CHAPTER 2

CORPORATIONS: INTRODUCTION AND OPERATING RULES

LECTURE NOTES

SUMMARY OF CHANGES IN THE CHAPTER

The following are notable changes in the chapter from the 2012 Edition. For major changes, see the Preface to the Instructor's Edition of the text.

News Boxes

- Added Tax in the News titled *Not all Corporations are Treated Equal*.
- Removed Tax in the News titled *U.S. Corporate Tax Rate Second Highest among OECD States*.

Ethical and Equity Considerations

- Added Ethics and Equity titled *A Long Lost Relative?*
- Removed Ethics and Equity titled *Timing is Everything!*

Global Tax Issues

- Added Global Tax Issues titled *U.S. Corporate Tax Rate and Global Competitiveness*.
- Removed Global Tax Issues titled *Matching Principle Applies When Related Party is Foreign Taxpayer.*

2.1 TAX TREATMENT OF VARIOUS BUSINESS FORMS

1. Business forms include: sole proprietorships, partnerships (covered in Chapters 10 and 11), trusts and estates (covered in Chapter 20), Subchapter S corporations (covered in Chapter 12), and regular Subchapter C corporations.
2. C corporations are separate taxable entities, compute their own taxable income, and pay their own taxes.

Sole Proprietorship

3. Sole proprietorship is not a taxable entity. Net income or loss from the proprietorship is computed on Schedule C, which is attached to the proprietor's Form 1040. Thus, the proprietor pays tax on the profits of the proprietorship.

Partnerships

4. Partnerships, which are not taxable entities, must file Form 1065 (an information return). Each partner receives a Schedule K-1 that reports the partner's share of ordinary business income (loss) along with each separately reported pass-through item. Schedule K-1 items are reported on each partner's return.

Corporations

5. There are two types of corporations: regular corporations governed by Subchapter C and nontaxable corporations governed by Subchapter S. S corporations have the following characteristics.

    - Similar to partnerships with respect to tax treatment because both are not taxable entities, but are reporting entities (Form 1120S).
    - Income and expense items pass through to shareholders, who report the items on their own returns.
    - Generally enjoy the same legal benefits (e.g., limited liability) as C corporations.

6. Many items, such as capital gains and losses, retain their character when passed through to the owners of proprietorships, partnerships, and S corporations.

7. Regular C corporations are subject to double taxation effects.

    a. Closely held corporations may attempt to avoid the double taxation by making deductible payments to their shareholders (e.g., salaries, interest, or rents) that are large enough to reduce corporate taxable income to zero.

    b. Reduction of the dividend tax rate to a maximum of 15% (0% for low-income taxpayers) alleviates some of the double taxation effect.

        (1) Shareholders prefer dividends rather than salary or interest because of the lower tax rate dividends receive.

        (2) Corporations prefer payments that are deductible in computing their taxable income. However, dividends do reduce the possible accumulated earning tax, unreasonable compensation, and thin capitalization problems with the IRS.

8. The choice of entity should be based on a combination of tax and nontax factors.

    a. Tax Factors. The top corporate rate is 35% (39% on a limited range of taxable income), as is the top rate for individuals. However, for a specified level of income the corporate or individual tax rate can be higher because their tax rate schedules are different.

        (1) Tax rate of dividends should also be considered.

(2) With pass-through entities, items of income, gains, deductions, and losses retain their character for the owner. C corporation items do not pass through.

b. Nontax Considerations. Nontax considerations may override tax considerations. Those considerations favoring the corporate form include the following.

- Limited liability.
- Ability to raise large amounts of capital.
- Continuity of life for the entity.
- Free transferability of ownership interests.
- Centralized management.

c. The majority of businesses in the U.S. are small pass through entities. For a recent Congressional Research Service analysis of IRS data on U.S. business tax reporting, see CRS Report R40748 (August 6, 2009).

Limited Liability Companies

9. Limited liability company (LLC) offers a very important nontax advantage (limited liability) plus the tax advantage of being treated as a partnership (or proprietorship, in the case of a single-member LLC) and avoiding the double taxation problem associated with C corporations.

a. All 50 states and the District of Columbia recognize LLCs.

b. States vary in the corporate characteristics allowed to LLCs.

Entity Classification

10. Classification of an entity was left to the taxpayer when the "check-the-box" Regulations were promulgated.

a. Under these regulations, entities with two or more owners can elect to be treated as a partnership or a corporation. Entities with one owner can elect to be taxed as either a sole proprietorship or a corporation. Election is made on Form 8832, Entity Classification Election. See Rev. Proc. 2009-41, 2009-2 CB 439 for guidance on filing late Form 8832. For a late Form 8832 by a foreign entity, see Rev. Proc. 2010-32, 2010-2 CB 320.

b. Under the default rules, if no election is made, multi-owner entities are treated as partnerships and single-owner entities are sole proprietorships. New entities using a default classification should not file Form 8332.

c. The "check-the-box" election is not available to entities incorporated under state law or are required to be treated as corporations under Federal law (i.e., publicly traded partnerships).

d. An LLC that elects to be treated as a corporation under the check-the-box regulations may elect Subchapter S status. See, e.g., LTR 201140014 [late Form 8832 (Entity Classification Election) and late Form 2553 (Election by a Small Business Corporation) by LLC treated as timely filed].

e. Recently, there has been a lot of litigation regarding the liability for unpaid employment taxes of single-member LLCs (default sole proprietorships). The issue addressed by the courts generally is whether the single-member (sole proprietor) or the LLC is liable for unpaid employment taxes of the LLC. Invariably the sole proprietor is found to be liable for the unpaid employment taxes. [See, e.g., *Comensoli v. Comm.*, 2011–1 USTC ¶50,368, 107 AFTR 2d 2080, 442 Fed. Appx. 412 (CA–6, 2011) (single member liable for unpaid employment taxes of LLC); and *Tony L. Robucci*, 101 TCM 1060, T.C.Memo. 2011–19 (single member liable for self-employment taxes on LLC earnings)].

2.2 AN INTRODUCTION TO THE INCOME TAXATION OF CORPORATIONS

An Overview of Corporate versus Individual Income Tax Treatment

11. There are similarities and differences between corporate and individual income tax treatment. The tax formulas for these two types of taxpayers are contrasted in Figure 2.1.

    a. Determination of gross income is computed in much the same manner for corporations and individuals. However, corporations have no itemized deductions (as all its expenses are business deductions) nor do they have standard deductions or personal and dependency exemptions.

    b. Property transaction tax rules apply to both corporate and noncorporate taxpayers.

        (1) Includes definition of what are not capital assets (§ 1221) and nontaxable exchanges.

        (2) Fewer exclusion provisions are available to corporate taxpayers. The exclusion permitted by § 121 (the sale of a personal residence) does not apply to corporations. This last point seems simple enough, but consider the following illustration.

        Example. Ed is employed as general manager of Green Brewing Corporation. In this capacity, Ed is in charge of quality control, a feature highly touted by Green in advertising to its customers. To maintain constant quality control, Ed is required to live in a residence owned by Green and located adjacent to its brewery. If Green sold this residence for a gain, it may not use § 121 to exclude such gain. Had the residence been owned by Ed (and not Green Brewing Corporation), § 121 would be available to Ed.

    c. Credits that are personal in nature (child credit, earned income credit) are not available to corporations.

    d. Charitable contributions and casualty/theft losses have substantially different limitations for corporations and individuals.

Accounting Periods and Methods

12. C corporations may choose a calendar year or a fiscal year for reporting purposes, but S corporations and personal service corporations (PSCs) are subject to restrictions in the choice of a fiscal year.

13. Cash method of accounting, available to individuals, is not available to most regular corporations. Cash method is allowed for S corporations, qualified PSCs and corporations with average annual gross receipts of not more than $5 million.

ADDITIONAL LECTURE RESOURCE

Related Party Limitation. The § 267(a)(2) limitation on deducting accrued expense paid to related parties affects many closely held corporations, particularly those that are family owned. For purposes of the more-than-50% shareholder test, an individual is deemed to own the stock owned, directly or indirectly, by family members (i.e., siblings, spouse, ancestors, and lineal descendents) [§ 267(c)]. When a corporation's stock is only owned by family members, each shareholder will be a related party under the more-than-50% test. For many family-owned (accrual basis) corporations then, § 267(a)(2) will affect the deductibility of many different types of accrued expenditures (e.g., salary, bonus, interest, rent, and lease).

Example. Three brothers (cash basis, calendar year taxpayers) own all of the stock in Brown Corporation (accrual basis, calendar year taxpayer) and are its principal employees. After a particularly profitable year, in December 2012, Brown declares a bonus payable to each of its employees. Brown also accrues interest owed on amounts borrowed from its shareholders. The bonuses and interest are not paid until January 2013. Under the stock attribution rules of § 267, each of the brothers is deemed to own 100% of the stock of Brown. As a result, the bonuses attributable to the brothers and all of the interest are not deductible by Brown Corporation until 2013.

Capital Gains and Losses

14. Differences in corporate and individual taxpayer treatment of capital gains and losses.

    a. Net capital gains of corporations are not subject to lower rates, as are net capital gains of individuals.

    b. Corporate capital losses may only offset capital gains while individuals may deduct up to $3,000 of losses in excess of capital gains.

    c. Excess corporate capital losses are carried back 3 and forward 5 years to offset capital gains, while capital losses of individuals are carried forward indefinitely. When corporations carry over capital losses, they are treated as short term. For individuals, capital losses retain their original status as long term or short term.

Recapture of Depreciation

15. The § 291 amount is treated as additional § 1250 depreciation recapture. The result is a recharacterization of what would otherwise be § 1231 gain as ordinary income. Corporate taxpayers do not receive a preferential tax rate on long-term capital gains (e.g.,

a net § 1231 gain), but the recharacterization might reduce a corporation's ability to utilize capital losses in the current year.

Passive Losses

16. Passive loss limitations apply to closely held C corporations and personal service corporations (PSCs). However, closely held C corporations may offset passive losses against active income.

Charitable Contributions

17. Corporations are subject to limitations on their charitable contributions.

    a. For accrual basis corporations, there is an exception to the rule that deductions for charitable contributions are allowed only for the year in which payment is made. Corporations may deduct charitable contributions in the year preceding payment if the contribution is authorized by the board of directors by the end of that year and is paid on or before the 15th day of the third month of the next year.

    b. General rule that the amount of the deduction is fair market value on the date of the donation for long-term capital gain property and adjusted basis (or fair market value, if lower) for ordinary income property applies to corporations. However, there are exceptions to the general rule.

        (1) Long-term (held more than 1 year) capital gain property contributed to certain types of private nonoperating foundations and contributions of tangible personal property that are not used in the charity's tax exempt function are limited to adjusted basis on the date of donation.

        (2) Contributions of inventory to charities for use in their exempt purpose and solely for the care of the ill, needy, or infants, or where the property is used for research purposes under specified conditions are subject to special rules. The deduction is measured by the adjusted basis of the property plus half of the appreciation on the property. However, the deduction cannot exceed twice the basis of the property.

        Example: Gold Publishing Corporation donates 1,000 copies of a high school text on American history to Literacy U.S.A., a private nonoperating foundation. Each text costs Gold $3 to produce and retails for $13. The charitable deduction is limited to $6,000 [$3 X 2 (twice the basis) X 1,000 (copies donated)] which is less than $8,000 [$3,000 (basis) + $5,000 (50% of the $10,000 appreciation)].

    c. Limitation is 10% of taxable income computed without regard to charitable contribution deductions, net operating loss or capital loss carrybacks, dividends received deduction, and domestic production activities deduction. Any contribution in excess of the 10% limitation is carried forward for 5 years.

ADDITIONAL LECTURE RESOURCE

Art is in the Eye of the Beholder! (page 2-16). In order for Snipe to qualify for a deduction of $150,000 (fair market value), instead of $60,000 (basis), the museum's use of the painting must be related to its exempt purpose or function. To satisfy this requirement, Snipe must either establish that the painting was not in fact put to an unrelated use by the museum or that at the time of the contribution it was reasonable to assume that the museum would not put the painting to an unrelated use. For purposes of a gift to a museum, the latter requirement is satisfied if the painting is of a type normally retained by such museum, unless Snipe has actual knowledge to the contrary that the painting would be put to an unrelated use. [Reg. § 1.170A-4(b)(3).] The facts are not clear as to whether any of the above requirements were satisfied at the time of the contribution. However, if the museum sold the painting in the same tax year as Snipe's contribution, the deduction would be limited to the painting's basis. [§ 170(e)(1)(B)(i).] Further, if the museum's sale of the painting occurred within 3 years of the date of the contribution, Snipe would be required to recapture the excess contribution (fair market value in excess of basis) as gross income. [§ 170(e)(7).] Thus, it appears that either an amended return may be required for the year of the charitable deduction or income recognition may be required in the recapture year. As Snipe's tax practitioner, you are obligated, under Circular 230 and the AICPA Statements on Standards for Tax Services, to inform your client of the issues. (See Chapter 17 for discussion of Circular 230 and AICPA SSTSs.) If the corporation refuses to file a proper return with respect to the contribution, you should consider withdrawing from the engagement.

ADDITIONAL LECTURE RESOURCE

Charitable Contributions of Inventory. The regulations provide guidance on determining whether inventory is related to a qualified organization's exempt purpose or function. The regulations also elaborate on the requirement that the corporate donor receive a written statement from the qualified organization regarding the use and disposition of donated inventory [§ 170(e)(3)(A)(iii)], as well as the determination of inventory basis (Reg. § 1.170A-4A.) In some cases, the disposition of inventory by a donee within 3 years of the date of contribution will result in recapture (gross income) to the corporation, equal to the excess of the corporation's charitable deduction for the inventory over its basis in such property [§ 170(e)(7)]. For a recent ruling where the enhanced inventory deduction was disallowed due to inadequate substantiation, see NSAR 2011380IF (August 15, 2011).

Domestic Production Activities Deduction

18. Domestic production activities deduction (DPAD) is based on the income from manufacturing activities (see Chapter 3 for a detailed discussion).

    a. For 2012, DPAD is the lower of the following.

       - 9% of qualified production activities income.
       - 9% of taxable income (modified adjusted gross income for individuals).
       - 50% of W-2 wages related to the qualified production activities income.

    b. Deduction is available to all types of business entities.

Net Operating Losses

19. Individual and corporate taxpayers may have net operating losses (NOLs) that can be carried back 2 years and forward 20 years to offset taxable income.

    a. Corporations do not adjust their tax losses for capital losses as individuals do.

    b. Corporations do not make adjustments for nonbusiness deductions or for personal exemptions as individuals do.

    c. Corporations include their dividends received deduction in computing the NOL.

    d. Like individuals, corporations may elect to forgo the carryback period.

Deductions Available Only to Corporations

20. Dividends Received Deduction (DRD). For dividend distributions received from other domestic corporations.

    a. Purpose of DRD is to mitigate (or eliminate) the triple taxation of corporate-source income.

    b. Amount of DRD is limited as follows.

Percentage of Ownership by Corporation Shareholder	Deduction Percentage
Less than 20%	70%
20% or more but less than 80%	80%
80% or more and payor corporation is a member of an affiliated group with the payee corporation	100%

Example. During all of the current year, Silver Corporation (a calendar taxpayer) owned 4% of Bronze Corporation and 21% of Copper Corporation. Dividends received are: $50,000 from Bronze Corporation and $100,000 from Copper Corporation. Presuming the percentage of taxable income limitation does not apply, DRD =$115,000 [(70% X $50,000) + $80,000 (80% X $100,000)].

    c. DRD is limited to a percentage of the taxable income.

        (1) Computed without regard to the NOL deduction, DPAD, DRD, and any capital loss carryback to the current tax year.

        (2) Percentage of taxable income limitation corresponds to the deduction percentage.

Example. Assume the same facts as in the preceding example. The taxable income percentage limitation for Silver Corporation is 70% for Bronze Corporation dividends and 80% for Copper Corporation dividends.

    d. Taxable income limitation does not apply if the corporate shareholder has a net operating loss for the current taxable year or in the case of the 100% DRD available to members of an affiliated group.

e. In working with this myriad of rules, the following steps are useful.

- Multiply the dividends received by the deduction percentage.
- Multiply the taxable income by the deduction percentage.
- DRD is limited to the lesser of Step 1 or Step 2, unless deducting the amount derived in Step 1 results in an NOL. If so, the amount derived in Step 1 should be used. This is referred to as the NOL rule (Example 27).

f. Dividends not qualifying for DRD.

(1) Dividends on stock held for 45 days or less.

(2) Periods for which the corporation has diminished its risk of loss on the stock through a short sales do not count towards 45 day requirement (Reg. § 1.246-5).

g. DRD is reduced to extent of portfolio indebtedness (any indebtedness directly attributable to investment in stock).

(1) Amount of reduction is limited to the allocable amount of the corporation's interest deduction on the portfolio indebtedness. For determining whether indebtedness is "directly attributable" to stock investment, see, e.g., *OBH, Inc. v. U.S.*, 2005-2 USTC ¶50,627, 96 AFTR2d 6801, 397 F Supp.2d 1148 (D.Ct. Neb., 2005) and Rev. Rul. 88-66, 1988-2 C.B. 35.

(2) If corporation owns at least 50% of voting and value of another corporation's stock, DRD for this stock is not subject to the reduction.

21. Organizational Expenditures Deduction.

a. Such expenses may be amortized over a 180-month period starting in the month in which the business begins.

b. A special exception allows businesses to immediately expense the first $5,000 of organizational costs. The exception, however, is phased out on a dollar-for-dollar basis when these expenses exceed $50,000.

Example. Fox Corporation had $51,000 of organizational expenditures in the current year. Fox can elect to expense $4,000 [$5,000 – ($51,000 – $50,000)] of this amount and amortize the $47,000 balance ($51,000 – $4,000) over 180 months.

(1) In order for a corporation to qualify for this election, expenditures must be incurred before the end of the taxable year in which the corporation begins business. A corporation is deemed to make an election under § 248 to deduct organizational expenditures.

(2) A corporation may choose to forgo the deemed election by clearly electing to capitalize organizational expenditures for the taxable year in which the business begins. In this case, the organizational expenditures are not deductible until the corporation ceases to do business and liquidates (unless the corporate charter limits the life of the corporation).

c. Startup expenses (investigation and operating expenses incurred before the business begins producing income) are different from organizational costs. However, the amortization, immediate expensing, and deemed election rules described in a. and b. above for organizational expenditures also apply to startup costs.

d. Final Regulations (Reg. §§ 1.195-1 & 1.248-1) were issued in 2011 for organizational expenditures and startup costs (see T.D. 9542).

2.3 DETERMINING THE CORPORATE INCOME TAX LIABILITY

Corporate Income Tax Rates

22. Corporations compute their Federal income tax liability using the rate structure contained in § 11(b) (Exhibit 2.1 and inside front cover of text have rate schedules).

    a. An additional surtax of 5% is imposed on taxable income over $100,000, but such tax is not to exceed $11,750.

        (1) Consequently, the tax savings from the lower rates [i.e., 15% (on the first $50,000) and 25% (on the next $25,000)] is completely phased out once taxable income reaches $335,000 (Example 31).

        (2) As noted in Chapter 1, the tax law shows definite favoritism towards small businesses.

    b. At $10 million corporate rate goes to 35% and at $15 million, an additional 3% surtax applies (which brings total rate to 38% for that bracket). At $18,333,333, the surtax is no longer imposed.

    c. Personal service corporations (PSCs) are motivated to reduce taxable income as much as possible since they are taxed at the 35% rate on all taxable income.

        (1) PSC is a corporation substantially owned by employees (current, retired, estates thereof, or estate beneficiary) and its business activities consist of the performance of services in qualifying fields.[§§ 11(b)(2) and 448(d)].

        (2) This definition of a PSC also applies for purposes of the limitation on the cash method of accounting (outline item 13). However, for purposes of the limitation on the use of a fiscal year (outline item 12), definition of PSC is under §§ 269A(b) and 441(i)(2).

ADDITIONAL LECTURE RESOURCE

PSC Substantially All Activity Test. As to the function requirement, Temp. Reg. § 1.448-1T(e)(4) provides that the "substantially all" test is met if 95% or more of the time spent by employees of the corporation is devoted to performing services in qualifying fields. A recent case addressing the function requirement is *Grutman-Mazler Engineering, Inc.,* TC Memo 2008-140, 95 TCM 1551.

Similarly, Temp. Reg. § 1.448-1T(e)(5) establishes a 95% or more threshold for satisfying the stock ownership requirement. A recent case addressing the ownership requirement is *Robertson Strong & Apgar Architects, PC*, T.C. Summary Opinion 2007-48.

Alternative Minimum Tax

23. Corporations (other than "small corporations") are subject to an alternative minimum tax (AMT) that is similar to the AMT of individuals. Most adjustments and preferences are the same as for individuals, but the rates and exemption amounts are different. See Chapter 3 for a detailed discussion of the AMT.

Tax Liability of Related Corporations

24. A controlled group of corporations is entitled to one $250,000 accumulated earnings tax credit, one $40,000 exemption for the AMT, and is limited to taxable income in each of the first two brackets as though the group was one corporation. (See Examples 32 and 33) Controlled groups are parent-subsidiary corporations, brother-sister groups, combined groups and certain insurance companies.

    Final regulations on which corporations are included in a controlled group were issued in 2009 (T.D. 9451). See Reg. § 1.1563-1 for definition of "controlled group of corporations."

    Final regulations on apportionment of tax items among controlled group members were issued in 2010 (T.D. 9476). See Reg. § 1.1561-1 et seq.

ETHICS & EQUITY

A Long Lost Relative? (page 2-24). Brenda owns more than 50% of the stock of both Pelican Corporation and Seagull Corporation. Thus, Pelican and Seagull are related corporations and members of a controlled group of corporations (brother-sister controlled group). As a result, the two corporations are treated as if they were one corporation for purposes of the tax brackets below 35%, the $250,000 accumulated earnings credit, and the $40,000 AMT exemption amount. The fact that the bookkeepers lacked tax knowledge means it is very likely that the prior years' corporate returns failed to reflect the limitations applicable to related corporations. If this is the case, then you should advise the client of the error and recommend amended tax returns to correct the error. If the client refuses to amend any prior year's return that is in error, then you must consider whether you can prepare a proper income tax return for 2012. [See, e.g., AICPA's Statements on Standards for Tax Services (Statement No. 6: Knowledge of Error) in Chapter 17 of the text.]

2.4 PROCEDURAL MATTERS

Filing Requirements for Corporations

25. Corporations must file a tax return (Form 1120 or Form 1120S) on or before the 15th day of the third month following the close of the tax year.

    a. Form 1120 should be used if the corporation does not have an S election in effect.

    b. Corporations receive an automatic extension of 6 months by filing Form 7004 by the due date of the return.

Estimated Tax Payments

26. Corporations must make estimated tax liability payments unless the liability is less than $500.

    a. Required annual payment (including any AMT liability) is equal to the lesser of

        (1) 100% of the current year's tax.

        (2) 100% of the prior year's tax (prior year exception).

    b. Corporations having taxable income of at least $1 million in any of the prior three years (a "large" corporation) can use the prior year exception only for its first installment payment. Any shortfall of this payment must be remedied in the second installment payment.

       Example. Blue Corporation has a $1 million tax liability for the current year and an $800,000 tax liability last year. Using the prior year exception, Blue Corporation's first installment payment is $200,000 ($800,000 ÷ 4). Second installment payment is $300,000 [($1 million tax ÷ 4) + ($250,000 required quarterly payment using the current year tax – $200,000 paid as first installment)]. Third and fourth installment payments are $250,000 each (See Example 34).

    c. Calendar year corporation's estimated payments are due April 15, June 15, September 15, and December 15.

    d. Penalties apply to underpayments.

Schedule M-1–Reconciliation of Taxable Income and Financial Net Income

27. Schedule M-1. Reconciles the net income per financial accounting books with taxable income per the tax return. That is, Schedule M-1 computes the book to tax differences for the year.

    a. Schedule M-1 is required for corporations with total assets less than $10 million.

    b. Taxable income reconciled to net income per books is taxable income before the dividends received deduction and the NOL deduction.

28. Schedule M-2 reconciles unappropriated retained earnings for the year. Computations for Schedules M-1 and M-2 are illustrated in Examples 35 and 36.

Schedule M-3–Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More

29 Corporations with at least $10 million in total assets on their financial statements must report much greater detail relative to financial and tax income (loss) differences on Schedule M-3. This form is a response to the financial scandals.

a. Any corporation required to file a Schedule M-3 does not file a Schedule M-1.

b. Objectives of Schedule M-3 are the following.

(1) Create greater transparency between financial statements and tax returns.

(2) Identify corporations engaging in aggressive tax practices by highlighting transactions that create book/tax differences.

c. See Rev. Proc. 2011-13, 2011 C.B. 318 for guidance on when adequate disclosure requirement of §6662(d) (understatement of tax) is satisfied with regards to Schedule M-3.

30. Schedule M-3 has three parts.

a. Part I is financial information and the net income (loss) reconciliation.

(1) Financial net income (loss) sources come from the SEC Form 10-K, financial statements, or the corporation's books and records.

(2) Any income statement restatements or adjustments for the current or past 5 years should be included.

b. Part II reconciles net income (loss) of includible corporations with taxable income on the return. Corporations included in the financial reporting group may differ from the tax reporting group.

c. Part III reconciles expense and deduction items.

(1) Lists 36 expense and deduction items to reconcile.

(2) Differences between financial and tax amounts must be classified as being temporary or permanent.

Schedule UTP (Uncertain Tax Position Statement)

31. New reporting requirement, beginning with 2010 returns, for corporations with $100 million or more in assets ($10 million or more in assets beginning in 2014) [Reg. 1.6012-2(a)(4) and Announcement 2010-75, 2010-1 C.B. 428]. In general, requires reporting tax positions taken on a current (or prior) year's tax return and for which the corporation recorded a reserve for Federal income tax in its audited financial statements. Final Regulation [Reg. 1.6012-2(a)(4)] was issued in 2011 (see T.D. 9510). See Chapter 14 for a discussion on financial reporting of tax positions.

Form 1120 Illustration

32. The illustrative example is useful in introducing the corporate Form 1120.

Solutions to Tax Return and Research Problems appear separately as a download from the Instructor's Resource Page and on the Instructor's CD.

CHAPTER 2

CORPORATIONS: INTRODUCTION AND OPERATING RULES

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Learning Objective	Topic	Status: Present Edition	Q/P in Prior Edition
1	LO 1	Choice of entity: tax and nontax factors in entity selection	Unchanged	1
2	LO 1	Corporation versus S corporation: treatment of operating income and tax-exempt income; no distributions	New	
3	LO 1, 7	Corporation versus proprietorship: treatment of losses	Unchanged	3
4	LO 1, 2	Corporation versus partnership: treatment of operating losses and LTCG	Unchanged	4
5	LO 1, 2	Corporation versus LLC and S corporation	Unchanged	5
6	LO 1, 7	Closely held corporations: shareholder transactions	Unchanged	6
7	LO 1	Corporate and individual tax rates compared	Unchanged	7
8	LO 1	LLCs: tax treatment of	Unchanged	8
9	LO 1	LLCs: multi-owner default rule	New	
10	LO 2	Accounting periods: general rule and fiscal year limitation	New	
11	LO 2	Accounting periods: PSC fiscal year limitation	New	
12	LO 2	Accounting methods: limitation on cash method	New	
13	LO 2	Accounting methods: limitation on accrual of expenses to cash basis related party	Unchanged	13
14	LO 2	Net capital gain: corporate and individual tax rates contrasted	Unchanged	14
15	LO 2	Net capital loss: corporation and individual contrasted	Unchanged	15
16	LO 2	Recapture of depreciation: § 291 adjustment	New	
17	LO 2	Passive loss rules: closely held C corporations and PSCs contrasted	Unchanged	17
18	LO 2	Passive loss rules: closely held C corporation	Modified	18

Question/ Problem	Learning Objective	Topic	Status: Present Edition	Q/P in Prior Edition
19	LO 2	Charitable contributions: year of deduction for accrual basis corporation	Unchanged	19
20	LO 2	Charitable contributions: amount of contributions	New	
21	LO 2, 7	Charitable contributions: year-end planning issues with carryover	Unchanged	21
22	LO 2	Domestic production activities deduction: computation	New	
23	LO 2, 3, 7	NOL carryover issues	Unchanged	23
24	LO 1, 3	Dividends received deduction: corporate versus individual treatment	Modified	24
25	LO 3	Dividends received deduction: reduced ownership interest	Unchanged	25
26	LO 3	Dividends received deduction: holding period requirement	New	
27	LO 3	Organizational and startup expenditures contrasted	Unchanged	27
28	LO 4	Corporate income tax rates: highest marginal rate	Unchanged	28
29	LO 5	Tax liability of related corporations	New	
30	LO 6	Estimated tax payments: required annual payment	Unchanged	30
31	LO 6	Schedule M-1: adjustments	Unchanged	31
32	LO 6	Schedule M-3: reconciliation of expense item	Modified	32
33	LO 1	Compare LTCG treatment for regular corporations and proprietorships	Unchanged	33
34	LO 1	Tax treatment of income and distributions from partnership, S and C corporations	Unchanged	34
35	LO 1, 2	Corporation versus proprietorship: salary versus dividends; tax-exempt interest	Modified	35
36	LO 1, 2	Corporations versus S corporation: ordinary income and LTCG	New	
*37	LO 1	Corporation versus proprietorship: after-tax comparison	Updated	37
38	LO 2	Comparison of deduction for casualty loss for individual and corporate taxpayers	Modified	38
*39	LO 1, 4, 7	Tax liability determination as proprietorship or corporation	Unchanged	39
40	LO 2, 4	Personal service corporation: salary requirements for use of fiscal year and tax rate	New	
41	LO 2	Accounting methods: related party expense; cash versus accrual	New	
42	LO 2, 4	Capital gains and losses: tax rate on LTCG for corporation versus individual	Unchanged	42
43	LO 2	Net capital loss of corporation	Unchanged	43
44	LO 2	Comparison of treatment of net capital losses for individual and corporate taxpayers	Unchanged	44

Question/ Problem	Learning Objective	Topic	Status: Present Edition	Q/P in Prior Edition
45	LO 2	Capital gains and losses of a corporation; carryback/carryover	Unchanged	45
46	LO 2	Recapture of depreciation on § 1250 property: corporation versus individual	Modified	46
47	LO 2	Passive loss of closely held corporation; PSC	Unchanged	47
48	LO 2	Corporate charitable contributions: amount of contributions	New	
49	LO 2, 7	Corporate charitable contributions: tax planning	Unchanged	49
50	LO 2, 7	Corporate charitable contributions: carryover; tax planning	Unchanged	50
51	LO 2, 7	Corporate charitable contributions: timing of deduction; taxable income limit	Unchanged	51
52	LO 2	Domestic production activities deduction	New	
*53	LO 2, 3	Net operating loss: computed with dividends received deduction	New	
*54	LO 3	Dividends received deduction	Unchanged	54
55	LO 3	Organizational expenditures	Unchanged	55
*56	LO 3	Startup expenditures	Modified	56
*57	LO 4	Determine corporate income tax liability	Unchanged	57
58	LO 5	Tax liability of related corporations	Modified	58
59	LO 6	Estimated tax payments: large corporation	New	
*60	LO 6	Schedule M-1, Form 1120	Unchanged	60
61	LO 6	Schedule M-1, Form 1120	Modified	61
62	LO 6	Schedule M-2, Form 1120	Unchanged	62
63	LO 6	Schedule M-3, Form 1120	Unchanged	63
64	LO 6	Schedule M-3, Form 1120	Unchanged	64
65	LO 6	Schedule M-3, Form 1120	Modified	65
66	LO 2, 3, 7	Tax issues involved in starting a new business in the corporate form	Unchanged	66

*The solution to this problem is available on a transparency master.

Tax Return Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Corporation income tax (Form 1120 with Sch. M-3)	Modified	1
2	Corporation income tax (Form 1120)	Unchanged	2

Research Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Limitation on fiscal year-end for PSC: business purpose exception	New	
2	Charitable contribution of inventory: enhanced deduction	Unchanged	1
3	Personal service corporation: application to surveying business	Unchanged	2
4	Internet activity	Unchanged	4
5	Internet activity	New	
6	Internet activity	Unchanged	6

CHECK FIGURES

33.a. Juanita will report profit $50,000 and long-term capital gain $20,000.
33.b. Juanita's income is not increased.
34.a. Each partner reports $55,000 net profit and short-term capital loss $7,500.
34.b. Same as a.
34.c. Corporation reports $110,000 income. Shareholders each report $25,000 dividend income.
35.a. Azure tax of $119,000; Sasha $0 tax.
35.b. Azure tax of $119,000; Sasha $11,250 tax.
35.c. Azure tax of $90,500; Sasha $26,250 tax.
35.d. Azure tax of $0; Sasha $122,500 tax.
35.e. Azure tax of $0; Sasha $122,500 tax.
36.a. Taupe tax of $0; Charlene tax of $151,500.
36.b. Taupe tax of $153,000; Charlene $0 tax.
37.a. After-tax income $152,689.
37.b. After-tax income $124,702.
37.c. After-tax income $109,169.
38.a. $17,400 itemized deduction.
38.b. $40,000.
39.a. $56,000.
39.b. $43,350.
39.c. $45,650.
39.d. $54,023.
40.a. $84,000.
40.b. $33,250.
41.a. $440,000.
41.b. $460,000.
42.a. $17,150.
42.b. $12,750.
43.a. $60,000 taxable income; $10,000 tax.
43.b. $68,000 taxable income; $12,000 tax.
44.a. $19,000 deducted 2012; $12,000 carried forward to 2013.
44.b. $16,000 deducted 2012; $15,000 carried back to 2009, then 2010, etc.
45.a. Offset short-term capital gain of $70,000 against net long-term capital loss of $195,000. The $125,000 net capital loss is carried back 3 years and forward 5 years.
45.b. Total carryback $110,000.
45.c. $15,000; carry forward to 2013, etc.
45.d. Deduct $73,000 in 2012, $122,000 carried forward indefinitely.
46.a. Ordinary income of $57,498 and § 1231 gain of $429,994.
46.b. Section 1231 gain of $487,492.
47. Offset $225,000 of passive loss against active income. No offset if a PSC.
48. $118,500.
50. Gift land in 2013.
51. 2012.
52.a. $81,000.
52.b. $75,000.
53.a. $54,000.
53.b. ($12,000).
54. Green $140,000; Orange $105,000; Yellow $140,000.
55.a. $6,317.
55.b. $2,300.
56. $6,217.
57. Purple $6,750; Azul $104,150; Pink $799,000; Turquoise $7,350,000; Teal $28,000.
58. Red $42,325; White $69,625.
59. April 15, $59,500; June 15, $212,500; September 15, $136,000; December 15, $136,000.
60. Taxable income of $120,000.
61. Taxable income of $265,000.

DISCUSSION QUESTIONS

1. You should ask questions that will enable you to assess both tax and nontax factors that will affect the entity choice. Some relevant questions are addressed in the following table, although there are many additional possibilities.

Question	Reason for the question
What type of business are you going to operate?	This question will provide information that may affect the need for limited liability, ability to raise capital, ease of transferring interests in the business, how long the business will continue, and how the business will be managed.
What amount and type of income (loss) do you expect from the business?	Income from a business will eventually be reported on the tax returns of the owners.
What is the amount and type of income (loss) that you expect from other sources?	For example, income (loss) from a partnership, S corporation, or LLC will ‘‘flow through” to the owners. Dividends from a C corporation must be reported on the tax returns of the shareholders. Any income (loss) from other sources will also be reported on the returns of the owners. Thus, for planning purposes, it is important to know all sources and types of income (loss) that the owners will have.
Do you expect to have losses in the early years of the business?	Losses of partnerships, S corporations, and LLCs flow through to the owners and represent potential deductions on their individual returns. Losses of a C corporation do not flow through.
Will you withdraw profits from the business or leave them in the business so it can grow?	Profits from a partnership, S corporation, or LLC will ‘‘flow through” to the owners, and will be subject to taxation on their individual tax returns. Profits of a C corporation must be reported on the tax returns of the shareholders only if such profits are paid out to shareholders as dividends. Thus, in the case of a partnership, S corporation, or LLC, owners must pay tax on profits before plowing funds back into the business. In the case of a C corporation, the corporation must pay tax on its profits.
In what state(s) will the business be formed?	States assess business taxes (e.g., corporate income tax, franchise tax) on various forms of entities, including some that apply to S corporations, partnerships, and/or LLCs.

pp. 2-2 to 2-8

2. C corporations are separate taxable entities. Cassowary Corporation will report the operating income and tax-exempt income on its return (Form 1120), resulting in taxable income of \$120,000 for the year. Shareholders are required to report income from a C corporation only to the extent of dividends received; thus, Barbara reports no income from Cassowary for 2012. An S corporation is a tax reporting entity but (generally) not a taxable entity. Instead, its profit (loss) and separately stated items flow through to the shareholders. Emu Corporation will report ordinary business income of \$120,000 and separately stated tax-exempt interest income of \$8,000 on its return (Form 1120S), with 40% of these amounts allocated to Barbara (Schedule K-1). Barbara will report ordinary business income of \$48,000 and tax-exempt interest income of \$3,200 on her individual return (Form 1040). The absence of dividend distributions from Emu Corporation does not affect Barbara's treatment of the income. pp. 2-3 and 2-5

3. Art should consider operating the business as a sole proprietorship (or a single-member LLC) for the first three years. If he works 15 hours per week in the business, he will exceed the minimum number of hours required to be a material participant ($52 \times 15 = 780$) under the passive loss rules. Therefore, he will be able to deduct the losses against his other income. When the business becomes profitable, Art should consider incorporating. If he reinvests the profits in the business, the value of the stock should grow accordingly, and he should be able to sell his stock in the corporation for long-term capital gain. pp. 2-2 to 2-8, 2-38, and 2-39

4. A C corporation is a separate taxable entity, and its taxable income has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Thus, Plover Corporation will have a net operating loss of \$60,000 (operating loss of \$80,000 + long-term capital gain of \$20,000), and the NOL does not pass through to the shareholders. Since no dividends were distributed, the shareholders have no tax consequences in the current year with respect to Plover Corporation.

   Partnerships are tax reporting entities, and the income, gains, deductions, and losses of a partnership are passed through to and reported by the partners on their tax returns. Long-term capital gains of a partnership retain their character when reported by the partners. Distributions (or the lack thereof) typically do not affect the tax treatment of partnership activities. Thus, each partner of Vireo will report an operating loss of \$20,000 (\$80,000 ÷ 4 partners) and a LTCG of \$5,000 (\$20,000 ÷ 4 partners). Various loss limitation rules (e.g., partnership loss limitation, at-risk rules, and passive loss rules) may limit a partner's ability to currently deduct some or all of the operating loss.

   pp. 2-2, 2-3, and 2-5

5. If Blue Company is an LLC: A single-member LLC is taxed as a proprietorship. Thus, Samantha will report the \$200,000 operating income (Schedule C), \$10,000 short-term capital loss (Schedule D), and \$3,000 tax-exempt interest (Form 1040, page 1) on her tax return. The \$50,000 withdrawal would have no effect on Samantha's individual tax return.

   If Blue Company is an S corporation: An S corporation is a tax reporting entity (Form 1120S), and its income, gains, deductions, and losses are passed through to and reported by the shareholders on their tax returns. Separately stated items, e.g., tax-exempt income and capital losses, retain their character at the shareholder level. Consequently, Samantha will report the \$200,000 operating income (Schedule E), \$10,000 short-term capital loss (Schedule D), and \$3,000 tax-exempt interest (Form 1040, page 1) on her tax return. The \$50,000 withdrawal would have no effect on Samantha's individual tax return.

   If Blue Company is a C corporation: A C corporation is a separate taxable entity, and its taxable income has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Thus, Blue Company will report taxable income of $200,000 on its Form 1120. Corporations can deduct capital losses only to the extent of capital gains. The $10,000 net capital loss (STCL) will be carried back 3 years and forward 5 years. The tax-exempt interest income is excluded from Blue's gross income. Samantha will report dividend income of $50,000 (Schedule B) on her individual tax return.

pp. 2-2 to 2-8

6.
- Shareholder employment by the corporation.
    - Compensation paid to shareholder must be reasonable (i.e., not in excess of arms-length amount).
- Shareholder rents or leases property to corporation.
    - Rent/lease payment to shareholder must be reasonable (i.e., not in excess of fair rental value).
- Shareholder loans money to corporation.
    - Interest payment (rate) to shareholder must be reasonable (i.e., not in excess of market rate).
- Shareholder sells property to corporation.
    - Sale price to corporation must be reasonable (i.e., not in excess of fair market value).
- Corporation rents or leases property to shareholder.
    - Rent/lease payment to corporation must be reasonable (i.e., not less than fair rental value).
- Corporation loans money to shareholder.
    - Interest payment (rate) to corporation must be reasonable (i.e., not less than market rate).
- Corporation sells property to shareholder.
    - Sale price to shareholder must be reasonable (i.e., not less than fair market value).

pp. 2-4, 2-39, and 2-40

7. The marginal tax rates for C corporations are: 15%, 25%, 34%, 35%, 38%, and 39%. The marginal tax rates for individuals are 10%, 15%, 25%, 28%, 33%, and 35%. p. 2-4 and Exhibit 2.1

8. Under the check-the-box Regulations, LLCs are be taxed as follows. A single-member LLC is taxed as a proprietorship unless an election is made on Form 8832 to be taxed as a corporation. An LLC with more than one owner is taxed as a partnership unless an election is made on Form 8832 to be taxed as corporation. Entities that are incorporated under state law or required to be taxed as corporations under Federal law (e.g., certain publicly traded partnerships) cannot make an election under the check-the-box Regulations. p. 2-8

9. The statement is correct. Because no Form 8832 was filed, the LLC will be taxed as a partnership, the default classification for multi-member LLCs under the check-the-box Regulations. A Form 8832 is required to be filed only if the taxpayer wants to elect to have the entity classified as a corporation for Federal tax purposes. p. 2-8

10. In general, the statement is correct. That is, corporate taxpayers generally may choose a calendar year or a fiscal year for reporting purposes. However, the use of a fiscal year is restricted for personal service corporations and S corporations. For such corporations, the calendar year is the required reporting period, subject to a few limited exceptions (e.g., business purpose for fiscal year can be demonstrated, deferral under a § 444 election). p. 2-10

11. A C corporation is relatively unrestricted as to the 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, however, can elect a fiscal year only under one of the following circumstances:

    - A business purpose for the year can be demonstrated.
    - The 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 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.

    Thus, Salmon Corporation can elect a March 31 fiscal year-end, but Scarlet Corporation would need to satisfy the business purpose exception to qualify for a March 31 fiscal year-end.

    p. 2-10

12. In general, a corporation is *not* allowed to use the cash method of accounting for Federal tax purposes. However, S corporations, qualified personal service corporations, and C corporations engaged in the trade or business of farming or timber are exceptions to this rule. Further, a C corporation with $5 million or less of average gross receipts over the past three years is allowed to use the cash method.

    a. Jade Corporation has $4.8 million of average gross receipts over the 2009-2011 period. Thus, Jade satisfies the gross receipts exception and may use the cash method of accounting.

    b. Lime Corporation, a PSC, may use the cash method of accounting without regard to its gross receipts.

    pp. 2-10 and 2-11

13. A corporation that uses the accrual method cannot claim a deduction for an expense involving a related party (e.g., a more than 50% shareholder) until the recipient reports that amount as income. Wang, a cash basis taxpayer, must report the $35,000 interest income in 2013, the year she receives the payment. The corporation may deduct the $35,000 interest expense in 2013, the year Wang is required to report it as income. p. 2-11 and Example 12

14. Both corporations and individuals include recognized capital gains in their taxable income. For a corporate taxpayer, there is no preferential tax rate applicable to long-term capital gains.

Instead, the capital gain is taxed at Parrot's normal tax rate of 35%. The preferential tax rate of 15% would apply to Jeanette's long-term capital gain. p. 2-11

15. John and Eagle Corporation each net the $6,000 STCG against the $8,000 LTCL, resulting in a $2,000 net capital loss. John reports the capital transactions on his individual tax return, and deducts the $2,000 net capital loss in the current year. Eagle reports the capital transactions on its the corporate tax return, but none of the $2,000 net capital loss is deductible in the current year. Instead, Eagle carries back a $2,000 STCL three years and, if necessary, forward 5 years, to be offset against capital gains in such years. pp. 2-11 and 2-12

16. For an individual taxpayer, there is no deprecation recapture under § 1250 with respect to realty placed in service after 1986 and depreciated under the straight-line method. However, under § 291, a C corporation must treat a portion of gain recognized on the disposition of § 1250 property as depreciation recapture (ordinary income). The § 291 ordinary income amount is equal to 20% of the excess of the amount of depreciation recapture that would arise if the property was § 1245 property over the amount of depreciation recapture computed under § 1250 (without regard to § 291). As a result, some of the gain recognized by a C corporation on the sale of the warehouse will be ordinary income (and not § 1231 gain). p. 2-12 and Example 15

17. a. If Osprey is a personal service corporation, it cannot deduct any of the passive loss in the current year. A personal service corporation cannot offset a passive loss against either active or portfolio income.

    b. A closely held corporation that is not a personal service corporation can offset passive losses against active income but not against portfolio income. Therefore, Osprey can deduct the entire $60,000 passive loss.

    p. 2-13

18. A closely held C corporation that is not a personal service corporation can offset a passive loss against active income, but not against portfolio income. Hummingbird can deduct only $40,000 of the $45,000 passive loss. Thus, Hummingbird's taxable income is $15,000 ($40,000 + $15,000 – $40,000). Example 16

19. In order to be deductible by an accrual basis corporation in the year authorized by its board of directors, a charitable contribution must be paid within 2 1/2 months of the end of the year of authorization (March 15, 2013, in this case). Because payment was made within the required time period, the charitable contribution is deductible in 2012. p. 2-14

20. The rules for determining the amount of a charitable contribution of property by a C corporation are:

    - Loss property (fair market value less than basis) = fair market value.
    - Ordinary income property (property that, if sold, would *not* result in a long-term capital gain or § 1231 gain) = basis.
        - Certain contributions of *inventory* qualifying for increased contribution amount (e.g., contribution of inventory that is related to organization's exempt function and such use is solely for the care of the ill, needy, or infants) = 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.

- Capital gain property (property that, if sold, would result in a long-term capital gain or § 1231 gain) = fair market value.
  - Contributions of tangible personal property to charitable organization which does not use the property for purpose related to its exempt function = basis.
  - Contributions to certain private foundations = basis.

pp. 2-14 and 2-15

21. The following tax issues should be considered.

- Is Orange an accrual method taxpayer and, if so, will the contribution be made by March 15, 2013, so as to obtain a deduction in 2012?
- Will the contribution consist of property or cash?
- If the contribution consists of property, what is the character of the property (capital gain or ordinary income property) and amount of the contribution deduction?
- What is the current year's taxable income limitation on the deductibility of charitable contributions?
- In what tax year did the charitable contribution carryover originate and when does the 5-year period for such carryover expire?
- If the $45,000 sum of the current year's contribution plus the carryover amount exceeds the taxable income limitation, should the current year's gift be deferred to the subsequent tax year?

pp. 2-14 to 2-16, 2-39, and 2-40

22. The domestic productions activities deduction for 2012 is equal to 9% of the *lesser* of the taxpayer's (1) qualified productions activities income or (2) taxable income. However, the deduction cannot exceed 50% of the corporation's W-2 wages related to qualified productions activities income. pp. 2-16 and 2-17

23. As a general rule, an NOL is carried back 2 years and forward 20 years to offset taxable income in such carryover years. However, a taxpayer can (irrevocably) elect to forgo the carryback period and just carry the NOL forward. In determining whether Gold should make the election, some of the relevant issues are:

- What are Gold's marginal tax rates for the carryback years?
  - What effect, if any, would an NOL carryback have on the prior years' tax computations?
- What is Gold's estimated future marginal tax rate?
  - What is Gold's estimated future taxable income?
  - Are corporate income tax rates anticipated to change in the future?
- Does Gold have immediate cash flow needs that would favor the carryback approach?

pp. 2-17 and 2-41

24. Otter Corporation will be allowed a dividends received deduction equal to 70% of the $37,500 dividend it received from Marmot (subject to taxable income limitation described in Example 27). It will pay tax at the applicable corporate tax rate of 35% on the remaining portion of the dividend. Gerald must include in income the entire $37,500 dividend he received from Marmot, and he will pay tax at the 15% rate applicable to individuals. Examples 3 and 27

25. A corporation that owns stock in another corporation is allowed a dividends received deduction. The deduction percentage is based on the percentage of ownership that the recipient corporation has in the dividend-paying corporation. While Mauve owns 85% of Lavender, the deduction percentage is 100%. After the stock sale, Mauve will own 42.5% of Lavender, and the deduction percentage will be reduced to 80%. p. 2-18

26. In order to claim the dividends received deduction with respect to any stock, the corporation must have held the stock for more than 45 days during the 91-day period beginning on the date that is 45 days before the ex-dividend date (or, in the case of preferred stock, more than 90 days during the 181-day period beginning on the date that is 90 days before the ex-dividend date). p. 2-19 and Footnote 20

27. Cuckoo Corporation's organizational expenditures include legal expenses incurred for drafting of corporate charter and bylaws (option a.), expenses of temporary board of directors' organizational meetings (option c.), and state incorporation fee (option e.). Startup expenditures include employee salaries incurred during training period before opening for business (option d.). Expenses incurred in printing stock certificates (option b.) are neither organizational expenditures nor startup expenditures. The printing expenses cannot be deducted but reduce the amount of the capital realized from the sale of stock. pp. 2-20 and 2-21

28. The statement is incorrect. A 39% marginal tax rate applies to corporate taxable income in the $100,000 to $335,000 range. The 39% rate is the sum of a 34% marginal rate plus a 5% surtax that applies to taxable income in excess of $100,000 (and up to taxable income of $335,000). Example 31

29. Plum Corporation and Ivory Corporation are members of a controlled group of corporations (related corporations) and subject to a special income tax liability computation. The special computation limits the amount of a controlled group's taxable income that is taxed at rates lower than 35% to that amount the corporations in the group would have if they were one corporation. As a result, Omar's plan will be ineffective in lowering the overall corporate income tax liability of the two corporations. p. 2-23

30. Estimated tax payments are required if the corporation's tax liability is expected to be $500 or more. The required annual payment (which includes estimated AMT liability) is the *lesser* of (1) 100% of the corporation's tax for the current year or (2) 100% of the corporation's tax for the preceding year. p. 2-24

31. The starting point on Schedule M-1 is net income per books. Additions and subtractions are entered for items that affect net income per books and taxable income differently. An example of an addition is Federal income tax expense, which is deducted in computing net income per books but is disallowed in computing taxable income. An example of a subtraction is a charitable contributions carryover that was deducted for book purposes in a prior year but deducted in the current year for tax purposes.

    ADDITIONS

    a. Nondeductible portion of meals and entertainment
    c. Federal income tax per books

d. Capital loss in excess of capital gain
e. Charitable contributions in excess of taxable income limitation

SUBTRACTIONS
b. Tax depreciation in excess of book tax depreciation
f. Tax-exempt interest income
g. Domestic production activities deduction

p. 2-25 and Example 35

32. Corporations with total assets of *$10 million or more* are required to file Schedule M-3; thus, Woodpecker, with $8.5 million of assets, is not required to file the form. If a Schedule M-3 is filed by Woodpecker, the amortization is reported on line 28, Part III as follows: $40,000 book amortization in column (a), $15,000 temporary difference in column (b), and $55,000 tax return amortization in column (d). p. 2-26 and Example 39

PROBLEMS

33. a. Income, gains, deductions, and losses of a proprietorship are reported on the individual tax return of the sole proprietor. Consequently, Juanita reports the $50,000 net operating profit ($320,000 operating income – $270,000 operating expenses) and $20,000 long-term capital gain on her tax return.

b. A C corporation is a separate taxable entity, and its taxable income has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Therefore, Juanita does not report Osprey's net profit or long-term capital gain on her individual return.

pp. 2-2 to 2-4

34. a. Otter, a partnership, is not a taxpaying entity. Its profit (loss) and separate items flow through to the partners. The partnership's Form 1065 reports net profit of $110,000 ($320,000 income – $210,000 expenses). The partnership also reports the $15,000 short-term capital loss as a separately stated item on Form 1065. Ellie and Linda each receive a Schedule K-1 reflecting net profit of $55,000 and separately stated short-term capital loss of $7,500, which each reports on her own return (subject to capital loss limitation). The withdrawals do not affect taxable income but decrease their basis in the partnership. Example 2

b. Otter, an S corporation, is not a taxpaying entity. Its profit (loss) and separate items flow through to the shareholders. The S corporation's Form 1120S reports net profit of $110,000 ($320,000 income – $210,000 expenses). The S corporation also shows the $15,000 short-term capital loss as a separately stated item on Form 1120S. Ellie and Linda each receive a Schedule K-1 reporting net profit of $55,000 and separately stated short-term capital loss of $7,500, which each reports on her own return (subject to capital loss limitation). The withdrawals do not affect taxable income but decrease their basis in the S corporation. p. 2-3

c. Otter, a C corporation, is a taxpaying entity. Otter's Form 1120 reports taxable income of $110,000 ($320,000 income – $210,000 expenses). The short-term capital loss is not deductible in the current year. Instead, the $15,000 net capital loss is carried back 3 years and forward 5 years. Ellie and Linda report dividend income of $25,000 each. The dividend income is subject to a maximum tax rate of 15%. pp. 2-3, 2-4, 2-12, and Example 3

35. a. Azure Company, as a C corporation, has taxable income of $350,000 and corporate income tax of $119,000 [$350,000 × 34% (see Exhibit 2.1)]. The exclusion for municipal bond interest applies to C corporations. Since Sasha received no dividends or salary from Azure during the year, she is not currently taxed on any the corporation's income.

b. Since dividend distributions are not deductible, the income tax consequences to Azure Company, a C corporation, are the same as in a. above (i.e., corporate income tax of $119,000). Sasha incurs income tax of $11,250 ($75,000 × 15%) with respect to the dividends she received during the year.

c. The salary paid to Sasha is deducible by Azure Company, resulting in taxable income of $275,000 ($350,000 net operating income – $75,000 salary), and corporate income tax of $90,500 (see Exhibit 2.1). Sasha incurs income tax of $26,250 ($75,000 × 35%) with respect to the salary she received during the year.

d. There is no Federal income tax applicable to businesses formed as sole proprietorships. Instead, the income and expenses of a proprietorship retain their character and are reported on the individual income tax return of the proprietor. Sasha therefore incurs income tax of $122,500 ($350,000 net operating income × 35% marginal tax rate) with respect to Azure Company.

e. The result would be the same as in d. above. Sasha must pay tax on the net operating income of Azure Company, regardless of the amount she withdraws.

pp. 2-2 to 2-5 and 2-8

36. a. An S corporation is not a taxable entity. Its profit (loss) and separately stated items flow through to the shareholders. Taupe Corporation's Form 1120S reports ordinary business income of $420,000 and separately stated long-term capital gain of $30,000. Charlene receives a Schedule K-1 reporting ordinary business income of $420,000 and separately stated long-term capital gain of $30,000. Charlene will report ordinary business income of $420,000 and long-term capital gain of $30,000 on her individual income tax return (Form 1040), regardless of how much of the income was withdrawn from Taupe. Charlene's tax liability with respect to the income from Taupe is $151,500 [($420,000 ordinary business income × 35% marginal tax rate) + ($30,000 LTCG × 15% preferential tax rate)].

b. A C corporation is a taxable entity, and Taupe Corporation's Form 1120 reports taxable income of $450,000 ($420,000 ordinary business income + $30,000 LTCG) and income tax of $153,000 [$450,000 × 34% (see Exhibit 2.1)]. C corporations do not receive any preferential tax rate with respect to long-term capital gains. The taxable income of a C corporation has no effect on the shareholders until such time a dividend is paid. Therefore, Charlene has no tax consequences in 2012 with respect to Taupe Corporation.

pp. 2-3, 2-4, and 2-11

37. If Purple Company is a proprietorship, Kirsten must report net income of $200,000, regardless of the amount she withdraws. If the company is a C corporation, it must pay corporate tax on its taxable income and Kirsten must report any dividends she receives from the company as income.

a. Kirsten's after-tax income is computed below:

Income from proprietorship	$200,000

	Less deductions ($5,950 standard deduction + $3,800 exemption)	(9,750)
	Taxable income	$190,250
	Tax on $190,250 (see Appendix A for Tax Rate Schedules)	$ 47,311
	After-tax income ($200,000 – $47,311)	$152,689
b.	Tax on corporation's net income of $200,000:	
	Tax on $200,000 (see Exhibit 2.1)	$ 61,250
	Corporation's after-tax income ($200,000 – $61,250)	$138,750
	Kirsten's taxable income ($138,750 dividend – $5,950 standard deduction – $3,800 exemption)	$129,000
	Kirsten's tax on $129,000 at rates applicable to dividends [($35,350 × 0%) + .15($129,000 – $35,350)]	$ 14,048
	Kirsten's after-tax income ($138,750 – $14,048)	$124,702

c. The corporation will have taxable income of $61,250 ($200,000 net income before compensation deduction – $138,750 salary). Kirsten will have taxable income of $129,000 ($138,750 – $5,950 standard deduction – $3,800 exemption). Her tax will be $29,581, and her after-tax income will be $109,169 ($138,750 – $29,581).

pp. 2-2 to 2-5

38. a. Wilson can claim an itemized deduction of $17,400 [$90,000 – $50,000 (insurance recovery) – $100 (floor on personal casualty losses) – $22,500 (10% of $225,000 AGI)].

b. Wilson can deduct $40,000 [$90,000 – $50,000 (insurance recovery)]. Corporations are not subject to the $100 floor or the 10%-of-AGI limitation.

p. 2-9

39.	a.	Gross income	$295,000	
		Ordinary deductions	(135,000)	
		Taxable income (to owner of proprietorship)	$160,000	
		Tax @ 35%		$56,000
	b.	Gross income of corporation	$295,000	
		Ordinary deductions	(135,000)	
		Salary	(70,000)	
		Taxable income	$ 90,000	
		Corporate tax [$13,750 + (34% × $15,000)]		$18,850
		Gross income of shareholder		
		Salary	$ 70,000	
		Tax @ 35%		24,500
		Total tax		$43,350
	c.	Gross income of corporation	$295,000	
		Ordinary deductions	(135,000)	
		Taxable income	$160,000	
		Corporate tax [$22,250 + (39% × $60,000)]		$45,650

d.

Gross income of corporation	$295,000	
Ordinary deductions	(135,000)	
Salary	(70,000)	
Taxable income	$ 90,000	
Corporate tax (see part b. above)		$18,850
Tax paid by shareholder		
On salary ($70,000 × 35%)	$ 24,500	
On dividend [($90,000 – $18,850) × 15%]	10,673	35,173
Total tax		$54,023

e.

Hoffman, Raabe, Smith, and Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 3, 2012

Mr. Robert Benton
1121 Monroe Street
Ironton, OH 45638

Dear Mr. Benton:

This letter is in response to your inquiry as to the tax effects of incorporating your business in 2012. I have analyzed the tax results under both assumptions, proprietorship and corporation. I cannot give you a recommendation until we discuss the matter further and you provide me with some additional information. My analysis based on information you have given me to date is presented below.

COMPUTATION 1

Total tax on $160,000 taxable income if you continue as a proprietorship (35% tax rate)	$56,000
Total tax if you incorporate:	
Individual tax on $70,000 salary @ 35%	$24,500
Corporate tax on $90,000 corporate taxable income	18,850
Total	$43,350

Although this analysis appears to favor incorporating, it is important to consider that there will be additional tax on the $71,150 of income left in the corporation if you withdraw that amount as a dividend in the future, as calculated below:

COMPUTATION 2

After-tax income left in corporation ($90,000 taxable income – $18,850 corporate tax)	$71,150
Tax on $71,150 @ 15%	$10,673
Total tax paid if you incorporate ($43,350 + $10,673)	$54,023

Comparison of computations 1 and 2 appears to support incorporating. If you incorporate and recover the income left in the corporation as long-term capital gain from a sale of stock in the future, the total tax cost of incorporating will be the same, as shown in computation 3 below.

COMPUTATION 3

After-tax income left in corporation ($90,000 taxable income – $18,850 corporate tax)	$71,150
Tax on $71,150 @ 15% LTCG rate	$10,673
Total tax paid if you incorporate ($43,350 + $10,673)	$54,023

In summary, incorporation appears to be the most attractive option, whether you recover income left in the corporation as capital gain or as dividend income. Keep in mind, however, that there are important nontax considerations with respect to this decision. We can discuss those issues at our next meeting.

Thank you for consulting my firm on this important decision. We are pleased to provide analyses that will help you make the right choice.

Sincerely,

Jon Thomas, CPA

pp. 2-2 to 2-5, 2-39, and Exhibit 2.1

40. a. The salary for the deferral period (October 1 through December 31) must be at least proportionate to the employee's salary received for the prior fiscal year. The amount that Carmine Corporation must pay Juan during the period October 1 through December 31, 2012, to permit Carmine to continue to use its fiscal year without negative tax effects, is $84,000 ($336,000 × 3/12). Example 11

b. Carmine Corporation, a PSC, is subject to a tax rate of 35% on all of its taxable income. The corporation would pay tax of $33,250 ($95,000 × 35%) for the tax year ending September 30, 2012. To illustrate the negative tax impact of classification as a PSC, compare this amount with to the $20,550 (see Exhibit 2.1) that a corporation that is not a PSC would pay on taxable income of $95,000. p. 2-22

41. a. Under the cash method of accounting, the salaries are deducible in the year they are paid by Broadbill. Thus, Broadbill deducts $440,000 ($220,000 × 2), the amount of salaries paid by the corporation in 2012. The $40,000 of salaries paid by Broadbill in 2013 is deductible by the corporation in 2013.

b. An accrual method corporation cannot claim a deduction for an accrual with respect to a related party (e.g., more-than-50% shareholder). Instead, the deduction is deferred until such time the recipient reports that amount as income. Thus, Broadbill deducts $460,000 [$220,000 (salary paid in 2012 to related party Marcia) + $240,000 (salary paid and accrued to unrelated party Zack). The $20,000 of Marcia's 2012 salary that is accrued by Broadbill on December 31, 2012, is deductible by the corporation in 2013 (the year it is paid to Marcia).

Example 12

42. a. If Violet is a corporation, then $17,150 of corporate income tax results in 2012. Corporations do not receive a preferential rate for LTCGs, and such income is taxed at

the normal corporate rates resulting in a tax of $17,150 [($50,000 × 15%) + ($25,000 × 25%) + ($10,000 × 34%)].

b. If Violet is a proprietorship, then $12,750 ($85,000 × 15%) of individual income tax results in 2012 for Ramona. The income (or loss) of a proprietorship is reported on the proprietor's individual return. Individuals receive a preferential tax rate of 15% (or 0%, if the taxpayer is in the two lowest tax brackets) on LTCGs.

pp. 2-11 and Exhibit 2.1

43. a. $60,000 taxable income = $215,000 (operating income) – $155,000 (operating expenses) + $12,000 (LTCG) – $12,000 (STCL). No deduction is allowed for the $15,000 net capital loss. Instead, the net capital loss is carried back 3 years and forward 5 years. The tax on $60,000 of taxable income is $10,000 [($50,000 × 15%) + ($10,000 × 25%)].

b. $68,000 taxable income = $215,000 (operating income) – $155,000 (operating expenses) + $35,000 (LTCG) – $27,000 (STCL). The tax on $68,000 of taxable income is $12,000 [($50,000 × 15%) + ($18,000 × 25%)]. Corporations include LTCGs in taxable income and do not receive a preferential tax rate with respect to such income.

pp. 2-11, 2-12, and Exhibit 2.1

44. a. If Bronze is a proprietorship, only $19,000 of the $31,000 long-term capital loss can be deducted in 2012. The loss will offset the short-term capital gain of $16,000 first; then, an additional $3,000 of the loss may be utilized as a deduction against ordinary income. The remaining $12,000 of the net capital loss is carried forward to 2013 and years thereafter until completely deducted. The capital loss carryover retains its character as long term. Example 13

b. If Bronze is a C corporation, only $16,000 of the long-term capital loss can be deducted in 2012. The loss deduction is limited to the amount of capital gains ($16,000 STCG). A corporation may not claim a net capital loss as a deduction against ordinary income. The remaining $15,000 loss can be carried back to the three preceding years to reduce any net capital gains in those years. (The loss is carried back first to the tax year 2009.) Any remaining loss not offset against net capital gains in the three previous years can be carried forward for five years, to offset capital gains in those years. The long-term capital loss will be treated as a short-term capital loss as it is carried back and forward. Example 14

45. a.

Net short-term capital gain	$ 70,000
Net long-term capital loss	(195,000)
Net capital loss	($125,000)

Gorilla cannot deduct the net capital loss of $125,000 on its 2012 return, but must carry it back to the three preceding years, applying it against net capital gains in 2009, 2010, and 2011, in that order. The net capital loss is carried back or forward as a short-term capital loss.

b.

2012 net capital loss	($125,000)
Offset against	
2009 (net long-term capital gains)	$ 55,000
2010 (net short-term capital gains)	15,000

2011 (net long-term capital gains)	40,000
Total carrybacks	$110,000

c. $15,000 ($125,000 – $110,000) STCL carryover to 2013, 2014, 2015, 2016, and 2017, in that order.

d. These transactions are netted with the taxpayer's other capital transactions for 2012. Assuming these are the only capital transactions in 2012, the taxpayer offsets $70,000 of capital gains against the capital losses and deducts an additional $3,000 in capital losses. The remaining $122,000 ($195,000 – $70,000 – $3,000) is carried forward indefinitely (as long-term capital loss).

Examples 13 and 14

46. a. Under § 291, a corporation will incur an additional amount of depreciation recapture (ordinary income) upon a disposition of § 1250 property for a gain. The § 291 adjustment is equal to 20% of the excess of the amount of depreciation recapture that would arise if the property was § 1245 property over the amount of deprecation recapture computed under § 1250 (without regard to § 291).

First, determine the recognized gain:

Sales price		$850,000
Less adjusted basis:		
Cost of property	$650,000	
Less cost recovery	(287,492)	(362,508)
Recognized gain		$487,492

Second, determine the § 1245 recapture potential. This is the lesser of $487,492 (recognized gain) or $287,492 (cost recovery claimed).

Third, determine the normal § 1250 recapture amount:

Cost recovery taken	$287,492
Less straight-line cost recovery	(287,492)
§ 1250 ordinary income	$ –0–

Fourth, determine the additional § 291 amount:

§ 1245 recapture potential	$287,492
Less § 1250 recapture amount	(–0–)
Excess § 1245 recapture potential	$287,492
Apply § 291 percentage	20%
Additional ordinary income under § 291	$ 57,498

Heron Corporation's recognized gain of $487,492 is accounted for as follows:

Ordinary income under § 1250	$ –0–
Ordinary income under § 291	57,498
§ 1231 gain	429,994
Total recognized gain	$487,492

b. Heron Company, as a sole proprietorship, is not subject to § 291; instead, the normal depreciation recapture rules apply with respect to the gain recognized on the sale of the realty. The realty is § 1250 property and there is no recapture of depreciation under that provision when straight-line depreciation is used. As such, the entire gain of $487,492 is treated as § 1231 gain on the tax return of the proprietor of Heron.

Example 15

47. Condor, a closely held corporation that is not a PSC, may offset $225,000 of the $300,000 passive loss against the $225,000 of active business income. However, it may not offset the remaining $75,000 of loss against portfolio income.

If Condor were a PSC, it could not offset the passive loss against either active or portfolio income.

Example 16

48. The total amount of Aquamarine's charitable contributions for the year is $118,500. The painting is capital gain property, but it is tangible personal property which was not used for a purpose related to the qualified organization's exempt function. Thus, the amount of the contribution is limited to the painting's basis, or $15,000. The Apple stock is capital gain property and the amount of the contribution is the stock's fair market value, or $90,000. The canned groceries are ordinary income property but the donation qualifies for the enhanced deduction for corporate contributions of inventory. As such, the amount of the contribution of the inventory is equal to 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. Thus, the amount of the contribution of the canned groceries is $13,500 [$10,000 (basis) + .5($17,000 – $10,000)]. pp. 2-14, 2-15, and Example 22

49. Hoffman, Raabe, Smith, and Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 3, 2012

Mr. Joseph Thompson
Jay Corporation
1442 Main Street
Freeport, ME 04032

Dear Mr. Thompson:

I have evaluated the proposed alternatives for your 2012 year-end contribution to the University of Maine. I recommend that you sell the unimproved land and donate the proceeds to the University. The four alternatives are discussed below.

Donation of cash, the unimproved land, or the Maize stock each will result in a $200,000 charitable contribution deduction. Donation of the Brown Corporation stock will result in only a $70,000 charitable contribution deduction.

Contribution of the land will result in a less desirable outcome from a tax perspective. However, you will benefit in two ways if you sell the land and give the $200,000 in proceeds to the University. Donation of the proceeds will result in a $200,000 charitable contribution deduction. In addition, sale of the land will result in a $110,000 long-term capital loss. If Jay Corporation had capital gains of at least $110,000 and paid corporate income tax in the past three years, the entire loss can be carried back and Jay will receive tax refunds for the carryback years. If Jay Corporation had no capital gains in the carryback years, the capital loss can be carried forward and offset against capital gains of the corporation for up to five years.

Jay Corporation should make the donation in time for the ownership to change hands before the end of the year. Therefore, I recommend that you notify your broker immediately so there will be no problem in completing the donation on a timely basis.

I will be pleased to discuss my recommendation in further detail if you wish. Please call me if you have questions. Thank you for consulting my firm on this matter. We look forward to serving you in the future.

Sincerely,

Richard Stinson, CPA

Note to instructor: The land and stock are "unrelated use property" but they are not "tangible personal property."

pp. 2-12, 2-14, and 2-15

50. Gray Corporation should defer the gift of the land until 2013. This would allow Gray to fully deduct in 2012 the carryover contribution amount of $75,000. If, instead, Gray gifted the land in 2012, the corporation would lose any otherwise allowable deduction as to the $75,000 carryover amount. This occurs because current year gifts are applied against the taxable income limitation before application of any carryover amounts. Thus, the taxable income limitation for 2012 would be completely exhausted by the gift of land in 2012. Since 2012 represents the fifth and last year of the carryover period, a gift of the land in 2012 precludes any deduction for the $75,000. A gift of appreciated land held for more than one year as an investment results in a charitable deduction equal to the land's fair market value (subject to the taxable income limitation).

Assuming a gift of the land in 2013
2012 taxable income limitation: 10% × $1 million = $100,000.
2012 charitable contribution deduction: $75,000 (carryover from 2007 gift).
2013 taxable income limitation: 10% × 1.2 million = $120,000.
2013 charitable contribution deduction: $120,000 (gift of land; excess contribution of $130,000 is carried forward for up to 5 years).

Assuming a gift of the land in 2012
2012 taxable income limitation: 10% × $1 million = $100,000.
2012 charitable contribution deduction: $100,000 (gift of land; excess contribution of $150,000 is carried forward for up to 5 years). Carryover from 2007 gift ($75,000) disappears, as 2012 is the last year of the carryover period.
2013 taxable income limitation: 10% × 1.2 million = $120,000.
2013 charitable contribution deduction: $120,000 (carryover from 2012 gift; remaining $30,000 of carryover from 2012 gift carries over to 2014).

pp. 2-14, 2-15, 2-40, and 2-41

51. Hoffman, Raabe, Smith, and Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 17, 2012

Mr. Dan Simms, President
Simms Corporation
1121 Madison Street
Seattle, WA 98121

Dear Mr. Simms:

On December 13 you asked me to advise you on the timing of a contribution by Simms Corporation to the University of Washington. My calculations show that the corporation will maximize its tax savings by making the contribution in 2012.

If the corporation makes the contribution in 2012, it can deduct $25,000 as a charitable contribution, which will save $9,750 (39% tax rate × $25,000 deduction) in Federal income tax. However, if the corporation makes the contribution in 2013, the percentage limitations applicable to corporations will limit the 2013 deduction to $10,000 ($100,000 projected profit × 10% limit). The corporation will save $3,400 (34% tax rate × $10,000 deduction) in taxes as a result of this deduction. The corporation may carry the remaining $15,000 forward for five years or until exhausted. If the corporation continues at the 2013 profit level, it will save an additional $5,100, for a total tax savings of $8,500.

This analysis makes it clear that the corporation will save $1,250 more ($9,750 – $8,500) if it makes the contribution in 2012. In addition, all of the savings will occur in 2012. If the corporation makes the contribution in 2013, its tax savings will be split among several years. My advice is that the corporation should make the contribution immediately so ownership of the stock can be transferred by December 31.

Sincerely,

Alicia Gomez, CPA

pp. 2-14 and 2-16

52. a. White's domestic production activities deduction for 2012 is equal to 9% of the lesser of:

- taxable income (before DPAD) of $900,000, or
- qualified production activities income of $1.2 million.

The tentative deduction is $81,000 ($900,000 × 9%). Because W-2 wages attributable to QPAI were $200,000, the wage limitation ($200,000 × 50% = $100,000) does not apply. Therefore, White's DPAD for 2012 is $81,000.

b. The wage limitation now applies and White's DPAD for 2012 is $75,000 ($150,000 × 50%).

pp. 2-16, 2-17, and Example 25

53. a. The key to this question is the relationship between the dividends received deduction and the net operating loss 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	$660,000	
Dividends	240,000	$900,000
Less: Expenses from operations		(720,000)
Income before the dividends received deduction		$180,000
Dividends received deduction (70% × $180,000)		(126,000)
Taxable income		$ 54,000

The dividends received deduction is limited to 70% of taxable income (before the dividends received deduction) because taking 70% of $240,000 ($168,000) would not create a net operating loss. Example 27

b. If Swallow Corporation owns 26% of Brown Corporation's stock, the percentage for calculating the dividends received deduction would be 80%. Under these circumstances, taking the full dividends received deduction would create an NOL.

Gross income		
From operations	$660,000	
Dividends	240,000	$900,000
Less: Expenses from operations		(720,000)
Income before the dividends received deduction		$180,000
Dividends received deduction (80% × $240,000)		(192,000)
Net operating loss		($ 12,000)

The dividends received deduction is not limited to 80% of taxable income (before the dividends received deduction) because taking 80% of $240,000 ($192,000) creates a net operating loss. Example 26

54. Following the procedure used in Example 27 in the text, proceed as follows:

	Green Corporation	Orange Corporation	Yellow Corporation
Step 1			
70% × $200,000 (dividend received)	$140,000		
70% × $200,000 (dividend received)		$140,000	
70% × $200,000 (dividend received)			$140,000
Step 2			
70% × $250,000 (taxable income before DRD)	$175,000		
70% × $150,000 (taxable income before DRD)		$105,000	
70% × $50,000 (taxable income before DRD)			$35,000
Step 3			
Lesser of Step 1 or Step 2	$140,000	$105,000	
Generates a net operating loss			$140,000

Consequently, the dividends received deduction for Green Corporation is $140,000 under the general rule. Yellow Corporation also claims a dividends received deduction of $140,000 because a net operating loss results when the Step 1 amount ($140,000) is subtracted from 100% of taxable income before DRD ($50,000). Orange Corporation, however, is subject to the taxable income limitation and is allowed only $105,000 as a dividends received deduction.

pp. 2-18, 2-19, and Example 27

55. a. For 2012, the deduction for organizational expenditures is $6,317 {$5,000 (amount that can be immediately expensed) + [($44,500 – $5,000) ÷ 180 months × 6 months]}. Except for the expenses related to the printing and sale of the stock certificates, all other expenses qualify for the § 248 amortization election. Thus, organizational expenditures total $44,500 ($17,000 + $2,500 + $25,000). To qualify for the election, the expenditure must be *incurred* before the end of the taxable year in which the corporation begins business. Since the legal fees were incurred in 2012, the $25,000 qualifies as organizational expenditures.

b. Organizational expenditures now total $54,500 ($17,000 + $2,500 + $35,000). Since organizational expenditures exceed $50,000, the $5,000 first-year expensing limit is reduced to $500 [$5,000 – ($54,500 – $50,000)]. Thus, the 2012 deduction for organizational expenditures is $2,300 {$500 (amount that can be immediately expensed) + [($54,500 – $500) ÷ 180 months × 6 months]}.

Examples 29 and 43

56. All $41,500 of the expenditures are startup expenditures. Egret can elect under § 195 to currently write off the first $5,000 and to amortize the remaining amount of such expenditures over a 180-month period beginning with the month in which it begins business (i.e., July 1, 2012). Thus, Egret's deduction in 2012 for startup expenditures is $6,217 {$5,000 + $1,217 [($41,500 – $5,000) ÷ 180 months × 6 months]}. Egret makes the § 195 election simply by claiming the deduction on its 2012 tax return. (If Egret decides to forgo the § 195 election, the $41,500 must be capitalized and is deductible only when the corporation ceases to do business and liquidates.) p. 2-21

57. Purple Corporation:

Tax on $45,000 × 15%	$ 6,750

Azul Corporation:

Tax on—$310,000	
Tax on $100,000	$ 22,250
Tax on $210,000 × 39%	81,900
Total tax	$ 104,150

Pink Corporation:

Tax on—$2,350,000	
Tax on $335,000	$ 113,900
Tax on $2,015,000 × 34%	685,100
Total tax	$ 799,000

Turquoise Corporation:

Tax on $21,000,000 × 35%	$7,350,000

Teal Corporation (a personal sevice corporation):

Tax on $80,000 × 35%	$ 28,000

p. 2-22, Exhibit 2.1, and Examples 30 and 31

58. Since Red and White are members of a controlled group of corporations, and since they did not consent to an apportionment plan, the marginal tax brackets are apportioned equally to the two entities. As such, Red Corporation's income tax liability is $42,325 [($25,000 × 15%) + ($12,500 × 25%) + ($12,500 × 34%) + ($80,000 × 39%)], and White Corporation's income tax liability is $69,625 [($25,000 × 15%) + ($12,500 × 25%) + ($12,500 × 34%) + ($150,000 × 39%)]. (Note that the combined tax liability of $111,950 for the two corporations is equal to the tax liability they would have incurred if they were taxed as one corporation with their combined taxable income of $330,000.) pp. 2-22, 2-23, and Exhibit 2.1

59. Grouse, a large corporation, may use the prior year's tax liability exception only for purposes of its first estimated tax payment for 2012. Any shortfall from not using the current year's (2012) tax liability for the first installment must be paid in conjunction with the second installment payment. As such, Grouse's installment payment dates and amounts are as follows:

Payment	Amount
April 15, 2012	$ 59,500*
June 15, 2012	212,500**
September 15, 2012	136,000
December 15, 2012	136,000
Total	$544,000

*Based on preceding year's tax, for first installment only: [$700,000 taxable income × 34% (see Exhibit 2.1)] = $238,000 ÷ 4 = $59,500.

**Based on current year's tax, for remaining installments: [$1.6 million taxable income × 34% (see Exhibit 2.1)] = $544,000 ÷ 4 = $136,000. Second installment must include shortfall from first installment: [$136,000 + ($136,000 – $59,500)] = $212,500.

Example 34

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

Net income per books (after tax)	$386,250
Plus:	
Items that decreased net income per books but did not affect taxable income:	
+ Federal income tax per books	30,050
+ Excess of capital losses over capital gains	5,300
+ Nondeductible penalties	2,500
+ Interest on loan to purchase tax-exempt bonds	1,700
+ Premiums paid on life insurance policy on life of Albatross's president	4,200
Subtotal	$430,000
Minus:	
Items that increased net income per books but did not affect taxable income:	
– Tax-exempt interest income	(5,000)

– Life insurance proceeds received as a result of the death of the corporate president	(300,000)
– Excess of tax depreciation over book depreciation	(3,000)
– Domestic production activities deduction	(2,000)
Taxable income	$120,000

Example 35

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

Net income per books (after tax)	$174,100
Plus:	
Items that decreased net income per books but did not affect taxable income:	
+ Federal income tax per books	86,600
+ Excess of capital loss over capital gains	9,400
+ Interest paid on loan incurred to purchase tax-exempt bonds	1,100
+ Nondeductible meals and entertainment	5,500
Subtotal	$276,700
Minus:	
Items that increased net income per books but did not affect taxable income:	
– Tax-exempt interest income	(4,500)
– Excess of MACRS over book depreciation	(7,200)
Taxable income	$265,000

Example 35

62. Unappropriated retained earnings per books, as of December 31, 2012, is determined as follows:

Balance at beginning of year	$636,450
Plus:	
Net income (loss) per books	174,700
Subtotal	$811,150
Minus:	
Cash dividend distributions	(35,000)
Balance at end of year	$776,150

Example 36

63. Pelican, Inc., reports the meals and entertainment expenditures on line 11, Part III as follows: book expense of $10,000 in column (a), permanent difference of ($5,000) in column (c), and tax return deduction of $5,000 in column (d). This problem illustrates reporting procedures when book expenses are greater than tax return deductions. It also illustrates the reporting of permanent differences. Example 40

64. Pelican, Inc., reports the fines and penalties on line 12, Part III as follows: book expense of $50,000 in column (a), permanent difference of ($50,000) in column (c), and tax return deduction of $0 in column (d). Further, PGW reports the depreciation on line 31, Part III as follows: book expense of $245,000 in column (a), temporary difference of $65,000 in column (b), and tax return deduction of $310,000 in column (d). This problem illustrates the Schedule M-3 reporting when book expenses are both more than and less than tax return

deductions. It also illustrates the reporting of both temporary and permanent differences. Examples 39 and 40

65. These amounts must be reported on line 32, Part III as follows: $190,000 book bad debt expense in column (a), ($130,000) temporary difference in column (b), and $60,000 tax return bad debt expense in column (d). This problem illustrates reporting procedures when book expenses are greater than tax return deductions. It also illustrates the reporting of temporary differences. Example 40

66. Organizational expenditures and startup expenditures were incurred in January, February, and March. For both types of expenditures, the corporation can elect to expense the first $5,000 of qualifying expenditures and amortize the remaining balance over a period of 180 months. Don and Steve should identify the organizational and startup expenditures that qualify, and decide whether to make the elections. Since the elections are deemed to be made, a decision to forgo either would require a statement to that effect attached to the corporation's return.

    The corporation must choose cost recovery methods and decide whether to elect immediate expensing under § 179. It is also necessary to select an accounting method. The accrual method will be required for sales and purchases of inventory, but the hybrid method may be chosen as the overall method. This would allow use of the cash method for all items other than purchases and sales.

    The corporation has a great deal of flexibility in selecting a fiscal or calendar year. The golf retail business is generally seasonal in nature, so the corporation should consider electing a November 30, January 31, or February 28 fiscal year.

    If Don and Steve are family members (e.g., brothers) as defined under § 267 and the corporation selects the accrual method of accounting, the accrued bonuses will not be deductible until the year of payment. If the payment date is not changed, the deduction for bonuses will be disallowed, which could result in underpayment of estimated payments, which would result in a penalty.

    pp. 2-10, 2-11, 2-20, 2-21, and 2-42

Proposed solutions to the **Research Problems** and the **Tax Return Problems** are found at the Instructor Companion Site for the textbook (www.cengage.com/taxation/swft). Previously, these items were a part of the Instructor's Guide for the text, but now they are available online at this site as free-standing documents, as well as on the Instructor's Resource CD.

NOTES

SOLUTIONS TO RESEARCH PROBLEMS

Research Problem 1.

A PSC [as defined under § 441(i)(2)] must use the calendar year for reporting purposes, unless the PSC can establish, to the satisfaction of the IRS, a business purpose for a fiscal year-end. [§ 441(i)(1)] (A fiscal year can also be elected under the provisions of § 444.) Approval of the IRS to adopt (or change to) a fiscal year under the business purpose exception is obtained by filing Form 1128, "Application to Adopt, Change, or Retain a Tax Year." [Reg. §§ 1.441-1(c)(2)(i), 1.441-3(b)(1), and 1.442-1(b)(1)] In determining whether a PSC has established a business purpose for a fiscal year, consideration will be given to all of the facts and circumstances relating to the adoption of the fiscal year, including the tax consequences resulting from such adoption. [Reg. § 1.442-1(b)(2)]

Reasons sufficient to satisfy the business purpose standard:

- Fiscal year coincides with the entity's natural business year. [Reg. § 1.442-1(b)(2)] In general, a natural business year exists if, for each of the 3 most recent 12-month periods that end with the last month of the requested fiscal year, 25% or more of the entity's gross receipts were derived in the last two months of such requested fiscal year. (In addition to the 25% gross receipts test, a natural business year can also be established under the annual business cycle test and the seasonal business test.) [Rev.Proc. 2002-39, 2002-1 C.B. 1046] In some cases, a PSC satisfying the 25% gross receipts test will be deemed to have established a business purpose and obtain automatic IRS consent. [See Rev.Proc. 2006-46, 2006-2 C.B. 859.]

Reasons *insufficient* to satisfy the business purpose standard:

- Deferral of income to shareholders. [§ 441(i); Reg. § 1.442-1(b)(2)]
- The use of a particular year for regulatory or financial accounting purposes;
- The hiring patterns of a particular business;
- The use of a particular year for administrative purposes;
- The fact that a particular business involves the use of price lists, model years, or other items that change on an annual basis;
- The use of a particular year by related entities; and
- The use of a particular year by competitors. [Rev. Proc. 2002-39, 2002-1 C.B. 1046]

Research Problem 2

In general, a contribution of inventory to a qualified charitable organization is deductible only the extent of the inventory's basis. However, certain contributions of inventory to charitable organizations will result in an increased deduction amount. When this enhanced deduction rule applies, the deduction is equal to the lesser of (1) basis plus one-half of the inventory's appreciation (excess of fair market value over basis) or (2) two times basis. [§ 170(e)(3)(B)] A local or regional food bank is an example of an organization that Southwest Grocer could target to obtain the enhanced deduction for contributions of its inventory. In order to qualify for the enhanced deduction amount, the following rules apply:

- The recipient organization is a § 501(c)(3) tax exempt organization (other than a private nonoperating foundation). [§ 170(e)(3)(A)]

- The use of the inventory by the recipient organization is related to the entity's exempt purpose or function. [§ 170(e)(3)(A)(i)]
    - The inventory may not be used to generate unrelated trade or business income for the exempt organization. [Reg. § 1.170A-4A(b)(2)(i)]
- The inventory will be used by the recipient organization solely for the care of the ill, the needy, or infants. [§ 170(e)(3)(A)(i)]
    - The inventory may not be used by any other person except as incidental to primary use in the care of the ill, needy, or infants. [Reg. § 1.170A-4A(b)(2)(ii)(A)]
    - The recipient organization may transfer the inventory to another exempt U.S. organization to meet this requirement, as long as the recipient organization obtains a written statement from the other exempt entity that the inventory will be used for appropriate purposes. [Reg. § 1.170A-4A(b)(2)(ii)(A)]
- The inventory is not transferred by the recipient organization in exchange for money, property, or services. [§ 170(e)(3)(A)(ii)]
    - There is an exception for nominal costs incurred by the recipient organization for administrative, warehousing, or other similar costs. However, any fee charged should not be based on the value of the inventory (a fee based on weight is acceptable). [Reg. § 1.170A-4A(b)(3)]
- Southwest Grocers receives from the recipient organization a written statement provides that the use and disposition of the inventory will be in accordance with the aforementioned requirements. [§ 170(e)(3)(A)(iii)]
    - The statement from the recipient organization should include a description of the contributed inventory, the date of receipt, an attestation that the organization qualifies as a § 501(c)(3) exempt entity, and an attestation that adequate books and records will be maintained and made available to the IRS upon request. [Reg. § 1.170A-4A(b)(4)(i)]
    - The statement must be received by Southwest Grocers no later than the due date (including extensions) of the income tax return for the year in which the contribution is made. [Reg. § 1.170A-4A(b)(4)(i)]
- The inventory must satisfy any applicable requirements of the Federal Food, Drug, and Cosmetic Act. [§ 170(e)(3)(A)(iv)]
- Southwest Grocers must decrease its cost of goods sold by the lesser of the inventory's fair market value or its basis. [Reg. § 1.170A-4A(c)(3)] The basis of inventory is determined under Southwest Grocers' method of inventory accounting. [Reg. § 1.170A-4A(c)(2)]
- It is necessary to determine the fair market value of the donated inventory and, in the case of some of the food products contemplated for gifting purposes (e.g., dented cans and fungible food items nearing their freshness expiration dates), the fair market value may be subject to dispute. In such cases, the fair market value may not be the usual retail sales price but rather the amount for which such inventory could have been sold at the time of the contribution (including consideration for the quantity involved). [Reg. § 1.170A-1(c)(3)]

  - The IRS likely would assert a reduction in fair market value for contributions of dented canned goods and fungible goods nearing their freshness expiration dates. See Rev.Rul. 85-8, 1985-1 C.B. 59 (donated pharmaceutical inventory shortly before their expiration date valued at less than full retail price).

  - See, however, *Lucky Stores, Inc.*, 105 T.C. 420 (1995) (donated 4-day-old bread and other "aged" baked goods valued at full retail price, not half retail price as asserted by IRS).

- Form 8283 (Noncash Charitable Contributions) must be filed when the value of the donated inventory exceeds $5,000. For purposes of the $5,000 threshold, only the excess of the charitable deduction over the basis of the inventory is counted. A qualified appraisal generally is required of inventory contributions in excess of $5,000. [Reg. § 1.170A-13(c)]

Research Problem 3

TAX FILE MEMORANDUM

Date: May 2, 2012
From: Jonathan Smith
Subject: Tern Corporation

Facts: Tern Corporation, a calendar year C Corporation, is solely owned by Jessica Ramirez. Tern's only business since its incorporation in 2009 has been land surveying services. In Tern's state of incorporation, land surveying can be performed only by a licensed surveyor. Jessica, Tern's only employee, is a licensed surveyor. Jessica is not a licensed engineer. Upon audit of Tern's 2009 and 2010 tax returns, the IRS asserted tax deficiencies stemming from its conclusion that the corporation was a personal service corporation subject to the flat tax rate of 35%. Jessica believes that the IRS's determination is incorrect and she has requested advice on how to proceed.

At issue: Is Tern Corporation a personal service corporation under § 448(d)(2) and therefore subject to the flat tax rate of 35?

Conclusion: Section 11(b)(2) provides that the taxable income of a qualified personal service corporation, as defined in § 448(d)(2), is subject to a flat tax rate of 35%. Under § 448(d)(2), a "qualified personal service corporation" means any corporation that satisfies both a function test and an ownership test. The function test requires that "substantially all of the activities" of the corporation involve the performance of services in one of eight specified fields, including engineering. [§ 448(d)(2)(A).] The ownership test requires, in general, that substantially all of the stock of the corporation is owned by employees (or retired employees) performing services for the corporation. [§ 448(d)(2)(B).] Since Jessica owns 100% of Tern Corporation and is the corporation's only employee, the ownership test is not in question.

Temp. Reg. § 1.448-1T(e)(4)(i) provides that the field of engineering includes surveying. Further, the provision notes that the "substantially all of the activities" requirement is satisfied if 95% or more of the time spent by employees of the corporation is devoted to the performance services in a designated field (e.g., engineering). Thus, Tern is a personal service corporation as defined under Temp. Reg. § 1.448-1T(e)(4)(i). In a recent case directly on point with our facts, a corporate taxpayer in the business of land surveying was held to be a personal service corporation as defined by § 448(d)(2). In *Kraatz & Craig Surveying Inc.* [134 T.C. 167 (2010)], the taxpayer argued that Temp. Reg. § 1.448-1T(e)(4)(i) was invalid in that it included surveying in the engineering field. The Tax Court rejected that argument, however, by noting, in part, that the underlying legislative language supported the regulation's interpretation. [See, e.g., H. Rep. No. 99-841, 99th Cong., 2d Sess., 1986, p. 285.] [The Tax Court also rejected the taxpayer's argument that state law is determinative of what is included in the field of engineering for purposes of § 448(d)(2).] Thus, the IRS's determination that Tern Corporation is a personal service corporation subject to the flat tax of 35% is correct and the tax deficiency should be paid. In the future, an attempt should be made to reduce or eliminate Tern's taxable income through increased compensation payments to Jessica.

Research Problems 4 through 6

These problems require that the student access various sites on the Internet. Thus, each student's solution likely will vary from that of the others.

You should determine the skill and experience levels of the students before making the assignment, coaching them where necessary so as to broaden the scope of the exercise to the entire available electronic world.

Make certain that you encourage students to explore all parts of the Web in this process, including the key tax sites, but also information found through the home pages of newspapers, magazines, businesses, tax professionals, government agencies, political outlets, and so on. They should work with Internet resources other than the Web as well, including newsgroups and other interest-oriented lists.

Build interaction into exercises wherever possible, asking the student to send and receive e-mail in a professional and responsible manner.