Advanced Income Taxation: Final Examination (June 1, 1961)

William & Mary Law School
A. Background-

1. What is the policy, or other, explanation for the non-recognition of gain or loss in each of the following situations: I.R.C. secs. 112; 301(3)(B); 305(a); 311(a); 332(a); 336; 337(a); 351(a); 354(a); 355(c); 361(a); 721; 731(a) and (b); 1031(a); 1032; 1033(a)(1); and 1036(a).

2. When one "property" is permitted to be exchanged for another "property" with non-recognition of gain or loss, and so-called "boot" is also received (or given) to even up the transaction the general rule is to recognize the gain to the extent of the boot. However, there are many variations and refinements in the formula. Please indicate why the formula is written as it is in the following I.R.C. sections: 351(b); 356(a)(1)(B) and 356(a)(2).

3. When one "property" is permitted to be exchanged for another "property" with non-recognition of gain or loss, the general rule is to assign to the basis of the property received the basis of the property given up plus any gain recognized and minus any loss recognized. However, there are many variations and refinements in this rule. Please indicate why the rule is written as it is in the following I.R.C. sections: secs. 334(c); 358(a); 362(a) and (b).

4. What is the reason for making the distinction that appears in sub-paragraphs (A) and (B) of sec. 301(b)(1)?

5. Why does the law include the parenthetical phrase (but not below zero) in sec. 301(b)(2)?

6. What is the purpose of the words, "substantially disproportionate" in sec. 302(b)(2)?

7. What is the meaning and purpose of sec. 312(b)(1)(B)(ii)?

8. How does one justify the taxation of distributions paid by corporations from earnings and profits derived from "tax-exempt interest." Compare this with similar distributions by partnerships and Subchapter S corporations.

9. At what, and why, is sec. 306(c)(1)(A) aimed?

10. What is the reason for and purpose of secs. 341 and 751?

B. Contributions to capital.

Individual A owns an acre of land for which he paid $10,000 in 1950. On July 1, 1960, its fair market value was $25,000. On July 1, 1959, he borrowed $15,000 on the land giving a mortgage on it for this amount.

What is the tax effect of each of the following types of transfers in terms of (a) gain or loss, (b) recognized gain or loss, and (c) basis of the properties exchanged, to the transferor and transferee if in each case the mortgage was assumed by the transferee?

1. On July 1, 1960, Individual A transferred the land on his books from his name to a sole proprietorship which he owned and operated in the name of B Parking Lot.

2. On July 1, 1960, Individual A transferred the title to the land from his name to a newly formed two man equal partnership known as the C Parking Lot, in exchange for half interest in the partnership.
3. On July 1, 1960, Individual A transferred the title to the land from his name to a newly formed corporation known as the D Parking Lot, Inc., in exchange for 100% of the stock with a fair market value of $10,000.

4. On July 1, 1960, Individual A transferred the title to an old established corporation known as the E Parking Lot, Inc. The E Parking Lot needed to expand and acquired the land from Individual A as his contribution to capital in exchange for 10% of the stock which was authorized but not previously issued. The fair market value of the stock was $10,000.

C. Tax on Incomes.

During the first year of operations following each of the transfers referred to in B above-

1. B Parking Lot realized a net profit for tax purposes of $10,000. The owner, Individual A, had no other income. He was single, no dependents, under 65 years of age and used the standard deduction. What is his Federal income tax liability?

2. C Parking Lot realized a net profit for tax purposes of $20,000. Assuming the same factors for Ind. A above, what is his tax liability?

3. D Parking Lot realized a net profit for tax purposes of $10,000. After paying its corporate income tax, it distributed the remainder of the profits to Individual A (above). Assuming the same factors for Ind. A above, what is his tax liability?

D. Earnings and Profits.

1. In the first year of its existence, Corp. X, had the following receipts and expenses. What is its taxable income and the amount of its earnings and profits available for dividends (after the tax on the taxable income computed by you)?

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross profit from sales</td>
<td>$60,000</td>
</tr>
<tr>
<td>Tax exempt interest</td>
<td>100</td>
</tr>
<tr>
<td>Dividends from domestic corporations</td>
<td>200</td>
</tr>
<tr>
<td>Dividends from foreign corporations</td>
<td>200</td>
</tr>
<tr>
<td>Gains from the sale of stock (cap. asset)</td>
<td>1,000</td>
</tr>
<tr>
<td>Loss from the sale of stocks (cap. asset)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Operating expenses-allowable deductions</td>
<td>30,000</td>
</tr>
<tr>
<td>Depletion-Percentage-$500, Cost</td>
<td>100</td>
</tr>
<tr>
<td>Net loss deduction</td>
<td>1,500</td>
</tr>
<tr>
<td>State property taxes</td>
<td>300</td>
</tr>
<tr>
<td>Cash dividends distributed</td>
<td>6,000</td>
</tr>
</tbody>
</table>

2. At the end of the taxable year, Corp. W's earnings and profits, before adjustment for distributions during the taxable year, were $50,000. During the year it made distributions to its stockholders as follows: Cash, $10,000; the corporation's own 10 year 4% bonds in the principal amount of $5000, which had a fair market value upon distribution of $1,750; and $10,000 principal amount of bonds of another corporation, with an adjusted basis in the hands of the W Corp. of $8500, which upon distribution had a fair market value of $9100. The distributions were not subject to any indebtedness. Show the adjustments to the earnings and profits of the W Corp. on account of the distributions.
2. **Distributions**

What are the tax effects in terms of rules only - no computations - from the standpoint of the distributor and distributee under the following circumstances:

1. On July 1, 1960, Individual M, withdrew from his sole proprietorship one-half of his fifo valued inventory goods with a basis of $10000 and a fair market value of $15000, and gave them to his son to set up a sole proprietorship of his own.

2. On July 1, 1960, Individual M., a partner whose share in the fifo valued inventory assets of his partnership had a basis of $20000 and a value of $30000, withdrew from his share of inventory, goods with a basis of $10000 and a value of $15000, and gave them to his son to set up a sole proprietorship of his own.

3. On July 1, 1960, Ind. M., a 50% stockholder in a Subchapter S. Corp., received as a distribution fifo valued inventory with a basis to the company of $10000 and a value of $15000. The company had no accumulated earnings and profits at the beginning of the year nor any previously taxed income. The current year taxable income was $50000. The basis of the stock in the hands of the 50% stockholder at time of the distribution was $40000.

4. Assume the same facts as in 3 above, except the distributor was a regular taxable corporation rather than a subchapter S corporation.

F. **Capital Changes**

1. Corporation A transfers 25% of its voting stock to Corporation B in exchange for one-half of B's properties. Neither B nor B's stockholders controlled Corp. A after the transfer. B distributes the A stock to its (B's) stockholders. B is not liquidated. Is any gain taxable to the B Corp.? To the B stockholders?

2. Corporation A has been engaged in mining and manufacturing for 20 years. Its stock is held by three individuals, X, Y, and Z, in the following proportions: X - 40%; Y - 30%; and Z - 30%. Two new corporations - B and C - are organized to continue these two businesses. Corp. A transfers all of its manufacturing assets to Corp. B in exchange for all of B's stock and transfers all of its mining assets to C in exchange for all of C's stock. X surrenders his A stock for all of the B stock. X and Y surrender all of their A stock, and each receives 50% of the C stock. Corp. A is then liquidated. Will any gain be recognized to X, Y, or Z?

3. Corp. X transfers 85% of its assets to Corp. Y for 50% of Y's voting stock. Simultaneously X transfers its remaining assets to Y for bonds worth $150000. X then distributes both the Y stock and the Y bonds to its (X's) stockholders in liquidation. X's earnings and profits are in excess of $150000 at this time. (a) Will any gain be taxable to X on the transfer of its property? (b) Will the distribution of Y stock or Y bonds result in taxable income to the X stockholders?