Advanced Tax: Final Examination (January 18, 1971)

William & Mary Law School
Mr. Llewellyn
January 18, 1971

Question 1 - (60 minutes)

Your client, Mr. Big, operates a motel complex. The complex contains forty motel rooms, a convention hall and a restaurant. He formerly operated the motel as a sole proprietor. On December 31, 1967 he transferred to a newly formed corporation the following assets:

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>(The numbers indicate thousands of dollars)</th>
<th>ADJ. BASIS - F.M.V.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Furniture (Acquired in 1964 at a cost of 400)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) Motel buildings (Acquired in 1954 at a cost of 550. The property is presently subject to a mortgage of 400)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) Miscellaneous equipment (Acquired in 1968 at a cost of 500)</td>
<td>450</td>
<td>150</td>
</tr>
</tbody>
</table>

$1,000,000 $1,000,000

In return for the assets listed above, Mr. Big received 500 shares of stock valued at $1,000 per share, an assumption of the mortgage of 400,000 by the corporation on the motel building and a four-year note with interest of 4% per annum with a face amount and fair market value of $100,000. All of the stock issued by the corporation was common stock. On January 1, 1968, Mr. Big transferred 250 of the 500 shares of stock to his son George as a gift.

On January 1, 1969, the corporation a "small business corporation" under section 1371(a) of the Code made an effective election under section 1372(a) of the Code. At the time of the election, the corporation had accumulated earnings and profits of $20,000.

The corporation, a cash basis calendar year, taxpayer had receipts for its calendar year 1969 as follows:

$100,000 from room rentals, $100,000 from the restaurant
$40,000 from the rental of the convention hall, $100,000 from the sale of short term securities which were purchased by the corporation (a holding period of less than 6 mos.) (the gain from the sale of the securities totalled $10,000) and $10,000 of dividends from the securities.

The corporation's taxable income in 1969 computed as provided in section 63(a) totalled $91,500. The corporation also paid in 1969 its tax for the year 1968 in the amount of $50,000. The corporation made no distribution to its shareholders in 1969.

On January 1, 1970, Mr. Big sold his 250 shares of the corporation to the Ace Corporation for $400,000. On January 8, 1970, the corporation distributed $40,000 pro rata to the shareholders of that date. The corporation had taxable income and earnings and profits of 30,000 for the year 1970 and no other distributions were made.

Questions:

A. What amount of gain or loss, if any, should have been recognized by Mr. Big on the transfer of the motel assets on December 31, 1967 to the corporation?
B. What is the nature of that gain or loss, if any?

C. What is the amount of gain or loss, if any, on the sale by Mr. Big of the 250 shares of stock to Ace Corporation?

D. What are the tax consequences to the son of Mr. Big as a result of the 20,000 distributed to him on January 8, 1970?

Question 2. - (60 minutes - 2 parts)

(A) 25 minutes

Early in 1966, A and B (individuals) formed the X Corporation to engage in the laundry and linen supply business (hereinafter, "the L business") A and B each paid $50,000 and each received 50 shares of common stock having a par value of $100 per share. Thus the opening balance sheet of X would show the following:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 100,000</td>
<td>Capital stock (100 shares)</td>
</tr>
<tr>
<td></td>
<td>of $100 par value each $10,000</td>
</tr>
<tr>
<td></td>
<td>Paid in surplus</td>
</tr>
<tr>
<td></td>
<td>... 90,000</td>
</tr>
</tbody>
</table>

X has at all times used a calendar year and cash method of tax accounting. The tax history of X, including distributions (cash unless otherwise stated) through 1970 is as follows:

1966 --- X broke even on the L business and distributed a total of $10,000 to A and B.

1967 --- X had a $10,000 loss from the operation of the L business (this was a "net operating loss" see section 172) X made no distributions.

1968 --- X had a profit (excess of gross income over costs and expenses occurring during the year) of $10,000 from the operation of the L business. X distributed $10,000 pro rata to A and B.

1969 --- X had a profit of $10,000 from operation of the L business. X made a pro rata distribution of X preferred stock having a total fair market value of 6,000.

1970 --- X had a profit of $20,000 from operation of L business. X distributed 20,000 pro rata to A and B in April of 1970 and 20,000 pro rata to A and C, (who had purchased B's stock in June of 1970) in September of 1970.

Question:

(1) As to each distribution, what is the amount thereof, if any, taxable as dividend income to the shareholders.

(B) 35 minutes

Your client A owns 40 shares of the X Corporation's 100 outstanding shares of common stock (the only class of stock issued by Corporation X). The remaining shares of X stock are owned as follows: F, A's father - 30 shares; Y Corporation - 20 shares; G, A's grandfather - 10 shares.

A owns 50 shares of the Y Corporation's 100 outstanding shares of common stock (the only class of stock issued by Y Corporation). The remaining 50 shares of Y Corporation common stock are owned as follows: F, A's father - 20 shares; G, A's grandfather - 30 shares.

Corporation X has earnings and profits of $40,000 and Corporation Y has earnings and profits of $20,000. X Corporation plans to redeem the 40 shares of stock held by A in exchange for the fair
market value of the shares, $140,000. A's total basis for the said 40 shares is $10,000.

Questions:

(1) Discuss fully the tax consequences of such a redemption to A and the X Corporation.

(2) Discuss fully the tax consequences to A if instead of redeeming the shares he sold the shares to Y Corporation.

Question 3 - (60 minutes)

Mr. A owns all the stock of P Corporation, which in turn owns all the stock of S Corporation. P's only other assets are two parcels of improved Richmond real estate held for production of rental income. S owns only some unimproved farmland in a suburban area, which has attracted some interest from K and L, who are builders. There has also been some interest, though less active, expressed by prospective purchasers in the improved real estate owned by P. All properties have been held more than 3 years.

In December 1970, A asked your law firm for advice as to the best procedure tax-wise to effect the sale of the properties held in the P and S Corporations.

For the property owned by S, K and L are willing to sign a contract right now providing for a purchase price of $400,000, of which $40,000 would be paid on signing the contract and $60,000 on closing (within 6 months), with notes being given on closing for the $300,000 balance, payable over the next 6 years and secured by a mortgage on the property.

The buyers desire to convert the farmland in the suburban area from its present use (soil bank land and a golf driving range) to a housing development. The buyers do not desire to complete settlement for the real estate unless the buyers are assured that the property will be permitted to be used for a housing development. This requires approval from the local planning commission for the subdivision plan and approval from the county board of health for the lot sewage disposal system. The buyers desire settlement as soon as possible but no later than 6 months. Also, K and L contemplate that the buyer would be X Corporation, to be organized by them. K and L refuse to be personally liable on the real estate mortgage and notes.

For the properties owned by P assume that the value of these is fixed at $200,000. Assume that purchaser would probably desire to purchase the lots on an installment basis. Note that there is no immediate prospect willing to pay this much and it may be some time (perhaps as long as two years) before a buyer can be found.

P's basis for its real estate is $125,000 and its basis for the S stock is $140,000. S's basis for the land owned by S is $150,000. A's basis for the P stock is $200,000. All parties are on a calendar year. P has earnings and profits of $50,000. S has neither earnings and profits or a deficit in earnings and profits.

Your Assignment:

(1) The tax-man for the law firm left on the 1st of the year. However, before leaving he sketched out some alternative procedures that could be used in accomplishing the sale of the unimproved land (keeping in mind the potential sale of the improved land) and having the funds passed out to A. The departed tax-man gave no explanation of the details of the treatment under the various sections referred to. Prepare a memorandum explaining in detail the treatment under the various sections referred to including your evaluation of each of the alternative methods set forth below. You may include in your memorandum any original ideas you may have respecting procedures for handling the sale from a tax standpoint. Be sure to include the affect that each procedure will have on the buyers and what the possibilities are of convincing the buyers to go along with the procedures.
(A) A liquidation of S into P under 330; a sale of the unimproved land by P to X and a Sub. S election by P.

(B) A liquidation of S into P under 332; a liquidation of P under 333, and a sale of unimproved land by A to X.

(C) A liquidation of S into P under 332; a 337 election and sale of the unimproved land by P to X, and then a liquidation of P under 331.

(D) A dividend of S stock by P to A; a sale of S stock by A to X and a 332 liquidation of S into X.

(E) A 337 election by P; a sale of S stock by P to X; a liquidation of S into X under 332, and a liquidation of P under 331.

(F) A liquidation of P under 331; a sale of S stock by A to X, and a liquidation of S into X under 332.

(2) How would you handle the contingency of the subdivision approval? If S seeks the approval, will there be a risk of the application of § 341?