea remains part of a control group. With either her son or Ed, she can determine control, and thus would fail the not equivilent to a dividend test.

Therefore the redemption is treated as a regular distribution under §301. 301(c) states

that share holders should treat distributions as dividends (normal income) to the extent the company has E+P, ~~and~~ then recapture basis, then realize a capital gain to the extent that basis is exceeded.

To determine the handling of Andrea's payment we need to know how much E+P XYZ had. As, distributions are taken from current E+P first and accumulated E+P second, we must determine both ~~accumulated~~ current E+P for 2002 and accumulated E+P upto July 1, 2002. XYZ had a loss of $360k in 2002, so no current E+P. At the start of the year, there was accumulated E+P of $200k. To find the accumulated E+P as of July 1, ~~the~~ half of the current year's loss (180k) must be subtracted from the accumulate E+P. This gives an accumulated E+P as of July, 1, 2002 of $20k (200k - 180k). Thus the first 20K of the distribution is a dividend and taxed to Andrea as regular income. Next, Andrea's basis is drawn down by the remaing $30k of the distribution, As a result Andre gets 30K tax free, but is left with only 5k of basis (35k origional basis - 30k of dist).

All of this effects XYZ's E+P. Ass of July 1, 2002 XYZ had $20k E+P, then made a distribution that was in part from accumlated E+P, reducing the accumulated E+P to 0. Then ~~the~~ XYZ lost an additional 180k in the remainder of the year for a final E+P deficit of 180k.

In total. Andrea gets $50,000; $20,000 is a dividend from accumulated E&P and is taxed as regular income; $30,000 is a recapture of basis, leaving Andrea with 25 shares, and a total basis of $5,000. XYZ will end 2002 with an E&P deficit of $180,000.

B. Ed could have federal tax consequences if this transaction were reclassified as the following: XYZ distributes $25,000 to both Ed and Barry, then Barry and Ed both buy 10 shares from Andrea. This would result in the same resting place for the cash, and the same shift in voting power. This would also be considered a taxable distribution to Ed.

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Although the IRS has the power to reclassify, it is highly unlikely that a lone redemption will be reclassified (barring evidence of income tax evasion). So Ed need not worry.

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Question 3

On formation Rachel and Sandy will not recognize ~~realize~~ any gain, however as the note is paid off Sandy will recognize gain up to the face value of the note on the installment method.

§ 351 provides that the formation of a company is a non-recognition event if property is put in solely for stock, provided all those contributing property control 80% of the company after the transfer. One or all parties receiving boot does not destroy the 351 charm for the others; the individual receiving boot just recognizes gain ~~up~~ on the value of the boot up to the amount realized in the transfer. 351 is also not hurt by a group of transactions not being simultaneous. As long as a series of transactions is part of a plan, they will count as one. Share holders take a basis in any boot of FMV, and basis in stock received of transfer basis from the contributed property minus the FMV of boot - cash received - loss recognized + dividend amount + recognized gain - liabilities assumed (deemed cash). The company gets a ~~basis of~~ transfer basis in the property plus any gain recognized by the share holder. Holding periods for capitol assets transfer to the company, and to the new stock from the share holder's old property. Those who put in non capitol property start their holding period on the transfer date.

Here we have two ~~trans~~ exchanges that are part of a plan, so we will treat them as one. After the total exchange, those putting property

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in hold 100% of the stock. Note cash is
property. So 351 Applies to the formation of
Newco. Rachel put in Cash and ~~a~~ received
Only stock back. This is a non-recognition event
for her. After the transaction, Rachel has 10 shares
with a basis of $20,000 and a holding period starting
May 15, 2002. Rachel pays ~~not tax at this time~~
no tax on the exchange, and Newco pays no tax either.

Sandy put in land and received stock and
boot, a note. Because there is boot, Sandy must ~~realize~~
recognize
Some gain. The total gain realized by sandy is
$35,000 ($50,000 ~~re~~ Amount realized - $15,000 basis) The
note's FMV is $32,000; this is less than the total
amount realized, so Sandy must recognize the
total amount of the note as gain on the
disposition of Greenacre. Fortunately for Sandy,
Instalment reporting is allowed on a note received in a 351
transaction. The result is: as interest is paid, it will
be ordinary income to Sandy, and deductable to Newco.
When principal is paid, it will be capitol gains income
to sandy, as it is from gain realized on disposing of
land, a capitol asset. The payments of principal are not
deductable to newco. ~~The~~ The $8,000 payment on
May 29, 2003 will be $8000 of capitol gain to Sandy in
2003.

Newco gets a transfer of basis in Greenacre
increased by the amount recognized by Sandy, However
Newco does not get these basis increases until

Sandy actually recognizes the gain, so ~~on~~ on the date of transfer, Newco has a basis in green acre of $15,000. On may 29, 2003 the basis increases to $23,000, Newco's holding period is Sandy's old holding period on green acre.

Sandy's stock basis is determined by the amount she will eventually recognize, Stock basis = $15,000 (transfer) - 32,000 (Boot FMV) + 32,000 (amount eventually recognized) = $15,000 Sandy takes $15,000 as basis in her 10 shares of Newco stock. Sandy's holding period is tacked on from her old property Green acre.

On March 14, 2004, Newco filed for S corp status with consent of its share holders. This request ~~was~~ was made by the 15th day of the 3rd month of Newco's tax year, so it is valid for the current year. Newco qualifies for S status: it has fewer than 75 shareholders, only ~~2~~ one class of stock, all shareholders are US citizens or residents, all share holders are individuals, and all of Newco's debt is straight/true debt. As a result, Newco's S-election will work, and 2004 will create pass through income.

S-corps do not pay tax themselves. instead their income and losses passes through to their shareholders pro rata by shares. The shareholders then report the income at their

individual rates. This produces a single tax.
The share holder's stock basis is increased by the amount of income passed through and decreased by loss passed through.

At the end of 2004, Newco has income of $15,000. This passes through $7,500 a piece to Rachel and Sandy as each is a 50% share holder. Each Rachel and Sandy must report this on their taxes. Rachel's stock basis will increase by $7,500 from $20,000 to $27,500. Sandy's stock basis will increase from $15,000 to $22,500.

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Some caution should be taken at NewCo in the future as when distributions are made, any amount from the wild and wacky C-corp days must be double taxed. First to Newco at corporait raits when earned in the past, and then when withdrawn, taxed to Sandy and Rachel via §301 with reference to the E+P from the C-corp days.

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