

Case 36C Issues & Legal Authority

1. What are the Federal income tax consequences to
A. Speculation Corp. B. Wise Corp. C. Mr. Glynn D. Ms. Carillo E. Ms. Schlinger
of a \$10,000 cash dividend for each share of stock?
2. What are the financial management consequences of paying the \$10,000 per share?
3. What are the Federal income tax consequences to A, B, C, D & E if B & C receive the
\$10,000 cash per share and D
& E each receive an undivided half interest in one of the apartment buildings?
4. Which apartment building would be better for minimizing Federal income taxes on the
income from the apartments?
5. What would be Ms. Carillo's and Ms. Schlinger's basis in the one-half interest in the
apartment building?
6. From a Federal income tax point of view, what type of property would the apartment
building be to Ms. Carillo and
Ms Schlinger?

Legal authority: Secs. 162, 167, 168, 212, 246, 301, 311, 312, 316, 317, 1221, 1231, 1245 & 1250

PROBLEM 36C

Janice Carillo and Ruth Schlinger formed Speculation Corporation (Speculation) ten years ago. At present they each own 30% of the stock of Speculation (30 shares each), Wise Investments, Inc. (Wise) owns 35% of the stock (35 shares), and the balance (5% or five shares) is owned by Thomas Glynn. Both Wise and Thomas acquired their interests four years ago by purchase from Janice and Ruth. The adjusted basis in the stock owned by each of Speculation's owners is shown in the parentheses which follow his or her name: (1) Janice (\$180,000); (2) Ruth (\$240,000); (3) Wise (\$700,000); and (4) Thomas (\$100,000).

Speculation is currently involved in the operation of an intra-city express mail service and the ownership and rental of real estate. The net worth of the corporation is presently about \$4,800,000. Approximately one-half of its assets are dedicated to the operation of the express mail service. One-quarter of its assets consist of two apartment houses, Regency Park and Lindell Manor, which constitute the corporation's real estate operations. The remainder of the corporation's assets consists of \$1,200,000 in cash and certificates of deposit. Speculation has a deficit in accumulated earnings and profits of \$160,000. It currently has a net loss of \$20,000 half-way through its tax year, and, in the absence of the distributions proposed below, it would be expected to finish the year with a deficit in current earnings and profits of \$40,000.

Regency Park is rented to Geriatrics, Inc. on a net lease basis for use as a senior citizens' residence. The lease, which has nine years until expiration, was entered into last year as part of a restructuring of the real estate operations of Speculation. It obligates Geriatrics, Inc. to pay all operating expenses and real estate taxes assessed against the property. Prior to entering into the lease with Geriatrics, Inc., Speculation had operated Regency Park as a traditional, residential apartment house for which it collected the rents and provided basic maintenance services.

Since its opening eight years ago, Lindell Manor, Speculation's other apartment house, has been operated as a luxury apartment structure. Speculation has provided 24 hour doorman service and a 12 hour per day reception service. It also has provided the tenants with package pick up facilities, and contact with commercial housekeeping, dry cleaning and laundry services all of which are provided through Speculation approved independent contractors. There is a modest fitness facility in Lindell Manor

which is available to all tenants and is staffed by a Speculation employee on week-ends and evenings.

Last year, when it became clear that the Lindell Manor units could be operated more profitably as professional offices, Speculation, as units became available through vacancy or at the end of a lease, began to switch units over to professional tenants. Approximately 45% of the units are now commercial providing almost 60% of total rent receipts. The balance of the receipts, approximately 40%, come from the 55% of the units dedicated to residential use. Since the new professional tenants are somewhat upscale and were attracted to Lindell Manor primarily because of its personalized services, Speculation intends to continue providing the same level of personal services currently provided to residential tenants and is also considering expanding the hours in which the fitness facility is staffed to better accommodate the needs of commercial tenants who would use the facility during the lunch hours or in the late afternoon.

Each of Speculation's apartment houses has a fair market value of \$600,000 and an adjusted basis of \$120,000. If sold for their fair market value, it is estimated that Speculation would incur a combined state, local and federal income tax liability of \$180,000 on each apartment house. The buildings are not subject to any liabilities, and each currently produces annual gross rents of almost \$120,000.

Janice, who is president of Speculation, and Ruth, who is its executive vice-president, serve as the corporation's chief operating officers. They seek your advice with respect to the following matter.

Wise, which is in need of liquid assets, has recently been lobbying for payment of a large dividend. Bryan Bromberger, Wise's president, suggested at a Speculation shareholders' meeting that Speculation's Board of Directors pay a dividend of \$10,000 per share. If that would deprive Speculation of too much of its liquid assets, Mr. Bromberger suggested that the Board consider paying Wise and Thomas a cash dividend of \$10,000 per share and distributing to Janice and Ruth an in-kind dividend of a 50% interest in either Regency Park or Lindell Manor. Thomas, who is a shrewd venture capitalist, strongly objected to the proposal for an in-kind dividend. He indicated that although, in this particular case, he would not object to a cash dividend of \$10,000 per share, he generally was opposed to taking his profits out of an investment in the form of a dividend. He preferred to receive his reward in the form of a capital gain when he sold his stock. Mr. Bromberger said that

he could see that the shareholders would be in for a long day if he and Thomas were to thrash out their differences. Prior commitments dictated that the shareholders' meeting end at that moment.

Janice and Ruth, who are highly skilled entrepreneurs but have only a fundamental knowledge of tax law, seek your advice in preparing for a resumption of the shareholders' meeting next week. Please advise them as to the basic tax considerations which are driving the positions of Bryan and Thomas and the tax consequences of each of the proposals. In addition, please consider whether it would be "cheaper" in a tax sense to meet Wise's cash needs by Speculation making an interest free loan of \$10,000 to it.