CHAPTER 2

CORPORATIONS: INTRODUCTION AND OPERATING RULES

Instructor: The test items in both the print Test Bank and ExamView test-creation software are numbered by question type within each chapter. Thus, users of ExamView can more easily preview their selections using the printed Test Bank in the same numbering system.

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
	TRUE OR FALSE		
1	Sole proprietorship taxation	New	
2	Partnership taxation	Unchanged	2
3	S corporation taxation	Unchanged	3
4	Corporate tax versus partnership tax	Modified	4
5	C corporation taxation: double taxation effect	Modified	5
6	S corporation: capital loss pass through	Unchanged	6
7	C corporation reasonable compensation	Unchanged	7
8	Unreasonable compensation	Unchanged	8
9	Salary versus dividend	Unchanged	9
10	Corporate tax computation	Modified	10
11	Corporate tax rates versus individual rates	New	
12	Nontax considerations in entity selection	New	
13	Classification for Federal taxation: single-member LLC	New	
14	Accounting periods: fiscal year limitation for PSC	New	
15	Accounting methods: inventories	Unchanged	14
16	Accounting methods: accrual basis corporation and cash basis related party	Unchanged	15
17	Corporate tax on LTCG	Modified	16
18	Corporation’s capital loss	Modified	17
19	Passive loss rules: closely held C corporations and PSCs contrasted	Unchanged	19
20	Passive loss rules: closely held corporation	Modified	20
21	Charitable contributions: accrual corporation exception	Unchanged	21
22	Charitable contributions: capital gain property	Modified	23
23	Charitable contributions: corporate inventory exception	Modified	22

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
24	Charitable contributions: limitation with carryover applied	Unchanged	24
25	Domestic production activities deduction	New	
26	NOL carryover	Unchanged	26
27	Dividends received deduction	Unchanged	27
28	Dividends received deduction	Modified	29
29	Dividends received deduction: holding period requirement	New	
30	Organizational expenditures: cash basis corporation	Unchanged	30
31	Personal service corporation rates	Modified	31
32	Tax liability of related corporations	Unchanged	32
33	Form 1120: requirements	New	
34	Schedule M-1	Unchanged	33
35	Schedule M-1: tax-exempt income	Modified	37
36	Schedule M-1: nondeductible expense	Modified	38
37	Schedule M-1: tax-exempt income	Unchanged	39
38	Schedule M-1: net capital loss	Unchanged	40
39	Schedule M-1: interest on loan to purchase tax-exempt bonds	Modified	41
40	Schedule M-3: voluntary filing	Unchanged	34
41	Financial accounting considerations: FAS 109 deferred asset defined	New	
42	Financial accounting considerations: FIN 48	New	

MULTIPLE CHOICE

1	Corporate tax versus proprietorship tax	New	
2	Corporate tax versus S corporation tax	Unchanged	2
3	S corporation tax versus proprietorship tax	Unchanged	3
4	Proprietorship tax: LTCL	Unchanged	4
5	Corporate versus proprietorship: LTCG rates	Unchanged	5
6	Partnership tax: ordinary income and LTCG	Modified	7
7	Corporate taxable income: net capital loss	Unchanged	9
8	Taxation of dividends	Modified	10
9	LLC taxation	Modified	11
10	Accounting periods: PSC, fiscal year salary required	Modified	13
11	Accounting periods: PSC, fiscal year salary required	Unchanged	14
12	Accounting methods: cash method limitation for corporations	Modified	12
13	Accounting methods: accrual method corporation and cash method related party	Unchanged	22
14	Capital gains and losses: corporate loss carryover	Modified	16
15	Capital gains and losses: corporate taxable income	Unchanged	17
16	Passive losses: personal service corporation	Unchanged	18
17	Passive losses: personal service corporation	Modified	19
18	Passive losses: closely held corporation	Modified	20
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Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
20	Charitable contributions: inventory, loss property, capital gain property	Modified	23
21	Charitable contributions: limitation	Modified	24
22	Domestic production activities deduction	Unchanged	25
23	Net operating loss: when to forgo carryback	Unchanged	26
24	Dividends received deduction: percentage of ownership	Modified	27
25	Dividends received deduction: computation	Modified	28
26	Dividends received deduction: percentage of ownership	Modified	29
27	Dividends received deduction: percentage of ownership	Unchanged	30
28	Organizational expenses	Modified	31
29	Corporate tax liability: computing with net capital gain	New	
30	Corporate tax provisions: miscellaneous rules	New	
31	Corporate tax provisions: miscellaneous rules	New	
32	Schedule M-1 additions	Unchanged	32
33	Schedule M-1 subtractions	Unchanged	33

PROBLEMS

1	Compare tax treatment for corporation, S corporation, and partnership	Unchanged	1
2	Compare tax treatment for corporation and proprietorship: dividends versus salary	Modified	2
3	Compare tax treatment for corporation and proprietorship: dividends versus withdrawals	Unchanged	3
4	Net capital loss: corporation versus proprietorship	Modified	4
5	PSC: fiscal year required salary payments; tax liability	Modified	6
6	Corporate charitable deduction: effect of dividends received deduction	Unchanged	9
7	Corporate charitable deduction: limitation with carryover from prior year	New	
8	Corporate NOL: applicability of dividends received deduction	Unchanged	10
9	Dividends received deduction: taxable income limitation and NOL exception	Unchanged	11
10	Dividends received deduction: taxable income limitation and NOL exception	Unchanged	12
11	Corporate tax computation	Unchanged	14
12	Schedule M-1	Modified	13
13	FIN 48: determining tax positions	New	

ESSAY

1	Entity choice: tax and nontax factors	Unchanged	1
2	Proprietorship net income	Unchanged	2

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
3	Unreasonable compensation	Unchanged	4
4	Salary versus dividend to shareholder-employee	Unchanged	5
5	Corporation versus proprietorship: tax and nontax differences	New	
6	LLC versus proprietorship: advantages and "check-the-box" regulations	New	
7	Fiscal year election for corporation and PSC	Unchanged	6
8	Fiscal year of PSC: reason for limitation	Unchanged	7
9	Accounting methods: accrual method corporation and cash basis related party	Unchanged	9
10	Incorporating a proprietorship: identifying relevant issues	Unchanged	11
11	Accounting methods: cash method small corporation exception	Modified	13
12	Corporate contribution deduction: accrual of	Unchanged	14
13	Dividends received deduction: related corporations	Unchanged	18
14	Corporate organizational expenditures and start-up expenditures	Unchanged	16
15	Tax liability of related corporations	Unchanged	17
16	Schedule M-1 reconciliation	Unchanged	15
17	Financial accounting considerations: FAS 109	New	

TRUE/FALSE

1. An individual who owns a proprietorship must report profit from the proprietorship on his/her Federal income tax return.

   ANS: T
   A sole proprietorship is not a taxable entity separate from the individual who owns the proprietorship. The owner of a proprietorship reports transactions of the business on Schedule C of his or her individual tax return.

   PTS: 1 REF: Example 1

2. Herman and Henry are equal partners in Badger Enterprises, a calendar year partnership. During the year, Badger Enterprises had $305,000 gross income and $230,000 operating expenses. Badger distributed $20,000 to each of the partners. Herman and Henry each must report $37,500 of income from the partnership.

   ANS: T
   The partnership is not a taxpaying entity. Its profit (loss) and separate items flow through to the partners. The partnership's Form 1065 reports net profit of $75,000 ($305,000 income – $230,000 expenses). Herman and Henry both receive a Schedule K-1 reporting net profit of $37,500. Each partner reports net profit of $37,500 on his own return.

   PTS: 1 REF: Example 2

3. Robin is a 50% shareholder in Robin-Wren, an S corporation. Robin-Wren earned net income of $100,000 during the year, and Robin received a distribution of $35,000 from the corporation. Robin must report a $35,000 dividend on his individual Federal income tax return (Form 1040).

   ANS: F
   The shareholders of an S corporation report their shares of the entity's net income or loss, regardless of how much of the income was withdrawn from the corporation. Robin must report income of $50,000.

   PTS: 1 REF: p. 2-3

4. Jeff owns a 30% interest in a partnership that earned $100,000 in the current year. He also owns 30% of the stock in a C corporation that earned $100,000 during the year. The corporation did not make any distributions, and the partnership distributed $20,000 to him. Jeff must report $30,000 of income on his individual tax return.

   ANS: T
   Jeff must report his $30,000 (30% × $100,000) share of the partnership's income on his individual tax return. The C corporation's income is not taxed to Jeff until it is distributed to him. The $20,000 partnership distribution does not affect his income.

   PTS: 1 REF: p. 2-3 | p. 2-4

5. Quail Corporation is a C corporation with net income of $500,000 during 2008. If Quail paid dividends of $70,000 to its shareholders, the corporation must pay tax on $430,000 of net income. Shareholders must report the $70,000 of dividends as income.

   ANS: F
   Quail Corporation must pay tax on the $500,000 of corporate net income. Dividends paid are not deductible by the corporation. Shareholders must pay tax on the $70,000 of dividends received from the corporation. This is commonly referred to as double taxation.

   PTS: 1 REF: Example 3

6. Coyote Enterprises, an S corporation, had a capital loss of $50,000 during the year. Gerald, who owns 40% of Coyote's stock, may report $20,000 of Coyote's capital loss on his individual Federal income tax return (Form 1040).

   ANS: T
   Capital losses of an S corporation pass through from the entity to the shareholders.

   PTS: 1 REF: p. 2-3

7. Emma, the sole shareholder of Quail Corporation (a C corporation), has the corporation pay her a salary of $300,000 in 2008. The Tax Court has held that $80,000 represents unreasonable compensation. Assuming Emma is in the 35% bracket in 2008, the Tax Court's holding will reduce the total tax she pays in 2008.

   ANS: T
   To the extent a salary payment is not considered reasonable, the payment is treated as a dividend, which is generally taxed at a maximum rate of 15%. The Tax Court's holding saves Emma $16,000 [$80,000 × (35% – 15%)].

   PTS: 1 REF: p. 2-4

8. Compensation that is determined to be unreasonable is usually treated as a constructive dividend to the shareholder and is not deductible by the corporation.

   ANS: T
   Unreasonable compensation is treated as a constructive dividend to the shareholder and is not deductible by the corporation.

   PTS: 1 REF: p. 2-4

9. Lou, an employee and sole shareholder of Amarillo Corporation, a C corporation, has the corporation pay him $175,000. Lou is in the 35% tax bracket. His income tax will be the same, regardless of whether Amarillo treats the payments as a dividend or as salary.

   ANS: F
   Lou must pay tax on his salary at his marginal rate of 35%, while dividends are generally taxed at a 15% rate.

PTS: 1 REF: p. 2-4

10. Thrush Corporation files Form 1120, which reports taxable income of $200,000. The corporation's tax is $56,250.

ANS: F
The tax is equal to $61,250 [($50,000 × 15%) + ($25,000 × 25%) + ($25,000 × 34%) + ($100,000 × 39%)].

PTS: 1 REF: Exhibit 2-1

11. The corporate marginal tax rates range from 10% to 35%, while the individual marginal tax rates range from 15% to 39%.

ANS: F
The opposite is the case: the corporate marginal tax rates range from 15% to 39%, and the individual marginal tax rates range from 10% to 35%.

PTS: 1 REF: p. 2-5

12. Nontax considerations in the selection of business form include limited liability, free transferability of ownership interests, continuity of life, and centralized management.

ANS: T PTS: 1 REF: p. 2-6

13. Under the "check-the-box" Regulations, a single-member LLC that fails to elect to be to treated as a corporation will be taxed as a partnership.

ANS: F
Sole proprietorship, not corporation, is the default classification for a single-member LLC that does not elect to be treated as a corporation under the "check-the-box" Regulations.

PTS: 1 REF: p. 2-8

14. All corporations are allowed to choose a calendar year or a fiscal year for Federal tax reporting purposes.

ANS: F
There are limitations on the use of a fiscal year in the case of personal service corporations and S corporations. Such entities generally must use the calendar year as their reporting period, but several exceptions to this rule apply (e.g., business purpose for fiscal year).

PTS: 1 REF: p. 2-9 | p. 2-10

15. In general, corporations that maintain inventory for sale to customers may use either the cash or accrual method of accounting for determining sales and cost of goods sold.

ANS: F
As a general rule, corporations that maintain inventory for sale to customers are required to use the *accrual* method of accounting for determining sales and cost of goods sold. The cash method may be used for other income and expense items.

PTS: 1 REF: p. 2-11

16. On December 31, 2008, Lavender, Inc., an accrual basis C corporation, accrues a $90,000 bonus to Barry, its vice president and a 40% shareholder. Lavender pays the bonus to Barry, who is a cash basis taxpayer, on March 15, 2009. Lavender can deduct the bonus in 2008.

    ANS: T
    Lavender is allowed a deduction in 2008 because Barry is not a related party (more than 50% shareholder).

    PTS: 1 REF: Example 12

17. In 2008, Fox Corporation had taxable income of $100,000, which included a long-term capital gain of $30,000. The maximum amount of tax applicable to the capital gain is $4,500 ($30,000 × 15%).

    ANS: F
    While the maximum rate on long-term capital gains of individuals is limited to 15%, there is no maximum rate applicable to long-term capital gains of C corporations.

    PTS: 1 REF: p. 2-12

18. Albatross, a C corporation, had $200,000 net income from operations and a $25,000 short-term capital loss in 2008. Albatross Corporation's taxable income is $200,000.

    ANS: T
    A corporation cannot deduct a net capital loss in the year incurred. For corporations, a net capital loss must be carried back three years or forward five years and be offset against capital gains in the carryback/forward years.

    PTS: 1 REF: p. 2-12

19. The passive loss rules apply more favorably to closely held C corporations than to personal service corporations (PSCs).

    ANS: T
    The passive loss rules prohibit PSCs from offsetting passive losses against either active or portfolio income. Closely held corporations, however, may offset passive losses against active income.

    A corporation is closely held if, at any time during the taxable year, more than 50% of the value of the corporation's outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

    PTS: 1 REF: Example 15

20. Peach Corporation had $135,000 of active income, $180,000 of portfolio income, and a $155,000 passive loss during the year. If Peach is a closely held C corporation that is not a PSC, it can deduct the $155,000 passive loss.

    ANS: F
    If Peach is a closely held corporation, the passive loss is deductible to the extent of the corporation's active income, or $135,000.

PTS: 1 REF: Example 15

21. On December 30, 2008, Debbie, a sole proprietor, pledged to make a $10,000 charitable contribution on or before January 15, 2009. Green Corporation, an accrual basis corporation, made a similar pledge on the same date, and the contribution was authorized by Green's board of directors. Debbie and Green Corporation, both calendar year taxpayers, can deduct these contributions in 2008.

ANS: F
Individuals cannot deduct contributions until they are actually made. Therefore, Debbie must wait until 2009 to deduct the contribution, assuming she honors the pledge. Green Corporation, whose board of directors authorized the contribution in 2008, can deduct the contribution in 2008, assuming the pledge is paid on or before March 15, 2008.

PTS: 1 REF: Example 16

22. On April 8, 2008, Oriole Corporation donated a painting worth $150,000 to the Texas Art Museum, a qualified public charity. The museum included the painting in its permanent collection. Oriole Corporation purchased the painting 5 years ago for $75,000. Oriole's charitable contribution deduction is $150,000 (ignoring the taxable income limitation).

ANS: T
The painting is capital gain property which the museum puts to a use that is related to its exempt function. Thus, the amount of the deduction is equal to the fair market value of the painting, or $150,000.

PTS: 1 REF: Example 17

23. Zircon Corporation donated scientific property worth $350,000 to City University (a qualified charitable organization) to be used in research. The basis of the property was $100,000, and Zircon had held it for ten months as inventory. Zircon Corporation may deduct $225,000 as a charitable contribution (ignoring the taxable income limitation).

ANS: F
The scientific property is ordinary income property but it qualifies for the increased deduction amount available for certain corporate contributions of inventory. As such, the amount of the deduction is equal to the lesser of (1) the sum of inventory's basis plus 50% of the appreciation on the property [$225,000 = $100,000 + 50%($350,000 – $100,000)] or (2) twice the basis [$200,000 = $100,000 × 2]. In this case, the ceiling applies, and the deduction amount is $200,000.

PTS: 1 REF: Example 20

24. Egret Corporation, a calendar year taxpayer, had an excess charitable contribution for 2007 of $10,000. In 2008, it made a further charitable contribution of $14,000. Its 2008 deduction is limited to $16,000. In applying the 10% limitation, the $10,000 carryover must be used after the current year contribution.

ANS: T
The current (2008) contribution must be used first and the carryover (2007) used last.

PTS: 1 REF: Example 22

25. For a corporation, the domestic production activities deduction is equal to 6% of the lower of (1) qualified production activities income or (2) taxable income. However, the deduction cannot exceed the W-2 wages related to qualified production activities income.

    ANS: F
    The deduction cannot exceed 50% of the W-2 wages related to qualified production activities income.

    PTS: 1 REF: Example 23

26. A corporate net operating loss can be carried back 3 years and forward 5 years to offset taxable income for those years.

    ANS: F
    A corporate net operating loss can be carried back 2 years and forward 20 years to offset taxable income for those years.

    PTS: 1 REF: p. 2-16

27. Bass Corporation received a dividend of $80,000 from Trout Corporation. Bass owns 15% of the Trout Corporation stock. Assuming it is not subject to the taxable income limitation, Bass's dividends received deduction is $64,000.

    ANS: F
    The deduction percentage for less than 20% ownership is 70%. The dividends received deduction would be $56,000 ($80,000 × 70%).

    PTS: 1 REF: p. 2-17

28. Bluebird Corporation received a $200,000 dividend from Canary Corporation. Bluebird, which owns 80% of Canary Corporation, may take a dividends received deduction of $200,000.

    ANS: T
    The allowable dividends received deduction for a corporation that owns 80% or more of the dividend-paying corporation is 100%. Therefore, Bluebird can take a dividends received deduction of $200,000.

    PTS: 1 REF: p. 2-17

29. No dividends received deduction is allowed unless the corporation has held the stock for more than 60 days.

    ANS: F
    The corporation must hold the stock for more than 45 days in order to qualify for the dividends received deduction.

    PTS: 1 REF: Example 26

30. A cash basis corporation that incurs (but does not pay) qualifying organizational expenditures in its first year of operations may include such expenses in the 180-month amortization period.

    ANS: T
    As long as they are *incurred*, such expenses do not have to be paid in the first year.

    PTS: 1 REF: p. 2-19

31. A personal service corporation with taxable income of $100,000 will have a tax liability of $22,250.

    ANS: F
    A personal service corporation is subject to the 35% rate on all taxable income; thus, the tax liability is $35,000.

    PTS: 1 REF: p. 2-20

32. Ed, an individual, incorporates two separate businesses that he owns by establishing two new corporations. Each corporation generates taxable income of $50,000. Each corporation will have a tax liability of $7,500.

    ANS: F
    Since the corporations would be a controlled group, their taxable income would be combined in applying the corporate income tax rates. The tax on $100,000 would be $22,250, or $11,125 tax for each corporation.

    PTS: 1 REF: p. 2-21

33. A corporation with no taxable income need not file a Form 1120.

    ANS: F
    No such exemption exists.

    PTS: 1 REF: p. 2-22

34. Schedule M-1 is used to reconcile net income as computed for financial accounting purposes with taxable income reported on the corporation's income tax return.

    ANS: T PTS: 1 REF: p. 2-23

35. Income that is included in net income per books but not included in taxable income is a subtraction item on Schedule M-1.

    ANS: T PTS: 1 REF: p. 2-23

36. An expense that is deducted in computing net income per books but not deductible in computing taxable income is a subtraction item on Schedule M-1.

    ANS: F
    An expense that is deducted in computing net income per books but not deductible in computing taxable income is an addition item on Schedule M-1.

    PTS: 1 REF: p. 2-23

37. Macayo, Inc., received $800,000 life insurance proceeds on the death of its president. The $800,000 will be an addition item on Macayo's Schedule M-1.

    ANS: F
    The $800,000 is treated as a *subtraction*.

    PTS: 1 REF: Example 32

38. Canary Corporation, which sustained a $5,000 net short-term capital loss during the year, will enter $5,000 as an addition on Schedule M-1.

    ANS: T
    A net short-term capital loss is entered as an addition on Schedule M-1. The loss is deductible for book purposes but not for tax purposes. Therefore, the $5,000 capital loss must be *added* in reconciling from book income to taxable income.

    PTS: 1 REF: p. 2-23

39. Aqua, Inc., paid $15,000 interest on a loan to purchase tax-exempt bonds. The $15,000 is a subtraction on Aqua's Schedule M-1.

    ANS: F
    The interest is deductible for book purposes but not for tax purposes; thus, an addition on Schecule M-1 is required.

    PTS: 1 REF: Example 32

40. A corporation that is not required to file Schedule M-3 is permitted to file a Schedule M-3 voluntarily.

    ANS: T
    A corporation may file Schedule M-3 even if it is not required to file the schedule.

    PTS: 1 REF: p. 2-24

41. Under FAS 109, a deferred tax asset results when the book (financial) basis of an item exceeds its tax basis (e.g., MACRS over straight-line depreciation).

    ANS: F
    The definition provided is that of a deferred tax liability. A deferred tax asset results when the book (financial) basis of an item is less than its tax basis (e.g., accrual for product warranty expense).

    PTS: 1 REF: p. 2-27

42. FIN 48 provides that a tax position must be recognized when it has a "more-likely-than-not" probability of being sustained on examination. In this analysis, the statutes of limitation should be considered.

    ANS: T
    In determining the probability of a position being sustained on examination, the statutes of limitation should be taken into account. For example, a tax position which originally does not satisfy the "more-likely-than-not" threshold would satisfy the threshold when the statutes of limitation expire with respect to the return for which the position was claimed.

PTS: 1 REF: p. 2-28

MULTIPLE CHOICE

1. Luis is the sole shareholder of Stork, Inc., a C corporation, and Eduardo owns a sole proprietorship. Both businesses were started in 2008 and make a profit of $80,000 this year. Each owner withdraws $50,000 from his business during the year. Which of the following statements relating to 2008 is *incorrect*?
   a. Eduardo must report $80,000 of net profit on his individual return.
   b. Luis must report dividend income of $80,000.
   c. Eduardo's proprietorship is not subject to an entity (separate) level income tax.
   d. Stork Corporation must pay tax on $80,000.
   e. None of the above.

   ANS: B
   Luis must report dividend income of $50,000, and Stork must pay tax on $80,000. Eduardo must report net profit from his business of $80,000, but the proprietorship is not a taxable entity. Luis is not required to report income from the Stork until he receives a dividend.

   PTS: 1 REF: Example 1 | Example 3

2. Bjorn owns a 40% interest in an S corporation that earned $150,000 in 2008. He also owns 30% of the stock in a C corporation that earned $150,000 during the year. The S corporation distributed $35,000 to Bjorn and the C corporation paid dividends of $35,000 to Bjorn. How much income must Bjorn report from these businesses?
   a. $0 income from the S corporation and $0 income from the C corporation.
   b. $35,000 income from the S corporation and $35,000 income from the C corporation.
   c. $60,000 income from the S corporation and $35,000 of dividend income from the C corporation.
   d. $60,000 income from the S corporation and $0 income from the C corporation.
   e. None of the above.

   ANS: C
   Bjorn must report his $60,000 share ($150,000 × 40%) of the S corporation's income on his individual tax return. He will report $35,000 of dividend income from the C corporation.

   PTS: 1 REF: p. 2-3 | p. 2-4

3. Juan is the sole shareholder of an S corporation, and Diego owns a sole proprietorship. Both businesses, which were started in 2008, make a profit of $300,000 in 2008. Each owner withdraws $225,000 from his business during the year. Which of the following statements is correct?
   a. Diego must report net profit from his business of $300,000 for 2008.
   b. Juan must report dividend income of $300,000 for 2008.
   c. Diego's proprietorship is required to pay tax on the $300,000 profit for 2008.
   d. Juan's S corporation must pay tax on $300,000 for 2008.
   e. None of the above.

   ANS: A
   Juan must report the profit of $300,000 for 2008 (but not as dividend income—see choice b.). The S corporation, which is a flow-through entity, is not required to pay tax on its $300,000 profit. Diego must report net profit from his business of $300,000 for 2008, but the proprietorship is not a taxable entity.

PTS: 1 REF: p. 2-2 to 2-5

4. Norma formed Hyacinth Enterprises, a proprietorship, in 2008. In its first year, Hyacinth had operating income of $150,000 and operating expenses of $100,000. In addition, Hyacinth had a long-term capital loss of $4,000. Norma, the proprietor of Hyacinth Enterprises, withdrew $25,000 from Hyacinth during the year. Assuming Norma has no other capital gains or losses, how does this information affect her taxable income for 2008?
   a. Increases Norma's taxable income by $25,000.
   b. Increases Norma's taxable income by $21,000 ($25,000 income – $4,000 long-term capital loss).
   c. Increases Norma's taxable income by $47,000 ($50,000 income – $3,000 long-term capital loss).
   d. Increases Norma's taxable income by $50,000.
   e. None of the above.

   ANS: C
   A proprietorship is not a separate taxable entity. As a proprietor, Norma reports profit or loss from Hyacinth on her individual return. Norma's taxable income for 2008 will be increased by $47,000 ($150,000 – $100,000 = $50,000 net profit – $3,000 long-term capital loss limit). The $25,000 she withdrew from Hyacinth has no effect on her taxable income.

   PTS: 1 REF: p. 2-2 | p. 2-3 | p. 2-12

5. Geneva, a sole proprietor, sold one of her business assets for a $20,000 long-term capital gain. Geneva's marginal tax rate is 35%. Gulf, a C corporation, sold one of its assets for a $20,000 long-term capital gain. Gulf's marginal tax rate is 35%. What tax rates are applicable to these capital gains?
   a. 15% rate applies to both Geneva and Gulf.
   b. 15% rate applies to Geneva and 35% rate applies to Gulf.
   c. 15% rate applies to Gulf and 35% rate applies to Geneva.
   d. 35% rate applies to both Geneva and Gulf.
   e. None of the above.

   ANS: B
   Geneva reports the long-term capital gain on her individual tax return, and it is subject to a maximum tax rate of 15%. Corporations do not receive special tax treatment for its long-term capital gain. Therefore, Gulf's gain will be taxed at 35%.

   PTS: 1 REF: p. 2-12

6. Glen and Michael are equal partners in Trout Enterprises, a calendar year partnership. During the year, Trout Enterprises had gross income of $500,000 and operating expenses of $270,000. In addition, the partnership sold land that had been held for investment purposes for a long-term capital gain of $120,000. During the year, Glen withdrew $50,000 from the partnership, and Michael withdrew $75,000. Discuss the impact of this information on the taxable income of Trout, Glen, and Michael.
   a. Trout has $0 taxable income, Glen's taxable income increases by $50,000, and Michael's taxable income increases by $75,000.
   b. Trout has $230,000 taxable income, Glen's taxable income increases by $50,000, and Michael's taxable income increases by $75,000.
   c. Trout has $0 taxable income, Glen's taxable income increases by $175,000, and Michael's taxable income increases by $175,000.
   d. Trout has $0 taxable income, Glen's taxable income increases by $115,000, and Michael's taxable income increases by $115,000.
   e. None of the above.

   ANS: C

Trout, a partnership, is not a taxpaying entity. Its profit (loss) and separate items flow through to the partners. The partnership's Form 1065 reports net profit of $230,000 ($500,000 income – $270,000 expenses). The partnership also reports the $120,000 long-term capital gain as a separately stated item on Form 1065. Glen and Michael both receive a Schedule K-1 reporting net profit of $115,000 and separately stated long-term capital gain of $60,000. Each partner reports net profit of $115,000 and long-term capital gain of $60,000 on his own return. The withdrawals do not affect taxable income for the partners but decrease their basis in the partnership.

PTS: 1 REF: Example 2

7. Elk, a C corporation, has $400,000 operating income and $350,000 operating expenses during the year. In addition, Elk has a $30,000 long-term capital gain and a $52,000 short-term capital loss. Elk's taxable income is:
   a. ($2,000).
   b. $28,000.
   c. $50,000.
   d. $80,000.
   e. None of the above.

ANS: C
$400,000 (operating income) – $350,000 (operating expenses) + $30,000 (LTCG) – $30,000 (STCL) = $50,000 taxable income. A corporation cannot deduct a net capital loss in the year incurred. The net loss ($22,000) can be carried back three years and offset against capital gain in the carryback years. If the capital loss is not used in the carryback, it can be carried forward five years. Capital gains of corporations are included in taxable income and are not subject to the favorable rates applicable to individuals.

PTS: 1 REF: p. 2-12

8. Penguin Corporation, a C corporation, has two equal shareholders, Bob and Leo. Penguin earned $100,000 net profit during its first year of operations and paid a dividend of $50,000 to each shareholder. Before considering the dividend, Bob is in the 10% marginal tax bracket and Leo is in the 28% marginal tax bracket. Which of the following statements is incorrect?
   a. $100,000 will be subject to double taxation.
   b. Penguin could have avoided paying corporate tax if, instead of paying a dividend, it had paid Bob and Leo a salary of $50,000 each (assuming a $50,000 salary for each is reasonable).
   c. A preferential tax rate will apply to the dividend income of both Bob and Leo.
   d. If Penguin had paid Bob and Leo a salary of $50,000 each, Bob would have paid less Federal income tax on his salary than Leo would have paid on his salary.
   e. None of the above.

ANS: A
To the extent Bob's dividend income would otherwise be taxed at 10% or 15%, the preferential rate on his dividend is 0%. Thus, Bob will not pay tax on some of his dividend income and, to that extent, not all $100,000 is subject to double taxation.

PTS: 1 REF: p. 2-4

9. Which of the following statements about a limited liability company is correct?
   a. A limited liability company with more than one owner can elect to be classified as either a partnership or a proprietorship.
   b. A limited liability company with only one owner can elect to be classified as either a proprietorship or a corporation.
   c. If a limited liability company does not make an election under the "check-the-box" regulations, multi-owner entities are classified as corporations.
   d. If a limited liability company does not make an election under the "check-the-box" regulations, single-person entities are classified as corporations.
   e. None of the above.

   ANS: B
   Statements a., c., and d. are incorrect.

   PTS: 1 REF: p. 2-7

10. Patrick, an attorney, is the sole shareholder of Gander Corporation. Gander is a PSC with a fiscal year ending October 31. The corporation paid Patrick a salary of $360,000 during its fiscal year ending October 31, 2008. How much salary must Gander pay Patrick during the period November 1 through December 31, 2008, to permit the corporation to continue to use its fiscal year without negative tax effects?
    a. $0.
    b. $30,000.
    c. $60,000.
    d. $120,000.
    e. None of the above.

    ANS: C
    $60,000 ($360,000 × 2/12).

    PTS: 1 REF: Example 11

11. Jason, an architect, is the sole shareholder of Purple Corporation, a PSC. The corporation paid Jason a salary of $180,000 during its fiscal year ending October 31, 2008. How much salary must Purple pay Jason during the period November 1 through December 31, 2008, to permit the corporation to continue to use its fiscal year without negative tax effects?
    a. $0.
    b. $20,000.
    c. $30,000.
    d. $60,000.
    e. None of the above.

    ANS: C
    The salary for the deferral period (November and December) must be at least proportionate to the employee's salary received for the fiscal year. The amount that Purple Corporation must pay Jason during the period November 1 through December 31, 2008, to permit the continued use of its fiscal year without negative tax effects is $30,000 ($180,000 × 2/12).

    PTS: 1 REF: Example 11

12. Falcon Corporation had gross receipts of $5 million in 2005, $6 million in 2006, and $3 million in 2007. Hawk Corporation, a PSC, had gross receipts of $4 million in 2005, $6 million in 2006, and $7 million in 2007. Which of the corporations will be allowed to use the cash method of accounting in 2008?
    a. Falcon Corporation only.
    b. Hawk Corporation only.
    c. Both Falcon Corporation and Hawk Corporation.
    d. Neither Falcon Corporation nor Hawk Corporation.
    e. None of the above.

    ANS: C
    Hawk Corporation, a PSC, may use the cash method. Falcon Corporation can use the cash receipts method because it had average annual gross receipts of $5 million or less during the three preceding years.

    PTS: 1 REF: p. 2-11

13. Rodney, the sole shareholder of a calendar year, accrual basis C corporation, loaned the corporation a substantial amount of money on January 1, 2008. The corporation accrued $45,000 of interest expense on the loan on December 31, 2008. It pays the interest to Rodney, a cash basis taxpayer, on April 1, 2009. Under these facts:
    a. The corporation will be allowed to deduct the interest expense in 2008 and Rodney will be required to report the interest income in 2009.
    b. The corporation will be allowed to deduct the interest expense in 2009 and Rodney will be required to report the interest income in 2009.
    c. The corporation will be allowed to deduct the interest expense in 2009 and Rodney will be required to report the interest income in 2008.
    d. The corporation will be allowed to deduct the interest expense in 2008 and Rodney will be required to report the interest income in 2008.
    e. None of the above.

    ANS: B
    A corporation that uses the accrual method cannot claim a deduction for an accrual owed to a related party until the recipient reports that amount as income. Rodney, a cash basis taxpayer, must report the income in the year he receives the payment from the corporation.

    PTS: 1 REF: Example 12

14. Bear Corporation has net short-term capital gains of $25,000 and net long-term capital losses of $170,000 during 2008. Bear Corporation had taxable income from other sources of $700,000. Prior years' transactions included the following:

2004	Net short-term capital gains	$55,000
2005	Net long-term capital gains	30,000
2006	Net short-term capital gains	25,000
2007	Net long-term capital gains	5,000

Compute the amount of Bear's capital loss carryover to 2009.

a. $0.
b. $30,000.
c. $85,000.
d. $145,000.
e. None of the above.

ANS: C

Net short-term capital gain for 2008	$ 25,000
Net long-term capital loss for 2008	(170,000)
Net capital loss	($145,000)

The net capital loss of $145,000 is not deductible on the 2008 return, but must be carried back to the three preceding years, applying it to 2005, 2006, and 2007, in that order. The net capital loss is carried back or forward as short-term capital loss.

2008 net capital loss	($145,000)
Offset against	
2005 (net long-term capital gains)	$ 30,000
2006 (net short-term capital gains)	25,000
2007 (net long-term capital gains)	5,000
Total carrybacks	($ 60,000)

Bear's capital loss carryover is $85,000 ($145,000 – $60,000), which may be carried over to 2009, 2010, 2011, 2012, and 2013, in that order.

PTS: 1 REF: p. 2-12

15. Maize Corporation had $100,000 operating income and $40,000 operating expenses during the year. In addition, Maize had a $3,000 long-term capital gain and a $5,000 short-term capital loss. Compute Maize's taxable income for the year.

a. $60,000.
b. $108,000.
c. $109,000.
d. $111,000.
e. None of the above.

ANS: A
$100,000 operating income – $40,000 operating expenses + $3,000 LTCG – $3,000 STCL = $60,000 taxable income. The net capital loss of $2,000 ($3,000 LTCG – $5,000 STCL) cannot be deducted in the year incurred, but can be carried back 3 years and forward five years.

PTS: 1 REF: p. 2-12

16. Starling Corporation, a closely held personal service corporation, has $90,000 of active income, $54,000 of portfolio income, and a $135,000 loss from a passive activity. How much of the passive loss can Starling deduct?

a. $0.
b. $54,000.
c. $90,000.
d. 135,000.
e. None of the above.

ANS: A

Personal service corporations cannot offset passive losses against either active or portfolio income.

PTS: 1 REF: p. 2-12 | p. 2-13

17. Azul Corporation, a personal service corporation, had $450,000 of active income, $65,000 of portfolio income, and a $70,000 passive loss during the year. How much is Azul's taxable income?
   a. $380,000.
   b. $445,000.
   c. $450,000.
   d. $515,000.
   e. None of the above.

ANS: D
A personal service corporation may not offset passive loss against active income or portfolio income. Thus, Azul's taxable income is $515,000 ($450,000 + $65,000).

PTS: 1 REF: p. 2-13

18. Sage, Inc., a closely held corporation that is not a PSC, has a $140,000 passive loss, $85,000 of active business income, and $35,000 of portfolio income. How much of the passive loss can Sage deduct?
   a. $0.
   b. $85,000.
   c. $120,000.
   d. $140,000.
   e. None of the above.

ANS: B
As a closely held corporation, Sage may offset $85,000 of the $140,000 passive loss against the $85,000 of active business income, but may not offset the remaining $55,000 against portfolio income.

PTS: 1 REF: Example 15

19. Redwood, Inc., a closely held personal service corporation, has a $240,000 passive loss from a rental activity, $135,000 of active business income, and $105,000 of portfolio income. How much of the passive loss can Redwood deduct?
   a. $0.
   b. $105,000.
   c. $135,000.
   d. $240,000.
   e. None of the above.

ANS: A
Because Redwood is a PSC, it cannot offset the passive loss against either active or portfolio income.

PTS: 1 REF: Example 15

20. Grocer Services Corporation (a calendar year taxpayer), a wholesale distributor of food, made the following donations to qualified charitable organizations during the year:

	Adjusted Basis	Fair Market Value
Food (held as inventory) donated to the Ohio Children's Shelter	$6,500	$7,800
Passenger van to Ohio Children's Shelter, to be used to transport children to school	8,500	6,100
Stock in Acme Corporation acquired two years ago and held as an investment, donated to Southwest University	5,000	9,200

How much qualifies for the charitable contribution deduction?
a. $21,800.
b. $24,840.
c. $24,100.
d. $22,450.
e. None of the above.

ANS: D
Since Grocer Services is a corporation and the inventory exception is met, one-half of the appreciation on the food may be claimed, or $650 [1/2 of ($7,800 – $6,500)]. Therefore, $7,150 ($6,500 + $650 appreciation) is allowed as a deduction. Because the Acme stock is long-term capital gain property and not tangible personalty, the deduction is based on fair market value ($9,200). The deduction for the delivery van, which is *not* a capital asset, is limited to the *lesser* of adjusted basis or fair market value ($6,100). Thus, $7,150 + $9,200 + $6,100 = $22,450.

PTS: 1 REF: p. 2-13 | p. 2-14

21. Rhino, Inc., a calendar year C corporation, had the following income and expenses in 2008:

Income from operations	$450,000
Expenses from operations	210,000
Dividends received (less than 20% ownership)	20,000
Domestic production activities deduction	4,000
Charitable contribution	34,000

How much is Rhino's charitable contribution deduction for 2008?
a. $24,200.
b. $24,600.
c. $26,000.
d. $34,000.
e. None of the above.

ANS: C
Taxable income for purposes of applying the 10% charitable contributions limitation does not include the dividends received deduction or domestic production activities deduction. Thus, taxable income is $260,000 ($450,000 – $210,000 + $20,000) and the maximum charitable contribution allowed is $26,000 (10% × $260,000).

PTS: 1 REF: Example 21

22. Hippo, Inc., a calendar year C corporation, manufactures golf gloves. For 2008, Hippo had taxable income of $200,000, qualified domestic production activities income of $250,000, and W-2 wages related to qualified production activities income of $23,000. Hippo's domestic production activities deduction for 2008 is:
    a. $11,500.
    b. $12,000.
    c. $15,000.
    d. $23,000.
    e. None of the above.

    ANS: A
    Hippo's tentative domestic production activities deduction for 2008 is 6% of the lesser of:

    - $200,000 taxable income $12,000
    - qualified production activities income of $250,000 $15,000

    Although the tentative deduction is $12,000 ($200,000 × 6%), the wage limitation applies ($23,000 × 50% = $11,500). Therefore, Hippo's domestic production activities deduction is $11,500.

    PTS: 1 REF: Example 23

23. Fender Corporation was organized in 2006 and had profits in 2006 and 2007. The corporation had an NOL in 2008. The corporation should elect to forgo carrying the NOL back:
    a. If tax rates in the preceding years were low and if higher tax rates are expected in the future.
    b. If tax rates in the preceding years were high and if lower tax rates are expected in the future.
    c. If all of the NOL cannot be used in the carryback years.
    d. If it cannot accurately predict future tax rates.
    e. None of the above.

    ANS: A
    Fender Corporation should elect to forgo the NOL carryback if tax rates in the two preceding years were low and if higher tax rates are expected in the future (choice a.). Before electing to forgo an NOL carryback, a corporation should be able to predict with confidence that future tax rates will be higher (choice d.)

    PTS: 1 REF: Example 40

24. Red Corporation, which owns stock in Blue Corporation, had net operating income of $400,000 for the year. Blue pays Red a dividend of $60,000. Red takes a dividends received deduction of $48,000. Which of the following statements is correct?
    a. Red owns less than 20% of Blue Corporation.
    b. Red owns 20% or more, but less than 80% of Blue Corporation.
    c. Red owns 80% of Blue Corporation.
    d. Red owns 80% or more of Blue Corporation.
    e. None of the above.

    ANS: B
    Red's dividends received deduction is 80% of the dividend received ($48,000 ÷ $60,000). The 80% dividends received deduction applies if ownership is 20% or more, but less than 80%.

PTS: 1 REF: p. 2-17

25. Eagle Corporation owns stock in Hawk Corporation and has taxable income of $233,000 for the year before considering the dividends received deduction. Hawk Corporation pays Eagle a dividend of $300,000, which was considered in calculating the $233,000. What amount of dividends received deduction may Eagle claim if it owns 25% of Hawk's stock?
   a. $0.
   b. $186,400.
   c. $240,000.
   d. $300,000.
   e. None of the above.

   ANS: C
   The dividends received deduction depends upon the percentage of ownership by the corporate shareholder. Because Eagle Corporation owns 25% of Hawk Corporation, Eagle would qualify for a 80% deduction, calculated as shown below.

   1. Multiply the dividends received by the deduction percentage ($300,000 × 80% = $240,000).

   2. Multiply the taxable income before the dividends received deduction by the deduction percentage ($233,000 × 80% = $186,400).

   3. Limit the deduction to the lesser of step 1 or step 2, unless subtracting the amount derived in step 1 ($240,000) from 100% of taxable income before the dividends received deduction ($233,000) generates an NOL ($233,000 – $240,000 = $7,000 NOL). If so, use the amount derived in step 1 ($240,000).

   PTS: 1 REF: Example 25

26. Copper Corporation owns stock in Bronze Corporation and has net operating income of $600,000 for the year. Bronze Corporation pays Copper a dividend of $200,000. What amount of dividends received deduction may Copper claim if it owns 95% of Bronze stock (assuming Copper's dividends received deduction is not limited by its taxable income)?
   a. $0.
   b. $140,000.
   c. $160,000.
   d. $190,000.
   e. None of the above.

   ANS: E
   The dividends received deduction depends upon the percentage of ownership by the corporate shareholder. If Copper Corporation owns 95% of Bronze Corporation, Copper would qualify for a 100% deduction, or $200,000 in this case.

   PTS: 1 REF: p. 2-17

27. Orange Corporation owns stock in White Corporation and has net operating income of $800,000 for the year. White Corporation pays Orange a dividend of $300,000. What amount of dividends received deduction may Orange claim if it owns 18% of White stock (assuming Orange's dividends received deduction is not limited by its taxable income)?
    a. $0.
    b. $210,000.
    c. $240,000.
    d. $300,000.
    e. None of the above.

    ANS: B
    The dividends received deduction depends upon the percentage of ownership by the corporate shareholder. If Orange Corporation owns 18% of White Corporation, Orange would qualify for a 70% deduction, or $210,000 in this case.

    PTS: 1 REF: p. 2-17

28. Saguaro Corporation, a cash basis and calendar year taxpayer, was formed and began operations on August 1, 2008. Saguaro incurred the following expenses during its first year of operations (August 1-December 31, 2008):

Expenses of temporary directors and of organizational meetings	$22,500
Fee paid to the state of incorporation	8,000
Expenses in printing and sale of stock certificates	5,200
Legal services for drafting the corporate charter and bylaws	21,800
Total	$57,500

If Saguaro Corporation makes a timely election under § 248 to amortize qualifying organizational expenses, how much may the corporation deduct for tax year 2008?
a. $4,078.
b. $5,000.
c. $6,314.
d. $6,458.
e. None of the above.

ANS: A
Qualifying organizational expenditures include these items:

Expenses of temporary directors and of organizational meetings	$22,500
Fee paid to the state of incorporation	8,000
Legal services for drafting the corporate charter and bylaws	21,800
Total	$52,300

Since an appropriate and timely election under § 248(c) was made, the amount that Saguaro Corporation may write off for the tax year 2008 is determined as follows:

(1) Immediate expensing [$5,000 – ($52,300 – $50,000)]	$2,700
(2) Amortization: [($52,300 – $2,700) ÷ 180] × 5 (months in tax year)	1,378
Total	$4,078

PTS: 1 REF: Example 27

29. During 2008, Sparrow Corporation, a calendar year C corporation, had operating income of $425,000, operating expenses of $210,000, a short-term capital loss of $45,000, and a long-term capital gain of $125,000. How much is Sparrow's tax liability for 2008?
   a. $67,100.
   b. $79,100.
   c. $98,300.
   d. $103,250.
   e. None of the above.

   ANS: C
   Sparrow's taxable income is $295,000 [$425,000 operating income – $210,000 operating expenses + $80,000 net capital gain ($125,000 long-term capital gain – $45,000 short-term capital loss)]. Corporate income tax on taxable income of $295,000 is $98,300:

Tax on $100,000 =	$22,250
Tax on $195,000 × 39% =	76,050
Total tax liability	$98,300

   Corporations do not receive a preferential tax rate on long-term capital gains.

   PTS: 1 REF: Exhibit 2-1 | Example 29

30. Which of the following statements is incorrect regarding the taxation of C corporations?
   a. The highest corporate marginal tax rate is 39%.
   b. Taxable income of a personal service corporation is taxed at a flat rate of 35%.
   c. A tax return must be filed whether or not the corporation has taxable income.
   d. Similar to individuals, the marginal tax rate brackets for corporations are adjusted for inflation.
   e. None of the above.

   ANS: D
   The corporate marginal tax rate brackets are not inflation adjusted.

   PTS: 1 REF: Exhibit 2-1 | p. 2-20 | p. 2-22

31. Which of the following statements is correct regarding the taxation of C corporations?
   a. The alternative minimum tax does not apply.
   b. Large corporations are subject to special rules regarding estimated tax payments.
   c. The due date for a corporate income tax return (ignoring extensions) is the fifteenth day of the fourth month following the close of the corporation's tax year.
   d. In general, the required annual payment for corporate estimated taxes is 90% of the corporation's final tax for the current year.
   e. None of the above.

   ANS: B
   Corporations are subject to the alternative minimum tax (option a.). The due date for a corporate income tax return (ignoring extensions) is the fifteenth day of the third month following the close of the corporation's tax year (option c.). In general, the required annual payment for corporate estimated taxes is 100% of the corporation's final tax (option d.).

   PTS: 1 REF: p. 2-21 | p. 2-22

32. Schedule M-1 of Form 1120 is used to reconcile financial net income with taxable income reported on the corporation's income tax return as follows: net income per books + additions – subtractions = taxable income. Additions or subtractions on Schedule M-1 include the following:
    a. Charitable contributions carryover from previous year.
    b. Travel and entertainment expenses in excess of deductible limits.
    c. Book depreciation in excess of allowable tax depreciation.
    d. Federal income tax per books.
    e. Charitable contributions in excess of deductible limits.
    f. Premiums paid on life insurance policy on key employee.
    g. Proceeds of life insurance paid on death of key employee.
    h. Tax-exempt interest.
    i. Interest incurred to carry tax-exempt bonds.

    Which of the above items are *additions* on Schedule M-1?
    a. Items b., d., e., and f.
    b. Items a., b., c., d., f., and g.
    c. Items a., g., and h.
    d. Items b., c., d., e., f., and i.
    e. None of the above.

    ANS: D
    Additions are as follows:
    b. Travel and entertainment expenses in excess of deductible limits.
    c. Book depreciation in excess of allowable tax depreciation.
    d. Federal income tax per books.
    e. Charitable contributions in excess of deductible limits.
    f. Premiums paid on life insurance policy on key employee.
    i. Interest incurred to carry tax-exempt bonds.

    PTS: 1 REF: Example 32

33. Schedule M-1 of Form 1120 is used to reconcile financial net income with taxable income reported on the corporation's income tax return as follows: net income per books + additions – subtractions = taxable income. Additions or subtractions on Schedule M-1 include the following:
    a. Charitable contributions carryover from previous year.
    b. Travel and entertainment expenses in excess of deductible limits.
    c. Book depreciation in excess of allowable tax depreciation.
    d. Federal income tax per books.
    e. Charitable contributions in excess of deductible limits.
    f. Premiums paid on life insurance policy on key employee.
    g. Proceeds of life insurance paid on death of key employee.
    h. Tax-exempt interest.
    i. Interest incurred to carry tax-exempt bonds.

    Which of the above items are *subtractions* on Schedule M-1?
    a. Items a., b., c., e., and f. only.
    b. Items a., g., and h. only.
    c. Items a., d., e., g., and h. only.
    d. Items b., c., d., e., f., and i. only.
    e. None of the above.

ANS: B

Subtractions are as follows:

a. Charitable contributions carryover from previous year.
g. Proceeds of life insurance paid on death of key employee.
h. Tax-exempt interest.

PTS: 1 REF: Example 32

PROBLEM

1. Beth and Debbie are equal owners in Muskrat Enterprises, a calendar year business. During the year, Muskrat had $1 million of gross income and $600,000 of operating expenses. In addition, it sold land that had been held as an investment for a long-term capital gain of $120,000. During the year, Beth and Debbie each received a distribution of $80,000 from Muskrat. Discuss the tax impact of these transactions on the parties involved if Muskrat is:

   a. A partnership.

   b. An S corporation.

   c. A C corporation.

   ANS:

   a. Muskrat, a partnership, is not a taxpaying entity. Its profit (loss) and separate items flow through to the partners. The partnership's Form 1065 reports net profit of $400,000 ($1,000,000 income – $600,000 expenses). The partnership also reports the $120,000 long-term capital gain as a separately stated item on Form 1065. Pursuant to the Schedule K-1 Beth and Debbie receive, each reports net profit of $200,000 and long-term capital gain of $60,000 on her own return. The withdrawals do not affect taxable income but decrease the partner's basis in the partnership.

   b. Muskrat, an S corporation, is not a taxpaying entity. Its profit (loss) and separate items flow through to the shareholders. The S corporation's Form 1120S reports net profit of $400,000 ($1,000,000 income – $600,000 expenses). The S corporation also reports the $120,000 long-term capital gain as a separately stated item on Form 1120S. Pursuant to the Schedule K-1 Beth and Debbie receive, each reports net profit of $200,000 and long-term capital gain of $60,000 on her own return. The withdrawals do not affect taxable income but decrease the shareholder's basis in the S corporation.

   c. Muskrat, a C corporation, is a taxpaying entity. Muskrat's Form 1120 reports taxable income of $520,000 consisting of net operating profit of $400,000 ($1,000,000 income – $600,000 expenses) and $120,000 long-term capital gain. Beth and Debbie report dividend income of $80,000 each. The dividend income will be subject to a maximum individual tax rate of 15%.

   PTS: 1 REF: p. 2-3 | p. 2-4 | Example 2

2. Beige Company has approximately $400,000 in net income in 2008 before deducting any compensation or other payment to its sole owner, Janet (who is single). Assume that Janet is in the 35% marginal tax bracket. Discuss the tax aspects of each of the following arrangements:

   a. Janet operates Beige Company as a proprietorship.

   b. Janet incorporates Beige Company and pays herself a salary of $100,000 and no dividend.

   c. Janet incorporates the company and pays herself a $100,000 salary and a dividend of $199,750 ($300,000 – $100,250 corporate income tax).

   d. Janet incorporates the company and pays herself a salary of $400,000.

ANS:

a.	Janet's tax on $400,000 at 35%	$140,000
b.	Janet's tax on $100,000 at 35%	$ 35,000
	Beige's tax on $300,000 at corporate rates	100,250
	Total tax	$135,250
c.	Tax on $300,000 at corporate rates	$100,250
	Tax on $199,750 dividend distributed to Janet at 15%	29,963
	Tax on $100,000 salary to Janet at 35%	35,000
	Total tax	$165,213
d.	Janet's tax on $400,000 at 35%	$140,000

PTS: 1 REF: p. 2-2 to 2-5

3. Maroon Company had $100,000 net profit from operations in 2008 and paid Bobbie, its sole shareholder, a dividend of $77,750 ($100,000 net profit – $22,250 corporate tax). Assume that Bobbie is in the 35% marginal tax bracket. Would Bobbie's tax situation be better or worse if Maroon Company were a proprietorship and Bobbie withdrew $77,750 from the business during the year? Explain.

ANS:
If Maroon Company is a corporation, the $100,000 is taxable at the corporate level, resulting in corporate tax of $22,250. Bobbie will pay tax of $11,663 on the dividend income ($77,750 × 15%). Total taxes amount to $33,913 ($22,250 + $11,663). If Maroon Company is a proprietorship, Bobbie must pay tax of $35,000 ($100,000 × 35%). In the case of a corporation, FICA taxes would add to the tax burden of the corporation and the individual. In the case of the proprietorship, the individual would be subject to self-employment taxes.

PTS: 1 REF: p. 2-2 to 2-5 | Example 5 | Example 6

4. Ostrich Corporation has net short-term capital gains of $50,000 and net long-term capital losses of $280,000 during 2008. Ostrich had taxable income from other sources of $1 million. Prior years' transactions included the following:

2004 net short-term capital gains	$100,000
2005 net long-term capital gains	70,000
2006 net short-term capital gains	30,000
2007 net long-term capital gains	90,000

a. How are the capital gains and losses treated on Ostrich's 2008 tax return?
b. Determine the amount of the 2008 capital loss that is carried back to each of the previous years.
c. Compute the amount of capital loss carryover, if any, and indicate the years to which the loss may be carried.
d. If Ostrich were a proprietorship, how would Ellen, the owner, report these transactions on her 2008 tax return?

ANS:

a.

Net short-term capital gain	$ 50,000
Net long-term capital loss	(280,000)
Net capital loss	($230,000)

The net capital loss of $230,000 is not deductible on the 2008 return, but must be carried back to the three preceding years, applying it to 2005, 2006, and 2007, in that order. Such net capital loss is carried back or forward as a short-term capital loss.

b.

2008 net captial loss	($230,000)
Offset against—	
2005 net long-term capital gains	$ 70,000
2006 net short-term capital gains	30,000
2007 net long-term capital gains	90,000
Total carrybacks	$190,000

c. $40,000 ($230,000 – $190,000) STCL carryover to 2009, 2010, 2011, 2012, and 2013, in that order.

d. Ellen would net these transactions with all other capital transactions for 2008. Assuming these were her only capital transactions in 2008, she would offset $50,000 of capital losses against the capital gains and deduct an additional $3,000 in capital losses on her return. The remaining $227,000 ($280,000 – $50,000 – $3,000) would be carried forward indefinitely.

PTS: 1 REF: p. 2-11 | p. 2-12

5. Shaw, an architect, is the sole shareholder of Shaw Corporation, a professional association. The corporation paid Shaw a salary of $360,000 during its fiscal year ending September 30, 2008.

   a. How much salary must Shaw Corporation pay Shaw during the period October 1 through December 31, 2008, to enable the corporation to continue to use its fiscal year without negative tax effects?

   b. If Shaw Corporation had net profit of $150,000 for the year ending September 30, 2008, what is its tax liability?

ANS:

a. The salary for the deferral period (October through December) must be at least proportionate to the employee's salary received for the fiscal year. The amount that Shaw Corporation must pay Shaw during the period October 1 through December 31, 2008, to permit the continued use of its fiscal year without negative tax effects, is $90,000 ($320,000 × 3/12).

b. As a PSC is subject to a tax rate of 35%, Shaw's tax is $52,500 ($150,000 × 35%). To illustrate the negative tax impact of classification as a PSC, compare this amount to the $41,750 that a regular corporation would pay.

PTS: 1 REF: p. 2-20 | Example 11

6. Wallaby, Inc., a calendar year C corporation, had the following income and expenses in 2008:

Income from operations	$100,000
Expenses from operations	40,000
Dividends received (less than 20% ownership)	8,000
Charitable contribution	8,000

   a. How much is Wallaby, Inc.'s charitable contribution deduction for 2008?

   b. What happens to the portion of the contribution not deductible in 2008?

ANS:

a. Taxable income for purposes of applying the 10% charitable contribution limitation does not include the dividends received deduction. For purposes of the 10% limitation, Wallaby's taxable income is $68,000 ($100,000 – $40,000 + $8,000). The maximum charitable deduction allowed for the year, therefore, is $6,800 (10% × $68,000).

b. The excess $1,200 not allowed ($8,000 contribution – $6,800 allowed) can be carried forward for up to 5 years.

PTS: 1 REF: Example 21

7. During 2008, Violet Corporation (a calendar year taxpayer) had the following income and expenses:

Income from operations	$300,000
Expenses from operations	210,000
Charitable contribution	5,000

In addition to the above, Violet had a domestic production activities deduction of $3,000, and a charitable contribution carryover (originating in 2004) of $6,000.

a. What is Violet's charitable contribution deduction for 2008?

b. If any of Violet's charitable contributions are not deductible in 2008, how is such excess treated?

ANS:

a. Taxable income for purposes of the 10% charitable contribution limitation does not include the domestic production activities deduction. Thus, Violet's taxable income for purposes of the limitation is $90,000 ($300,000 – $210,000), and the maximum deduction for charitable contributions for 2008 is $9,000 (10% × $90,000).

b. In applying contributions towards the 10% limitation, current year's contributions are deducted first, with carryover amounts from prior years then applied on a first-in, first-out basis. In Violet's case then, the $9,000 charitable deduction allowed for 2008 consists of the current year's contributions of $5,000 plus $4,000 of the contribution carryover. As a result, there is a $2,000 ($6,000 – $4,000) contribution carryover to 2009. Since the contribution carryover originated in 2004, the 5-year carryover period will expire in 2009.

PTS: 1 REF: Example 21 | Example 22

8. During the year, Quartz Corporation (a calendar year taxpayer) has the following transactions:

Income from operations	$200,000
Expenses from operations	250,000
Dividends received from ABC Corporation	100,000

Quartz owns 15% of ABC Corporation's stock. How much is Quartz Corporation's taxable income (loss) for the year?

ANS:
Quartz has an NOL, computed as shown below:

Gross income:		
From operations	$200,000	
Dividends	100,000	$300,000
Less:		
Expenses from operations	$250,000	
Dividends received deduction ($100,000 × 70%)	70,000	(320,000)
Net operating loss		($ 20,000)

The dividends received deduction is not limited to 70% of taxable income because it creates a net operating loss.

PTS: 1 REF: Example 24 | Example 25

9. During the year, Coyote Corporation (a calendar year taxpayer) has the following transactions:

Income from operations	$330,000
Expenses from operations	360,000
Dividends received from Roadrunner Corporation	120,000

a. Coyote owns 18% of Roadrunner Corporation's stock. How much is Coyote Corporation's taxable income (loss) for the year?

b. Would your answer change if Coyote owned 30% of Roadrunner Corporation's stock?

ANS:

a. The key to this question is the relationship between the dividends received deduction and the NOL deduction. The dividends received deduction is limited to a percentage of taxable income of the corporation (unless taking the full dividends received deduction would cause or increase an NOL). In this case, the dividends received deduction is limited to 70% of taxable income.

Gross income:		
From operations	$330,000	
Dividends	120,000	$450,000
Less: Expenses from operations		(360,000)
Taxable income before the dividends received deduction		$ 90,000
Dividends received deduction (70% × $90,000)		(63,000)
Taxable income		$ 27,000

The dividends received deduction is limited to 70% of taxable income because taking 70% of $120,000 ($84,000) would not create an NOL.

b. If Roadrunner Corporation owns 30% of Crow Corporation's stock, the percentage for calculating the dividends received deduction is 80%. Under these circumstances, taking the full dividends received deduction would create an NOL.

Gross income:		
From operations	$330,000	
Dividends	120,000	$450,000
Less: Expenses from operations		(360,000)
Taxable income before the dividends received deduction		$ 90,000
Dividends received deduction (80% × $120,000)		(96,000)
Net operating loss		($ 6,000)

PTS: 1 REF: Example 24 | Example 25

10. During the year, Platinum Corporation (a calendar year taxpayer) has the following transactions:

Income from operations	$440,000
Expenses from operations	480,000
Dividends received from Indigo Corporation	160,000

a. Platinum owns 18% of Brass Corporation's stock. What is Platinum's taxable income (loss) for the year?

b. What is the dividends received deduction if Platinum owned 75% of Brass Corporation's stock?

ANS:

a. The dividends received deduction (DRD) is limited to a percentage of taxable income of the corporation (unless taking the full dividends received deduction causes or increases an NOL). In this case and with an 18% stock ownership, the dividends received deduction is limited to 70% of taxable income.

Income from operations	\$440,000
Less: Expenses from operations	(480,000)
Dividends	160,000
Taxable income before the dividends received deduction	\$120,000
Dividends received deduction (70% × \$120,000)*	(84,000)
Taxable income	\$ 36,000

*Computation of the DRD limitation:

Step 1

Multiply the dividends received by the deduction percentage [\$160,000 × 70% (based on 18% ownership)]	\$112,000

Step 2

Multiply the taxable income before the DRD by the deduction percentage (\$120,000 × 70%)	\$ 84,000

Step 3

Lesser of Step 1 or Step 2 unless full DRD generates NOL	\$ 84,000

The dividends received deduction is limited to 70% of taxable income because taking 70% of the \$160,000 dividends received (\$112,000) would not create an NOL (\$120,000 – \$112,000 = \$8,000 taxable income).

b. The dividends received deduction (DRD) is limited to a percentage of taxable income of the corporation (unless taking the full dividends received deduction causes or increases an NOL). With a 75% stock ownership, the full 80% dividends received deduction creates an NOL, as shown below.

Income from operations	\$440,000
Less: Expenses from operations	(480,000)
Dividends	160,000

Taxable income before the dividends received deduction	$120,000
Dividends received deduction (80% × $160,000)*	(128,000)
Net operating loss	($ 8,000)

*Computation of the DRD limitation:

Step 1

Multiply the dividends received by the deduction percentage [$160,000 × 80% (based on 75% ownership)]	$128,000

Step 2

Multiply the taxable income before the DRD by the deduction percentage ($120,000 × 80%)	$ 96,000

Step 3

Lesser of Step 1 or Step 2 *unless* full DRD generates NOL	$128,000

The dividends received deduction is not limited to 80% of taxable income because taking 80% of the $160,000 dividends received ($128,000) would create an NOL [$120,000 – $128,000 = ($8,000)].

PTS: 1 REF: Example 25

11. In each of the following independent situations, determine the corporation's income tax liability. Assume that all corporations use a calendar year and that the year involved is 2008.

	Taxable Income
Violet Corporation	$ 32,000
Indigo Corporation	280,000
Orange Corporation	335,000
Blue Corporation	4,335,000
Green Corporation	20,000,000

ANS:

Violet Corporation:

Tax on $32,000 × 15%	$ 4,800

Indigo Corporation:

Tax on $280,000—	
$100,000	$22,250
$180,000 × 39%	70,200
Total tax	$92,450

Orange Corporation:

Tax on $335,000—

$100,000	$ 22,250
$235,000 × 39%	91,650
Total tax	$113,900

Blue Corporation:
Tax on $4,335,000—

$335,000	$ 113,900
$4,000,000 × 34%	1,360,000
Total tax	$1,473,900

Green Corporation:

Tax on $20,000,000 × 35%	$7,000,000

PTS: 1 REF: Example 28 | Example 29

12. Heron Corporation, a calendar year, accrual basis taxpayer, provides the following information for this year and asks you to prepare Schedule M-1:

Net income per books (after-tax)	$539,950
Taxable income	220,000
Federal income tax liability	69,050
Interest income from tax-exempt bonds	9,000
Interest paid on loan incurred to purchase tax-exempt bonds	3,000
Life insurance proceeds received as a result of death of Heron's president	400,000
Premiums paid on policy on life of Heron's president	12,000
Excess of capital losses over capital gains	5,000
Retained earnings at beginning of year	675,000
Cash dividends paid	90,000

ANS:
Net income per books is reconciled to taxable income as follows:

Net income per books (after tax)	$539,950
Plus: Items that decreased net income per books but did not affect taxable income	
+ Federal income tax liability	69,050
+ Excess of capital losses over capital gains	5,000
+ Interest paid on loan incurred to purchase tax-exempt bonds	3,000
+ Premiums paid on policy on life of president of the corporation	12,000
Subtotal	$629,000
Minus: Items that increased net income per books but did not affect taxable income	
– Interest income from tax-exempt bonds	(9,000)
– Life insurance proceeds received as a result of the death of the corporate president	(400,000)
Taxable income	$220,000

PTS: 1 REF: Example 32

13. Under FIN 48, an entity must evaluate tax positions taken to determine whether the positions satisfy the more-likely-than-not threshold required for recognition of related tax benefits. Provide at least four examples of "tax positions" that an entity must evaluate under FIN 48.

ANS:

- No return is filed. (E.g., a state tax return is not filed because the entity has determined that no "nexus" exists.)
- Income or expense is allocated between jurisdictions. (E.g., an entity's intercompany pricing methodology.)
- Expenditures are deducted rather than capitalized. (E.g., an entity's treatment of costs associated with self-constructed fixed assets.)
- Income is excluded from the return. (E.g., a debtor entity omits income from discharge of indebtedness.)
- A transaction or an entity is classified as tax exempt. (E.g., an entity maintains that it qualifies for tax-exempt status.)

PTS: 1 REF: p. 2-27 | p. 2-28

ESSAY

1. Compare the basic tax and nontax factors of doing business as a partnership, an S corporation, and a C corporation. Circle the corrent answers.

Tax Questions	Column A Partnership	Column B S Corporation	Column C C Corporation
Who pays tax on the entity's income?	Partners Partnership	Shareholders S corporation	Shareholders C Corporation
Are operating losses passed through to owners?	Yes No	Yes No	Yes No
Are capital gains (losses) reported on owners' tax returns as such?	Yes No	Yes No	Yes No
Are distributions of profits taxable to owners?	Yes No	Yes No	Yes No
Nontax Factors	**Partnership**	**S Corporation**	**C Corporation**
Is the liability of owners limited?	Yes No	Yes No	Yes No
Is there free transferability of ownership interests?	Yes No	Yes No	Yes No

ANS:

Tax Questions	Column A Partnership	Column B S Corporation	Column C C Corporation
Who pays tax on the entity's income?	Partners Partnership	Shareholders S corporation	Shareholders C Corporation
Are operating losses passed through to owners?	Yes No	Yes No	Yes No
Are capital gains (losses) reported on owners' tax returns as such?	Yes No	Yes No	Yes No
Are distributions of profits taxable to owners?	Yes No	Yes No	Yes No
Nontax Factors	**Partnership**	**S Corporation**	**C Corporation**
Is the liability of owners limited?	Yes No	Yes No	Yes No
Is there free transferability of ownership interests?	Yes No	Yes No	Yes No

PTS: 1 REF: p. 2-3 to 2-7

2. Chuck is the sole proprietor of Chuck's Carpet Shop, which had gross income of $432,000 and operating expenses of $225,000 during the year. In addition, Chuck sold a capital asset that had been held by the business for 3 years for a $10,500 capital loss. He withdrew $112,500 from the business for living expenses during the year. What is Chuck's net income from the proprietorship for the year?

ANS:
Chuck reports the income and expenses of the business on Schedule C of Form 1040, resulting in net profit (ordinary income) of $207,000 ($432,000 – $225,000). He reports the $207,000 net profit from the business on Form 1040, where he computes taxable income for the year. The $112,500 that Chuck withdrew from the business has no impact on his taxable income. If he has capital gains during the year, these can be offset by the capital loss. If capital losses exceed capital gains, he can use up to $3,000 of the capital loss to offset ordinary income and can carry any unused capital loss forward.

PTS: 1 REF: Example 1

3. Before paying salaries to its two shareholders, Steamboat Corporation has net income of $640,000 during the year ($1,200,000 revenue – $560,000 operating expenses). Dean and Mary are equal shareholders of Steamboat and work in similar jobs as employees of the corporation. Steamboat pays each shareholder-employee a salary of $320,000, which results in zero taxable income for the corporation. On audit, an IRS agent determines that $40,000 of the amount paid to each of the shareholders is unreasonable compensation. The shareholders' tax adviser has told them that the IRS agent is probably correct in his determination. What effect will the IRS agent's finding have on the taxable income of Dean, Mary, and Steamboat Corporation?

   ANS:
   Salaries are deductible by a corporation. Thus, to the extent salaries are paid to shareholders, the shareholder and corporation are able to avoid double taxation. A problem can occur if compensation to shareholders-employees is held to be unreasonable. In that case, the deduction is disallowed. The payment is treated as a dividend paid by the corporation and a constructive dividend received by the shareholder-employee. Dividends are taxed at a maximum rate of 15%, while salary may be taxed at a rate as high as 35%. However, salaries are deductible by the corporation but dividends are not. Thus, dividends continue to be subject to double taxation, but usually at a much lower rate at the individual level. Mary and Dean each would report income of $320,000 ($280,000 salary + $40,000 dividend). Steamboat's net income would be $80,000 ($1,200,000 revenue – $560,000 operating expenses – $560,000 allowed salaries).

   PTS: 1 REF: p. 2-4

4. Charles is a 45% shareholder and the president of Chinook, Inc. The board of directors of Chinook has decided to pay him a $50,000 bonus for the year based on outstanding performance. The directors want to pay the $50,000 as salary, but Charles would prefer to have it paid as a dividend. Discuss.

   ANS:
   Charles will be subject to a 15% maximum rate on the $50,000 if Chinook pays it as a dividend, but Chinook will not be allowed to deduct the amount in computing corporate taxable income. If Chinook pays Charles the additional $50,000 as salary, he will be taxed at his marginal rate (presumably higher than 15%), and the corporation will be allowed to deduct the salary payment in computing corporate taxable income.

   PTS: 1 REF: p. 2-4

5. Nicole owns and operates a sole proprietorship. She is considering incorporating the business as a C corporation and has asked you to explain how a corporate tax return differs from the return for a sole proprietorship. In addition, she has asked you to explain the nontax factors that she should consider in deciding whether to incorporate her business.

   ANS:
   Differences between a proprietorship and corporate tax return: A sole proprietorship is not a separate taxable entity. The owner of a sole proprietorship reports net profit (loss) on Schedule C of Form 1040 and transfers the result to Form 1040. Several income and expense items (such as capital gain or loss and charitable contributions) are not aggregated in computing net income (loss) of the proprietorship. Such items retain their character when reported on the proprietor's Form 1040.

A regular corporation is a separate taxable entity that reports net income (loss) on Form 1120. Shareholders do not report net income (loss) of the corporation on their separate returns. If the corporation pays dividends, the shareholders must report dividend income on their separate returns.

Nontax considerations relative to incorporation: Nontax considerations include limited liability, the ability to raise large amounts of capital, freely transferability of ownership interests, continuity of life, and centralized management.

Corporate shareholders are not personally liable for debts of the corporation. They stand to lose only the amount invested in the shares of stock they hold. A sole proprietor is personally liable for debts of the proprietorship. Because the number of shareholders is virtually unlimited, corporations have the ability to raise large amounts of capital. Proprietorships represent a more cumbersome vehicle for raising large amounts of capital. Corporate shares are freely transferable, while a sale of a proprietorship is more problematic (e.g., locating a buyer, business valuation). Finally, the corporate structure provides for centralized management through a board of directors that appoints corporate officers.

PTS: 1 REF: p. 2-5 to 2-7 | Concept Summary 2-1

6. A client has requested from you information regarding the advantages of converting his sole proprietorship to an LLC. Describe the advantages an LLC would provide the client, and discuss the "check-the-box" Regulations in regard to a single-member LLC.

ANS:
A limited liability company (LLC) is an entity that has the corporate feature of limited liability. This is the primary nontax characteristic that makes LLC status attractive, particularly in comparison with a proprietorship. Similar to proprietorship status, the profits (loss) of an LLC generally will not be subject to the double taxation associated with C corporations. Depending on the LLC statute of the state of formation, other corporate attributes (e.g., free transferability of ownership interest, continuity of life) may be available.

Under the "check-the-box" Regulations, a single-member LLC generally will be disregarded as an entity separate from its owner; as such, the income (loss) of the LLC will be reported as a proprietorship (i.e., on Schedule C of the member's individual return). This treatment is the default classification for a single-member LLC that does not elect under the Regulations to be treated as a corporation.

PTS: 1 REF: p. 2-7

7. Cecelia is the sole shareholder of Aqua Corporation, a newly formed C corporation. Joyce is the sole shareholder of Teal Corporation, a newly formed C corporation that is classified as a PSC. Both Cecelia and Joyce plan to have their corporations elect a March 31 fiscal year. Will the IRS treat both corporations alike with respect to the fiscal year election? Explain.

ANS:
A C corporation is relatively unrestricted as to choice of accounting periods, and generally may choose either a fiscal year or a calendar year. It is not necessary for a new C corporation to obtain consent of the IRS with regard to its choice of an accounting period. Personal service corporations, on the other hand, face severe restrictions, and may elect a fiscal year only under the following circumstances:

- A business purpose for the year can be demonstrated.

- The PSC year results in a deferral of not more than three months' income. The corporation must pay the shareholder-employee's salary during the portion of the calendar year after the close of the fiscal year. In addition, the salary for that period must be at least proportionate to the employee's salary for the fiscal year.

- The PSC retains the same year that was used for its fiscal year ending 1987, provided the latter two requirements applicable to the preceding option are satisfied.

PTS: 1 REF: p. 2-10

8. C corporations can elect fiscal years that are different from those of their shareholders, but personal service corporations (PSCs) are subject to substantial restrictions in the choice of a fiscal year. Why are the fiscal year choices of PSCs limited?

ANS:
The shareholder-employees in a PSC are largely responsible for generating the earnings of the entity. If the entity is not incorporated, there is no opportunity for tax deferral through election of different fiscal years for the owners and the entity. However, tax deferral for shareholder-employees would be possible if PSCs were not restricted in their choice of a fiscal year.

PTS: 1 REF: p. 2-10

9. Serena, a cash basis taxpayer, owns 60% of the stock of Lark Corporation, a calendar year, accrual basis corporation. On December 31, 2008, Lark accrues a salary of $30,000 to Serena, but the payment is not made until 2009.

   a. When does Serena report the salary as income, and when does Lark deduct the salary expense?

   b. How would your answer change if Serena were a 25% shareholder?

ANS:
   a. Serena and the corporation are related parties under § 267. Serena, a cash basis taxpayer, must report the salary income in 2009, the year of receipt. The corporation, which is on the accrual basis, cannot deduct the salary expense when accrued in 2008, but must wait until Serena reports the salary as income (2009).

   b. If Serena were a 25% shareholder, the related party rules would not apply. Lark would deduct the accrued salary in 2008 and Serena would report it in 2009.

PTS: 1 REF: Example 12

10. Virginia, who owns a proprietorship, has scheduled an appointment to talk with you about the advisability of incorporating. At this time, you know nothing about Virginia's business or her existing tax situation. List the questions you will need to ask during the appointment so you can help her make an informed decision.

ANS:
There are many relevant questions that you should ask Virginia. Some of these questions are listed below:

· How much income does she have from the proprietorship?

· Does she have any sources of income other than the proprietorship? If so, how much and what kind of income?

· Does she ever experience a net operating loss from the proprietorship?

· Does she have capital gains or losses from the proprietorship? If so, how much and how often?

· Is she aware of the nontax differences between the proprietorship and corporate forms of business organization?

PTS: 1 REF: p. 2-35 | p. 2-36

11. Which of the following C corporations will be allowed to use the cash method of accounting for 2008? Explain your answers.

a. Cardinal Corporation, which had net profits as follows: $3 million in 2005, $6 million in 2006, and $4 million in 2007.

b. Redbird Corporation, which had gross receipts as follows: $2 million in 2005, $6 million in 2006, and $9 million in 2007.

ANS:
Cardinal Corporation can use the cash method because its average annual gross receipts for the previous three years are $5 million or less [$4.33 million = ($3 million + $6 million + $4 million) ÷ 3]. Redbird Corporation cannot use the cash method of accounting because its average annual gross receipts for the previous three years exceeds $5 million [$5.67 million = ($2 million + $6 million + $9 million) ÷ 3].

PTS: 1 REF: p. 2-11

12. On December 29, 2008, the directors of Greyhawk Enterprises (an accrual basis, calendar year taxpayer) authorized a cash donation of $10,000 to the United Way, a qualified charity. The payment is made on March 13, 2009.

a. Can Greyhawk claim the $10,000 contribution as a deduction for tax year 2008? Explain.

b. Would your answer differ if Greyhawk were a partnership and its partners authorized a donation on December 29, 2008, and Greyhawk paid it on March 13, 2009? Explain.

ANS:

a. The contribution is deductible in 2008. In order to be deductible by an accrual basis corporation in the year authorized by its board of directors, a charitable contribution must be paid within 2 1/2 months of the end of the year of authorization (March 15 in this case). Because payment was made by March 15, 2009, the contribution is deductible in 2008.

b. The rules that apply to corporations (see part a.) do not apply to partnerships. If Greyhawk were a partnership, the contribution would be deductible in 2009.

PTS: 1 REF: Example 16

13. Wren Corporation received a dividend from Martin Corporation in December 2007; at that time, Wren owned 70% of Martin's stock. Wren acquires the remaining 30% of Martin's stock in 2008. Assume Martin pays a dividend in 2008. How will this stock acquisition affect the amount of dividend income that Wren Corporation will report for 2008?

ANS:
Corporate shareholders are allowed a dividends received deduction. The amount of the deduction depends on the percentage of ownership the recipient corporation holds in the corporation that pays the dividend. Wren's deduction percentage in 2007 would be 80%, based on ownership of 20% or more but less than 80%. In 2008, Wren's deduction percentage would be 100%, based on 100% ownership of Martin.

PTS: 1 REF: p. 2-17 | p. 2-18

14. Distinguish between organizational expenditures and start-up expenditures and give examples of each. Discuss the tax treatment of each type of expenditure.

ANS:
Organizational expenditures are those incurred in connection with the formation and organization of a corporation. They include legal and accounting expenses, expenses of temporary directors, expenses of organizational meetings, and fees paid to the state of incorporation. Start-up expenditures include investigation expenses of entering a new business and operating expenses that are incurred before the business actually begins to produce income. Corporations can elect to deduct up to $5,000 (subject to limitations) of either type of expenditure in the year incurred and amortize the remainder over a period of 180 months, beginning with the month in which the corporation begins business. If the amortization election is not made, the expenditures are capitalized and cannot be deducted until the corporation ceases to do business or liquidates.

PTS: 1 REF: p. 2-19 | p. 2-20

15. Pierre is the sole shareholder of Pine Corporation, which has annual taxable income of approximately $100,000. He decides to transfer half of the Pine assets to Oak Corporation (a new corporation of which Pierre is sole shareholder) in order to reduce overall corporate income taxes. Will Pierre's plan work? Discuss.

    ANS:
    Pierre's plan will not reduce corporate income taxes. Pine and Oak would be related corporations and would be subject to special rules for computing the corporate income tax. Therefore, the total corporate tax liability would remain unchanged.

    PTS: 1 REF: Example 30 | Example 31

16. Discuss the purpose of Schedule M-1. Give an example of one addition and one subtraction that could be reported on Schedule M-1.

    ANS:
    Schedule M-1 is used to reconcile the differences between taxable income and financial net income (book income). An example of an addition is Federal income tax expense, which is deducted in computing net income per books but is disallowed in computing taxable income. An example of a subtraction is an excess charitable contribution carryover that was deducted for book purposes in a prior year but deducted in the current year for tax purposes.

    PTS: 1 REF: p. 2-23

17. FAS 109 prescribes the rules regarding the determination of current income tax expense for income statement presentation and deferred taxes for balance sheet presentation. Briefly describe how current income tax expense for book purposes is determined under FAS 109.

    ANS:
    As provided under FAS 109, current income tax expense for book purposes is determined by adjusting net income (before tax) for permanent differences (e.g., interest income on municipal bonds) and applying the applicable tax rate to the balance. The temporary differences between financial and tax accounting give rise to deferred taxes, which are accounted for through the use of deferred tax asset and deferred tax liability accounts.

    PTS: 1 REF: p. 2-27