

CHAPTER 2--CORPORATIONS: INTRODUCTION AND OPERATING RULES

Student: _____

1. Olga's proprietorship earned a net profit of \$95,000 during the year and she withdrew \$70,000 of this profit. Olga must report \$70,000 net income from the proprietorship on her individual income tax return (Form 1040).

True False

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.

True False

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 Federal individual income tax return.

True False

4. Donald owns a 40% interest in a partnership that earned \$140,000 in the current year. He also owns 40% of the stock in a C corporation that earned \$140,000 during the year. Donald received \$30,000 in distributions from each of the two entities during the year. With respect to this information, Donald must report \$60,000 of income on his individual income tax return for the year.

True False

5. Quail Corporation is a C corporation with net income of \$300,000 during 2010. If Quail paid dividends of \$50,000 to its shareholders, the corporation must pay tax on \$300,000 of net income. Shareholders must report the \$50,000 of dividends as income.

True False

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.

True False

7. Emma, the sole shareholder of Quail Corporation (a C corporation), has the corporation pay her a salary of \$300,000 in 2010. The Tax Court has held that \$80,000 represents unreasonable compensation. Assuming Emma is in the 35% bracket in 2010, the Tax Court's holding will increase total tax she pays in 2010.
True False

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.
True False

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.
True False

10. Thrush Corporation files Form 1120, which reports taxable income of \$110,000. The corporation's tax is \$26,150.
True False

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

12. There is no Federal income tax assessed on partnerships (including those formed as LLCs) or S corporations. Since all states follow the Federal approach as to entity taxation, state income taxation is a neutral factor in the selection of an entity form.
True False

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

14. As a general rule, a personal service corporation (PSC) must use a fiscal year as its accounting period.
True False

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

True False

16. On December 31, 2010, 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, 2011. Lavender can deduct the bonus in 2010, the year in which Barry's services were performed.

True False

17. Unlike individual taxpayers, corporate taxpayers do not receive a preferential tax rate with respect to long-term capital gains.

True False

18. Albatross, a C corporation, had \$125,000 net income from operations and a \$10,000 short-term capital loss in 2010. Albatross Corporation's taxable income is \$115,000.

True False

19. Owl Corporation, a C corporation, recognizes a gain on the sale of a \$1250 asset in the current year. Owl had used the straight-line method for depreciating the realty. Some of Owl's gain on the sale of the realty will be treated as depreciation recapture (ordinary income).

True False

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

True False

21. Peach Corporation had \$210,000 of active income, \$45,000 of portfolio income, and a \$230,000 passive loss during the year. If Peach is a closely held C corporation that is not a PSC, it can deduct \$210,000 of the passive loss in the year.

True False

22. On December 20, 2010, 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, 2011, may be claimed as a deduction for tax year 2010.

True False

23. On April 8, 2010, Oriole Corporation donated a painting worth \$75,000 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 \$25,000. Oriole's charitable contribution deduction is \$25,000 (ignoring the taxable income limitation).

True False

24. Zircon Corporation donated scientific property worth \$300,000 to City University (a qualified charitable organization) to be used in research. The basis of the property was \$140,000, and Zircon had held it for ten months as inventory. Zircon Corporation may deduct \$220,000 as a charitable contribution (ignoring the taxable income limitation).

True False

25. Egret Corporation, a calendar year C corporation, had an excess charitable contribution for 2009 of \$15,000. In 2010, it made a further charitable contribution of \$20,000. Its 2010 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.

True False

26. For a corporation in 2010, the domestic production activities deduction is equal to 9% of the lower of (1) qualified production activities income or (2) taxable income. However, the deduction cannot exceed 50% of the W-2 wages related to qualified production activities income.

True False

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

True False

28. 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.

True False

29. The dividends received deduction may be subject to a limitation based on a percentage of taxable income computed without regard to the NOL deduction, the domestic production activities deduction, the dividends received deduction, and any capital loss carryback to the current tax year.

True False

30. No dividends received deduction is allowed unless the corporation has held the stock for more than 45 days.

True False

31. Black Corporation, an accrual basis taxpayer, was formed and began operations on February 1, 2010. During its first year of operations (February 1 – December 31, 2010), 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.

True False

32. A corporation may elect to amortize startup expenditures over the 60-month period beginning with the month in which the corporation begins business.

True False

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

True False

34. 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.

True False

35. Generally, corporations with no taxable income must file a Form 1120.

True False

36. For purposes of the estimated tax payment rules, a “large corporation” is defined as a corporation that had an average taxable income of \$1 million or more over the preceding three-year period.

True False

37. 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.

True False

38. Income that is included in net income per books but not included in taxable income is an addition item on Schedule M-1.

True False

39. 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.

True False

40. 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.

True False

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

True False

42. A corporation with \$10 million or more in assets must file Schedule M-3 (instead of Schedule M-1).

True False

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

True False

44. Juanita owns 45% of the stock in a C corporation that had a profit of \$120,000 in 2010. Carlos owns a 45% interest in a partnership that had a profit of \$120,000 during the year. The corporation distributed \$20,000 to Juanita, and the partnership distributed \$20,000 to Carlos. Which of the following statements relating to 2010 is *incorrect*?

- A. Juanita must report \$20,000 of income from the corporation.
- B. The corporation must pay corporate tax on \$120,000 of income.
- C. Carlos must report \$20,000 of income from the partnership.
- D. The partnership is not subject to a Federal entity-level income tax.
- E. None of the above.

45. Bjorn owns a 35% interest in an S corporation that earned \$200,000 in 2010. 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. \$0 income from the S corporation and \$0 income from the C corporation.
- B. \$10,000 income from the S corporation and \$10,000 income from the C corporation.
- C. \$70,000 income from the S corporation and \$0 income from the C corporation.
- D. \$70,000 income from the S corporation and \$10,000 of dividend income from the C corporation.
- E. None of the above.

46. Ted is the sole shareholder of a C corporation, and Sue owns a sole proprietorship. Both businesses were started in 2010, 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 2010.
- B. Ted's corporation can deduct \$3,000 of the capital loss in 2010.
- 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 2010.
- E. None of the above.

47. Norma formed Hyacinth Enterprises, a proprietorship, in 2010. 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 2010?

- A. Increases Norma's taxable income by \$97,000 (\$100,000 ordinary business income – \$3,000 long-term capital loss).
- 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 \$50,000.
- E. None of the above.

48. 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 both Geneva and Gulf.
- B. 15% rate applies to Geneva and 25% rate applies to 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.

49. Glen and Michael are equal partners in Trout Enterprises, a calendar year partnership. During the year, Trout Enterprises had gross income of \$400,000 and operating expenses of \$220,000. In addition, the partnership sold land that had been held for investment purposes for a long-term capital gain of \$100,000. During the year, Glen withdrew \$60,000 from the partnership, and Michael withdrew \$60,000. Discuss the impact of this information on the taxable income of Trout, Glen, and Michael.

- A. Trout pays tax on \$0 income, Glen's taxable income increases by \$60,000, and Michael's taxable income increases by \$60,000.
- B. Trout pays tax on \$280,000 income, Glen's taxable income increases by \$60,000, and Michael's taxable income increases by \$60,000.
- C. Trout pays tax on \$0 income, Glen's taxable income increases by \$200,000, and Michael's taxable income increases by \$200,000.
- D. Trout pays tax on \$0 income, Glen's taxable income increases by \$140,000, and Michael's taxable income increases by \$140,000.
- E. None of the above.

50. 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. \$98,000.
- B. \$118,000.
- C. \$150,000.
- D. \$170,000.
- E. None of the above.

51. Flycatcher Corporation, a C corporation, has two equal individual shareholders, Nancy and Pasqual. In the current year, Flycatcher earned \$200,000 net profit and paid a dividend of \$40,000 to each shareholder. Regardless of any tax consequences resulting from their interests in Flycatcher, Nancy is in the 28% marginal tax bracket and Pasqual is in the 35% marginal tax bracket. With respect to the current year, which of the following statements is *incorrect*?

- A. Flycatcher pays corporate tax on \$200,000.
- B. Nancy incurs income tax of \$6,000 on her dividend income.
- C. Pasqual incurs income tax of \$6,000 on his dividend income.
- D. Flycatcher can avoid the corporate tax altogether by paying out all \$200,000 of net profit as dividends to the shareholders.
- E. None of the above.

52. Which of the following statements is *incorrect* about the check-the-box Regulations?

- A. A limited liability company with one owner can elect to be taxed as a corporation.
- B. A limited liability company with more than one owner can elect to be taxed as a corporation.
- C. An entity with more than one owner and formed as a corporation can elect to be taxed as a partnership.
- D. If a limited liability company with one owner does not make an election, the entity is taxed as a sole proprietorship.
- E. If a limited liability company with more than one owner does not make an election, the entity is taxed as a partnership.

53. Patrick, an attorney, is the sole shareholder of Gander Corporation. Gander is a personal service corporation with a fiscal year ending September 30. The corporation paid Patrick a salary of \$294,000 during its fiscal year ending September 30, 2010. How much salary must Gander pay Patrick during the period October 1 through December 31, 2010, to permit the corporation to continue to use its fiscal year without negative tax effects?

- A. \$0.
- B. \$73,500.
- C. \$220,500.
- D. \$294,000.
- E. None of the above.

54. 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, 2010. How much salary must Purple pay Jason during the period December 1 through December 31, 2010, 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.

55. Falcon Corporation, a C corporation, had gross receipts of \$3 million in 2007, \$7 million in 2008, and \$6 million in 2009. Hawk Corporation, a personal service corporation (PSC), had gross receipts of \$3 million in 2007, \$5 million in 2008, and \$4 million in 2009. Which of the corporations will be allowed to use the cash method of accounting in 2010?

- 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.

56. Rodney, the sole shareholder of a calendar year, accrual basis C corporation, loaned the corporation a substantial amount of money on January 1, 2010. The corporation accrued \$25,000 of interest expense on the loan on December 31, 2010. It pays the interest to Rodney, a cash basis taxpayer, on February 1, 2011. Under these facts:

- A. The corporation will be allowed to deduct the interest expense in 2010 and Rodney will be required to report the interest income in 2011.
- B. The corporation will be allowed to deduct the interest expense in 2011 and Rodney will be required to report the interest income in 2010.
- C. The corporation will be allowed to deduct the interest expense in 2011 and Rodney will be required to report the interest income in 2011.
- D. The corporation will be allowed to deduct the interest expense in 2010 and Rodney will be required to report the interest income in 2010.
- E. None of the above.

57. On December 31, 2010, 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 2010, if the bonus was authorized by the Board of Directors and payment was made on or before March 15, 2011.
- B. In 2010, if payment was made on or before March 15, 2011.
- C. In 2011, if payment was made at any time during that year.
- D. In 2011, but only if payment was made on or before March 15, 2011.
- E. None of the above.

58. Bear Corporation has a net short-term capital gain of \$35,000 and a net long-term capital loss of \$200,000 during 2010. Bear Corporation has taxable income from other sources of \$600,000. Prior years' transactions included the following:

2006	Net short-term capital gain	\$45,000
2007	Net long-term capital gain	20,000
2008	Net short-term capital gain	55,000
2009	Net long-term capital gain	30,000

Compute the amount of Bear's capital loss carryover to 2011.

- A. \$0.
- B. \$105,000.
- C. \$165,000.
- D. \$200,000.
- E. None of the above.

59. In 2010, 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 2010 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 2010 of \$47,000.
- D. Bluebird Corporation may deduct \$8,000 of the capital loss in 2010 and may carry forward the remainder of the capital loss indefinitely to offset capital gains.
- E. None of the above.

60. 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. \$119,000.
- E. None of the above.

61. Beige Corporation, a C corporation, purchases a warehouse on December 4, 2001, for \$500,000. Straight-line depreciation is taken in the amount of \$104,701 before the property is sold on February 8, 2010, for \$600,000. What is the amount and character of the gain recognized by Beige on the sale of the realty?

- A. Ordinary income of \$0 and § 1231 gain of \$204,701.
- B. Ordinary income of \$20,940 and § 1231 gain of \$183,761.
- C. Ordinary income of \$40,940 and § 1231 gain of \$163,760.
- D. Ordinary income of \$104,701 and § 1231 gain of \$100,000.
- E. None of the above.

62. 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.

63. Azul Corporation, a personal service corporation, had \$300,000 of active income, \$40,000 of portfolio income, and a \$190,000 passive loss during the year. How much is Azul's taxable income?

- A. \$340,000.
- B. \$300,000.
- C. \$150,000.
- D. \$110,000.
- E. None of the above.

64. Sage, Inc., a closely held corporation that is not a PSC, has a \$110,000 passive loss, \$90,000 of active income, and \$25,000 of portfolio income during the year. How much of the passive loss can Sage deduct in the current year?

A. \$0.
 B. \$25,000.
 C. \$90,000.
 D. \$110,000.
 E. None of the above.

65. Pelican, Inc., a closely held corporation (not a PSC), has a \$350,000 loss from a passive activity, \$135,000 of active income, and \$160,000 of portfolio income. How much is Pelican's taxable income?

A. (\$55,000).
 B. \$0.
 C. \$135,000.
 D. \$295,000.
 E. None of the above.

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

	<u>Adjusted Basis</u>	<u>Fair Market Value</u>
Food (held as inventory) donated to the Ohio Children's Shelter	\$3,500	\$8,000
Passenger van to Ohio Children's Shelter, to be used to transport children to school	7,500	7,100
Stock in Acme Corporation acquired 7 months ago and held as an investment, donated to Southwest University	4,000	6,200

How much qualifies for the charitable contribution deduction?

A. \$15,000.
 B. \$16,850.
 C. \$17,250.
 D. \$19,450.
 E. None of the above.

67. 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.

68. During the current year, Kingbird Corporation (a calendar year C corporation) had the following income and expenses:

Income from operations	\$135,000
Expenses from operations	99,000
Dividends received (40% ownership)	9,000
Domestic production activities deduction	2,700

On October 1, Kingbird Corporation made a contribution to a qualified charitable organization of \$6,300 in cash (not included in any of the above items). Determine Kingbird's charitable contribution deduction for the current year.

- A. \$0.
- B. \$4,230.
- C. \$4,500.
- D. \$6,300.
- E. None of the above.

69. Hippo, Inc., a calendar year C corporation, manufactures golf gloves. For 2010, Hippo had taxable income (before DPAD) of \$800,000, qualified domestic production activities income of \$950,000, and W-2 wages related to qualified production activities income of \$130,000. Hippo's domestic production activities deduction for 2010 is:

- A. \$0.
- B. \$65,000.
- C. \$72,000.
- D. \$85,500.
- E. None of the above.

70. In the current year, Amber, Inc., a calendar 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.

71. Fender Corporation was organized in 2008 and had profits in 2008 and 2009. The corporation had an NOL in 2010. 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.

72. Red Corporation, which owns stock in Blue Corporation, had net operating income of \$200,000 for the year. Blue pays Red a dividend of \$40,000. Red takes a dividends received deduction of \$28,000. 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.

73. 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.

74. Copper Corporation owns stock in Bronze Corporation and has net operating income of \$900,000 for the year. Bronze Corporation pays Copper a dividend of \$150,000. What amount of dividends received deduction may Copper claim if it owns 65% of Bronze stock (assuming Copper's dividends received deduction is not limited by its taxable income)?

- A. \$0.
- B. \$105,000.
- C. \$120,000.
- D. \$150,000.
- E. None of the above.

75. Orange Corporation owns stock in White Corporation and has net operating income of \$400,000 for the year. White Corporation pays Orange a dividend of \$60,000. What amount of dividends received deduction may Orange claim if it owns 15% of White stock (assuming Orange's dividends received deduction is not limited by its taxable income)?

- A. \$0.
- B. \$42,000.
- C. \$48,000.
- D. \$60,000.
- E. None of the above.

76. 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.

77. Emerald Corporation, a calendar year C corporation, was formed and began operations on July 1, 2010. The following expenses were incurred during the first tax year (July 1 through December 31, 2010) of operations:

Expenses of temporary directors and of organizational meetings	\$9,000
Fee paid to the state of incorporation	1,000
Accounting services incident to organization	2,500
Legal services for drafting the corporate charter and bylaws	3,500
Expenses incident to the printing and sale of stock certificates	4,000

Assuming a § 248 election, what is the Emerald's deduction for organizational expenditures for 2010?

- A. \$0.
- B. \$533.
- C. \$5,367.
- D. \$5,500.
- E. None of the above.

78. During 2010, Sparrow Corporation, a calendar year C corporation, had operating income of \$510,000, operating expenses of \$370,000, a short-term capital loss of \$25,000, and a long-term capital gain of \$80,000. How much is Sparrow's tax liability for 2010?

- A. \$46,100.
- B. \$59,300.
- C. \$69,050.
- D. \$76,050.
- E. None of the above.

79. 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.

80. 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 39%.
- C. A tax return must be filed whether or not the corporation has taxable income.
- D. Unlike those applicable to individuals, the marginal tax rate brackets for corporations are not adjusted for inflation.
- E. None of the above.

81. Which of the following statements is correct regarding the taxation of C corporations?

- A. The alternative minimum tax does not apply.
- B. A corporation with taxable income of less than \$500 need not file a tax return.
- C. 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.
- 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.

82. Vireo Corporation, a calendar year C corporation, has taxable income of \$1.3 million and \$3 million for 2009 and 2010, respectively. The minimum 2010 estimated tax installment payments for Vireo are:

- A. April 15, 2010, \$110,500; June 15, 2010, \$110,500; September 15, 2010, \$110,500; December 15, 2010, \$110,500.
- B. April 15, 2010, \$110,500; June 15, 2010, \$399,500; September 15, 2010, \$399,500; December 15, 2010, \$399,500.
- C. April 15, 2010, \$110,500; June 15, 2010, \$399,500; September 15, 2010, \$255,000; December 15, 2010, \$255,000.
- D. April 15, 2010, \$255,000; June 15, 2010, \$255,000; September 15, 2010, \$255,000; December 15, 2010, \$255,000.
- E. None of the above.

83. 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. Proceeds of life insurance paid on death of key employee.
- C. Charitable contributions in excess of deductible limits.
- D. Tax-exempt interest.
- E. None of the above.

84. 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.

85. 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.

86. Beige Company has approximately \$250,000 in net income in 2010 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 \$150,000 and no dividend.
- c. Janet incorporates the company and pays herself a \$150,000 salary and a dividend of \$77,750 (\$100,000 – \$22,250 corporate income tax).
- d. Janet incorporates the company and pays herself a salary of \$250,000.

87. Maroon Company had \$150,000 net profit from operations in 2010 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.

88. Canary Corporation, an accrual method C corporation, uses the calendar year for tax purposes. Leticia, a cash method taxpayer, is both a shareholder of Canary and the corporation's CFO. On December 31, 2010, Canary has accrued a \$100,000 bonus to Leticia. Describe the tax consequences of the bonus to Canary and to Leticia under the following independent situations.

- a. Leticia owns 75% of Canary Corporation's stock and the corporation pays the bonus to Leticia on February 1, 2011.
- b. Leticia owns 75% of Canary Corporation's stock and the corporation pays the bonus to Leticia on April 1, 2011.
- c. Leticia owns 25% of Canary Corporation's stock and the corporation pays the bonus to Leticia on February 1, 2011.

89. Ostrich, a C corporation, has a net short-term capital gain of \$40,000 and a net long-term capital loss of \$180,000 during 2010. Ostrich also has taxable income from other sources of \$1 million. Prior years' transactions included the following:

2006 net short-term capital gains	\$60,000
2007 net long-term capital gains	35,000
2008 net short-term capital gains	15,000
2009 net long-term capital gains	40,000

- a. How are the capital gains and losses treated on Ostrich's 2010 tax return?
- b. Determine the amount of the 2010 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 2010 tax return?

90. Shaw, an architect, is the sole shareholder of Shaw Corporation, a professional association. The corporation paid Shaw a salary of \$255,000 during its fiscal year ending October 31, 2010.

- a. How much salary must Shaw Corporation pay Shaw during the period November 1 through December 31, 2010, to enable the corporation to continue to use its fiscal year without negative tax effects?
- b. If Shaw Corporation had taxable income of \$95,000 for the year ending October 31, 2010, what is its tax liability?

91. 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?

92. On December 30, 2010, the board of directors of Gull Corporation, a calendar year, accrual method C corporation, authorized a contribution of \$50,000 to a qualified charitable organization. For purposes of the taxable income limitation applicable to charitable deductions, Gull has taxable income of \$420,000 and \$370,000 for 2010 and 2011, respectively. Describe the tax consequences to Gull Corporation under the following independent situations.

- a. The \$50,000 donation is made on February 25, 2011, by Gull Corporation.
- b. The \$50,000 donation is made on April 29, 2011, by Gull Corporation.

93. 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?

94. 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?

95. Warbler Corporation, an accrual method regular corporation, was formed and began operations on July 1, 2010. The following expenses were incurred during its first year of operations (July 1 - December 31, 2010):

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 2010?
- b. Same as a., except that Warbler also incurred in 2010 legal fees of \$25,000 for the drafting of the corporate charter and bylaws. What is the amount of Warbler's 2010 deduction for organizational expenditures?

96. 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 2010.

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

97. Almond Corporation, a calendar year C corporation, had taxable income of \$900,000, \$1.1 million, and \$790,000 for 2007, 2008, and 2009, respectively. Almond's taxable income is \$1.5 million for 2010. Compute the minimum estimated tax payments for 2010 for Almond Corporation.

98. 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)	\$257,950
Taxable income	150,000
Federal income tax liability	41,750
Interest income from tax-exempt bonds	15,000
Interest paid on loan incurred to purchase tax-exempt bonds	1,500
Life insurance proceeds received as a result of death of Heron's president	150,000
Premiums paid on policy on life of Heron's president	7,800
Excess of capital losses over capital gains	6,000
Retained earnings at beginning of year	375,000
Cash dividends paid	90,000

99. 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 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

100. Osprey Company had a net loss of \$200,000 from merchandising operations in 2010, 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.

101. Shareholders of closely held C corporations frequently engage in transactions that produce a tax benefit to the corporations. In many cases, shareholders receive compensation for employment with closely held corporations, and such payments generate a deduction for the corporations. To avoid the double taxation effect, shareholders generally prefer these and other corporate deductible payments over dividend distributions. Explain how this strategy avoids double taxation, including examples of other shareholder-corporation transactions that could be used for such purpose. Also, discuss the possible pitfalls surrounding corporate payments to shareholders.

102. 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.)

103. 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.

104. Describe the Federal tax treatment of entities formed as limited liability companies.

105. 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-end. Will the IRS treat both corporations alike with respect to the fiscal year election? Explain.

106. 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?

107. Jessica, a cash basis individual, is the sole shareholder of Crow Corporation, a regular corporation. On January 1, 2010, 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, 2010, and paid the \$50,000 to Jessica on January 1, 2011. How much is Crow's deduction for interest on this loan for 2010? Would your answer change if Jessica was a 45% shareholder of Crow?

108. Briefly describe the accounting methods available for adoption by a C corporation.

109. 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.

110. 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.

111. In connection with the deduction of organizational expenditures under § 248, comment on the following:

- a. Expenditures qualifying for the deduction.
- b. Determination of the deduction amount.
- c. The election requirement.

112. 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.

113. Discuss the purpose of Schedule M-1. Give two examples of an addition and two examples of a subtraction that could be reported on Schedule M-1.

CHAPTER 2--CORPORATIONS: INTRODUCTION AND OPERATING RULES **Key**

1. Olga's proprietorship earned a net profit of \$95,000 during the year and she withdrew \$70,000 of this profit. Olga must report \$70,000 net income from the proprietorship on her individual income tax return (Form 1040).

FALSE

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.

FALSE

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 Federal individual income tax return.

TRUE

4. Donald owns a 40% interest in a partnership that earned \$140,000 in the current year. He also owns 40% of the stock in a C corporation that earned \$140,000 during the year. Donald received \$30,000 in distributions from each of the two entities during the year. With respect to this information, Donald must report \$60,000 of income on his individual income tax return for the year.

FALSE

5. Quail Corporation is a C corporation with net income of \$300,000 during 2010. If Quail paid dividends of \$50,000 to its shareholders, the corporation must pay tax on \$300,000 of net income. Shareholders must report the \$50,000 of dividends as income.

TRUE

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.

TRUE

7. Emma, the sole shareholder of Quail Corporation (a C corporation), has the corporation pay her a salary of \$300,000 in 2010. The Tax Court has held that \$80,000 represents unreasonable compensation. Assuming Emma is in the 35% bracket in 2010, the Tax Court's holding will increase total tax she pays in 2010.

FALSE

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.

TRUE

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.

TRUE

10. Thrush Corporation files Form 1120, which reports taxable income of \$110,000. The corporation's tax is \$26,150.

TRUE

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

TRUE

12. There is no Federal income tax assessed on partnerships (including those formed as LLCs) or S corporations. Since all states follow the Federal approach as to entity taxation, state income taxation is a neutral factor in the selection of an entity form.

FALSE

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

TRUE

14. As a general rule, a personal service corporation (PSC) must use a fiscal year as its accounting period.

FALSE

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

FALSE

16. On December 31, 2010, 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, 2011. Lavender can deduct the bonus in 2010, the year in which Barry's services were performed.

FALSE

17. Unlike individual taxpayers, corporate taxpayers do not receive a preferential tax rate with respect to long-term capital gains.

TRUE

18. Albatross, a C corporation, had \$125,000 net income from operations and a \$10,000 short-term capital loss in 2010. Albatross Corporation's taxable income is \$115,000.

FALSE

19. Owl Corporation, a C corporation, recognizes a gain on the sale of a \$ 1250 asset in the current year. Owl had used the straight-line method for depreciating the realty. Some of Owl's gain on the sale of the realty will be treated as depreciation recapture (ordinary income).

TRUE

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

FALSE

21. Peach Corporation had \$210,000 of active income, \$45,000 of portfolio income, and a \$230,000 passive loss during the year. If Peach is a closely held C corporation that is not a PSC, it can deduct \$210,000 of the passive loss in the year.

TRUE

22. On December 20, 2010, 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, 2011, may be claimed as a deduction for tax year 2010.

FALSE

23. On April 8, 2010, Oriole Corporation donated a painting worth \$75,000 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 \$25,000. Oriole's charitable contribution deduction is \$25,000 (ignoring the taxable income limitation).

FALSE

24. Zircon Corporation donated scientific property worth \$300,000 to City University (a qualified charitable organization) to be used in research. The basis of the property was \$140,000, and Zircon had held it for ten months as inventory. Zircon Corporation may deduct \$220,000 as a charitable contribution (ignoring the taxable income limitation).

TRUE

25. Egret Corporation, a calendar year C corporation, had an excess charitable contribution for 2009 of \$15,000. In 2010, it made a further charitable contribution of \$20,000. Its 2010 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.

FALSE

26. For a corporation in 2010, the domestic production activities deduction is equal to 9% of the lower of (1) qualified production activities income or (2) taxable income. However, the deduction cannot exceed 50% of the W-2 wages related to qualified production activities income.

TRUE

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

TRUE

28. 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.

TRUE

29. The dividends received deduction may be subject to a limitation based on a percentage of taxable income computed without regard to the NOL deduction, the domestic production activities deduction, the dividends received deduction, and any capital loss carryback to the current tax year.

TRUE

30. No dividends received deduction is allowed unless the corporation has held the stock for more than 45 days.

TRUE

31. Black Corporation, an accrual basis taxpayer, was formed and began operations on February 1, 2010. During its first year of operations (February 1 – December 31, 2010), 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.

FALSE

32. A corporation may elect to amortize startup expenditures over the 60-month period beginning with the month in which the corporation begins business.

FALSE

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

TRUE

34. 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.

TRUE

35. Generally, corporations with no taxable income must file a Form 1120.

TRUE

36. For purposes of the estimated tax payment rules, a “large corporation” is defined as a corporation that had an average taxable income of \$1 million or more over the preceding three-year period.

FALSE

37. 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.

FALSE

38. Income that is included in net income per books but not included in taxable income is an addition item on Schedule M-1.

FALSE

39. 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.

TRUE

40. 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.

TRUE

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

FALSE

42. A corporation with \$10 million or more in assets must file Schedule M-3 (instead of Schedule M-1).

TRUE

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

TRUE

44. Juanita owns 45% of the stock in a C corporation that had a profit of \$120,000 in 2010. Carlos owns a 45% interest in a partnership that had a profit of \$120,000 during the year. The corporation distributed \$20,000 to Juanita, and the partnership distributed \$20,000 to Carlos. Which of the following statements relating to 2010 is *incorrect*?

A. Juanita must report \$20,000 of income from the corporation.

B. The corporation must pay corporate tax on \$120,000 of income.

C. Carlos must report \$20,000 of income from the partnership.

D. The partnership is not subject to a Federal entity-level income tax.

E. None of the above.

45. Bjorn owns a 35% interest in an S corporation that earned \$200,000 in 2010. 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. \$0 income from the S corporation and \$0 income from the C corporation.
- B. \$10,000 income from the S corporation and \$10,000 income from the C corporation.
- C. \$70,000 income from the S corporation and \$0 income from the C corporation.
- D.** \$70,000 income from the S corporation and \$10,000 of dividend income from the C corporation.
- E. None of the above.

46. Ted is the sole shareholder of a C corporation, and Sue owns a sole proprietorship. Both businesses were started in 2010, 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 2010.
- B. Ted's corporation can deduct \$3,000 of the capital loss in 2010.
- 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 2010.
- E.** None of the above.

47. Norma formed Hyacinth Enterprises, a proprietorship, in 2010. 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 2010?

- A.** Increases Norma's taxable income by \$97,000 (\$100,000 ordinary business income – \$3,000 long-term capital loss).
- 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 \$50,000.
- E. None of the above.

48. 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 both Geneva and Gulf.
- B.** 15% rate applies to Geneva and 25% rate applies to 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.

49. Glen and Michael are equal partners in Trout Enterprises, a calendar year partnership. During the year, Trout Enterprises had gross income of \$400,000 and operating expenses of \$220,000. In addition, the partnership sold land that had been held for investment purposes for a long-term capital gain of \$100,000. During the year, Glen withdrew \$60,000 from the partnership, and Michael withdrew \$60,000. Discuss the impact of this information on the taxable income of Trout, Glen, and Michael.

A. Trout pays tax on \$0 income, Glen's taxable income increases by \$60,000, and Michael's taxable income increases by \$60,000.

B. Trout pays tax on \$280,000 income, Glen's taxable income increases by \$60,000, and Michael's taxable income increases by \$60,000.

C. Trout pays tax on \$0 income, Glen's taxable income increases by \$200,000, and Michael's taxable income increases by \$200,000.

D. Trout pays tax on \$0 income, Glen's taxable income increases by \$140,000, and Michael's taxable income increases by \$140,000.

E. None of the above.

50. 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. \$98,000.

B. \$118,000.

C. \$150,000.

D. \$170,000.

E. None of the above.

51. Flycatcher Corporation, a C corporation, has two equal individual shareholders, Nancy and Pasqual. In the current year, Flycatcher earned \$200,000 net profit and paid a dividend of \$40,000 to each shareholder. Regardless of any tax consequences resulting from their interests in Flycatcher, Nancy is in the 28% marginal tax bracket and Pasqual is in the 35% marginal tax bracket. With respect to the current year, which of the following statements is *incorrect*?

A. Flycatcher pays corporate tax on \$200,000.

B. Nancy incurs income tax of \$6,000 on her dividend income.

C. Pasqual incurs income tax of \$6,000 on his dividend income.

D. Flycatcher can avoid the corporate tax altogether by paying out all \$200,000 of net profit as dividends to the shareholders.

E. None of the above.

52. Which of the following statements is *incorrect* about the check-the-box Regulations?

A. A limited liability company with one owner can elect to be taxed as a corporation.

B. A limited liability company with more than one owner can elect to be taxed as a corporation.

C. An entity with more than one owner and formed as a corporation can elect to be taxed as a partnership.

D. If a limited liability company with one owner does not make an election, the entity is taxed as a sole proprietorship.

E. If a limited liability company with more than one owner does not make an election, the entity is taxed as a partnership.

53. Patrick, an attorney, is the sole shareholder of Gander Corporation. Gander is a personal service corporation with a fiscal year ending September 30. The corporation paid Patrick a salary of \$294,000 during its fiscal year ending September 30, 2010. How much salary must Gander pay Patrick during the period October 1 through December 31, 2010, to permit the corporation to continue to use its fiscal year without negative tax effects?

- A. \$0.
- B.** \$73,500.
- C. \$220,500.
- D. \$294,000.
- E. None of the above.

54. 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, 2010. How much salary must Purple pay Jason during the period December 1 through December 31, 2010, 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.

55. Falcon Corporation, a C corporation, had gross receipts of \$3 million in 2007, \$7 million in 2008, and \$6 million in 2009. Hawk Corporation, a personal service corporation (PSC), had gross receipts of \$3 million in 2007, \$5 million in 2008, and \$4 million in 2009. Which of the corporations will be allowed to use the cash method of accounting in 2010?

- 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.

56. Rodney, the sole shareholder of a calendar year, accrual basis C corporation, loaned the corporation a substantial amount of money on January 1, 2010. The corporation accrued \$25,000 of interest expense on the loan on December 31, 2010. It pays the interest to Rodney, a cash basis taxpayer, on February 1, 2011. Under these facts:

- A. The corporation will be allowed to deduct the interest expense in 2010 and Rodney will be required to report the interest income in 2011.
- B. The corporation will be allowed to deduct the interest expense in 2011 and Rodney will be required to report the interest income in 2010.
- C.** The corporation will be allowed to deduct the interest expense in 2011 and Rodney will be required to report the interest income in 2011.
- D. The corporation will be allowed to deduct the interest expense in 2010 and Rodney will be required to report the interest income in 2010.
- E. None of the above.

57. On December 31, 2010, 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 2010, if the bonus was authorized by the Board of Directors and payment was made on or before March 15, 2011.
- B. In 2010, if payment was made on or before March 15, 2011.
- C.** In 2011, if payment was made at any time during that year.
- D. In 2011, but only if payment was made on or before March 15, 2011.
- E. None of the above.

58. Bear Corporation has a net short-term capital gain of \$35,000 and a net long-term capital loss of \$200,000 during 2010. Bear Corporation has taxable income from other sources of \$600,000. Prior years' transactions included the following:

2006	Net short-term capital gain	\$45,000
2007	Net long-term capital gain	20,000
2008	Net short-term capital gain	55,000
2009	Net long-term capital gain	30,000

Compute the amount of Bear's capital loss carryover to 2011.

- A. \$0.
- B. \$105,000.
- C. \$165,000.
- D. \$200,000.
- E.** None of the above.

59. In 2010, 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 2010 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 2010 of \$47,000.
- D. Bluebird Corporation may deduct \$8,000 of the capital loss in 2010 and may carry forward the remainder of the capital loss indefinitely to offset capital gains.
- E. None of the above.

60. 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.** \$119,000.
- E. None of the above.

61. Beige Corporation, a C corporation, purchases a warehouse on December 4, 2001, for \$500,000. Straight-line depreciation is taken in the amount of \$104,701 before the property is sold on February 8, 2010, for \$600,000. What is the amount and character of the gain recognized by Beige on the sale of the realty?

- A. Ordinary income of \$0 and § 1231 gain of \$204,701.
- B.** Ordinary income of \$20,940 and § 1231 gain of \$183,761.
- C. Ordinary income of \$40,940 and § 1231 gain of \$163,760.
- D. Ordinary income of \$104,701 and § 1231 gain of \$100,000.
- E. None of the above.

62. 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.

63. Azul Corporation, a personal service corporation, had \$300,000 of active income, \$40,000 of portfolio income, and a \$190,000 passive loss during the year. How much is Azul's taxable income?

- A.** \$340,000.
- B. \$300,000.
- C. \$150,000.
- D. \$110,000.
- E. None of the above.

64. Sage, Inc., a closely held corporation that is not a PSC, has a \$110,000 passive loss, \$90,000 of active income, and \$25,000 of portfolio income during the year. How much of the passive loss can Sage deduct in the current year?

- A. \$0.
- B. \$25,000.
- C. \$90,000.**
- D. \$110,000.
- E. None of the above.

65. Pelican, Inc., a closely held corporation (not a PSC), has a \$350,000 loss from a passive activity, \$135,000 of active income, and \$160,000 of portfolio income. How much is Pelican's taxable income?

- A. (\$55,000).
- B. \$0.
- C. \$135,000.
- D. \$295,000.
- E. None of the above.**

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

	<u>Adjusted Basis</u>	<u>Fair Market Value</u>
Food (held as inventory) donated to the Ohio Children's Shelter	\$3,500	\$8,000
Passenger van to Ohio Children's Shelter, to be used to transport children to school	7,500	7,100
Stock in Acme Corporation acquired 7 months ago and held as an investment, donated to Southwest University	4,000	6,200

How much qualifies for the charitable contribution deduction?

- A. \$15,000.
- B. \$16,850.**
- C. \$17,250.
- D. \$19,450.
- E. None of the above.

67. 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.

68. During the current year, Kingbird Corporation (a calendar year C corporation) had the following income and expenses:

Income from operations	\$135,000
Expenses from operations	99,000
Dividends received (40% ownership)	9,000
Domestic production activities deduction	2,700

On October 1, Kingbird Corporation made a contribution to a qualified charitable organization of \$6,300 in cash (not included in any of the above items). Determine Kingbird's charitable contribution deduction for the current year.

- A. \$0.
- B. \$4,230.
- C.** \$4,500.
- D. \$6,300.
- E. None of the above.

69. Hippo, Inc., a calendar year C corporation, manufactures golf gloves. For 2010, Hippo had taxable income (before DPAD) of \$800,000, qualified domestic production activities income of \$950,000, and W-2 wages related to qualified production activities income of \$130,000. Hippo's domestic production activities deduction for 2010 is:

- A. \$0.
- B.** \$65,000.
- C. \$72,000.
- D. \$85,500.
- E. None of the above.

70. In the current year, Amber, Inc., a calendar 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.

71. Fender Corporation was organized in 2008 and had profits in 2008 and 2009. The corporation had an NOL in 2010. 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.

72. Red Corporation, which owns stock in Blue Corporation, had net operating income of \$200,000 for the year. Blue pays Red a dividend of \$40,000. Red takes a dividends received deduction of \$28,000. 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.

73. 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.

74. Copper Corporation owns stock in Bronze Corporation and has net operating income of \$900,000 for the year. Bronze Corporation pays Copper a dividend of \$150,000. What amount of dividends received deduction may Copper claim if it owns 65% of Bronze stock (assuming Copper's dividends received deduction is not limited by its taxable income)?

- A. \$0.
- B. \$105,000.
- C. \$120,000.**
- D. \$150,000.
- E. None of the above.

75. Orange Corporation owns stock in White Corporation and has net operating income of \$400,000 for the year. White Corporation pays Orange a dividend of \$60,000. What amount of dividends received deduction may Orange claim if it owns 15% of White stock (assuming Orange's dividends received deduction is not limited by its taxable income)?

- A. \$0.
- B. \$42,000.**
- C. \$48,000.
- D. \$60,000.
- E. None of the above.

76. 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.**

77. Emerald Corporation, a calendar year C corporation, was formed and began operations on July 1, 2010. The following expenses were incurred during the first tax year (July 1 through December 31, 2010) of operations:

Expenses of temporary directors and of organizational meetings	\$9,000
Fee paid to the state of incorporation	1,000
Accounting services incident to organization	2,500
Legal services for drafting the corporate charter and bylaws	3,500
Expenses incident to the printing and sale of stock certificates	4,000

Assuming a § 248 election, what is the Emerald's deduction for organizational expenditures for 2010?

- A. \$0.
- B. \$533.
- C. \$5,367.**
- D. \$5,500.
- E. None of the above.

78. During 2010, Sparrow Corporation, a calendar year C corporation, had operating income of \$510,000, operating expenses of \$370,000, a short-term capital loss of \$25,000, and a long-term capital gain of \$80,000. How much is Sparrow's tax liability for 2010?

- A. \$46,100.
- B. \$59,300.**
- C. \$69,050.
- D. \$76,050.
- E. None of the above.

79. 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.

80. 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 39%.**
- C. A tax return must be filed whether or not the corporation has taxable income.
- D. Unlike those applicable to individuals, the marginal tax rate brackets for corporations are not adjusted for inflation.
- E. None of the above.

81. Which of the following statements is correct regarding the taxation of C corporations?

- A. The alternative minimum tax does not apply.
- B. A corporation with taxable income of less than \$500 need not file a tax return.
- C.** 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.
- 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.

82. Vireo Corporation, a calendar year C corporation, has taxable income of \$1.3 million and \$3 million for 2009 and 2010, respectively. The minimum 2010 estimated tax installment payments for Vireo are:

- A. April 15, 2010, \$110,500; June 15, 2010, \$110,500; September 15, 2010, \$110,500; December 15, 2010, \$110,500.
- B. April 15, 2010, \$110,500; June 15, 2010, \$399,500; September 15, 2010, \$399,500; December 15, 2010, \$399,500.
- C.** April 15, 2010, \$110,500; June 15, 2010, \$399,500; September 15, 2010, \$255,000; December 15, 2010, \$255,000.
- D. April 15, 2010, \$255,000; June 15, 2010, \$255,000; September 15, 2010, \$255,000; December 15, 2010, \$255,000.
- E. None of the above.

83. 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. Proceeds of life insurance paid on death of key employee.
- C.** Charitable contributions in excess of deductible limits.
- D. Tax-exempt interest.
- E. None of the above.

84. 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.

85. 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.
-
- 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).]

86. Beige Company has approximately \$250,000 in net income in 2010 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 \$150,000 and no dividend.
- c. Janet incorporates the company and pays herself a \$150,000 salary and a dividend of \$77,750 (\$100,000 – \$22,250 corporate income tax).
- d. Janet incorporates the company and pays herself a salary of \$250,000.

a.	Janet's tax on \$250,000 at 35%	<u>\$87,500</u>
b.	Janet's tax on \$150,000 at 35%	\$52,500
	Beige's tax on \$100,000 at corporate rates	<u>22,250</u>
	Total tax	<u>\$74,750</u>
c.	Beige's tax on \$100,000 at corporate rates	\$22,250
	Janet's tax on \$77,750 dividend distributed at 15%	11,663
	Janet's tax on \$150,000 salary at 35%	<u>52,500</u>
	Total tax	<u>\$86,413</u>
d.	Janet's tax on \$250,000 at 35%	<u>\$87,500</u>

87. Maroon Company had \$150,000 net profit from operations in 2010 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.

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.

88. Canary Corporation, an accrual method C corporation, uses the calendar year for tax purposes. Leticia, a cash method taxpayer, is both a shareholder of Canary and the corporation's CFO. On December 31, 2010, Canary has accrued a \$100,000 bonus to Leticia. Describe the tax consequences of the bonus to Canary and to Leticia under the following independent situations.

- Leticia owns 75% of Canary Corporation's stock and the corporation pays the bonus to Leticia on February 1, 2011.
- Leticia owns 75% of Canary Corporation's stock and the corporation pays the bonus to Leticia on April 1, 2011.
- Leticia owns 25% of Canary Corporation's stock and the corporation pays the bonus to Leticia on February 1, 2011.

Under § 267(a)(2), an accrual method taxpayer must defer a deduction for an expenditure attributable to a cash method related party until such time the related party reports the amount as income. For purposes of this limitation, a more-than-50% shareholder of the corporation is a related party.

- a. Since Leticia, a cash method related party, does not include the bonus in her income until its receipt in 2011, Canary's deduction for the bonus occurs in 2011. The fact that the payment to Leticia occurs prior to the filing date for Canary's 2010 tax return is of no consequence.
- b. Again, Leticia is a cash method related party who does not include the bonus in her income until its receipt in 2011; thus, Canary's deduction for the bonus is deferred until 2011.
- c. Since Leticia is not a related party for purposes of the § 267(a)(2) limitation, Canary deducts the bonus, under the accrual method, in 2010.

89. Ostrich, a C corporation, has a net short-term capital gain of \$40,000 and a net long-term capital loss of \$180,000 during 2010. Ostrich also has taxable income from other sources of \$1 million. Prior years' transactions included the following:

2006 net short-term capital gains	\$60,000
2007 net long-term capital gains	35,000
2008 net short-term capital gains	15,000
2009 net long-term capital gains	40,000

- a. How are the capital gains and losses treated on Ostrich's 2010 tax return?
- b. Determine the amount of the 2010 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 2010 tax return?

a.	Net short-term capital gain	\$ 40,000
	Net long-term capital loss	<u>(180,000)</u>
	Net capital loss	<u>(\$140,000)</u>

The net capital loss of \$140,000 is not deductible in 2010 but must be carried back to the three preceding years, applying it to 2007, 2008, and 2009, in that order. Such net capital loss is carried back or forward as a short-term capital loss.

b.	2010 net capital loss	<u>(\$140,000)</u>
	Offset against—	
	2007 net long-term capital gains	\$35,000
	2008 net short-term capital gains	15,000
	2009 net long-term capital gains	<u>40,000</u>
	Total carrybacks	<u>\$90,000</u>

c. \$50,000 (\$140,000 – \$90,000) STCL carryover to 2011, 2012, 2013, 2014, and 2015, in that order.

d. Ellen would net these transactions with all other capital transactions for 2010. Assuming these were her only capital transactions in 2010, she would offset \$40,000 of capital losses against the capital gains and deduct an additional \$3,000 in capital losses on her return. The remaining \$137,000 (\$180,000 – \$40,000 – \$3,000) would be carried forward indefinitely.

90. Shaw, an architect, is the sole shareholder of Shaw Corporation, a professional association. The corporation paid Shaw a salary of \$255,000 during its fiscal year ending October 31, 2010.

- a. How much salary must Shaw Corporation pay Shaw during the period November 1 through December 31, 2010, to enable the corporation to continue to use its fiscal year without negative tax effects?
- b. If Shaw Corporation had taxable income of \$95,000 for the year ending October 31, 2010, what is its tax liability?

- a. The salary for the deferral period (November 1 through December 31) 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 November 1 through December 31, 2010, to permit the continued use of its fiscal year without negative tax effects, is \$42,500 (\$255,000 × 2/12).
- b. As a PSC is subject to a tax rate of 35%, Shaw's tax is \$33,250 (\$95,000 × 35%). To illustrate the negative tax impact of classification as a PSC, compare this amount to the \$20,550 that a regular (non-PSC) corporation would pay.

91. 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?

- 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 [$\$60,000 = \$25,000 \text{ basis} + .5(\$95,000 \text{ fair market value} - \$25,000 \text{ basis})$] or (2) twice the property's basis ($\$50,000 = 2 \times \$25,000 \text{ basis}$). 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 [$10\% \times \$1 \text{ million (taxable income before charitable deduction)}$], and the excess charitable contribution of \$110,000 ($\$210,000 - \$100,000$) is carried forward to the five succeeding tax years.

92. On December 30, 2010, the board of directors of Gull Corporation, a calendar year, accrual method C corporation, authorized a contribution of \$50,000 to a qualified charitable organization. For purposes of the taxable income limitation applicable to charitable deductions, Gull has taxable income of \$420,000 and \$370,000 for 2010 and 2011, respectively. Describe the tax consequences to Gull Corporation under the following independent situations.

- a. The \$50,000 donation is made on February 25, 2011, by Gull Corporation.
- b. The \$50,000 donation is made on April 29, 2011, by Gull Corporation.

In general, charitable contributions are deductible in the year made. However, in the case of an accrual method corporation, a deduction can be claimed in the current year for a charitable contribution made in the subsequent year if (1) the contribution is approved by the board of directors of the corporation in the current year, and (2) the contribution is made on or before the fifteenth day of the third month of the subsequent year.

- a. The requirements for an accrual of the charitable deduction are satisfied; thus, the \$50,000 contribution is deductible by Gull in 2010, subject to the taxable income limitation. For 2010, the taxable income limitation for charitable deductions is \$42,000 (10% × \$420,000). The excess contribution amount of \$8,000 carries forward to 2011 (five-year carryover limit).
- b. The requirements for an accrual of the charitable deduction are not satisfied; thus, the \$50,000 contribution is deductible by Gull in 2011 (the year the contribution is made), subject to the taxable income limitation. For 2011, the taxable income limitation for charitable deductions is \$37,000 (10% × \$370,000). The excess contribution amount of \$13,000 carries forward to 2012 (five-year carryover limit).

93. 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?

Quartz has an NOL, computed as shown below:

Gross income:		
From operations	\$600,000	
Dividends	<u>200,000</u>	\$800,000
Less:		
Expenses from operations	\$700,000	
Dividends received deduction (\$200,000 × 80%)	<u>160,000</u>	<u>(860,000)</u>
Net operating loss		<u>(\$ 60,000)</u>

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

94. 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?

- 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	<u>150,000</u>	\$720,000
Less: Expenses from operations		<u>(610,000)</u>
Taxable income before the dividends received deduction		\$110,000
Dividends received deduction (70% × \$110,000)		<u>(77,000)</u>
Taxable income		<u>\$ 33,000</u>

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	<u>150,000</u>	\$720,000
Less: Expenses from operations		<u>(610,000)</u>
Taxable income before the dividends received deduction		\$110,000
Dividends received deduction (80% × \$150,000)		<u>(120,000)</u>
Net operating loss		<u>(\$ 10,000)</u>

95. Warbler Corporation, an accrual method regular corporation, was formed and began operations on July 1, 2010. The following expenses were incurred during its first year of operations (July 1 - December 31, 2010):

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 2010?
- b. Same as a., except that Warbler also incurred in 2010 legal fees of \$25,000 for the drafting of the corporate charter and bylaws. What is the amount of Warbler's 2010 deduction for organizational expenditures?

- a. Warbler has qualifying organizational expenditures of \$27,500 [\$17,000 (expenses of temporary directors and organizational 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 2010 deduction for the organizational expenditures is \$5,750 $\{ \$5,000 + [(\$27,500 - \$5,000)/180 \times 6 \text{ months}] \}$.
- b. Warbler now has qualifying organizational expenditures of \$52,500 [\$27,500 (as computed in a., above) + \$25,000 (legal fees)]. Warbler's 2010 deduction for the organizational expenditures is \$4,167 $\{ \$2,500 + [(\$52,500 - \$2,500)/180 \times 6 \text{ months}] \}$. 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.

96. 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 2010.

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

Violet
t
Corp
oratio
n:

Tax on
\$73,000

\$ 500,000	\$ 7,500
15%	
\$ 23,250	<u>5,750</u>
<u>\$13,250</u>	

Indigo Corporation:

Tax on
\$195,000

\$100,000	\$22,250
\$95,000	<u>37,050</u>
39%	
Total tax	<u>\$59,300</u>

Oran
ge
Corp
oratio
n:

Tax on
\$335,000

\$100,000	\$ 22,250
\$235,000	<u>91,650</u>
39%	
Total tax	<u>\$113,900</u>

Blue
Corp
oratio
n:

Tax on
\$6,710,00

\$335,000	\$ 113,900
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\$6,375,000	<u>2,167,500</u>
0 % 34%	
Total tax	<u>\$2,281,400</u>

Green
Corp
oration:
n:

Tax on	<u>\$7,875,000,000</u>
\$22,500,000	
0 % 35%	

97. Almond Corporation, a calendar year C corporation, had taxable income of \$900,000, \$1.1 million, and \$790,000 for 2007, 2008, and 2009, respectively. Almond's taxable income is \$1.5 million for 2010. Compute the minimum estimated tax payments for 2010 for Almond Corporation.

A corporation that had taxable income of \$1 million or more in any of the three preceding years is a "large corporation" for purposes of utilizing the prior year's tax exception for estimated tax payments. As such, Almond Corporation can use the prior year's tax exception for computing its first 2010 estimated tax payment only, and any shortfall as a result of such use must be paid with the second installment.

<u>Payment</u>	<u>Amount</u>
April 15, 2010	\$ 67,150*
June 15, 2010	187,850**
September 15, 2010	127,500
December 15, 2010	<u>127,500</u>
Total	<u>\$510,000</u>

*Based on preceding year's tax, for first installment only: [\$790,000 taxable income % 34% (see Exhibit 2.1)] = \$268,600 , 4 = \$67,150.

**Based on current year's tax, for remaining installments: [\$1.5 million taxable income % 34% (see Exhibit 2.1)] = \$510,000 ÷ 4 = \$127,500. Second installment must include shortfall from first installment: [\$127,500 + (\$127,500 – \$67,150)] = \$187,850.

98. 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)	\$257,950
Taxable income	150,000
Federal income tax liability	41,750
Interest income from tax-exempt bonds	15,000
Interest paid on loan incurred to purchase tax-exempt bonds	1,500
Life insurance proceeds received as a result of death of Heron's president	150,000
Premiums paid on policy on life of Heron's president	7,800
Excess of capital losses over capital gains	6,000
Retained earnings at beginning of year	375,000
Cash dividends paid	90,000

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

Net income per books (after tax)	\$257,950
Plus: Items that decreased net income per books but did not affect taxable income	
+ Federal income tax liability	41,750
+ Excess of capital losses over capital gains	6,000
+ Interest paid on loan incurred to purchase tax-exempt bonds	1,500
+ Premiums paid on policy on life of president of the corporation	<u>7,800</u>
Subtotal	\$315,000
Minus: Items that increased net income per books but did not affect taxable income	
– Interest income from tax-exempt bonds	(15,000)
– Life insurance proceeds received as a result of the death of the corporate president	<u>(150,000)</u>
Taxable income	<u>\$150,000</u>

99. 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 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

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	Shareholders	Shareholders
	Partnership	S corporation	C Corporation
Are operating losses passed through to owners?	Yes	Yes	Yes
	No	No	No
Are capital gains (losses) reported on owners' tax returns as such?	Yes	Yes	Yes
	No	No	No
Are distributions of profits taxable to owners?	Yes	Yes	Yes
	No	No	No
Nontax Factors	Partnership	S Corporation	C Corporation
Is the liability of owners limited?	Yes	Yes	Yes
	No	No	No
Is there free transferability of ownership interests?	Yes	Yes	Yes
	No	No	No

100. Osprey Company had a net loss of \$200,000 from merchandising operations in 2010, 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.

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 2010, thus saving \$70,000 of tax (\$200,000 × 35%). If Osprey were a regular (C) 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.

101. Shareholders of closely held C corporations frequently engage in transactions that produce a tax benefit to the corporations. In many cases, shareholders receive compensation for employment with closely held corporations, and such payments generate a deduction for the corporations. To avoid the double taxation effect, shareholders generally prefer these and other corporate deductible payments over dividend distributions. Explain how this strategy avoids double taxation, including examples of other shareholder-corporation transactions that could be used for such purpose. Also, discuss the possible pitfalls surrounding corporate payments to shareholders.

Other transactions frequently used to reduce corporate taxes include interest payments to a shareholder-creditor and rent payments to a shareholder-lessor. To the extent payments to shareholders result in corporate deductions, the double taxation effect associated with dividend distributions is avoided. Corporate income that is offset by trade or business deductions effectively avoids the corporate income tax. As a result, such income is taxed only at the shareholder level (e.g., as compensation, interest, or rent income). Since dividends are not deductible, corporate income that is distributed in such form is subject to both the corporate income tax and the shareholder level income tax (e.g., individual income tax).

The IRS is aware of the preference for deductible payments to shareholders over nondeductible dividend distributions. As a result, corporate payments to shareholders of purported trade or business expenditures generally will attract increased IRS scrutiny. In particular, the IRS will examine whether such payments satisfy the reasonableness requirement for a § 162 trade or business deduction. When shareholder compensation (or other payment) is unreasonable, the IRS may recharacterize the excessive amount as a constructive dividend and disallow the associated corporate deduction. To satisfy the reasonableness requirement of § 162, corporate payments to shareholders should be comparable to amounts that would be paid to unrelated parties in similar transactions (i.e., an arms-length price).

102. 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.)

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 [$\$100,000 \text{ (salary deduction)} \times 35\% \text{ (marginal tax rate)}$]. If, instead, the payment were treated as a dividend, none of the \$100,000 would be 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 [$\$100,000 \text{ (salary)} \times 35\% \text{ (marginal tax rate)}$]. Thus, Nancy would save \$20,000 of tax if the payment were treated as a dividend instead of salary.

103. 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.

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.

104. Describe the Federal tax treatment of entities formed as limited liability companies.

When the IRS issued the check-the-box Regulations in 1996, the Federal tax treatment of limited liability companies (LLCs) was simplified. Currently, an entity formed as an LLC has great flexibility in determining the manner in which it will be taxed for Federal purposes. Under the check-the-box Regulations, an LLC with more than one owner can elect to be taxed as a partnership or as a corporation. If no election is made, the LLC will be taxed as a partnership. An LLC with only one owner can elect under the Regulations to be taxed as a sole proprietorship or as a corporation. If no election is made for a single-owner LLC, the entity will be taxed as a sole proprietorship.

An election as to entity classification is made by filing Form 8832 (Entity Classification Election). Entities that are incorporated under state law and entities that are required to be taxed as corporations under Federal law (e.g., certain publicly traded partnerships) are not eligible to make an election under the check-the-box Regulations.

105. 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-end. Will the IRS treat both corporations alike with respect to the fiscal year election? Explain.

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. An election under § 444 is required, and the PSC will be subject to the deduction limitations of § 280H. 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 retained the same year that was used for its fiscal year ending 1987, provided an election was made under § 444 and subject to the deduction limitations of § 280H.

106. 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?

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.

107. Jessica, a cash basis individual, is the sole shareholder of Crow Corporation, a regular corporation. On January 1, 2010, 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, 2010, and paid the \$50,000 to Jessica on January 1, 2011. How much is Crow's deduction for interest on this loan for 2010? Would your answer change if Jessica was a 45% shareholder of Crow?

Crow Corporation and Jessica are related parties under § 267 (corporation and a 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 2011. Thus, Crow has no deduction for interest expense on the loan for 2010. 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 2010.

108. Briefly describe the accounting methods available for adoption by a C corporation.

In general, a C corporation must adopt the accrual method of accounting. However, there are several exceptions to this rule, and the following C corporations can use the cash method of accounting:

- Corporations engaged in the trade or business of farming or timber.
- Qualified personal service corporations.
- Corporations with average annual gross receipts of \$5 million or less for the previous 3-year period.

There is a limitation on the use of the cash method by otherwise qualifying corporations that maintain inventories. In general, these corporations must use the accrual method in determining sales and cost of goods sold. However, corporations with average annual gross receipts of \$1 million or less for the most recent 3-year period are not subject to the limitation. (Further, some corporations with average annual gross receipts of \$10 million or less for the previous 3-year period also can avoid the limitation.)

Accrual method corporations are subject to a limitation on the deductibility of an accrued expenditure attributable to a cash method related party (e.g., a more-than-50% shareholder). In such cases, the corporation's deduction for the expenditure is deferred until the recipient includes the amount in income.

109. 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.

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.

110. 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.

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.

111. In connection with the deduction of organizational expenditures under § 248, comment on the following:

- a. Expenditures qualifying for the deduction.
- b. Determination of the deduction amount.
- c. The election requirement.

- a. Expenditures that qualify as “organizational expenditures” include the following: legal services incident to organization, such as costs of drafting the corporate charter, the bylaws, the minutes, and the terms of original stock certificates; necessary accounting services; expenses of temporary directors and of organizational meetings of directors or stockholders; and fees paid to the state of incorporation. Expenditures that do not qualify for amortization include those connected with the issuing or selling of shares of stock or other securities (e.g., commissions, professional fees, and printing costs) or with the transfer of assets to a corporation.

To qualify for amortization under § 248, the expenditure must be incurred before the end of the taxable year in which the corporation begins business. In this regard, the corporation’s method of accounting is of no consequence. Expenditures incurred by a cash basis corporation in its first tax year but paid in a subsequent year qualify for the election.

- b. In general, the first \$5,000 of qualifying organizational expenditures are deductible in the current year plus an amortization of the remaining expenditures over the 180-month period beginning with the month in which the corporation begins business. However, the \$5,000 first-year expensing amount is reduced to the extent qualifying organizational expenditures exceed \$50,000.
- c. A corporation is deemed to have made the § 248 election by claiming the allowable deduction on the tax return for its first tax year. No separate statement or specific identification of the deducted amount as organizational expenditures is required. A corporation can elect to forgo the deemed election by clearly electing to capitalize organizational expenditures on a timely filed return for its first tax year. In such cases, organizational expenditures cannot be deducted until the corporation ceases to do business and liquidates. (However, if the corporate charter limits the life of the corporation, the expenditures could be amortized over the life of the corporation.)

112. 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.

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.

113. Discuss the purpose of Schedule M-1. Give two examples of an addition and two examples of a subtraction that could be reported on Schedule M-1.

Schedule M-1 is used to reconcile the differences between net income per books with taxable income (before any dividends received deduction and NOL deduction). Examples of items that are additions include Federal income tax expense, excess of capital losses over capital gains, income subject to tax but not recognized for book purposes, book depreciation in excess of tax depreciation, and nondeductible expenditures (e.g., fines and penalties, meals and entertainment disallowance). Examples of items that are subtractions include tax-exempt income (e.g., life insurance proceeds), tax depreciation in excess of book depreciation, carryover amounts deductible in current year but expensed in prior year for book purposes (e.g., charitable contribution carryover deductible in current year), and domestic production activities deduction.