1970

Taxation of Corporations: Final Examination (May 25, 1970)

William & Mary Law School

Mr. Davies

May 25, 1970

FINAL EXAMINATION

TAXATION OF CORPORATIONS (089)

(3 hours)

Instructions:

1. Place your name only on the outside cover of each examination booklet that you use. Answer the questions only in these examination booklets.

2. The total time limit is 3 hours. Suggested times are indicated for each question which are also equal to the relative weight of each question for grading purposes. These suggested times total 2-1/2 hours so that you should have 1/2 hour remaining to review your answers.

3. Assume that all taxpayers have adopted a calendar year and are on the cash method of accounting unless otherwise indicated.

4. No citations of Code sections or cases are necessary, although such citations may be used as a shorthand for expressing your ideas where relevant. Be sure, however, to give complete reasoning for each answer.

5. If you conclude that a question is incorrect or incomplete, you may make a reasonable assumption and then proceed with your answer. Any such assumptions should be clearly set forth as part of your answer.

6. This is an open-book examination only to the extent that you may refer to the Code and Regulations and to any notes or outlines that you have prepared yourself.

I. (40 minutes)

Testator executed a will in June, 1966, which named his wife and son as co-executors and which contained the following clause:

> "I presently own all the common stock of X, a custom printing corporation. X, in addition to its operating assets, owns certain real estate (the "777 property") not used in the business. I hereby direct my executors to effect the liquidation of X and, thereafter, to cause the distribution of all the assets, in kind, 75% to my wife and 25% to my son."

As of the testator's death in June 1969, the assets of X had appreciated greatly in value. The 777 property represented one forth of the gross assets, and there existed a large amount of accumulated earnings and profits. The liabilities of X all were incurred in the ordinary course of business..

In December 1969 the testator's wife and son decided to and did cause the incorporation of Y. Thereafter, testator's executors in January 1970 liquidated X, pursuant to the above clause, by transferring all of X's assets and liabilities to the estate. The executors then immediately distributed all of the assets and liabilities of X in undivided shares to the wife and son. The wife and son immediately transferred these undivided shares to Y for common stock in proportion to their ownership of the assets of X, except for the 777 property which they retained, and thereafter have operated the business without interruption just as the testator had operated it before his death. X was dissolved pursuant to state law in May 1970.

What arguments would you make to the Tax Court as to how these facts should be treated for federal income tax purposes under the Internal Revenue Code and relevant judicial authorities, assuming that you were representing:

(a) the wife and son, individually, and as executors;

(b) the U.S. Government.

II. (50 minutes)

A came into your office last week and said: "I have been talking to National Trucking, Inc., and, as I am approaching retirement age, I have been thinking about selling them my local trucking business. They don't want the company's oil and gas interests or investment securities, however, and I'd just as soon keep those myself. National's accountants say that I can just distribute the oil and gas interests and investment securities to myself tax free and then sell them the rest for National's voting common stock, but I thought I'd better check out the tax angles with you first. I don't want to incur any corporate or personal income tax unless I have to."

During the interview, you uncovered the following facts:

(1) A owns all the common stock of X (its only class of stock). His tax basis for the stock is $300,000.

(2) X has been a "Subchapter S" corporation since its incorporation in 1960 and each year has made a cash distribution to A which was exactly equal to X's taxable income as adjusted under §1373(d). All of its properties have appreciated greatly since 1960; its net assets are now worth $1,000,000. The oil and gas interests and the investment securities provide about equal amounts of income each year and combined are worth $300,000.

(3) As to the oil and gas interests acquired from time-to-time, beginning in 1960, X calculates its net profits using percentage depletion which has saved an accumulated total of $150,000 over what the net profits would have been using cost depletion. X operates the oil and gas interests under an employment contract with an "operator" and receives a percentage of the net profits or pays its share of the operating deficit at the end of each year.

Are National's accountants correct in their advice to A, and if so, what type of transaction with National would you propose, and why? If the advice is not correct, why not, and what alternative would you recommend as the best way to accomplish A's objective of keeping taxes to a minimum?

III. (20 minutes)

Father and son each own 50% of the common stock of X Co. Ten years ago, X Co. needed a business loan from B bank, but B would not make the loan unless X Co.'s capitalization was increased by $25,000. Son did not have the $12,500 to invest, but both agreed that the voting control should remain 50-50. Therefore, Father contributed the $25,000 in exchange for non-voting preferred stock and B made the loan to X Co. Ten years later, when X Co. now has earnings and profits (current and accumulated) of $40,000, the loan is repaid by X Co. to B, and X Co. then, in accordance with the original understanding, redeems all of Father's preferred stock for $25,000.

What are the tax consequences, if any, to Father? Why?

IV. (20 minutes)

A and B each own 50% of X Corp. On January 1, 1969, they agree orally to liquidate X Corp. completely by selling all of its assets for cash, paying off its liabilities, and distributing the remainder equally to themselves. A and B each has a basis for his X Corp. stock of $1,000. The balance sheet of X Corp. is as follows:

Balance Sheet of X Corp. as of November 1, 1969

Inventory		3,000	Liabilities	1,500
Accounts Receivable	2,000			
Less Reserve for Bad Debts	(200)	1,800	Capital Stock	2,000
			Earnings and Profits	4,500
Machinery:				
Cost	5,000			
Less Reserve for Depreciation	(1,800)	3,200		
		8,000		8,000

A and B come into your office on November 1, 1969, and tell you that X Corp. has conducted no business operations during 1969 and thus has no further income from operations. A buyer has been found for the assets who will pay $10,500 ($5,000 Inventory; $1,800 Accounts Receivable (net); $3,700 Machinery). The buyer wants to wait until January 2, 1970, to make the purchase but will close the deal sooner if it makes any difference to A and B.

What difference would the closing date make, if any? Detail the tax consequences to X Corp. and to A and B under the arrangement that you would propose.

V. (20 minutes)

A and B own adjoining farms of equal size. Both farms are on the edge of an expanding metropolitan area and therefore have appreciated greatly in value over the past several years. A's farm is incorporated (F Co.) and B runs his farm as a sole proprietorship.

B decided to get out of farming and to subdivide his land and sell off lots. He transferred his farm land to a new corporation, X Co., in exchange for all of its voting common stock (100 shares). A, a month later, decided to join B in this venture and he transferred his stock in F Co. to X Co. for 100 shares of convertible non-voting preferred stock.

X Co. then, to simplify its corporate structure, immediately liquidated F Co. and assumed ownership of this second farm directly. One month later, A exercised his conversion privilege and surrendered his preferred stock to X Co. for 100 shares of voting common.

What are the tax consequences to A, B, and X Co.?