1972

Corporate and Shareholder Tax: Final Exam (January 1972)

William & Mary Law School
A, B, C, D, E, F, and G have been friends for many years and for those many years they have lamented over the difficulty a physician has in keeping up with the latest developments in medicine and the time spent in researching particular disease conditions. As a result of these discussions A conceived an idea for a computer-generated medical information retrieval system which would enable a physician to get immediate printouts of the most recent publications on any disease or condition.

The idea has been enthusiastically received by all the above friends and they decide to form a company to exploit said idea. They estimate that they will require about $800,000 in working capital of which approximately one half will be raised by the parties and the balance from a lending institution which has already agreed to the loan.

Part I

B comes to you for advice. He wants to know the consequences of the following plan for the incorporation of Medical Information Retrieval Systems, Inc. (hereafter referred to as X)

A, who will not participate in the management of the company will contribute $100,000 in cash in return for 100 shares of X common stock.

B, who likewise will not participate in the management of X, is willing to contribute to X a computer which he acquired several years ago, but which he has never used in return for 100 shares of X common stock. The fair market value of the computer is $100,000 and the adjusted basis to B is $20,000.

C will contribute land with a fair market value of $100,000 and an adjusted basis to C of $10,000 in return for 50 shares of X common stock. X will also assume a $50,000 mortgage on the land held by the national bank.

D will contribute machinery with a fair market value of $50,000 and an adjusted basis to him of $100,000 in return for 25 shares of X common stock and $25,000 in cash.

E will contribute an office building with a fair market value of $200,000 and an adjusted basis to him of $100,000 for 100 shares of X common stock and $100,000 in cash.

F will contribute no money to X, but he has agreed to lend his expertise in computer programming by working for the corporation for at least five years. He will also supply X with a list of doctors to whom he has sold medical journals when he was a salesman for a magazine company. F will receive 25 shares of X common stock for his promise to work and the list.

G is the most important man in the group because he is a doctor as well as a computer expert and he has agreed to serve as the chief executive officer of X. G will contribute $20,000 in cash and will receive 100 shares of X common stock.

B asks you to determine the realized gain or loss, if any, to each of the transferors if they contribute property to X simultaneously under the above plan. He would also like to know what the tax basis for the stock will be to each shareholder and what the tax basis for the property held by X will be.

In answer to your question, B states that the fair market value of the stock to be issued by X is $1,000 per share. Advise B as to what the tax consequences of the above plan will be to the various parties.

Part II

D asks you to comment on the following plan as an alternative to B's plan.

Under D's proposal the parties will commit only 10% of their financial participation to X in return for equity. The balance of each transferor's funds would be contributed to X in return for debentures carrying an interest rate of 7% and maturing in 6 years. F and G will not participate in the debentures but will receive equity only.
This plan is based upon alternative premises. On one hand, if the business is financially successful the parties will be able to withdraw some of X's earnings in the form of interest on the debentures and thereby avoid the double taxation problem of dividends. Moreover, the parties will be able to recover the major portion of their investment as a tax free return of basis when the debt is paid off by X.

On the other hand, if the business is unsuccessful the shareholders will be able to share in the assets of the corporation equally with outside creditors. Moreover, D feels that the amount of the debt unrecovered will be deductible as a business bad debt under § 166 of the Internal Revenue Code of 1954.

Comment on the merit or the lack of merit of D's proposal.

Part III

B asks you [without prejudicing your answer to Part II above] if you can offer a viable alternative to D's plan which will attain substantially the goals of D's proposal.

Adviser B.

2. In 1958 A and B organized Z corporation to manufacture and sell high fashion dresses to specialty shops throughout the country. A owns 100 shares with an adjusted basis to him of $10,000 and B also owns 100 shares with an adjusted basis to him of $25,000.

On January 3, 1963 the parties met and decided that, in view of recent economic and fashion uncertainties which existed at the time, difficulties were ahead for the company. Accordingly, consents to be taxed under Subchapter S were filed by A and B, the only shareholders of Z, for the year 1968.

As of the end of 1967 Z had $38,000 of accumulated Earnings and Profits. All the parties are cash basis - calendar year taxpayers.

During calendar year 1968 Z had taxable income of $10,000 from operations as well as tax exempt interest of $10,000 and long term gains of $5,000 from certain § 1231 assets. Z made a pro rata distribution of $10,000 to A and B.

During calendar year 1969 Z had taxable income from operations of $20,000 and a short term capital loss of $3,000. Z made pro rate distributions of $8,000 and $9,000 to A and B on June 6, 1969 and November 3, 1969 respectively.

During calendar year 1970 Z corporation suffered a loss from operations of $18,250. A had sold his shares to C for $50,000 on March 31, 1970. Until that time the corporation had been modestly successful, posting gain for the first quarter of $14,000, but C's inexperience caused the ultimate loss. Nonetheless, Z made a pro rata distribution of property with a fair market value and adjusted basis of $50,000 December 8, 1970. Z had also made a pro rata cash distribution of $3,000 to A and B on January 10, 1970.

During calendar year 1971 the company performed an almost miraculous recovery by earning $40,000 in taxable income. The reasons for this profit were attributable to A who returned to the company after purchasing 50% of C's shares on January 31, 1971. The profits were also partly attributable to the work of B's son S who came into the business after B retired. B gave his shares to S on June 1, 1971. On December 15, 1971 the company distributed $120,000 in cash pro rata to A, C, and S.


What is the amount of gain or loss recognized to A on the sale of shares to C?

What is the amount of gain or loss recognized to C on the sale of stock to A?
3. In June, 1955 F and his two sons S₁ and S₂ organized X Company for the manufacture of water beds. F contributed $10,000 in cash to X in return for 1000 shares of X common and 1000 shares of X non-voting common. S₁ and S₂ each contributed $5,000 in return for 500 shares of X common.

Although the initial resistance to water beds was strong the company did manage to register modest profits. On December 31, 1966, the end of the taxable year, X had $44,000 in earnings and profits.

The financial picture since then has changed dramatically. For taxable year 1967 the company posted $60,000 of post tax earnings from operations plus $20,000 in tax exempt interest. For taxable year 1968 X registered $80,000 in post tax earnings from operations.

On January 8, 1969 X purchased all the assets of the Y retail store which was in the business of selling novelty items such as water beds and inflatable plastic chairs. The purchase price for Y was $150,000. S₁ who originally pressed for the purchase took over the retail store and operated the store as an almost autonomous division of X. As a result of the purchase X's post tax earnings were $160,000 for the year 1969. Approximately $80,000 of the profit was attributable to the retail operation and the balance attributable to the manufacturing operation.

For taxable years 1970 and 1971 the X company earned respectively $200,000 and $280,000 in post tax earnings. However, in 1970 the total profit picture was marred by a $120,000 short term capital loss.

Not to be outdone by his brother S₂ conceived an idea for water filled automobile tires, but F vetoed the idea that X should engage in the manufacture thereof. Not to be dissuaded, S₂, in 1969, formed Z corporation with a contribution of $15,000, receivin return all the capital stock of Z corporation. The company fairied poorly from its inception and has shown a loss for every year of its existence. Despite his bad business acumen S₂ did manage to cause Z to purchase a corner lot in downtown Boston which has appreciated to a value in excess of $500,000.

All the taxpayers are cash basis taxpayers and report on a calendar year basis.

(1) Determine the accumulated earnings and profits of X corporation at the end of 1967, 1968, 1969, 1970, and 1971 if X made the following distributions with respect to the voting common stock:

1967 - Pro rata distribution of property with a fair market value of $100,000 and an adjusted basis of $10,000 to X.

1968 - No distribution

1969 - Pro rata distribution of $200,000 in cash.

1970 - Pro rata distribution of $150,000 in cash.

1971 - No distribution

(2) What is the basis of the property distributed in 1967 in the hands of the shareholders?

(3) Suppose that F in 1969 formed Family Trust with a corpus of 500 shares of X non-voting common stock. The trust was set up to benefit GC, S₁'s sole son. F also gave 500 shares of this stock to S₂ in order to equalize his gifts between S₁ and S₂.

How many shares are actually or constructively owned by each of the parties, F, S₁, S₂, X, Z, GC, and Family Trust.

(4) F comes to you with the following problem. He wants to retire from the business but finds that S₁ and S₂ do not have the cash to purchase his shares. He could sell his stock to B, but this he is unwilling to do because S₁ and S₂ would lose complete control.

He therefore asks you whether or not he could have X corporation redeem his shares for their fair market value of $200,000 without adverse tax consequences. That is, may he have all or any part of his shares redeemed without incurring dividend income.

Advise F.
(6) Without prejudicing your answer to #3 above consider whether F would be well advised to sell his shares to Z.

(7) S₁ comes to you with still another alternative. Fearful that a sale to Z would cause S₂ to unfairly utilize his added stock power and fearful that the $200,000 used to redeem F’s stock would jeopardize X’s cash position, S₁ proposes that X redeem F’s stock with subordinated debentures. The debentures would be issued so that 10% of the debentures would mature in each of the next 10 years.

S₁ feels that this would, in effect, result in a 10 year annuity for F at relatively modest tax because F would be in a low - tax bracket. S₁ wants you to tell him if there are any potential tax hazards to F, S₁, or S₂ involved with this proposal. Explain.

(8) After discussing all these problems S₂ decides he wants to quit the business and go to Tahiti and paint pictures. S₁ is willing to continue running X but he is not willing to continue with the manufacturing operation as he is unsophisticated in that area of the business. B is willing to purchase the manufacturing portion of the business and the parties are willing to sell it to him. F is also disgusted with the business and wants to retire.

The parties therefore decide to sell the manufacturing operation and make a pro rata distribution of the sale proceeds in redemption of 50% of the stock of each party.

What tax problems are involved in this plan? What are the tax consequences to the shareholders? To what extent are the earnings and profits of the corporation affected?