ADDRESS REPLY TO
"tHE ATTORNEY GENERAL OF HAWAII"
AND REFER TO
INITIALS AND NUMBER
RVL: rs
764:45,OLC

OP. 57-60

TERRITORY OF HAWAII

DEPARTMENT OF THE ATTORNEY GENERAL
HONOLULU

July 8, 1957

Honorable Earl W. Fase
Tax Commissioner
Territory of Hawaii
Honolulu, Hawaii

Dear Sir:

This concerns your oral request for advice as to the application of the compensation and dividends tax and the net income tax in connection with the purchase, by a Z Company subsidiary, of X Company assets and the ensuing liquidation of X Company.

Pursuant to an agreement made between X Company and Z. Co., the latter acquired all of the former's assets, except $4,000 in cash. The agreed consideration was Z Co. stock having a fair market value as of March 31, 1956 when the assets were acquired by Z Co. of $450,000. plus the assumption of X Company's liabiliaties by Z Co. The $4000 retained each was to be used for taxes, and X Company was to be completely liquidated.

The Z Co. stock was, by the terms of the agreement, part of the payment to X Company. While These shares were to be issued to the X Company stockholders in proportion to their stock holdings, and they were to surrender the X Company stock, it definitely appears from Paragraph 3 G on page 5 of the agreement that the transfer of Z Co. stock to the stockholders of X Company was made by the latter corporation. Z co. merely distributed the stock among X Company stockholders at a convenience to carry out the final liquidation.

Thus, X Company assets were by it transferred to Z Co. in exchange for stock and the assumption of liabilities. X Company did not liquidate, distribute the assets among the shareholders, and the shareholders thereupon transfer the assets to Z Co. in exchange for stock.

The assets acquired by Z Co. or some of them, were turned over by Z Co. to Y Company, an Hawaiian corporation, formed January 20, 1956, which on March 29, 1956 changed its name to X Co. The present X Co. is a Z Co. subsidiary.

There have been a number of letters written by this office concerning the effect of the above cited tax laws in reorganization matters. Reference is made to our letters of November 1, 1954 (774:45) and May 21, 1956 (695:45).

The principal questions are: Were the earnings and profits of X Co. (the original corporation) increased by the transfer of the assets for the consideration above stated? What was the amount of earnings and profits as of the time of distribution of the Z Co. stock to the stockholders? Was there a taxable capital gain upon the transfer?

1. I have reached the conclusion that, by reason of the transfer, there was a profit of X Company (the original corporation) in the amount of $77,246.48 computed as follows:

The price consisted in $450,000 in stock, and $312,106 in liabilities assumed in round numbers. (This amount of liabilities assumed by Z Co. does not include the dealer's reserve. Upon the assumption that the entire dealer's reserve will be retained, this amount has been deducted from the cost to X Company (the original corporation) of the assets transferred. On the other hand, if the amount of the dealers’ reserve is added to the amount of assumed liabilities, on the assumption that this sum will be paid out to the dealers, the same amount would not be deducted from the cost of the assets. It therefore is not material which assumption is made.)

The liabilities assumed include notes payable, insurance accounts payable, insurance premiums credit and taxes, the letter amount being in the sum set up as the reserve for taxes.

The cost of the assets, adjusted for depreciation allowances, is in the amount of $684,860 in round numbers. These are the book figures, less $4,000 of cash retained by X Company, and also deducting from the face amounts of discounted contracts, loans and mortgages, the unearned interest and the dealers' reserve. (As to the latter see the explanation above.) Thus, comparing the price and the depreciated cost of assets, the profit was $77,246.48.

2. Before the transfer X Company had undivided profits of $51,669.26, and a reserve for loan losses of $13,084.26. By reason of the transfer of the loan accounts to Z Co. this amount is released from the reserve and becomes an addition to undivided profits, having been created out of earnings and profits in the first place. The amount of profit on the transfer of the assets was $77,246.48 as above noted. Thus the amount of earnings and profits as of the time of distribution of the Z Co. stock to the stockholders is $142,000. (Against the assets $450,000

of fair market value of stock and $4,000 in cash) there was $300,000 of common stock and $12,000 of capital surplus, leaving $142,000 as above stated. However, the amount of net income tax accruing upon the transfer of the assets is still to be deducted in determining the earnings and profits available for distribution to the stock-holders.

3. As to the amount of taxable capital gain upon the transfer of the assets, the capital gain upon the transfer of the real estate is not taxable. According to the information you have furnished the portion of the profit consisting in gain from the sale of the real estate was $36,965.29, leaving $40,281.19 of taxable gain.

It is noted that on the closing tax return of the old company all 1956 installments of income tax were deducted. As a result the tax return showed a loss of $15,060.81. However the taxable gain of $40,281.19 was not reflected in the return. When this is added the return shows, or should have shown, taxable income of $25,220.38. After deducting from this the tax accruing on this net income, the tax is $2,292.76.

4. The final question is what is the amount of taxable liquidating dividends as to which the shareholders are liable for the compensation and dividends and net income tax?

Returning to the question of earned surplus available for distribution to stockholders, there must be deducted from the $l42,000 the tax of $2,292.76 and also, in order to apply the provisions of the compensation and dividends tax law and the net income tax law to liquidating dividends, there must be deducted the earnings and profits accumlated or increase in value of property accrued before January 1, 1943. According to the information you have furnished this latter amount was $33,029.97. This leaves $106,667.27 of taxable liquidating dividends. The compensation and dividends tax on this amount of liquidating dividends at 2% is $2,133.35. The 25,000 shares of Z Co. stock distributed represent, as to each share, a taxable liquidating dividend of $4,267 which should have been included in the net income tax return of each person receiving the shares, for 1956. However, each shareholder becomes entitled to the 75% credit for the 2% tax in respect of liquidating dividends received by him, or $.064 for each share of Z Co. stock received.

Respectfully,

RHODA V. LEWIS
Deputy Attorney General