A Comparative Life-Cycle Case for Teaching Corporate and Partnership Taxation

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Case learning objectives

Skill objectives:

- Understand & apply basic corporate & partnership tax rules
- Understand and assess tax & accounting differences between corporations and partnerships
- Understand how financial accounting and tax numbers fit together
- Enhance group-work skills

Goals of Developing the Case

- Effectiveness:
  - Active-learning vehicle
  - Furthers learning objectives
  - Discourage “unwanted collaboration” (i.e., cheating)

- Efficiency:
  - Leverage one set of facts for both versions
  - Facts differ when necessary
    - i.e., no income tax for the partnership version.
  - Relatively easy to create and grade multiple versions

The Case

Four related assignments:

- Formations: year 1 of JL life
- Operations: year 2 of JL life
- Distributions: years 2-6 of JL life
- Restructuring/liquidating: years 6-7 of JL life
  - Corporate only

Features of the Case

- Excel-based
- Multi-year (years 1-7)
- Two equal owners: Jason and Lucy
- Two entities: JL Corporation & JL LLC
- Can alter certain quantities to make different versions of the assignments
- The different assignments & their solutions adjust automatically for input changes…
  - …across years
  - …across entities

JL CORPORATE TAX CASE

CORPORATE ORGANIZATION

Facts:

Jason and Lucy want to manufacture and sell a new and innovative product called Glucc. Both Jason and Lucy will perform services for the business in addition to their roles as owners of the business. They formed the entity (JL) on 1-1-X1. JL will have the following estimated inflows and outflows between 1-1-X1 and 1-1-X2, the date that JL opened its store for business. JL Corporation has a calendar year-end.

1.	Received cash from Jason.	$148,000	<---	Input
	In addition, Jason performed accounting services:			
	1/3 to set up the entity and 2/3 for			
	setting up the accounting system. Total value =	$??		
2.	Paid legal fees to set up the entity.	$3,200		
3.	Received title to a building from Lucy.			
	At the time of transfer it had an unpaid mortgage of	$53,000		
	and was worth	$207,000	<---	Input
	Amount Lucy paid for the building	$120,000		
	Amount Lucy depreciated the building	$81,300	<---	Input
4.	Paid the state for a one-time franchise fee for			
	registration of the entity.	$950	<---	Input

CHECKS/INFO:	
JASON:	
Value of services	$6,000
LUCY:	
liabilities assumed:	$53,000
AB of building	$38,700
L>AB:	$14,300

JL LLC TAX CASE

LLC ORGANIZATION

Facts:

Jason and Lucy want to manufacture and sell a new and innovative product called Glucc. Both Jason and Lucy will perform services for the business in addition to their roles as owners of the business. They formed the entity (JL) on 1-1-X1. JL will have the following estimated inflows and outflows between 1-1-X1 and 1-1-X2, the date that JL opened its store for business. JL LLC has a calendar year-end. Jason and Lucy have elected for JL to be treated as a partnership for tax purposes.

1.	Received cash from Jason.	$148,000	Carried from Corporate version
	In addition, Jason performed accounting services:		
	1/3 to set up the entity and 2/3 for		
	setting up the accounting system. Total value =	$??	
	(Jason and Lucy have agreed that these services will be uncompensated, but will entitle Jason to share profits equally with Lucy throughout the life of the LLC, and have equal management rights.)		
2.	Paid legal fees to set up the entity.	$3,200	Carried from Corporate version
3.	Received title to a building from Lucy.		
	At the time of transfer it had an unpaid mortgage of	$53,000	Carried from Corporate version
	and was worth	$207,000	Carried from Corporate version
	Amount Lucy paid for the building	$120,000	Carried from Corporate version
	Amount Lucy depreciated the building	$81,300	Carried from Corporate version

JL Formation Case

Students must

- Record journal entries for formation /produce financial statements
- Determine NI and TI (plus any tax carryovers to year 2)
- Compute owner basis in the entity and entity's basis in assets
- Think of 3 tax planning ideas for the entity

Element	Corporate version	Partnership version
Services contributed	Income for shareholder	No income for partner (profits-only interest)
Contribute mortgaged, low-basis building	§357(c) gain	No gain, but low outside basis
Organization/startup costs	Tax deductions year 2	Tax deductions year 2
First-year NOL	Carried over to year 2	N/A

JL LLC TAX CASE

LLC ORGANIZATION

Facts:

Jason and Lucy want to manufacture and sell a new and innovative product called Glucc. Both Jason and Lucy will perform services for the business in addition to their roles as owners of the business. They formed the entity (JL) on 1-1-X1. JL will have the following estimated inflows and outflows between 1-1-X1 and 1-1-X2, the date that JL opened its store for business. JL LLC has a calendar year-end. Jason and Lucy have elected for JL to be treated as a partnership for tax purposes.

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and was worth	$207,000
Amount Lucy paid for the building	$120,000
Amount Lucy depreciated the building	$81,300

JL CORPORATE TAX CASE

CORPORATE ORGANIZATION--SOLUTION

Major Tax Results

Consequences to Lucy:

AR = value of stock + Debt relief =		*$154,000*	+	*$53,000*	=	*$207,000*
AB					=	*$38,700*
Realized Gain					=	***$168,300***
Liabilities in excess of basis		*$53,000*	-	*$38,700*	=	*$14,300*
Recognized Gain					=	***$14,300***
Lucy's AB in the stock=	*$38,700*	+	*$14,300*	-	*$53,000* =	***$0***

Lucy's DB in the stock includes the DB of the building.

This makes sense because a total of $154,000 of gain is deferred; this is the amount of gain Lucy will recognize if she sells her shares soon after acquiring them.

Consequences to Jason:

Jason has income because he performed services for the corporation. This income = the FMV of his services. What is this amount? It must equal the difference between the total value of the stock he received less the cash contributed. Since he holds an interest equal to Lucy's, his stock value must equal hers.

Thus, $154,000 is the value of his stock, and…

…his income is:	*$154,000*	-	*$148,000*	=	***$6,000***
…his AB in the stock is:	*$148,000*	+	*$6,000*	=	***$154,000***

…his DB in the stock is the date of the transfer.

Consequences to JL:

-- JL Corporation has no taxable income from the contributions

-- JL Corporation's AB in building is *$38,700* + *$14,300* = ***$53,000***

-- JL Corporation's DB in building is carryover DB.

-- JL Corporation's treatment of org./startup and syndication costs:

Organization Costs =	*$2,000*	+	*$3,200*	+	*$950*	=	*$6,150*
Deduction				=	***$5,000.00***	***in year X2***	
Amortization of remaining	*$1,150*	/	*180*	=	*$6.39*	*/ month, starting in 1/X2*	
Syndication Costs =	*$382*						

20x1 Financial accounting records:

CK. Figs.: ASSETS $ 346,048 LIAB&EQ $ 346,048

CASH

(1)	$ 148,000		
(2)		$ 3,200	
(4)		$ 950	
(5)		$ 382	
(6)		$ 85,000	
(8)		$ 3,500	
(8)		$ 2,400	
(8)		$ 415	
(8)		$ 900	
(8)		$ 705	
1/1/X2	$ 50,548		

ORG. COSTS

(1)	$ 6,000		
(2)	$ 3,200		
(4)	$ 950	$ 10,150	*(C)*
1/1/X2	$ -		

BUILDING

(3)	$ 207,000	
1/1/X2		

INVENTORY

(8)	$ 3,500	
1/1/X2		

PP&E

(6)	$ 85,000	
1/1/X2		

EXPENSES

(8)	$ 2,400		
(8)	$ 415		
(8)	$ 900		
(8)	$ 705		
(C)	$ 10,150		
		$ 14,570	*(D)*
1/1/X2	$ -		

MORTGAGE

(3)		$ 53,000
1/1/X2		

RETAINED EARNINGS

(D)	$ 14,570	
1/1/X2		

COMMON STOCK

Jason		$ 10,000
Lucy		$ 10,000
1/1/X2		$ 20,000

APIC

Jason		$ 144,000
Lucy		$ 144,000
(5)	$ 382	
		$ 287,618

JL Operations Case

Corporate version

- Form 1120
- Several common book-tax differences
- Additional capital contributions in year 2
- Two ways to change the numbers: set % or item-specific % change

Partnership version

- Form 1065
- Several common book-tax differences
- Additional capital contributions in year 2
- Changes to numbers carry over from corporate version

JL CORPORATE TAX CASE

CORPORATE OPERATIONS

REQUIRED: Below are JL Corporation's results of operations for its second year. These numbers are the accrual basis income and expense financial statement amounts for the Corporation. Not all tax-relevant amounts are computed because neither Jason nor Lucy feel qualified to make these determinations. Lucy and Jason want you to do two things: First, compute JL's taxable income for them and to advise them of any tax consequences of any of this information. Do this by preparing all pages of form 1120. You do not need to complete any suporting forms such as for depreciation. For these items, just include your computations on a separate sheet of paper attached to form 1120. Second, list three tax and/or financial planning ideas that they should consider for future years.

324.00

TO CREATE DIFFERENT VERSIONS OF THIS PROBLEM, FOLLOW STEPS 1-3 BY READING THE INSERTED COMMENTS AT EACH STEP.

Step 1: **Adjust numbers? (y/n)** y

Step 2: **Blanket adjustment %** 18.00%

(Set to 0% to use item-specific adjustments)

Step 3: item-specific adjustment

20x2 FINANCIAL ACCOUNTING INCOME STATEMENT

				Final adjustment	base numbers	item-specific adjustment
Income items:						
Sales			$ 502,680	**18.00%**	$ 426,000	5%
Preferred dividend income			$ 4,130	**18.00%**	$ 3,500	20%
Interest income			$ 2,950	**18.00%**	$ 2,500	0%
Tax-Exempt interest income			$ 4,720	**18.00%**	$ 4,000	7%
			$ 514,480			
Expense items:						
COGS:						
Beginning inventory	$ 3,500				formula	
+Inventory purchases	$ 106,200			**18.00%**	$ 90,000	10%
- Ending inventory	$ (15,000)	$ 94,700			formula	
Wages & salaries						
Jason	$ 106,200			**18.00%**	$ 90,000	0%
Lucy	$ 100,300	$ 206,500		**18.00%**	$ 85,000	0%

JL CORPORATE TAX CASE
CORPORATE OPERATIONS

324.00

REQUIRED: Below are JL Corporation's results of operations for its second year. These numbers are the accrual basis income and expense financial statement amounts for the Corporation. Not all tax-relevant amounts are computed because neither Jason nor Lucy feel qualified to make these determinations. Lucy and Jason want you to do two things: First, compute JL's taxable income for them and to advise them of any tax consequences of any of this information. Do this by preparing all pages of form 1120. You do not need to complete any suporting forms such as for depreciation. For these items, just include your computations on a separate sheet of paper attached to form 1120. Second, list three tax and/or financial planning ideas that they should consider for future years.

20x2 FINANCIAL ACCOUNTING INCOME STATEMENT

Income items:			
Sales			$ 502,680
Preferred dividend income			$ 4,130
Interest income			$ 2,950
Tax-Exempt interest income			$ 4,720
			$ 514,480
Expense items:			
COGS:			
Beginning inventory	$ 3,500		
+Inventory purchases	$ 106,200		
- Ending inventory	$ (15,000)	$ 94,700	
Wages & salaries			
Jason	$ 106,200		
Lucy	$ 100,300	$ 206,500	

20x2 BOOK-TAX INCOME RECONCILIATION

	BOOK	Difference	TAX
Income items:			
Sales	$ 502,680	$ -	$ 502,680
Preferred dividend income	$ 4,130	$ -	$ 4,130
Interest income	$ 2,950	$ -	$ 2,950
Tax-exempt Interest Income	$ 4,720	$ (4,720)	$ -
Expense items:			
COGS:	$ (94,700)	$ -	$ (94,700)
Wages & salaries			
Jason & Lucy	$ (106,200)	$ -	$ (106,200)
Other	$ (100,300)	$ -	$ (100,300)
Organizational costs	$ -	$ (5,230)	$ (5,230)
Start-up costs	$ -	$ (5,000)	$ (5,000)
Depreciation			
X1 Building	$ (5,175)	$ 3,873	$ (1,302)
X1 PP&E	$ (10,625)	$ (1,518)	$ (12,143)
X2 Computer	$ (2,950)	$ (590)	$ (3,540)
Bad debts expense	$ (1,593)	$ 1,593	$ -
Interest expense	$ (17,700)	$ -	$ (17,700)
Office supplies	$ (1,534)	$ -	$ (1,534)
Payroll taxes	$ (18,880)	$ -	$ (18,880)
Federal income taxes paid for X2	$ (22,600)	$ 22,600	$ -
State income taxes paid for X2	$ (8,325)	$ -	$ (8,325)
Meals and entertainment	$ (1,770)	$ 885	$ (885)
Telephone and utilities	$ (2,360)	$ -	$ (2,360)
NOL from 20x1	$ -	$ (1,120)	$ (1,120)
Dividends-received deduction	$ -	$ (2,891)	$ (2,891)
Income	**$ 119,768**	**$ 7,882**	**$ 127,650**

Some tax numbers: FIT $ 33,033

See "organize" problem for amortization 1120line28 $ 131,661

MACRS- X1 Building= $53,000 *(1/39)*(11.5/12)

MACRS- X1 Other PP&E= $85,000 *(1/7*2)/2

MACRS- X2 Computer = $17,700 *(1/5*2)/2

No bad debts deduction allowed--no write-offs

No FIT deduction--not allowed

50% of meals & entertainment deductible

NOL is the negative income from the prior year

DRD = 70% $4,130

CASH

1/1/X2	$ 50,548	$ 85,000	*(purch)*
(sales)	$ 310,000	$ 206,500	*(Wages)*
(div. inc.)	$ 4,130	$ 19,700	*(Prin&Interest)*
(int. inc)	$ 7,670	$ 1,534	*(Supplies)*
(note-lucy)	$ 100,000	$ 18,880	*(Payroll taxes)*
		$ 30,925	*(Inc. Taxes)*
		$ 1,770	*(M&E)*
		$ 2,360	*(T&U)*
		$ 17,700	*(new computer)*
1/1/X3	$ 87,979		

INVENTORY

1/1/X2	$ 3,500	
	$ 106,200	
		$ 94,700
1/1/X3	$ 15,000	

ACCTS. REC.

1/1/X2	$ -	
	$ 192,680	
1/1/X3	$ 192,680	

ALLOW. FOR BAD DEBTS

	$ -	*1/1/X2*
	$ 1,593	
	$ 1,593	*1/1/X3*

ACCUM. DEPRECIATION

	$ -	*1/1/X2*
computer	$ 2,950	
other PP&E	$ 10,625	
building	$ 5,175	
	$ 18,750	*1/1/X3*

PP&E

1/1/X2	$ 85,000	
	$ 17,700	
1/1/X3	$ 102,700	

BUILDING

1/1/X2	$ 207,000	
	$ -	
1/1/X3	$ 207,000	

PREFERRED STOCK

1/1/X2	$ -	
	$ 40,000	
1/1/X3	$ 40,000	

ORG. COSTS

1/1/X2	$ -	
		$ -
1/1/X3	$ -	

CITY OF BOULDER BONDS

$ -		*1/1/X2*
$ 21,000		
$ 21,000		*1/1/X3*

ACCOUNTS PAYABLE

	$ -	*1/1/X2*
	$ 21,200	
	$ 21,200	*1/1/X3*

NOTES PAYABLE, LUCY

	$ -	*1/1/X2*
	$ 100,000	
	$ 100,000	*1/1/X3*

MORTGAGE

	$ 53,000	*1/1/X2*
$ 2,000		
	$ 51,000	*1/1/X3*

RETAINED EARNINGS

1/1/X2	$ 14,570		
		$ 119,768	(a)
		$ 105,198	*1/1/X3*

JASON, CAPITAL

	$ 153,809	*1/1/X2*
	$ 21,000	
	$ 174,809	*1/1/X3*

LUCY, CAPITAL

	$153,809	*1/1/X2*
	$ 40,000	
	$193,809	*1/1/X3*

Temporary Accounts:

EXPENSES

JL Distributions Case

Corporate version

- Features
  - CE&P & AE&P sometimes negative
  - One high and one low stock basis shareholder
- Students compute
  - Dividend from E&P,
  - Return of basis/LTCG
  - Basis in non-$ assets

Partnership version

- Features
  - Income sometimes negative
  - One high and one low outside basis partner
- Students compute
  - Partner basis, gain (if any), & basis in non-$ assets
  - Suspended losses

JL LLC TAX CASE

LLC DISTRIBUTIONS

After 20x2, JL LLC expects to operate with highly variable results. Jason and Lucy want to know the likely consequences of a series of cash and property distributions that might occur in future years. Below is a summary of JL's results and potential distributions over the next few years of its life. Note that book income, taxable income, and current earnings and profits do not include the effects of distributions of appreciated property.

REQUIRED: A. Fill out the form below; B. Describe how the member(s) who will incur suspended (i.e., non-deductible) losses from the LLC can deduct those losses.

Year	Book Income	Taxable Income	Adjust. for Tax-exempt Income	Adjust. for Non-deduct Expenses	Adjustment to Basis from Income
x1	($8,570)	($1,120)	$0	$0	
x2	$150,693	$147,837	$4,720	$885	
x3	$171,000	$163,000	$4,000	$2,500	
x4	($177,000)	($183,000)	$4,000	$2,800	
x5	($30,000)	($37,000)	$5,000	$3,000	
x6	$47,000	$44,000	$5,000	$3,500	

Below are details related to the total distributions JL Corporation potentially will make to its two shareholders on the last day of each year.

Year	Property Type	Property AB	Property FMV	
x1		$0		
x2		$0		
x3	inventory	$35,000	$40,000	
x4	land	$128,500	$172,000	2 equal parcels
x5	cash	$29,000	$29,000	
x6	cash	$6,000	$6,000	

Impact to Corporation:

Year	BOY Accum Earnings & Profits	Current Earnings & Profits	Dividend Portion of Distribution	Gain Recognized on Distribution	EOY Accum Earnings & Profits
x1	0	(1,120)	0	0	(1,120)
x2	(1,120)	111,002	0	0	109,882
x3	109,882	122,000	13,000	0	218,882
x4	218,882	(159,500)	102,882	43,500	0
x5	0	(32,000)	0	0	(32,000)
x6	(32,000)	43,000	3,000	0	8,000

Impact to Shareholders:

Jason:

Year	Amount of Distribution	Character of Distribution		BOY Basis in Shares	EOY Basis in Shares
x1				0	154,000
x2				154,000	174,000
x3	6,500	6,500	DIV	174,000	174,000
x4	86,000	51,441	DIV	174,000	
		34,559	ROC		139,441
x5	9,500	9,500	ROC	139,441	129,941
x6	1,500	1,500	DIV	129,941	129,941

JL Restructuring Case

- Corporate version only
- Setup:
  - JL receives offers from a competitor to buy out the company
  - JL could sue competitor instead of accepting buyout
  - So: lawsuit & liquidation; taxable asset purchase option; C or B reorganization options.
  - JL has an NOL carryover, so §382 limit applies
- Students must evaluate each option and recommend a course of action to JL owners

ACCT347, Fall 2011
JL Corporate Restructuring Assignment

Instructions—Respond to all of the questions below. Below are some tips and guidelines you must follow in completing this part of the exam.

- You need to think carefully about each of the questions and communicate your responses effectively. Justify all your answers with logical reasoning. While you may attach supporting calculations, you must organize them neatly and clearly—I will not sift through unorganized pages of calculations, nor will I contact you if I cannot read your work!
- Make sure that you detail all tax consequences (gains/losses, tax liabilities, and adjusted bases of assets) for all relevant parties when asked to do so.
- Please type any long narratives, but feel free to write out short answers and supporting calculations.
- This is (loosely speaking) a continuation of the organization and distribution cases. However, you should take the numbers given in this case as given (that is, the facts in this document override the facts in the earlier cases).

Background—See the attached Appendix for a narrative of JL Corporation, from its inception through the beginning of year X7. This information will help you assess the tax and nontax costs of different restructuring alternatives. You may make any reasonable assumptions you feel are necessary to answer this question (but state these assumptions).

Question 1 (6 points)

What are the likely tax consequences and after-tax cash flow to JL, Lucy and Jason if they decide to reject all of the acquisition alternatives listed in the facts? (Tip1: think about what is the "true" value of JL is at the beginning of year 7. Tip2: one of your team should look into the taxation of lawsuit awards to compute the tax effects from the lawsuit.)

Question 2 (10 points)

What are all of the tax consequences to JL, Lucy and Jason for each of the acquisition alternatives listed in the facts?

Question 3 (5 points)

How much of JL's net operating loss can PDQ expect to use under each of the options available to Lucy and Jason? Assume that section 382 applies to all alternatives.

Question 4 (4 points)

How would you advise Lucy and Jason? Should they accept any of the acquisition alternatives proposed by PDC? Justify your answer, citing the tax and non-tax costs of each alternative. (Tip: See the course packet detailed M&A memo for a table that compares the non-tax advantages and disadvantages of different acquisition structures, and use this in answering this question.)

Use the attached table to organize your answers to Questions 1 and 2 above.

Answer sheet for Questions 1 & 2

Professor Toby Stock

Show your work and answers for Q1 & Q2 here	Do nothing; reject all acquisition offers	PDC Subsidiary statutory merger	PDC asset purchase for stock	PDC asset purchase for cash
Amount and character of gain/loss to JL, Jason & Lucy				
AB of non-cash assets Jason & Lucy receive				
Other consequences, if any				

Thank you for your attention!

If you want a copy of these materials, please email me at stockt@ohio.edu