First National State Bank of New Jersey (formerly National State Bank of Newark, N. J.), Petitioner v. Commissioner of Internal Revenue, Respondent, 51 T. C. 419 (1968)

The adjusted basis of a parent corporation's stock in a liquidated subsidiary must be increased by the subsidiary's earnings and profits from the period of stock purchase to the final liquidation distribution.

Summary

First National State Bank acquired and immediately liquidated Federal Trust Co. , taking over its assets and liabilities. The IRS required Federal to include its bad debt reserve in its final income, increasing its earnings and profits. The Tax Court ruled that under Section 334(b)(2) of the Internal Revenue Code, First National could increase its basis in Federal's stock by this amount, minus the resulting tax liability. This decision clarified the basis calculation for assets acquired in subsidiary liquidations, ensuring that earnings and profits adjustments are considered from the time of stock purchase until liquidation.

Facts

First National State Bank, a national bank, agreed to merge with Federal Trust Co. , a New Jersey banking association, subject to the approval of the Comptroller of the Currency. On October 10, 1958, First National acquired all of Federal's stock and completed the liquidation and merger on the same day. Federal's final income tax return did not include its bad debt reserve of $998,325. 96 as income. The IRS later determined this reserve should be included, increasing Federal's earnings and profits by $479,196. 46 after accounting for the resulting tax liability of $519,129. 50, which First National paid as Federal's successor.

Procedural History

First National filed a petition with the U. S. Tax Court challenging the IRS's determination of its basis in the assets acquired from Federal. The IRS had disallowed First National's inclusion of the net increase in Federal's earnings and profits due to the bad debt reserve in the basis calculation. The Tax Court heard the case and ruled in favor of First National.

Issue(s)

1. Whether the net increase in Federal's earnings and profits, resulting from the inclusion of its bad debt reserve in its final income, should be used to increase the adjusted basis of First National's stock in Federal for purposes of determining the basis of the assets First National acquired from Federal under Section 334(b)(2) of the Internal Revenue Code.

Holding

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1. Yes, because the increase in Federal's earnings and profits due to the inclusion of the bad debt reserve in its final income falls within the period specified by the IRS regulations under Section 334(b)(2), which requires the basis of the subsidiary's stock to be adjusted for such earnings and profits.

Court's Reasoning

The Tax Court's decision was based on the interpretation of Section 334(b)(2) and its accompanying regulations. The court noted that the statute allows for adjustments to the basis of the subsidiary's stock, including for earnings and profits from the date of stock purchase to the date of the last distribution in liquidation. The court found that the increase in Federal's earnings and profits due to the bad debt reserve was directly attributable to the liquidation event and thus should be included in the basis calculation. The court also addressed the IRS's concern about a potential

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