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FEDERAL INCOME TAX LAW
EXAMINATION

DONALDSON
Jan. 1972

I

In two sentences or less, identify or explain the following terms:

a) Tainted stock

b) Step transaction

c) Capitalization of earnings or surplus

d) ADR

e) 3% floor on the deduction

II

Jones bought a piece of machinery on January 1, 1969 for $10,000 and for tax purposes depreciated in on the sum of the years digits method, assuming a useful life of five years. He sold the machinery on December 31, 1970 for $9,000.

a) How much depreciation did Jones deduct in 1969?

In 1970?

b) Did he realize and/or recognize any gain in 1970 on the disposition of the machine and if so how much and of what character?

III

James Beam, who is 63 years old, took out an annuity policy at age 30 for which he paid premiums of $1,000 a year for 30 years. The policy will begin paying Beam $5,000 yearly when he reaches age 65.

a) How much of each annual payment of $5,000 will be taxable as income to Beam?

b) Will such amount be ordinary income or capital gain?

c) If Beam dies at the end of his 66th year of life, will his administrator be able to deduct a loss of the final return with respect to the annuity which "has become worthless"?

IV

Hiram Walker, a $4,000 a year night watchman at Lumber Yard, Inc., had an exceedingly good year. In January, he purchased from a junk dealer an old bed for $10.00 to furnish his rented room. Four days afterwards he discovered that the bed was an antique worth $900.00 and gave it to his sister. In February he found a wallet containing $2,000.00 and no identification and kept the contents. He used the $2,000.00 to buy a corner lot for $1,500.00 and a used trailer for $500.00. In March a truck went out of control and hit his trailer while he was asleep inside. Although not badly hurt, he promptly received a settlement from the truck's insurance carrier that paid him $490.00 for the destruction of his trailer and $3,000.00 for pain and suffering. In April a brewery interested in locating in the area approached him about his lot and the end result was that he sold to the brewery for $300.00 a thirty day option to buy the lot for $5,000. However, at the end of the 30 days the brewery declined to exercise the option. In May, the state, for highway purposes, condemned the lot, paying Walker $6,000 compensation. Walker promptly purchased another lot for $5,000 and put another trailer there. In June Walker, while on duty at the Lumber Yard, apprehended a thief and was given a reward of $1,000 by his employer. In July Walker, purchased 10 shares of Amalgamated Industries common stock for $100 a share. By reason of a stock dividend of one for one, Walker within a few days owned 20 shares of the stock which now had a value of $60.00 per share. In August while loitering off duty near Lumber Yard, Walker smelled smoke, discovered a fire in the Lumber Yard office building and promptly extinguished it. Lumber Yard, realizing the need for greater security, increased Walker's salary to $6,000 a year on condition that Walker live in the apartment above Lumber Yard's office. Walker, satisfying himself that the apartment would be rent-free even though having a rental value of $100.00 per month, agreed and moved in. In September, Walker decided to permit a widow to occupy his vacant trailer rent-free on condition that the widow do his laundry and provide him six evening meals a week. Walker figured that this arrangement would save him $25.00 a week. In October Walker received notice that his half-brother had died and that he was sole beneficiary of a $50,000 policy on his half-brother's life, and in addition, would inherit from his estate $30,000. The insurance and estate settlements were promptly made. In November, Walker, feeling financially secure, submitted his resignation to Lumber Yard. However, Lumber Yard induced him to withdraw his resignation by offering him 100 shares of Lumber Yard common stock which was selling at $50.00 per share on condition that delivery of the stock would not be made for five years, that Walker would lose all interest in the stock and his right to receive it if he resigned during the five year period, and that upon delivery in 5 years Walker would not sell the stock for another seven years. Walker agreed. In December Walker discovered that the lot he had purchased for $5,000 in May contained valuable gravel deposits, causing the lot to be worth $25,000. Walker borrowed $20,000 from a bank and gave a mortgage on the lot. He then bought a nice home and married the widow mentioned above on December 18. On December 23 his employer presented him with a 16 lb. frozen turkey having a value of $14.00.

Which of the above transactions affect the calculation of Walker's gross income for tax purposes for the year and why?

January

February

March

April

May

June

July

August

September

October

November

December

V

The Revenue Act of 1971 contained a number of amendments to the IRC of 1954.

a) What did the Act provide that has the effect of discouraging the purchase of equipment manufactured abroad? (Not an excise tax question.)

b) What did the Act provide that has the effect of encouraging married women to seek employment?

VI

As Assistant Secretary of Treasury for Tax Policy, you are asked to recommend tax legislation which will have the effects listed below. What would you recommend and why?

a) Encourage private colleges to enlarge their facilities through construction programs financed by bonds.

b) Encourage persons to use public transportation when going to work, thereby reducing automobile congestion and pollution.

VII

A, B, and C formed X Corporation in 1968. A contributed equipment having a basis of $10,000 and a fair market value of $20,000 for 200 shares of X common stock. B contributed property having a basis of $5,000 and a fmv of $35,000 to X and received 100 shares of X common stock. However, B had mortgaged his property just before the transfer to secure a bank loan of $25,000 and X, as part of the transfer, had assumed the mortgage. C transferred nothing to the corporation but nevertheless was issued 50 shares of X common stock because of his services in organizing X and because of his agreement to serve as manager. Two weeks later, as part of their plan for adequately capitalizing X, A, B, and C each advanced X $100,000 and received X notes in the face amount of $100,000 each, carrying 7% interest and payable in 25 years and each carrying the notation: "This note is subordinate in priority to all claims against X by lending institutions and suppliers." X paid all interest payments on the note.

The corporation prospered far beyond original expectations and after taking all deductions including those for interest payments, the corporation showed a net profit of $80,000 for 1968, a net profit of $120,000 for 1969 and a net profit of $400,000 in 1970. No dividends were declared in any of these years. Early in 1971, to dispose of the excess cash generated by success, X paid A, B, and C $100,000 each and the three notes were surrendered and cancelled. In 1971 X earned a net profit of $300,000 and still declared no dividends. On January 3, 1972, A, B, and C, desiring to get cash out of the corporation at capital gains rates, liquidated X and each received assets and cash, but mostly cash, in proportion to their stock holdings. On January 10, 1972, A, B and C formed Y Corporation, to which they transferred assets received on the January 3rd liquidation, together with nominal amounts of cash, and received respectively, 400 shares, 200 shares and 100 shares of Y common stock. Discuss from the vantage point of a revenue agent:

a) The tax treatment of A, B and C upon the organization of X Corporation.

A)

B)

C)

b) The tax treatment to A, B and C with respect to the retirement of the notes in 1971.

c) Any adjustments to X Corporation's tax return or additional tax liabilities that X may be subject to for the period 1968-71. (No need to discuss dollar amounts--discuss concepts)

d) The tax significance of the January 3 and 10, 1972 transactions to each individual and corporation involved. Again, no need to discuss dollar amounts.

VIII

Corporation X, solely owned by Harold Harris, engages in the manufacture and sale of widgets. On December 31, 1971 it had no liabilities and its assets consisted of $20,000 of cash and plant and equipment having a value of $300,000 and an adjusted basis of $200,000. Surplus on the books available for dividend distributions was $40,000. Harris had a basis of $160,000 for his stock in the corporation. If the plant and equipment were sold by X Corporation, depreciation subject to recapture would be $60,000. Smith is 64 years old, in poor health, and wants to get out of the business. He is very fond of his wife, age 62, and his son, age 30, and plans, on his death, to leave them his entire net estate. Corporation Y, a competitor of X, wishes to acquire X's business, either by purchase of assets, 20 year lease of the assets, or purchase of Harris's stock in X. Harris, in his dual capacity of president and sole shareholder of X, has begun negotiations with Corporation Y, and, as may be expected, all parties are keenly interested in the tax significance of the possible arrangements. Please advise on the following points:

a) Giving due regard to Harris's age and health, are there any reasons why he should not dispose of his interest in X corporation?

b) By what method could X, as vendor, sell its assets to Y with minimum tax effect on X, and what are those effects?

c) As a revenue agent, how would you view a negotiation of the sale of X's assets by Harris in his capacity as president, to Y, where X, rather than consummating the sale, liquidates and distributes its assets to Harris, who in turn sells/Y on the terms negotiated?
to

d) Y is willing to pay X $300,000 for its plant and equipment (Y would not, of course, under this approach, buy X's cash). Would Y be well advised to pay Harris $320,000 for Harris's stock in X if Y intended to liquidate X upon acquiring all of its stock?

e) If Harris should choose to liquidate and then he, as lessor, lease the assets to Y for $31,000 annually, how should the liquidation be effected at the smallest tax cost to Harris in the year of liquidation and what would be that tax cost?

f) If Harris wanted to "sell out" and be paid over a 10 year period with minimum tax cost, how should the transaction be effected?

IX

Anita Bier Badley, a spinster, owns 50 shares of American Brewing Co. stock which she purchased in 1950 for $1,000, 50 shares purchased in 1960 for $2,000 and 50 shares purchased in 1968 for $10,000. Now disillusioned with the company, she wants out and has decided to sell 50 shares to her accountant, give 50 shares to her sister and give 50 shares to her alma mater. However, with respect to the latter, she wants to retain the right to receive the income from that fifty shares for her life. Giving due regard to the tax angles and her love for her sister, which shares should she transfer to whom and are any special techniques or forms of conveyance needed to minimize her tax liability for the year; and assuming a block of 50 shares is worth $5,000?

a) To accountant

b) To sister

c) To alma mater

a) Jones had taxable income for 1971 of $16,000 aside from capital exchanges. His recognized gains and losses from the sale of capital assets were:

short-term gains	$4,000
short-term losses	$1,000
long-term gains	$6,000
long-term losses	$2,000

What was his taxable income for the year?

b) Smith had the following capital gains and losses for 1971:

short-term gains	$1,000
short-term losses	$2,000
long-term gains	0
long-term losses	$1,000

Smith's taxable income from other sources was $6,000. What was his taxable income for 1971 taking into account the capital transactions?