Corporate Reorganizations: Examination (May 1971)

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CORPORATE REORGANIZATIONS
Examination
May, 1971

Instructions

Answer all questions fully, giving appropriate code references. Assume that all references to "stock" are to "voting common" unless otherwise indicated. In each situation, consider the presence or absence of a reorganization and the nature and extent to which gain or loss are recognized to each participant in the transaction, unless otherwise instructed.

I. Corporation X is engaged in the manufacture and sale of wood products, has a net worth of $900,000 and its stock is owned equally by A, B and C. Corporation Y is engaged in the wholesale lumber business, has suffered financial reverses in recent years, and is owned equally by D, E and F. Y's operating assets have a basis of $500,000 and an FMV of $600,000. Y's other assets have a basis of $200,000 and its liabilities, all unsecured, are $200,000. Y's estimated net operating losses for the current year and earlier years, which are all eligible for carry-forward, are $90,000. Corporation X desires to acquire Y's assets or control of Y and D, E and F are agreeable if they, or Y, will receive stock in X, securities from X or cash. Y shareholders have a basis for their stock of $40,000 per share and it is estimated that their stock is worth $50.00 per share.

1. It is proposed that X corporation purchase Y's operating assets for $400,000 in cash and $200,000 in securities, payable to Y, which in turn will liquidate. Is this advantageous to X? To Y or its shareholders?

2. It is proposed that X issue voting stock to Y, assume Y liabilities and receive all Y assets. Y will then liquidate.

3. It is proposed that X acquire 5/6 of Y's operating assets in exchange for X stock, that X not assume liabilities and that Y discharge liabilities and liquidate.

4. It is proposed that Y corporation issue new stock to X corporation for cash and securities, that Y then redeem the stock held by the other Y stockholders and that Y corporations then be liquidated into X corporation.

5. It is proposed that Y corporation merge into X corporation under an arrangement whereby for each share of Y stock outstanding X will issue one share of X stock worth $20.00 and one 20 year 6% unsecured note having a face amount of $30.00.

6. It is proposed that Y corporations merge into X corporation under an arrangement whereby each Y shareholder can elect to receive non-voting, preferred X stock or X securities. M, N, and O, Y stockholders holding 60% of the Y stock, elected to receive the X stock. The remaining holders of 40% of the Y stock elected to receive securities.
II

X corporation, owned equally by A, B and C is in the ice cream business and has substantial earnings and profits. A, B and C wish to diversify their investments. The stockholders of Y corporation, which is engaged in the dairy products distribution business, wish either to sell out or amalgamate with a larger enterprise. X and Y work out a package under which for each 10 shares of Y stock surrendered to X, X will exchange one share of X voting stock and issue one 6% 10 year note in the face amount of $50.00. Stockholders owning 85% of Y stock participates in the package deal with X corporation and as a result, Y stockholders come to own 5% of X stock. A, B and C, simultaneously have purchased for cash the remaining 15% of Y stock. X corporation then distributes all of the Y stock acquired in the package deal to A, B and C, the former stockholders of Y who are now stockholders of X having agreed, as part of the package, that this would occur.

III

On January 1, 1960, X corporation issued 1,000 shares of stock each to A, B and C for $20.00 per share and began doing business. The business prospered and on December 20, 1970 its assets consisted of land, improvements and equipment with a value of $150,000 and an adjusted basis of $100,000, inventories with a basis of $10,000 and a fair market value of $15,000 and cash and receivables in the amount of $95,000. X corporation, with substantial earnings over the period, had never paid dividends. X's liabilities were $5,000. C, a shareholder in X, was the sole owner of Y corporation, whose business was similar to X's. Preferring not to go through a reorganization, but desiring to use a sale-purchase, approach, X corporation decided to sell its operating assets to Y Corporation. X thereupon on December 20, 1970 sold its land, improvements, equipment, and inventories to Y corporation for $165,000 pursuant to section 337, paid off its liabilities, and distributed $225,000 in cash and receivables pro-rata to A, B and C, each receiving $85,000 in complete liquidation.

A and B, shortly thereafter invested $30,000 each in Y voting common stock and C invested $30,000 in Y 20-year unsecured notes at 6% interest. As a result, Y was owned 40% by C, 30% by A and 30% by B.

Are there any advantages to their approach as opposed to a traditional-type reorganization? Discuss fully.

IV

A, B, C and D owned X corporation, which was engaged in the wholesale distribution business and at the time was handling principally the products of Z corporation, an unrelated entity. X corporation had a falling out with Z and chose to do no further business on behalf of Z. X's director adopted a plan of liquidation under section 337 in November of 1970 and proceeded to sell to Z certain supply contracts with X's customers for the sum of $20,000. X then distributed its warehouse, equipment, cash, inventories, cash and remaining assets to A, B, C and D pro-rata in complete liquidation on December 30, 1970. X was on a July 1-June 30 fiscal year. A, B, C and D each filed a tax return reporting sizeable capital gains by reason of the liquidation, the gain being largely attributable to the warehouse and equipment, which had appreciated in value. A, B, C and D then conveyed the assets to A, each retaining $20,000 in cash, his pro-rata portion of the total cash distributed. On March 1, 1971 A, as trustee, conveyed to assets to newly formed corporation Y, which began business as a distributor dealing with many of the former customers of X. The assets are carried on the books at a basis determined by reference to that of A, B, C and D.

From the vantage point of a revenue agent, examine the transaction.
X corporation, formed in 1960, prospered in the construction business. Its co-equal shareholders in 1964 received as a dividend one share of non-voting preferred stock for each 3 shares of common stock held. In 1968, X for a business purpose created a new subsidiary transferring to it $200,000 worth of construction assets and $200,000 in cash and receiving from the subsidiary 20 year 6% notes having an aggregate face amount $300,000 and voting stock in an aggregate par value of $100,000. In 1970 X distributed all of the subsidiary stock (but not the securities) to X shareholders in exchange for their shares of X preferred stock.

Y corporation borrowed $200,000 from a bank on March 15, 1970 and gave a mortgage on its assets. On May 1, 1970, Y's assets consisted of a warehouse and lot having a basis of $400,000 and a FMV of $450,000, equipment having a basis of $100,000 and a FMV of $150,000, undeveloped land having a basis of $150,000 and a FMV of $300,000, inventories having a basis and FMV of $300,000 and cash of $195,000. Liabilities were $250,000, of which $200,000 was secured by the undeveloped land and $50,000 was unsecured. Y corporation by deed transferred all its liabilities. Y then liquidated. The stock transferred by X to Y was worth $950,000.

Analyse the transaction, indicating basis of assets received by the corporate parties. Would your analysis differ if inventories were $460,000 rather than $300,000, and cash retained by X was $35,000 rather than $195,000.

In an attempt to improve its financial posture X corporation offers to exchange securities for stock and securities for securities under a specified formula. A, who owned 200 shares of X voting stock having a basis of $10.00 per share, exchanged 50 shares for a face amount $1,000 20-year bond paying 7% interest. B, who owned both voting stock and securities exchanged a $500, 10 year 6% note for a $550 20-year, 7% bond. C who owned only 25 shares of X voting stock having a basis to him of $10.00 per share, exchanged all of it for a $550 20 year 7% bond. The basis of the note surrendered by B was its face amount and the FMV of the bonds received by A, B and C were their face amount.