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.

Learning Objective, Level of Difficulty, Estimated Time to Completion, and the AACSB's and AICPA's Core Competencies for each test item are located within the item itself.

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

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

MULTIPLE CHOICE

1	Corporate tax versus proprietorship tax	Unchanged	1
2	Corporate tax versus S corporation tax	Modified	2
3	Corporate versus proprietorship: net capital loss	New	
4	Proprietorship tax: LTCL	Modified	4
5	Corporate versus proprietorship: LTCG rates	Modified	5
6	Partnership tax: ordinary income and LTCG	Unchanged	6
7	Corporate taxable income: net capital loss	Modified	7
8	Taxation of dividends	Unchanged	8
9	LLC taxation	Unchanged	9
10	Accounting periods: PSC, fiscal year salary required	Unchanged	10
11	Accounting periods: PSC, fiscal year salary required	Modified	11
12	Accounting methods: cash method limitation for corporations	Unchanged	12
13	Accounting methods: accrual method corporation and cash method related party	Modified	13
14	Accounting methods: accrual method corporation and cash method related party	New	
15	Capital gains and losses: corporate loss carryover	Unchanged	14
16	Capital gains and losses: corporate net capital loss and taxable income	New	
17	Capital gains and losses: corporate taxable income	Modified	15

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
18	Passive losses: personal service corporation	Modified	16
19	Passive losses: personal service corporation	Unchanged	17
20	Passive losses: closely held corporation	Unchanged	18
21	Passive losses: closely held corporation	New	
22	Charitable contributions: inventory, loss property, capital gain property	Unchanged	20
23	Charitable contributions: inventory exception	New	
24	Charitable contributions: limitation	Unchanged	21
25	Domestic production activities deduction	Modified	22
26	Net operating loss: carryover rules; dividends received deduction	New	
27	Net operating loss: when to forgo carryback	Unchanged	23
28	Dividends received deduction: percentage of ownership	Unchanged	24
29	Dividends received deduction: computation	Modified	25
30	Dividends received deduction: percentage of ownership	Unchanged	26
31	Dividends received deduction: percentage of ownership	Modified	27
32	Dividends received deduction: limitations	New	
33	Organizational expenses	Unchanged	28
34	Corporate tax liability: computing with net capital gain	Unchanged	29
35	Corporate tax liability: PSC and shareholder combined	New	
36	Corporate tax provisions: miscellaneous rules	Unchanged	30
37	Corporate tax provisions: miscellaneous rules	Unchanged	31
38	Schedule M-1 additions	Modified	32
39	Schedule M-1 subtractions	Modified	33
40	Financial accounting considerations	New	

PROBLEMS

1	Compare tax treatment for proprietorship, LLC, S corporation, and regular corporation	New	
2	Compare tax treatment for corporation and proprietorship: dividends versus salary	Unchanged	2
3	Compare tax treatment for corporation and proprietorship: dividends versus withdrawals	Modified	3
4	Net capital loss: corporation versus proprietorship	Unchanged	4
5	PSC: fiscal year required salary payments; tax liability	Unchanged	5
6	Corporate charitable deduction: inventory exception and capital gain property	New	
7	Corporate charitable deduction: limitation with carryover from prior year	Unchanged	7
8	Corporate NOL: applicability of dividends received deduction	Modified	8
9	Dividends received deduction: taxable income limitation and NOL exception	Modified	9

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
10	Organizational expenditures	New	
11	Corporate tax computation	Modified	11
12	Schedule M-1	Unchanged	12
13	FIN 48: determining tax positions	Unchanged	13

ESSAY

1	Entity choice: tax and nontax factors	Unchanged	1
2	Compare tax treatment for all entity forms: operating loss	New	
3	Unreasonable compensation	Unchanged	3
4	Salary versus dividend to shareholder-employee	New	
5	Corporation versus proprietorship: tax and nontax differences	Unchanged	5
6	LLC versus proprietorship: advantages and "check-the-box" regulations	Unchanged	6
7	Fiscal year election for corporation and PSC	Unchanged	7
8	Fiscal year of PSC: reason for limitation	Unchanged	8
9	Accounting methods: accrual method corporation and cash basis related party	New	
10	Incorporating a proprietorship: identifying relevant issues	Unchanged	10
11	Accounting methods: cash method small corporation exception	Unchanged	11
12	Corporate contribution deduction: advantages over individual	New	
13	Dividends received deduction	New	
14	Corporate organizational expenditures and startup expenditures	Unchanged	14
15	Tax liability of related corporations	Unchanged	15
16	Schedule M-1 reconciliation	Unchanged	16
17	Financial accounting considerations: FAS 109	Unchanged	17

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 DIF: 1 REF: Example 1 OBJ: 1
   NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

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 made no distributions to the partners. Badger must pay tax on $75,000 of income.

   ANS: F
   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 DIF: 1 REF: Example 2 OBJ: 1
   NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

3. Jay is the sole shareholder of Brown Corporation, which is an S corporation. During the current year, Brown earned net operating income of $80,000 and had a long-term capital loss of $3,000. Also, Jay withdrew $40,000 from the corporation. Jay must report $80,000 of Brown Corporation income and may deduct the $3,000 loss on his individual Federal income tax return.

   ANS: T
   S corporations are *similar* to partnerships in that net profit or loss flows through to the shareholders to be reported on their individual tax returns. Jay must report income of $80,000 and he may deduct the $3,000 LTCL.

   PTS: 1 DIF: 1 REF: p. 2-3 OBJ: 1
   NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

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 DIF: 1 REF: p. 2-3 | p. 2-4
   OBJ: 1 NAT: AICPA FN-Reporting | AACSB Analytic
   MSC: 5 min

5. Quail Corporation is a C corporation with net income of $500,000 during 2009. 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 DIF: 1 REF: Example 3 OBJ: 1
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

6. Eagle Company, a partnership, had a long-term capital gain of $15,000 during the year. Aaron, who owns 40% of Eagle, must report $6,000 of Eagle's long-term capital gain on his individual tax return.

ANS: T
Capital gains of a partnership pass through from the partnership to the partners and are reported on such partners' tax returns.

PTS: 1 DIF: 1 REF: Example 2 OBJ: 1
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

7. Emma, the sole shareholder of Quail Corporation (a C corporation), has the corporation pay her a salary of $300,000 in 2009. The Tax Court has held that $80,000 represents unreasonable compensation. Assuming Emma is in the 35% bracket in 2009, the Tax Court's holding will increase total tax she pays in 2009.

ANS: F
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%)]. (The total tax paid by *Quail* will increase as a result of the disallowed compensation deduction.)

PTS: 1 DIF: 1 REF: p. 2-4 OBJ: 1
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

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 DIF: 1 REF: p. 2-4 OBJ: 1
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

9. Jake, the sole shareholder of Peach Corporation, a C corporation, has the corporation pay him $100,000. For tax purposes, Peach would prefer to have the payment treated as salary instead of dividend.

ANS: T
The corporation can deduct salary payments but cannot deduct dividends. (Jake must include in gross income both salary and dividends, but he would prefer dividend income due to the preferential tax rate accorded such income.)

PTS: 1 DIF: 1 REF: p. 2-4 OBJ: 1
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

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 DIF: 1 REF: Exhibit 2.1 OBJ: 4
    NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

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 DIF: 1 REF: p. 2-5 | Exhibit 2.1
    OBJ: 1 | 4 NAT: AICPA FN-Measurement | AACSB Analytic
    MSC: 2 min

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 DIF: 1 REF: p. 2-7
    OBJ: 1 NAT: AICPA FN-Reporting | AACSB Analytic
    MSC: 2 min

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 partnership, 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 DIF: 1 REF: p. 2-8 OBJ: 1
    NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

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 DIF: 1 REF: p. 2-10 | p. 2-11
    OBJ: 2 NAT: AICPA FN-Reporting | AACSB Analytic
    MSC: 2 min

15. Corporations that maintain inventory for sale to customers are required to use the accrual method of accounting for all income and expense items.

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 DIF: 1 REF: p. 2-11 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

16. On December 31, 2009, Lavender, Inc., an accrual basis C corporation, accrues a $90,000 bonus to Barry, its vice president and a 70% shareholder. Lavender pays the bonus to Barry, who is a cash basis taxpayer, on March 15, 2010. Lavender can deduct the bonus in 2009, the year in which Barry's services were performed.

ANS: F
Because Barry is a related party (more than 50% shareholder), Lavender's deduction for the bonus occurs in 2010, the year in which the $90,000 is included in Barry's gross income.

PTS: 1 DIF: 1 REF: Example 12 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

17. In 2009, 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 DIF: 1 REF: p. 2-12 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

18. Albatross, a C corporation, had $200,000 net income from operations and a $25,000 short-term capital loss in 2009. 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 DIF: 1 REF: p. 2-12 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

19. The passive loss rules apply to noncorporate taxpayers and to personal service corporations but not to closely held C corporations.

ANS: F

The passive loss rules apply to noncorporate taxpayers, to personal service corporations, and to closely held C corporations. However, closely held corporations may deduct passive losses to the extent of their active income.

PTS: 1 DIF: 1 REF: p. 2-13 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

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 DIF: 1 REF: Example 15 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

21. On December 20, 2009, the directors of Quail Corporation (an accrual basis, calendar year taxpayer) authorized a cash donation of $5,000 to the American Cancer Society, a qualified charity. The payment, which is made on April 15, 2010, may be claimed as a deduction for tax year 2009.

ANS: F
In order to be deductible in the year authorized by the board of directors, a charitable contribution must be paid within 2 1/2 months of the end of the year of authorization (March 15, 2010, in this case) and must involve an accrual basis corporation. Because payment was made after March 15, 2010, the contribution is not deductible in 2009.

PTS: 1 DIF: 1 REF: p. 2-13 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

22. On April 8, 2009, 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 DIF: 1 REF: Example 17 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

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 the 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 DIF: 1 REF: Example 20 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

24. Egret Corporation, a calendar year taxpayer, had an excess charitable contribution for 2008 of $15,000. In 2009, it made a further charitable contribution of $20,000. Its 2009 deduction is limited to $25,000 (10% of taxable income). In applying the 10% limitation, the $15,000 carryover is used before the current year contribution.

ANS: F
The current (2009) contribution must be applied first against the taxable income limitation and the carryover (2008) used last.

PTS: 1 DIF: 1 REF: Example 22 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

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 DIF: 1 REF: Example 23 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 2 min

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

ANS: T PTS: 1 DIF: 1 REF: p. 2-16
OBJ: 2 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 2 min

27. Bass Corporation received a dividend of $100,000 from Trout Corporation. Bass owns 25% of the Trout Corporation stock. Assuming it is not subject to the taxable income limitation, Bass's dividends received deduction is $80,000.

ANS: T
The deduction percentage for a 20% or more ownership is 80%. Thus, the dividends received deduction would be $80,000 ($100,000 × 80%).

PTS: 1 DIF: 1 REF: p. 2-17 OBJ: 3
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

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 DIF: 1 REF: p. 2-17 OBJ: 3
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

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 DIF: 1 REF: Example 26 OBJ: 3
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

30. Black Corporation, an accrual basis taxpayer, was formed and began operations on February 1, 2009. During its first year of operations (February 1 – December 31, 2009), Black incurred the following expenses: fee paid to state of incorporation of $1,000, accounting and legal services incident to organization of $7,000, and expenses related to the printing and sale of stock certificates of $9,000. Black has $17,000 of qualified organizational expenditures that it may elect to amortize.

ANS: F
Expenditures incurred in connection with issuing and selling shares of stock or other securities do not qualify as organizational expenditures. Thus, Black’s organizational expenditures total $8,000.

PTS: 1 DIF: 1 REF: p. 2-19 OBJ: 3
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

31. A personal service corporation with taxable income of $150,000 will have a tax liability of $52,500.

ANS: T
A personal service corporation is subject to the 35% rate on all taxable income; thus, the tax liability is $52,500.

PTS: 1 DIF: 1 REF: p. 2-21 OBJ: 4
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 2 min

32. Ed, an individual, incorporates two separate businesses that he owns by establishing two new corporations. Each corporation generates taxable income of $90,000. Each corporation will have a tax liability of $26,725.

ANS: T
Since the corporations would be a controlled group, their taxable income would be combined in applying the corporate income tax rates. The tax on $180,000 would be $53,450, or $26,725 tax for each corporation.

PTS: 1 DIF: 1 REF: p. 2-22 OBJ: 5
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

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

ANS: F
No such exemption exists.

PTS: 1 DIF: 1 REF: p. 2-22 | p. 2-23
OBJ: 6 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 2 min

34. Schedule M-1 is used to reconcile unappropriated retained earnings at the beginning of the year with unappropriated retained earnings at the end of the year.

ANS: F
This describes the purpose of Schedule M-2, not Schedule M-1. 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.

PTS: 1 DIF: 1 REF: p. 2-23 | p. 2-24
OBJ: 6 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 2 min

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 DIF: 1 REF: p. 2-24
OBJ: 6 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 2 min

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 DIF: 1 REF: p. 2-24 OBJ: 6
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

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

ANS: T PTS: 1 DIF: 1 REF: Example 32
OBJ: 6 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 2 min

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

ANS: F
A net 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 net capital loss must be *added* in reconciling from book income to taxable income.

PTS: 1 DIF: 1 REF: Example 32 OBJ: 6
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

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 Schedule M-1 is required.

PTS: 1 DIF: 1 REF: Example 32 OBJ: 6
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

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 DIF: 1 REF: p. 2-25 OBJ: 6
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 2 min

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 DIF: 1 REF: p. 2-27 | p. 2-28
OBJ: 7 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 2 min

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 DIF: 1 REF: p. 2-28 OBJ: 7
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

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 2009 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 2009 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 DIF: 1 REF: Example 1 | Example 3
   OBJ: 1 NAT: AICPA FN-Reporting | AACSB Analytic
   MSC: 5 min

2. Bjorn owns a 35% interest in an S corporation that earned $200,000 in 2009. He also owns 10% of the stock in a C corporation that earned $200,000 during the year. The S corporation distributed $10,000 to Bjorn and the C corporation paid dividends of $10,000 to Bjorn. How much income must Bjorn report from these businesses?
   a. $10,000 income from the S corporation and $10,000 income from the C corporation.
   b. $70,000 income from the S corporation and $10,000 of dividend income from the C corporation.
   c. $70,000 income from the S corporation and $0 income from the C corporation.
   d. $0 income from the S corporation and $0 income from the C corporation.
   e. None of the above.

   ANS: B
   Bjorn must report his $70,000 share ($200,000 × 35%) of the S corporation's income on his individual tax return. He will report $10,000 of dividend income from the C corporation.

   PTS: 1 DIF: 1 REF: p. 2-3 | p. 2-4
   OBJ: 1 NAT: AICPA FN-Reporting | AACSB Analytic
   MSC: 5 min

3. Ted is the sole shareholder of a C corporation, and Sue owns a sole proprietorship. Both businesses were started in 2009, and each business sustained a $5,000 net capital loss for the year. Which of the following statements is correct?
   a. Ted's corporation can deduct the $5,000 capital loss in 2009.
   b. Ted's corporation can deduct $3,000 of the capital loss in 2009.

c. Sue can carry the capital loss back three years and forward five years.
d. Sue can deduct the $5,000 capital loss against ordinary income in 2009.
e. None of the above.

ANS: E
A corporation cannot deduct a net capital loss in the year incurred (options a. and b.). Individuals cannot carry back net capital losses (option c.), and can deduct net capital losses against ordinary income only to the extent of $3,000 in any year (option d.).

PTS: 1 DIF: 1 REF: p. 2-12 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

4. Norma formed Hyacinth Enterprises, a proprietorship, in 2009. In its first year, Hyacinth had operating income of $200,000 and operating expenses of $100,000. In addition, Hyacinth had a long-term capital loss of $9,000. Norma, the proprietor of Hyacinth Enterprises, withdrew $50,000 from Hyacinth during the year. Assuming Norma has no other capital gains or losses, how does this information affect her taxable income for 2009?
   a. Increases Norma's taxable income by $50,000.
   b. Increases Norma's taxable income by $41,000 ($50,000 ordinary business income – $9,000 long-term capital loss).
   c. Increases Norma's taxable income by $100,000.
   d. Increases Norma's taxable income by $97,000 ($100,000 ordinary business income – $3,000 long-term capital loss).
   e. None of the above.

   ANS: D
   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 2009 will be increased by $97,000 ($200,000 – $100,000 = $100,000 net ordinary business income – $3,000 long-term capital loss limit). The $50,000 she withdrew from Hyacinth has no effect on her taxable income.

   PTS: 1 DIF: 2 REF: p. 2-2 | p. 2-3 | p. 2-12
   OBJ: 1 | 12 NAT: AICPA FN-Reporting | AACSB Analytic
   MSC: 5 min

5. Geneva, a sole proprietor, sold one of her business assets for a $5,000 long-term capital gain. Geneva's marginal tax rate is 25%. Gulf, a C corporation, sold one of its assets for a $5,000 long-term capital gain. Gulf's marginal tax rate is 25%. What tax rates are applicable to these capital gains?
   a. 15% rate applies to Geneva and 25% rate applies to Gulf.
   b. 15% rate applies to both Geneva and Gulf.
   c. 15% rate applies to Gulf and 25% rate applies to Geneva.
   d. 25% rate applies to both Geneva and Gulf.
   e. None of the above.

   ANS: A
   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 long-term capital gains. Therefore, Gulf's gain will be taxed at 25%.

   PTS: 1 DIF: 1 REF: p. 2-12 OBJ: 2
   NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

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 ordinary business income 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 ordinary business income of $115,000 and separately stated long-term capital gain of $60,000. Each partner reports ordinary business income 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 DIF: 1 REF: Example 2 OBJ: 1
   NAT: AICPA FN-Reporting | AACSB Analytic MSC: 10 min

7. Elk, a C corporation, has $500,000 operating income and $350,000 operating expenses during the year. In addition, Elk has a $20,000 long-term capital gain and a $52,000 short-term capital loss. Elk's taxable income is:
   a. $170,000.
   b. $150,000.
   c. $118,000.
   d. $98,000.
   e. None of the above.

   ANS: B
   $500,000 (operating income) – $350,000 (operating expenses) + $20,000 (LTCG) – $20,000 (STCL) = $150,000 taxable income. A corporation cannot deduct a net capital loss in the year incurred. The net loss ($32,000) 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 DIF: 1 REF: p. 2-12 OBJ: 2
   NAT: AICPA FN-Measurement | AICPA FN-Reporting | AACSB Analytic
   MSC: 5 min

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 income 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 DIF: 2 REF: p. 2-4 | p. 2-5
   OBJ: 1 NAT: AICPA FN-Measurement | AACSB Analytic
   MSC: 5 min

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 DIF: 1 REF: p. 2-7 OBJ: 1
   NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

10. Patrick, an attorney, is the sole shareholder of Gander Corporation. Gander is a personal service corporation with a fiscal year ending October 31. The corporation paid Patrick a salary of $360,000 during its fiscal year ending October 31, 2009. How much salary must Gander pay Patrick during the period November 1 through December 31, 2009, 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 DIF: 1 REF: Example 11 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

11. Jason, an architect, is the sole shareholder of Purple Corporation, a personal service corporation. The corporation paid Jason a salary of $120,000 during its fiscal year ending November 30, 2009. How much salary must Purple pay Jason during the period December 1 through December 31, 2009, to permit the corporation to continue to use its fiscal year without negative tax effects?
a. $10,000.
b. $20,000.
c. $110,000.
d. $120,000.
e. None of the above.

ANS: A
The salary for the deferral period (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 December 1 through December 31, 2009, to permit the continued use of its fiscal year without negative tax effects, is $10,000 ($120,000 × 1/12).

PTS: 1 DIF: 1 REF: Example 11 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

12. Falcon Corporation, a C corporation, had gross receipts of $5 million in 2006, $6 million in 2007, and $3 million in 2008. Hawk Corporation, a personal service corporation (PSC), had gross receipts of $4 million in 2006, $6 million in 2007, and $7 million in 2008. Which of the corporations will be allowed to use the cash method of accounting in 2009?
a. Falcon Corporation only.
b. Hawk Corporation only.
c. Neither Falcon Corporation nor Hawk Corporation.
d. Both Falcon Corporation and Hawk Corporation.
e. None of the above.

ANS: D
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. Hawk Corporation, a PSC, may use the cash method.

PTS: 1 DIF: 1 REF: p. 2-11 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

13. Rodney, the sole shareholder of a calendar year, accrual basis C corporation, loaned the corporation a substantial amount of money on January 1, 2009. The corporation accrued $25,000 of interest expense on the loan on December 31, 2009. It pays the interest to Rodney, a cash basis taxpayer, on February 1, 2010. Under these facts:
a. The corporation will be allowed to deduct the interest expense in 2009 and Rodney will be required to report the interest income in 2010.
b. The corporation will be allowed to deduct the interest expense in 2010 and Rodney will be required to report the interest income in 2009.

c. The corporation will be allowed to deduct the interest expense in 2010 and Rodney will be required to report the interest income in 2010.
d. The corporation will be allowed to deduct the interest expense in 2009 and Rodney will be required to report the interest income in 2009.
e. None of the above.

ANS: C
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 DIF: 1 REF: Example 12 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

14. On December 31, 2009, Peregrine Corporation, an accrual method, calendar year taxpayer, accrued a performance bonus of $100,000 to Charles, a cash basis, calendar year taxpayer. Charles is president and sole shareholder of the corporation. When can Peregrine deduct the bonus?
a. In 2009, if the bonus was authorized by the Board of Directors and payment was made on or before March 15, 2010.
b. In 2009, if payment was made on or before March 15, 2010.
c. In 2010, if payment was made at any time during that year.
d. In 2010, but only if payment was made on or before March 15, 2010.
e. None of the above.

ANS: C
Because Charles is a related party, Peregrine's deduction for the bonus must wait until Charles includes the bonus in gross income. Charles, who is a cash basis, calendar year taxpayer, will include the payment in gross income in the year he receives it from Peregrine. Therefore, if Peregrine pays Charles the bonus anytime in 2010, the corporation can deduct the bonus in 2010.

PTS: 1 DIF: 1 REF: Example 12 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

15. Bear Corporation has a net short-term capital gain of $25,000 and a net long-term capital loss of $170,000 during 2009. Bear Corporation has taxable income from other sources of $700,000. Prior years' transactions included the following:

2005	Net short-term capital gain	$55,000
2006	Net long-term capital gain	30,000
2007	Net short-term capital gain	25,000
2008	Net long-term capital gain	5,000

Compute the amount of Bear's capital loss carryover to 2010.
a. $0.
b. $30,000.
c. $85,000.
d. $145,000.
e. None of the above.

ANS: C

Net short-term capital gain for 2009	$ 25,000
Net long-term capital loss for 2009	(170,000)
Net capital loss	($145,000)

The net capital loss of $145,000 is not deductible on the 2009 return, but must be carried back to the three preceding years, applying it to 2006, 2007, and 2008, in that order. The net capital loss is carried back or forward as short-term capital loss.

2009 net capital loss	($145,000)
Offset against	
2006 (net long-term capital gain)	$ 30,000
2007 (net short-term capital gain)	25,000
2008 (net long-term capital gain)	5,000
Total carrybacks	$ 60,000

Bear's capital loss carryover is $85,000 ($145,000 – $60,000), which may be carried over to 2010, 2011, 2012, 2013, and 2014, in that order.

PTS: 1 DIF: 1 REF: p. 2-12 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 10 min

16. In 2009, Bluebird Corporation had net income from operations of $50,000. Further, Bluebird recognized a long-term capital loss of $20,000, and a short-term capital gain of $5,000. Which of the following statements is correct?
   a. Bluebird Corporation may use the capital loss to offset the capital gain and must carry the net capital loss of $15,000 forward five years as a long-term capital loss.
   b. Bluebird Corporation will have taxable income in 2009 of $50,000 and will have a net capital loss of $15,000 that can be carried back 3 years and forward 5 years.
   c. Bluebird Corporation will have taxable income in 2009 of $47,000.
   d. Bluebird Corporation may deduct $8,000 of the capital loss in 2009 and may carry forward the remainder of the capital loss indefinitely to offset capital gains.
   e. None of the above.

ANS: B
The capital loss will offset the $5,000 capital gain. The remaining $15,000 capital loss can be carried back to the three preceding years to reduce any capital gains in those years. Any remaining loss not offset against capital gains in the three preceding tax years can be carried forward for five years to offset capital gains in those years. The long-term capital loss will be treated as short-term capital loss when carried back or forward.

PTS: 1 DIF: 1 REF: Example 14 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

17. Maize Corporation had $200,000 operating income and $90,000 operating expenses during the year. In addition, Maize had a $25,000 long-term capital gain and a $16,000 short-term capital loss. Compute Maize's taxable income for the year.
a. $91,000.
b. $94,000.
c. $110,000.
d. $135,000.
e. None of the above.

ANS: E
$200,000 operating income – $90,000 operating expenses + $25,000 LTCG – $16,000 STCL = $119,000 taxable income. The net capital gain of $9,000 ($25,000 LTCG – $16,000 STCL) is included in taxable income and taxed at the normal corporate tax rates.

PTS: 1 DIF: 1 REF: p. 2-12 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

18. Starling Corporation, a closely held personal service corporation, has $150,000 of active income, $60,000 of portfolio income, and a $165,000 passive loss during the year. How much of the passive loss can Starling deduct in the current year?
a. $0.
b. $60,000.
c. $150,000.
d. $165,000.
e. None of the above.

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

PTS: 1 DIF: 1 REF: Example 15 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

19. 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 DIF: 1 REF: Example 15 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

20. 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 during the year. How much of the passive loss can Sage deduct in the current year?
 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 DIF: 1 REF: Example 15 OBJ: 2
 NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

21. Pelican, Inc., a closely held corporation (not a PSC), has a $350,000 loss from a passive activity, $135,000 of active business income, and $160,000 of portfolio income. How much is Pelican's taxable income?
 a. ($55,000).
 b. $0.
 c. $160,000.
 d. $295,000.
 e. None of the above.

 ANS: C
 A closely held corporation that is not a PSC can deduct passive losses against active income but not portfolio income. Thus, Pelican's taxable income is $160,000 [$135,000 (active income) + $160,000 (portfolio income) – $135,000 (passive loss limited to active income)].

 PTS: 1 DIF: 1 REF: Example 15 OBJ: 2
 NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

22. 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 basis + $650 appreciation) is allowed as a deduction. Because the Acme stock is capital gain property that is 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 DIF: 2 REF: p. 2-14 | p. 2-15
OBJ: 2 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 10 min

23. In the current year, Plum Corporation, a computer manufacturer, donated 100 laptop computers to a local school district (a qualified educational organization). The computers were constructed by Plum earlier this year, and the school district allocated the computers among its various schools where they will be used for educational purposes. Plum's basis in the computers is $70,000, and their fair market value is $250,000. What is Plum's deduction for the contribution of the computers (ignoring the taxable income limitation)?
a. $70,000.
b. $140,000.
c. $160,000.
d. $250,000.
e. None of the above.

ANS: B
The contribution of computers qualifies for the increased contribution amount available with respect to certain inventory. The contribution amount is equal to the lesser of (1) the sum of the property's basis plus 50% of the appreciation on the property [$160,000 = $70,000 basis + .5($250,000 fair market value – $70,000 basis)] or (2) twice the property's basis ($140,000 = 2 × $70,000 basis). Thus, Plum's deduction for the charitable contribution of the inventory is $140,000.

PTS: 1 DIF: 2 REF: Example 20 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

24. Rhino, Inc., a calendar year C corporation, had the following income and expenses in 2009:

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 2009?
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 DIF: 1 REF: Example 21 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

25. Hippo, Inc., a calendar year C corporation, manufactures golf gloves. For 2009, Hippo had taxable income (before DPAD) of $300,000, qualified domestic production activities income of $350,000, and W-2 wages related to qualified production activities income of $30,000. Hippo's domestic production activities deduction for 2009 is:
a. $0.
b. $18,000.
c. $21,000.
d. $30,000.
e. None of the above.

ANS: E
Hippo's tentative domestic production activities deduction for 2009 is 6% of the lesser of:

• $300,000 taxable income (before DPAD)	$18,000
• qualified production activities income of $350,000	$21,000

Although the tentative deduction is $18,000 ($300,000 × 6%), the wage limitation applies ($30,000 × 50% = $15,000). Therefore, Hippo's domestic production activities deduction is $15,000.

PTS: 1 DIF: 2 REF: Example 23 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

26. In the current year, Amber, Inc., a C corporation, has income from operations of $400,000 and operating deductions of $535,000. Amber also had $50,000 of dividends from a 10% stock ownership in a domestic corporation. Which of the following statements is *incorrect* with respect to Amber's net operating loss deduction?
a. Amber's NOL is $120,000.
b. The NOL is carried back 2 years and forward 20 years by Amber.
c. No dividends received deduction is allowed in computing Amber's NOL.
d. Amber can elect to forgo the carryback period and only carry forward the NOL.
e. None of the above.

ANS: C
A 70% dividends received deduction is allowed and results in an NOL of $120,000 [$400,000 (operating income) + $50,000 (dividends) – $535,000 (operating deductions) – $35,000 (DRD of $50,000 × 70%)]. Generally an NOL is carried back 2 years and forward 20 years, but a corporation can elect to forgo the carryback period and just carry the NOL forward.

PTS: 1 DIF: 2 REF: p. 2-16 | p. 2-17 | Example 24
OBJ: 2 | 3 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 5 min

27. Fender Corporation was organized in 2007 and had profits in 2007 and 2008. The corporation had an NOL in 2009. The corporation should elect to forgo carrying the NOL back:
a. If it cannot accurately predict future tax rates.
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 tax rates in the preceding years were low and if higher tax rates are expected in the future.
e. None of the above.

ANS: D
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 d.). Before electing to forgo an NOL carryback, a corporation should be able to predict with confidence that future tax rates will be higher (choice a.)

PTS: 1 DIF: 2 REF: Example 40 OBJ: 2 | 8
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

28. 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 DIF: 1 REF: p. 2-17 OBJ: 3
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

29. Eagle Corporation owns stock in Hawk Corporation and has taxable income of $160,000 for the year before considering the dividends received deduction. Hawk Corporation pays Eagle a dividend of $200,000, which was considered in calculating the $160,000. What amount of dividends received deduction may Eagle claim if it owns 15% of Hawk's stock?
a. $0.
b. $112,000.
c. $140,000.
d. $160,000.
e. None of the above.

ANS: B
The dividends received deduction depends upon the percentage of ownership by the corporate shareholder. Because Eagle Corporation owns 15% of Hawk Corporation, Eagle would qualify for a 70% deduction, calculated as shown below.

1. Multiply the dividends received by the deduction percentage ($200,000 × 70% = $140,000).

2. Multiply the taxable income before the dividends received deduction by the deduction percentage ($160,000 × 70% = $112,000).

3. Limit the deduction to the lesser of step 1 or step 2, unless subtracting the amount derived in step 1 ($140,000) from taxable income before the dividends received deduction ($160,000) generates an NOL ($160,000 – $140,000 = $20,000 taaxable income). If so, use the amount derived in step 1 ($140,000). In this case, the taxable income limitation applies, and the deduction equals $112,000.

PTS: 1 DIF: 2 REF: Example 25 OBJ: 3
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 10 min

30. 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 DIF: 1 REF: p. 2-17 OBJ: 3
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

31. Orange Corporation owns stock in White Corporation and has net operating income of $500,000 for the year. White Corporation pays Orange a dividend of $100,000. What amount of dividends received deduction may Orange claim if it owns 28% of White stock (assuming Orange's dividends received deduction is not limited by its taxable income)?
    a. $0.
    b. $70,000.
    c. $80,000.
    d. $100,000.
    e. None of the above.

    ANS: C
    The dividends received deduction depends upon the percentage of ownership by the corporate shareholder. If Orange Corporation owns 28% of White Corporation, Orange would qualify for an 80% deduction, or $80,000 in this case.

    PTS: 1 DIF: 1 REF: p. 2-17 OBJ: 3
    NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

32. Which of the following statements is *incorrect* regarding the dividends received deduction?
    a. A corporation must hold stock for more than 45 days in order to qualify for a deduction with respect to dividends on such stock.
    b. The taxable income limitation does not apply with respect to the 100% deduction available to members of an affiliated group.
    c. If a stock purchase is financed 75% by debt, the deduction for dividends on such stock is reduced by 75%.
    d. The taxable income limitation does not apply if the normal deduction (i.e., 70% or 80% of dividends) results in a net operating loss for the corporation.
    e. None of the above.

    ANS: E
    All of the statements are correct.

    PTS: 1 DIF: 2 REF: p. 2-17 | p. 2-18 | Footnote 19
    OBJ: 3 NAT: AICPA FN-Measurement | AACSB Analytic
    MSC: 5 min

33. Saguaro Corporation, a cash basis and calendar year taxpayer, was formed and began operations on August 1, 2009. Saguaro incurred the following expenses during its first year of operations (August 1 - December 31, 2009):

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

With an election under § 248 to amortize qualifying organizational expenses, how much may the corporation deduct for tax year 2009?
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

With an election under § 248(c), the amount that Saguaro Corporation may write off for the tax year 2009 is determined as follows:

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

PTS: 1 DIF: 2 REF: Example 27 OBJ: 3
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 10 min

34. During 2009, 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 2009?
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 DIF: 2 REF: Exhibit 2.1 | Example 29
OBJ: 2 | 4 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 5 min

35. George Judson is the sole shareholder and employee of Black Corporation, a C corporation that is engaged exclusively in engineering services. During the year, Black has gross revenues of $300,000 and operating expenses (excluding salary) of $100,000. Further, Black Corporation pays George a salary of $150,000. The salary is reasonable in amount and George is in the 35% marginal tax bracket irrespective of any income from Black. Assuming that Black Corporation distributes all after-tax income as dividends, how much total combined income tax do Black and George pay in the current year? (Ignore any employment tax considerations.)
    a. $64,875.
    b. $70,000.
    c. $74,875.
    d. $81,375.
    e. None of the above.

    ANS: C
    Since Black Corporation is a personal service corporation, a 35% flat tax rate applies to its taxable income of $50,000 [$300,000 (gross receipts) – $150,000 (salary expense) – $100,000 (other operating expenses)]; thus, corporate income tax is $17,500. Black's after-tax income distributed to George therefore equals $32,500 ($50,000 – $17,500). George incurs income tax of $52,500 ($150,000 × 35%) on the salary income and $4,875 ($32,500 × 15%) on the dividend income, for a total tax of $57,375. Thus, the total combined income tax is $74,875 ($17,500 tax to Black Corporation + $57,375 tax to George).

    PTS: 1 DIF: 3 REF: p. 2-20 | p. 2-21 | Example 8
    OBJ: 4 NAT: AICPA FN-Measurement | AACSB Analytic
    MSC: 10 min

36. 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 DIF: 1 REF: Exhibit 2.1 | p. 2-20 | p. 2-22
    OBJ: 4 | 6 NAT: AICPA FN-Reporting | AACSB Analytic
    MSC: 5 min

37. 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 DIF: 1 REF: p. 2-21 to 2-23
OBJ: 4 | 6 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 5 min

38. 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. Which of the following items is an *addition* on Schedule M-1?
    a. Charitable contributions carryover from previous year.
    b. Charitable contributions in excess of deductible limits.
    c. Proceeds of life insurance paid on death of key employee.
    d. Tax-exempt interest.
    e. None of the above.

ANS: B
The other items are *subtractions* on Schedule M-1.

PTS: 1 DIF: 2 REF: Example 32 OBJ: 6
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

39. 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. Which of the following items is a *subtraction* on Schedule M-1.
    a. Book depreciation in excess of allowable tax depreciation.
    b. Federal income tax per books.
    c. Premiums paid on life insurance policy on key employee.
    d. Tax-exempt interest.
    e. None of the above.

ANS: D
The other items are *additions* on Schedule M-1.

PTS: 1 DIF: 2 REF: Example 32 OBJ: 6
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

40. Which of the following statements is *incorrect* regarding financial accounting considerations of a corporation?
    a. Differences between tax and financial accounting treatment of depreciation give rise to temporary differences.
    b. For financial purposes, FAS 109 sets forth rules regarding the determination of current tax expense (reported on the income statement) and deferred taxes (reported on the balance sheet).
    c. FIN 48 was issued by the FASB to provide greater clarity to the treatment of uncertain tax positions on financial statements.
    d. Under FIN 48, a tax position must be recognized in the financial statements when it has a

"reasonable probability" of being sustained on examination.
e. None of the above.

ANS: D
Under FIN 48, a tax position must be recognized in the financial statements when it has a "more-likely-than-not" probability of being sustained on examination. The other statements are correct.

PTS: 1 DIF: 2 REF: p. 2-27 to 2-30
OBJ: 7 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 5 min

PROBLEM

1. During the current year, Yellow Company had operating income of $380,000 and operating expenses of $300,000. In addition, Yellow had a long-term capital loss of $50,000. Based on this information, how does Alexandria, the sole owner of Yellow Company, report this information on her individual income tax return under following assumptions?

   a. Yellow is a proprietorship, and Alexandria does not withdraw any funds from the company during the year.

   b. Yellow is an LLC, and Alexandria does not withdraw any funds from the company during the year.

   c. Yellow is an S corporation, and Alexandria does not withdraw any funds from the company during the year.

   c. Yellow is a regular corporation, and Alexandria does not withdraw any funds from the company during the year.

   ANS:
   a. Revenues, expenses, gains, and losses of a proprietorship flow through to the proprietor. Consequently, Alexandria reports the $80,000 net profit and $50,000 long-term capital loss (subject to capital loss limitation) on her individual return.

   b. Revenues, expenses, gains, and losses of a single-member LLC flow through to the sole member. Consequently, Alexandria reports the $80,000 net profit and $50,000 long-term capital loss (subject to capital loss limitation) on her individual return.

   c. Revenues, expenses, gains, and losses of an S corporation flow through to the shareholders. Separately stated items, e.g., capital gains and losses, retain their character at the shareholder level. Consequently, Alexandria reports the $80,000 net profit and $50,000 long-term capital loss (subject to capital loss limitation) on her individual return.

   d. Shareholders of a regular (C) corporation report income from the corporation to the extent of dividends received. Therefore, Alexandria does not report any of Yellow's income or capital loss on her individual return. [Yellow Company would report the $80,000 net profit and $50,000 long-term capital loss (subject to capital loss limitation) on its corporate return

(Form 1120).]

PTS: 1 DIF: 3 REF: p. 2-2 to 2-4 OBJ: 1
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 10 min

2. Beige Company has approximately $400,000 in net income in 2009 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. (Ignore any employment tax considerations.)

   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 DIF: 3 REF: p. 2-2 to 2-5 OBJ: 1 | 4
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 15 min

3. Maroon Company had $150,000 net profit from operations in 2009 and paid Bobbie, its sole shareholder, a dividend of $108,250 ($150,000 net profit – $41,750 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 $108,250 from the business during the year? Explain.

ANS:
If Maroon Company is a corporation, the $150,000 is taxable at the corporate level, resulting in corporate tax of $41,750. Bobbie will pay tax of $16,238 on the dividend income ($108,250 × 15%). Total taxes amount to $57,988 ($41,750 + $16,238). If Maroon Company is a proprietorship, Bobbie must pay tax of $52,500 ($150,000 × 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 DIF: 2 REF: p. 2-2 to 2-5 | Example 5 | Example 6
OBJ: 1 | 4 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 10 min

4. Ostrich Corporation has a net short-term capital gain of $50,000 and a net long-term capital loss of $280,000 during 2009. Ostrich also has taxable income from other sources of $1 million. Prior years' transactions included the following:

2005 net short-term capital gains	$100,000
2006 net long-term capital gains	70,000
2007 net short-term capital gains	30,000
2008 net long-term capital gains	90,000

a. How are the capital gains and losses treated on Ostrich's 2009 tax return?
b. Determine the amount of the 2009 net 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 2009 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 2009 return, but must be carried back to the three preceding years, applying it to 2006, 2007, and 2008, in that order. Such net capital loss is carried back or forward as a short-term capital loss.

b.

2009 net capital loss	($230,000)
Offset against—	
2006 net long-term capital gains	$ 70,000
2007 net short-term capital gains	30,000
2008 net long-term capital gains	90,000
Total carrybacks	$190,000

c. $40,000 ($230,000 – $190,000) STCL carryover to 2010, 2011, 2012, 2013, and 2014, in that order.

d. Ellen would net these transactions with all other capital transactions for 2009. Assuming these were her only capital transactions in 2009, 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 DIF: 2 REF: p. 2-12 OBJ: 2

NAT: AICPA FN-Measurement | AACSB Analytic MSC: 10 min

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, 2009.

   a. How much salary must Shaw Corporation pay Shaw during the period October 1 through December 31, 2009, to enable the corporation to continue to use its fiscal year without negative tax effects?

   b. If Shaw Corporation had taxable income of $150,000 for the year ending September 30, 2009, 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, 2009, 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 DIF: 2 REF: p. 2-21 | Example 11
OBJ: 2 | 4 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 5 min

6. During the current year, Flamingo Corporation, a regular corporation in the book publishing business, made charitable contributions to qualified organizations as follows:

   - Children's books (basis of $25,000, fair market value of $95,000), held as inventory, to local public elementary schools that use the books in their educational programs.

   - Stock (basis of $10,000, fair market value of $30,000) in Violet Corporation, held for seven months as an investment, to United Way. (United Way plans on selling the stock.)

   - Land (basis of $60,000, fair market value of $150,000), held for three years as an investment, to State University. (State University plans on using the land for new dormitories.)

   Flamingo Corporation's taxable income (before any charitable contribution) is $1 million.

   a. What is the total amount of Flamingo's charitable contributions for the year?

   b. What is the amount of Flamingo's charitable contribution deduction in the current year, and what happens to any excess charitable contribution, if any?

ANS:

a. Flamingo's total amount of charitable contributions is $210,000 [$50,000 (inventory) + $10,000 (stock) + $150,000 (land)], computed as follows:

- Inventory: this qualifies for the enhanced contribution amount available with respect to certain inventory, since it consists of books contributed to public schools (K through 12) that use the books in their educational programs. The contribution amount is equal to the lesser of (1) the sum of the property's basis plus 50% of the appreciation on the property [$60,000 = $25,000 basis + .5($95,000 fair market value – $25,000 basis)] or (2) twice the property's basis ($50,000 = 2 × $25,000 basis). Thus, the amount of the contribution is $50,000.

- Stock: this is ordinary income property, since a sale of the stock would not result in long-term capital gain or § 1231 gain for Flamingo. Thus, the amount of the contribution is the stock's basis, or $10,000.

- Land: this is capital gain property, since a sale of the land would result in a long-term capital gain for Flamingo. Thus, the amount of the contribution is the land's fair market value, or $150,000.

b. Flamingo's current year charitable deduction is limited to $100,000 [10% x $1 million (taxable income before charitable deduction)], and the excess charitable contribution of $110,000 ($210,000 – $100,000) is carried forward to the five succeeding tax years.

PTS: 1 DIF: 3 REF: p. 2-13 to 2-15
OBJ: 2 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 10 min

7. During 2009, 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 2005) of $6,000.

a. What is Violet's charitable contribution deduction for 2009?

b. If any of Violet's charitable contributions are not deductible in 2009, 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 or the charitable contribution 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 2009 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 2009 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 2005, the 5-year carryover period will expire in 2010.

PTS: 1 DIF: 2 REF: Example 21 | Example 22
OBJ: 2 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 10 min

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

Income from operations	$600,000
Expenses from operations	700,000
Dividends received from ABC Corporation	200,000

Quartz owns 25% 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	$600,000	
Dividends	200,000	$800,000
Less:		
Expenses from operations	$700,000	
Dividends received deduction ($200,000 × 80%)	160,000	(860,000)
Net operating loss		($ 60,000)

The dividends received deduction is not limited to the taxable income limitation because it creates a net operating loss.

PTS: 1 DIF: 2 REF: Example 24 | Example 25
OBJ: 2 | 3 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 5 min

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

Income from operations	$570,000
Expenses from operations	610,000
Dividends received from Roadrunner Corporation	150,000

a. Coyote owns 5% 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 25% 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	$570,000	
Dividends	150,000	$720,000
Less: Expenses from operations		(610,000)
Taxable income before the dividends received deduction		$110,000
Dividends received deduction (70% × $110,000)		(77,000)
Taxable income		$ 33,000

The dividends received deduction is limited to 70% of taxable income because taking 70% of $150,000 ($105,000) would not create an NOL.

b. If Coyote Corporation owns 25% of Roadrunner 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	$570,000	
Dividends	150,000	$720,000
Less: Expenses from operations		(610,000)
Taxable income before the dividends received deduction		$110,000
Dividends received deduction (80% × $150,000)		(120,000)
Net operating loss		($ 10,000)

PTS: 1 DIF: 2 REF: Example 24 | Example 25
OBJ: 3 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 10 min

10. Warbler Corporation, an accrual method regular corporation, was formed and began operations on July 1, 2009. The following expenses were incurred during its first year of operations (July 1 - December 31, 2009):

Expenses of temporary directors and organizational meetings	$17,000
Incorporation fee paid to state	1,500
Expenses incurred in printing and selling stock certificates	16,000
Accounting services incident to organization	9,000

a. Assuming a valid election under § 248 to amortize organizational expenditures, what is the amount of Warbler's deduction for 2009?

b. Same as a., except that Warbler also incurred in 2009 legal fees of $25,000 for the drafting of the corporate charter and bylaws. What is the amount of Warbler's 2009 deduction for organizational expenditures?

ANS:
a. Warbler has qualifying organizational expenditures of $27,500 [$17,000 (expenses of directors and temporary meetings) + $1,500 (incorporation fee) + $9,000 (accounting fees)]. Expenses related to the printing or selling of stock or other securities do not qualify as organizational expenditures. Warbler's 2009 deduction for the organizational expenditures is $5,750 {$5,000 + [($27,500 – $5,000)/180 x 6 months]}.

b. Warbler now has qualifying organizational expenditures of $52,500 [$27,500 (as computed in a., above) + $25,000 (legal fees)]. Warbler's 2009 deduction for the organizational expenditures is $4,167 {$2,500 + [($52,500 – $2,500)/180 × 6 months]}. The $5,000 immediate expensing amount is reduced to the extent qualifying organizational expenditures exceed $50,000; thus, only $2,500 of the expenditures are immediately deductible, and the remainder of the expenditures are amortized over 180 months.

PTS: 1 DIF: 2 REF: p. 2-19 | p. 2-20
OBJ: 3 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 10 min

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 2009.

	Taxable Income
Violet Corporation	$ 73,000
Indigo Corporation	195,000
Orange Corporation	335,000
Blue Corporation	6,710,000
Green Corporation	22,500,000

ANS:

Violet Corporation:	
Tax on $73,000 —	
$50,000 × 15%	$ 7,500
$23,000 × 25%	5,750
	$13,250
Indigo Corporation:	
Tax on $195,000—	
$100,000	$22,250
$95,000 × 39%	37,050
Total tax	$59,300

Orange Corporation:	
Tax on $335,000—	
$100,000	$ 22,250
$235,000 × 39%	91,650
Total tax	$113,900
Blue Corporation:	
Tax on $6,710,000—	
$335,000	$ 113,900
$6,375,000 × 34%	2,167,500
Total tax	$2,281,400
Green Corporation:	
Tax on $22,500,000 × 35%	$7,875,000

PTS: 1 DIF: 2 REF: Example 28 | Example 29
OBJ: 4 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 15 min

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 DIF: 3 REF: Example 32 OBJ: 6
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 15 min

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 DIF: 2 REF: p. 2-28 | p. 2-29
OBJ: 7 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 15 min

ESSAY

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

Tax Questions	Column A Partnership	Column B S Corporation	Column C C Corporation
Who pays tax on the entity's	Partners	Shareholders	Shareholders

income?	Partnership	S corporation	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:
The correct answers are shaded.

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 DIF: 2 REF: p. 2-3 to 2-7 OBJ: 1
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 15 min

2. Osprey Company had a net loss of $200,000 from merchandising operations in 2009, its first year of operations. Mary, the sole owner of Osprey, works full time in the business. She has a large amount of income from other sources and is in the 35% marginal tax bracket irrespective of Osprey. Considering this information, compare the affect of Osprey's loss to Mary under the various types of entity forms discussed in the chapter.

ANS:
If Osprey were a proprietorship, LLC, or S corporation, the company's net loss of $200,000 would pass through to Mary. In such cases, Mary would deduct the $200,000 loss on her individual income tax return for 2009, thus saving $70,000 of tax ($200,000 ´ 35%). If Osprey were a regular corporation, the net loss would not pass through to Mary and instead, would have to be carried forward to succeeding tax years of the corporation.

PTS: 1 DIF: 2 REF: p. 2-2 to 2-8 | p. 2-37 | p. 2-38
OBJ: 1 | 8 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 5 min

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 DIF: 1 REF: p. 2-4 OBJ: 1
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 10 min

4. Nancy is a 40% shareholder and president of Robin Corporation, a regular corporation. The board of directors of Robin has decided to pay Nancy a $100,000 bonus for the year based on her outstanding performance. The directors want to pay the $100,000 as salary, but Nancy would prefer to have it paid as a dividend. If both Robin Corporation and Nancy are in a 35% marginal tax bracket irrespective of the treatment of the bonus, discuss which form of payment would be most beneficial for each party. (Ignore any employment tax considerations.)

ANS:

Robin Corporation prefers treating the payment as salary, as a $100,000 deduction for such would provide the corporation with a tax savings of $35,000 [$100,000 (salary deduction) ´ 35% (marginal tax rate)]. If, instead, the payment were treated as a dividend, none of the $100,000 would deductible by Robin.

Nancy prefers treating the payment as a dividend, as a preferential tax rate of 15% would apply to the $100,000 and result in only $15,000 of tax. If, instead, the payment were treated as salary, Nancy would incur tax of $35,000 [$100,000 (salary) × 35% (marginal tax rate)]. Thus, Nancy would save $20,000 of tax if the payment were treated as a dividend instead of salary.

PTS: 1 DIF: 1 REF: p. 2-4 | p. 2-37
OBJ: 1 | 8 NAT: AICPA FN-Measurement | AACSB Analytic
MSC: 5 min

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

Shareholders are not personally liable for debts of a 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 DIF: 2 REF: p. 2-5 to 2-7 | Concept Summary 2.1
OBJ: 1 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 10 min

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 profit (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 DIF: 1 REF: p. 2-7 | p. 2-8
OBJ: 1 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 5 min

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 personal service corporation. 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 (PSCs), 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 tax 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 DIF: 1 REF: p. 2-10 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 10 min

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 DIF: 1 REF: p. 2-10 OBJ: 2
NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

9. Jessica, a cash basis individual, is the sole shareholder of Crow Corporation, a regular corporation. On January 1, 2009, Jessica loaned Crow $500,000, with the principal due in 10 years and 10% interest due each January 1. Crow, an accrual method, calendar year taxpayer, accrued $50,000 of interest expense on the loan on December 31, 2009, and paid the $50,000 to Jessica on January 1, 2010. How much is Crow's deduction for interest on this loan for 2009? Would your answer change if Jessica was a 45% shareholder of Crow?

ANS:
Crow Corporation and Jessica are related parties under § 267 (corporation and more than 50% shareholder). As a result, the interest expense on the loan is deductible by Crow in the year it is actually paid to Jessica, or 2010. Thus, Crow has no deduction for interest expense on the loan for 2009. If Jessica was a 45% shareholder, the related party provisions of § 267 would not apply to the interest expense accrual, and Crow would have a $50,000 deduction for such in 2009.

PTS: 1 DIF: 2 REF: Example 12 OBJ: 2
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

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 that 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 DIF: 1 REF: p. 2-37 to 2-39
OBJ: 1 | 8 NAT: AICPA FN-Reporting | AACSB Reflective Thinking

MSC: 10 min

11. Which of the following C corporations will be allowed to use the cash method of accounting for 2009? Explain your answers.

    a. Cardinal Corporation, which had gross receipts as follows: $3 million in 2006, $6 million in 2007, and $4 million in 2008.

    b. Redbird Corporation, which had gross receipts as follows: $2 million in 2006, $6 million in 2007, and $9 million in 2008.

    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 DIF: 1 REF: p. 2-11 OBJ: 2
    NAT: AICPA FN-Reporting | AACSB Analytic MSC: 5 min

12. Corporate taxpayers have a few advantages over individual taxpayers with respect to charitable contribution deductions. Briefly describe the differences in tax treatment of charitable contributions that favor corporate taxpayers.

    ANS:
    An accrual basis corporation may claim a charitable deduction in the current year for a contribution that is made within 2 1/2 months after the end of such tax year. The corporation's board of directors must approve the charitable contribution by the end of the year in which the deduction is accrued. An accrual basis individual taxpayer can deduct a charitable contribution only for the year in which the payment is made.

    A charitable deduction for the contribution of inventory is generally limited to the property's basis. Corporate taxpayers have an opportunity to claim a larger charitable deduction in the case of certain contributions of inventory. In the case of inventory contributions subject to the enhanced deduction, the charitable amount is the lesser of (1) the sum of the property's basis plus 50% of the appreciation on the property or (2) twice the property's basis. Individual taxpayers are not eligible for this enhanced deduction and are limited to the property's basis.

    PTS: 1 DIF: 2 REF: p. 2-13 to 2-15 | p. 2-38
    OBJ: 2 | 8 NAT: AICPA FN-Measurement | AACSB Analytic
    MSC: 5 min

13. To close perceived tax loopholes, Congress enacted two limitations on the amount of any dividends received deduction. Briefly describe the two loophole closing provisions and explain why Congress felt they were necessary.

    ANS:

The two loophole closing provisions are the more-than-45-day holding period requirement and the reduced deduction in the case of debt-financed stock. No dividends received deduction is allowed for dividends on stock unless the corporation held the stock for more than 45 days. The holding period requirement was enacted to address situations where corporations purchase stock immediately before a dividend record date and soon thereafter sell the stock. In some cases, these stock sales result in a capital loss in an amount that corresponds directly with the amount of the dividend. If a dividends received deduction were allowed in such cases, the capital loss would exceed the amount of the related dividend income subject to tax.

The debt-financed stock restriction reduces the dividends received deduction with respect to any dividend-paying stock by the percentage of the investment in the stock that is debt financed. Without this provision, a corporation could finance a stock purchase with debt, claim an interest expense deduction on such debt, but incur tax on only a small amount of the dividend income from such stock.

PTS: 1 DIF: 2 REF: p. 2-18 OBJ: 3
NAT: AICPA FN-Measurement | AACSB Analytic MSC: 5 min

14. Distinguish between organizational expenditures and startup 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. Startup 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. The election, to amortize organizational or startup expenditures is deemed made with the filing of the corporation's return for its first taxable year. If a corporation elects to forgo the election, the expenditures are capitalized and cannot be deducted until the corporation ceases to do business or liquidates.

PTS: 1 DIF: 1 REF: p. 2-19 | p. 2-20
OBJ: 3 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 5 min

15. Pierre is the sole shareholder of Pine Corporation (a C corporation), which has annual taxable income of approximately $100,000. He decides to transfer half of the Pine assets to Oak Corporation (a new C 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 DIF: 1 REF: Example 30 | Example 31
OBJ: 5 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 5 min

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 DIF: 1 REF: p. 2-23 | p. 2-24
OBJ: 6 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 5 min

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 DIF: 1 REF: p. 2-27 | p. 2-28
OBJ: 7 NAT: AICPA FN-Reporting | AACSB Analytic
MSC: 5 min

CHAPTER 2

CORPORATIONS: INTRODUCTION AND OPERATING RULES

EXAMINATION QUESTIONS

1. Yellow Corporation had $300,000 operating income and $75,000 operating expenses during the year. In addition, Yellow had a $200,000 short-term capital gain and a $300,000 short-term capital loss. Compute Yellow's taxable income for the year.
   a. $425,000.
   b. $225,000.
   c. $222,000.
   d. $125,000.
   e. None of the above.

2. Orange Corporation, a closely held corporation (not a PSC), had $60,000 of active income, $90,000 of portfolio income, and a $150,000 passive loss during the year. How much of the passive loss is deductible?
   a. $0.
   b. $60,000.
   c. $90,000.
   d. $150,000.
   e. None of the above.

3. White Corporation, a personal service corporation, had $75,000 of active income, $15,000 of portfolio income, and a $90,000 passive loss during the year. How much of the passive loss is deductible?
   a. $0.
   b. $15,000.
   c. $75,000.
   d. $90,000.
   e. None of the above.

4. Which of the following statements is incorrect regarding the tax treatment of capital gains and losses for corporate taxpayers:
   a. Net long-term capital gains are taxed at ordinary income tax rates.
   b. Net capital losses can only be taken to the extent of capital gains.
   c. $3,000 of net capital losses can be taken in excess of capital gains each year.
   d. Net capital losses can be carried back three years and forward five years.
   e. All of the above.

5. Purple Corporation (a calendar year taxpayer) is engaged in the business of retailing CD players and makes the following donations during the year:

	Adjusted Basis	Fair Market Value
CD players (held as inventory) to the local Women's Shelter	$8,000	$12,000
Stock in Music acquired two years ago and held as an investment to a Catholic Church seminary	6,000	10,000
Delivery van to local SPCA (animal shelter)	8,000	4,000

How much qualifies for the charitable contribution deduction?
   a. $18,000.
   b. $22,000.
   c. $24,000.
   d. $26,000.
   e. None of the above.

6. During the current year, Sage Corporation (a calendar year taxpayer) had the following income and expenses:

Income from operations	$200,000
Expenses from operations	125,000
Qualifying dividends from domestic corporation in which Sage owns a 40% interest	17,000
NOL carryover from prior year	2,000

On October 1, Sage Corporation made a contribution to a qualified charitable organization of $25,000 in cash (not included in any of the above items). Determine Sage Corporation's charitable contribution deduction for the current year.
a. $7,300.
b. $9,000.
c. $9,200.
d. $25,000.
e. None of the above.

7. Plum Corporation owns 10% of the stock of Pearl Corporation, which pays it a dividend of $50,000. Plum Corporation also owns 80% of the stock of Sienna Corporation, which pays it a $25,000 dividend. Assuming the taxable income limitation does not apply, how much is Plum Corporation's dividend received deduction for the year?
a. $52,500.
b. $55,000.
c. $60,000.
d. $75,000.
e. None of the above.

8. Pink Corporation, which owns stock in Sienna Corporation, had net operating income of $125,000 for the year. Sienna pays Pink a dividend of $60,000. Pink takes a dividends received deduction of $48,000. Which of the following statements is correct?
a. Pink owns less than 20% of Sienna Corporation.
b. Pink owns 20% or more, but less than 80% of Sienna Corporation.
c. Pink owns 80% of Sienna Corporation.
d. Pink owns more than 80% of Sienna Corporation.
e. None of the above.

9. Coral Corporation, an accrual basis taxpayer, was formed and began operations on October 1, 2009. The following expenses were incurred during the first tax year (October 1 to December 31, 2009) of operations:

Expenses of temporary directors and of organizational meetings	$ 20,000
Fee paid to the state of incorporation	1,600
Accounting services incident to organization	6,800
Legal services for drafting the corporate charter and bylaws	2,000
Expenses incident to the printing and sale of stock certificates	4,000
	$34,400

Assume Coral Corporation makes an appropriate and timely election under § 248(c) and the related Regulations. What is the maximum organizational expense Coral may write off for tax year 2009?

a. $507.
b. $5,000.
c. $5,423.
d. $5,490.
e. None of the above.

10. In working with Schedule M-1 (reconciliation of income per books with income per return) of Form 1120, which of the following must be *subtracted* from net income per books?

a. Federal income tax.
b. Excess of capital losses over capital gains.
c. Tax-exempt interest.
d. Premiums on key employee insurance.
e. All of the above.

SOLUTIONS TO EXAMINATION QUESTIONS

1. b Yellow has a net short-term capital loss for the year, but it is not deductible. The loss is computed as follows:

Short-term capital loss	$300,000
Less: short-term capital gain	(200,000)
Net short-term capital loss	$(100,000)

Yellow 's taxable income is computed as follows:

Operating income	$300,000
Less: operating expenses	(75,000)
Net income from operations	$225,000

p. 2-12 and Example 14

2. b A closely held corporation may offset passive loss against active income, but not against portfolio income. p. 2-13

3. a A personal service corporation may not offset passive loss against active income or portfolio income. p. 2-13

4. c Net long-term capital gains are taxed at the corporate ordinary income rates. Net capital losses can only be taken to the extent of capital gains. The $3,000 excess capital loss provision for individuals does not apply to corporations. Losses that can not be used during the year are carried back three years and forward five. p. 2-12

5. c Since Purple is a corporation and the inventory exception is met (see Example 20 in the text), one-half of the appreciation on the CD players may be claimed, or $2,000 [1/2 of ($12,000 - $8,000)]. Therefore, $10,000 ($8,000 + $2,000 appreciation) is allowed as a deduction. Because the Music stock is long-term capital gain property and not tangible personalty, the appreciation may be included. The deduction for the delivery van, which is *not* a capital asset, is limited to the *lesser* of adjusted basis or fair market value. Thus, $10,000 + $10,000 + $4,000 = $24,000. Examples 17 and 20

6. b

Income from operations		$200,000
Qualifying dividend		17,000
Subtotal		$217,000
Less: Expenses from operations	$125,000	
NOL carryover from prior year	2,000	(127,000)
Limitation base for contributions		$90,000
Allowable contribution percentage		X 10%
Charitable contribution allowed		$ 9,000

The charitable contribution deduction is based on taxable income determined without regard to the charitable contribution deduction, any net operating loss carryback or capital loss carryback, and the dividends received deduction. Example 21

7. c Plum deducts 100% of the dividend received from Sienna Corporation and 70% of the dividend received from Pearl Corporation. [($25,000 X 100%) + ($50,000 X 70%)] = $60,000. pp. 2-17 and 2-18

8. b Pink'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%. pp. 2-17 and 2-18

9. c Qualifying organizational expenditures include these items:

Expenses of temporary directors and of organizational meetings	$20,000
Fee paid to the state of incorporation	1,600
Accounting services incident to organization	6,800
Legal services for drafting the corporate charter and bylaws	2,000
Total	$30,400

Since an appropriate and timely election under § 248(c) was made, the amount that Coral Corporation may write off for the tax year 2009 is determined as follows:

$5,000 + [(($30,400 - $5,000) ÷ 180) X 3] = $5,423

pp. 2-19, 2-20, and Example 2

10. c All of the items except c. must be added back to book income to reconcile book income to taxable income. pp. 2-22, 2-23, and Example 32