1960

Advanced Income Taxation: Final Examination (May 28, 1960)

William & Mary Law School
1. Two unrelated individuals, A and B and Corp. C (none of whose stock is owned by A or B) organized Corp. M on January 1, 1955, for the purpose of manufacturing shoe machinery. Only one class of stock was authorized, namely, voting no par common in the total number of 100 shares.

A contributed a cash of $100,000 and legal services fairly valued at $25,000, for which he received 25 shares with a fair market value of $125,000.

B contributed a plant site with an adjusted basis to him of $10,000, and worth $25,000; and a building with a basis of $40,000 and worth $100,000, for which he received 25 shares with a fair market value of $125,000.

Corp. C contributed machinery with a basis of $150,000 and worth $200,000 for which it received 40 shares with a fair market value of $200,000.

The remaining 10 shares of stock authorized was not issued at this time.

1. Up to this point - indicate
(a) Amount of taxable income and what kind, if any, was realized by any of the incorporators on the exchange of property or services for stock.

(b) Amount of gain or loss, if any, realized by Corp. M.

(c) Basis of each depreciable asset in the hands of Corp. M for purposes of depreciation deductions.

(d) Per share basis of Corp. M. stock in the hands of each incorporator.

2. During the year 1956 Corp. M's gross profit from the sale of manufactured shoe machinery was $10,000 which was the same computed for both tax and book purposes. Corp. M had no other income. Allowable deductions for tax purposes aggregated $20,000 leaving a negative taxable income of $10,000. For book purposes the deductions were $21,000 due to the fact that depreciation was computed on the basis of the fair market value of the contributed assets rather than on their tax basis.

During 1956 Corp. M had a gross profit from the sale of manufactured shoe machinery of $40,000 (same for book and tax purposes); and $1,000 receipts in the form of interest on tax-exempt bonds. Its allowable tax deductions were $20,000. Its accrued Federal income tax liability for 1955 was $3,000. (Thus its book deductions were $20,000 allowable tax deductions plus $1,000 excess depreciation plus $3,000 Federal taxes, or $24,000)

1. Up to this point - indicate
(a) Corp. M's earnings and profits for the current year (1955) available for dividends.

(b) Corp. M's accumulated earnings and profits as of Jan. 1, 1956 (assuming no distributions have been made).

3. During the year 1956 Corp. M's earnings were such as to result in current year earnings plus accumulated earnings of $90,000. This was the figure as of Dec. 31, 1956. On Dec. 31, 1956, it subdivided a portion of the unused plant site and distributed title to the lots as follows:

<table>
<thead>
<tr>
<th>Land with a basis of</th>
<th>Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>A 1938</td>
<td>3173</td>
</tr>
<tr>
<td>B 1938</td>
<td>3173</td>
</tr>
<tr>
<td>Corp. C 2222</td>
<td>5555</td>
</tr>
</tbody>
</table>

3. Up to this point - indicate
(a) The amount of the dividend taxable to each stockholder.

(b) The basis of the land in the hands of each stockholder.

(c) The accumulated earnings and profits of Corp. M immediately after this distribution.

4. During 1957 it was realized that the Company needed some additional warehouse space and made arrangements with individual D who owned a warehouse to acquire the warehouse in exchange for the remaining unissued 10 shares of stock. At this time the stock had a fair market value of $6,000 per share, or a total of $60,000. The warehouse was fairly worth $100,000, but was subject to a $40,000 mortgage...
and had an adjusted basis in D's hands of $30,000 and had been held by him as
business property for rent for several years. Corp. M issued the 10 shares
and exchanged them for the warehouse, assuming the mortgage.

h. In connection with this exchange, indicate
   (a) Gain or loss to Corp. M, if any.
   (b) Gain or loss to D, if any.
   (c) Basis of the 10 shares of stock in D's hands
   (d) Basis of the warehouse in Corp. M's hands for depreciation

E. On December 31, 1957, at a time when current earnings available for dividends
totalled $200,000, Stockholder A requested that he be permitted to redeem 5 of
his shares as he needed the cash and did not want the stock to have to be sold
to an outsider. The book value of the stock at this time was $6500 a share.
( Please refer to your answer in 1(c) to get the basis of the stock in A's hands).
Corp. M paid A $32,500 in cash for the 5 shares and held them as Treasury stock.

5. As to this redemption - indicate
   (a) Gain or loss, if any, to Corp. M.
   (b) Gain or loss, and what kind, to A.

F. During 1958, the stockholder, Corp. C, which owned 40 shares of Corp. M
began to get interested in acquiring control of Corp. M. Corp. C was a shoe
manufacturer and believed that it would be advisable to control the company -
manufacturing shoe making machines.

On Feb. 1, 1958, Corp. C. offered to exchange its own voting stock for all of
the stock of Corp. M tendered within 9 months. At that time, the per share
fair market value of C stock was $3600 and of M stock was $7,000. Corp. C
offered to exchange 2 of its shares for one of Corp. M. Stockholders A and B
of Corp. M surrendered all of their shares in exchange for Corp. C stock.
Stockholder D declined to trade.

6. As of this point - indicate
   (a) The number of shares and percentage of Corp. M stock outstanding now held
      by Corp. C.
   (b) Gain or loss to Corp. C, if any.
   (c) Gain or loss to Shareholders A and B
   (d) Basis of Corp. C stock per share in the hands of A and B
   (e) Basis of Corp. M stock now held by Corp. C

G. During 1959, Corp. C, which now owned substantially all the outstanding stock
of Corp. M (the 10 shares held by the latecomer and dissenter, D, being the only
exception) decided, and a formal resolution was adopted to that effect, that it
would be better to have one corporation rather than two. In order to do this
it wanted to liquidate Corp. M completely and quickly, and transfer all of the
assets into the corporate structure of Corp. C. This it did during the month
of May 1959.

On the date of the liquidation, Corp. M's net assets were as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Adj. Basis</th>
<th>Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash or equivalent</td>
<td>$150,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Land (Plant site)</td>
<td>$5,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Building (Factory)</td>
<td>$30,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Warehouse</td>
<td>$90,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Machinery</td>
<td>$100,000</td>
<td>$285,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$375,000</td>
<td>$635,000</td>
</tr>
</tbody>
</table>

Included in these assets were accumulated earnings and profits available
for dividends of $120,000.
Upon liquidation the 10 shares of Corp. M held by the minority stockholder D were redeemed and cancelled. Cash in the amount of $83,500 was paid to him (for his basis, see your answer at 4(c)).

All remaining assets were transferred to Corp. C and all stock held by Corp. C in Corp. M was cancelled.

7. At this point - indicate
(a) Gain or loss, amount and kind, if any, to D
(b) Gain or loss, if any, to Corp. M
(c) Gain or loss, if any, to Corp. C
(d) Basis of each transferred asset in the hands of Corp. C
(e) Nature of the effect, if any, on Corp. C's stockholders, other than stockholders A and B who are now also owners of Corp. C stock.