1963

Advanced Income Taxation: Final Examination (May 29, 1963)

William & Mary Law School

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1. Non-liquidating distributions-

Case 1. A non-inventory property distribution to stockholders where the earnings and profits are $50,000; the property distributed has a basis to the corporation of $5000 and a value of $10,000; and the corporation has two equal stockholders, one an individual and the other a corporation; the distribution has the following tax effects:

(a) The distributing corporation realizes no gain or loss
(b) Earnings and profits are reduced by $5000
(c) The Individual stockholder has a recognized dividend of $5000
(d) The Individual stockholder assigns a basis of $5000 to the property received
(e) The Corp. stockholder has a recognized dividend of $2500
(f) The Corp. stockholder assigns a basis of $2500 to the property received

Logically - (a) is true because it writes down its stockholder ownership by only the adjusted cost of the property distributed, namely its adjusted basis; (b) is true for the same reason; (c) is true because he is the ultimate recipient of income in kind which includes unrealized appreciation which if not recognized simultaneously with the "event" of transfer to him by the Corporation would permit capital gain treatment to be accorded a large share of corporate earnings distributed in the form of property; (d) is true because the individual's correct basis should include the total amount on which he is taxed; (e) is true because the corporate stockholder is not the ultimate recipient but merely a conduit; and (f) is true for the same reason.

In the following cases, to the extent appropriate, please show the tax effects along the lines indicated in the answers in (a), (b), (c), (d), (e), and (f) of Case 1, above; and, indicate briefly the logic for any variation from that applicable to Case 1. (Please confine any explanation of reasons for the tax effect listed to items that vary from Case 1)

Case 2. The facts are the same as Case 1, except the property is subject to a liability of $9500 passed on to the stockholders.

Case 3. The facts are the same as Case 1, except the property is subject to a mortgage of $1000 passed on to the stockholders.

Case 4. Earnings and profits are $50,000, two equal stockholders, Ind. A and Corp. B. Inventory property distributed carried by the Company on a Lifo basis of $6000; Fifo basis $7000; market value $8000; subject to a liability of $500.

Case 5. Earnings and profits are $50,000, two equal stockholders, Ind. A and Corp. B. Company bonds distributed, principal amount $2000, value $1900 (No recapitalization involved)
Case 6. Earnings and profits are $50,000, two equal stockholders, Ind. A and Corp. B. Company common stock, with election to take cash instead - which neither stockholder elected to do; one share to each stockholder, value of each share on date of dividend declaration $9, on date of distribution, $10.

Case 7. Earnings and profits are $50,000, two equal stockholders, Ind. A and Corp B. Individual stockholder A purchased non-inventory property from his company for $10 which had a basis to the Company of $15 and a value of $25. Corporate stockholder B did likewise.

Case 8. Earnings and profits of $100 as of Nov. 1, 1962, two equal stockholders, Ind. A and Corp. B. On Nov. 1, 1962, the Company distributed 100 shares (50 to each stockholder) of its common stock in discharge of preference dividend arrearages for 1959. As of Nov. 1, 1962, the stock had a fair market value of $15 per share. The allocated basis of the stock was $2 per share in the hands of each stockholder. On January 31, 1963, the Company redeemed the 100 shares for $15 a share. The Company’s earnings and profits at time of redemption had risen to $25000.

2. Corporate division-

(a) Please indicate the tax effect on Ind. A (a 10% stockholder in Corp. X) of the receipt by him of Corp. Y stock under the following circumstances:

In 1955, Corp. X acquired by purchase 90% of the stock of Corp. Y. In 1963, Corp. X acquired by purchase another 5% of the stock of Corp. Y. Corp. X and Corp. Y are separate operating businesses even though Y is controlled by X, from the standpoint of stock ownership. In 1963, after acquiring the added 5% of Y stock, Corp. X decides to "spin-off" all the stock of Corp. Y which it holds. Thus the stock of Corp. Y is transferred pro rata to all holders of Corp. X stock. Ind. A's ownership of X stock consists of 36 shares for which he has a basis of $5 a share and with a value of $10. Ind. A's pro rata share of the spun-off Y stock amounts to 19 shares. 18 of these shares came from the lot purchased by Corp. X in 1955 and 1 came from the lot purchased in 1963. The basis of the Y stock held by X at the time of the spin-off was $8 a share and its value was $10 a share. Assume no tax avoidance motives.

(b) Example 4 of Regs. 1.358-2(c) is designed to illustrate the results of certain basic rules. Read this example carefully and list all the "rules" that underlie the results brought out in this example.

3. Reorganization

The stated objectives of the operating and definition sections of Subchapter C is to permit technical "sales and exchanges" to take place without immediate recognition of gains and losses where substantially the same economic interests continue to carry on a business activity in a somewhat different form or, to some extent, different in nature

Unlimited freedom in this respect would be subject to much abuse from a conceptual standpoint. Accordingly, limiting rules are provided, such as, the denial of loss carry-overs where there has been a substantial change in ownership; and, the limitations of sec. 355 are made applicable to reorganizations of Type D, and to Type C, if like D.
3. Reorganizations (continued)

Thus, if you were attempting to warn someone regarding the pit-falls and limitations of the tax free exchange opportunities as defined by sec. 368, what items would you bring to his attention?

4. Tax differentials stemming from unlike business operations -

The method of Federal income taxation of incorporated manufacturing enterprises cannot be made to fit farm co-ops, banks, etc., neither do the rules for taxing a large manufacturing enterprise necessarily fit a small one. Accordingly, many specially tailored methods and rules have been provided by way of accommodating the tax law to American business.

What stands out in your mind as the most significant specially tailored provisions of tax law applicable to business enterprise? (In identifying these provisions, please indicate briefly their general nature and the justification for them)