

## CHAPTER 2--CORPORATIONS: INTRODUCTION AND OPERATING RULES

Student: \_\_\_\_\_

1. Tomas owns a sole proprietorship, and Lucy is the sole shareholder of a C corporation. In the current year both businesses make a net profit of \$60,000. Neither business distributes any funds to the owners in the year. For the current year, Tomas must report \$60,000 of income on his individual tax return, but Lucy is not required to report any income from the corporation on her individual tax return.

True False

2. Rose is a 50% partner in Wren Partnership. During the year, Wren earned net profit of \$100,000 (\$210,000 gross income – \$110,000 operating expenses) and distributed \$20,000 to each partner. Rose must report Wren Partnership profit of \$20,000 on her Federal income tax return.

True False

3. Rajib is the sole shareholder of Robin Corporation, a calendar year S corporation. Robin earned net profit of \$350,000 (\$520,000 gross income – \$170,000 operating expenses) and distributed \$80,000 to Rajib. Rajib must report Robin Corporation profit of \$350,000 on his Federal income tax return.

True False

4. Donald owns a 60% interest in a partnership that earned \$230,000 in the current year. He also owns 60% of the stock in a C corporation that earned \$230,000 during the year. Donald received \$50,000 in distributions from each of the two entities during the year. With respect to this information, Donald must report \$188,000 of income on his individual income tax return for the year.

True False

5. Quail Corporation is a C corporation with net income of \$125,000 during the current year. If Quail paid dividends of \$25,000 to its shareholders, the corporation must pay tax on \$100,000 of net income. Shareholders must report the \$25,000 of dividends as income.

True False

6. Eagle Company, a partnership, had a short-term capital loss of \$10,000 during the year. Aaron, who owns 25% of Eagle, will report \$2,500 of Eagle's short-term capital loss on his individual tax return.

True False

7. Katherine, the sole shareholder of Purple Corporation, a calendar year C corporation, has the corporation pay her a salary of \$450,000 in the current year. The Tax Court has held that \$150,000 represents unreasonable compensation. Purple Corporation's taxable income is unaffected by the Tax Court's determination.  
True False

8. Double taxation of corporate income results because dividend distributions are included in a shareholder's gross income but are not deductible by the corporation.  
True False

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

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

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

12. Employment taxes apply to all entity forms of operating a business. As a result, employment taxes are a neutral factor in selecting the most tax effective form of operating a business.  
True False

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

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

15. A calendar year C corporation with average annual gross receipts of \$5 million or less must use the cash method of accounting.

True False

16. On December 31, 2012, Lavender, Inc., an accrual basis C corporation, accrues a \$90,000 bonus to Barry, its vice president and a 70% shareholder. Lavender pays the bonus to Barry, who is a cash basis taxpayer, on March 15, 2013. Lavender can deduct the bonus in 2013, the year in which it is included in Barry's gross income.

True False

17. Azure Corporation, a C corporation, had a long-term capital gain of \$50,000 in the current year. The maximum amount of tax applicable to the capital gain is \$7,500 ( $\$50,000 \times 15\%$ ).

True False

18. Albatross, a C corporation, had \$140,000 net income from operations and a \$25,000 short-term capital loss in the current year. Albatross Corporation's taxable income is \$140,000.

True False

19. If a C corporation uses straight-line depreciation on real estate (§ 1250 property), no gain on the sale of the property will be recaptured as ordinary income.

True False

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

True False

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

True False

22. On December 20, 2012, the directors of Quail Corporation (an accrual basis, calendar year taxpayer) authorized a cash donation of \$5,000 to the American Cancer Society, a qualified charity. The payment, which is made on April 10, 2013, may be claimed as a deduction for tax year 2012.

True False

23. In the current year, Oriole Corporation donated a painting worth \$30,000 to the Texas Art Museum, a qualified public charity. The museum included the painting in its permanent collection. Oriole Corporation purchased the painting 5 years ago for \$10,000. Oriole's charitable contribution deduction is \$30,000 (ignoring the taxable income limitation).

True False

24. Crow Corporation, a C corporation, donated scientific property (basis of \$30,000, fair market value of \$50,000) to State University, a qualified charitable organization, to be used in research. Crow had held the property for four months as inventory. Crow Corporation may deduct \$50,000 for the charitable contribution (ignoring the taxable income limitation).

True False

25. Heron Corporation, a calendar year C corporation, had an excess charitable contribution for 2011 of \$5,000. In 2012, Heron made a further charitable contribution of \$20,000. Heron's 2012 deduction is limited to \$15,000 (10% of taxable income). The current year's contribution must be applied first against the \$15,000 limitation.

True False

26. For a corporation in 2012, the domestic production activities deduction is equal to 9% of the higher of (1) qualified production activities income or (2) taxable income. However, the deduction cannot exceed 50% of the W-2 wages related to qualified production activities income.

True False

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

True False

28. Azul Corporation, a calendar year C corporation, received a dividend of \$50,000 from Naranja Corporation. Azul owns 10% of the Naranja Corporation stock. Assuming it is not subject to the taxable income limitation, Azul's dividends received deduction is \$35,000.

True False

29. Because of the taxable income limitation, no dividends received deduction is allowed if a corporation has an NOL for the current taxable year.

True False

30. No dividends received deduction is allowed unless the corporation has held the stock for more than 90 days.

True False

31. Black Corporation, an accrual basis taxpayer, was formed and began operations on February 1, 2012. During its first year of operations (February 1 – December 31, 2012), Black incurred the following expenses: fee paid to state of incorporation of \$2,000, accounting and legal services incident to organization of \$9,000, and expenses related to the printing and sale of stock certificates of \$10,000. Black has \$11,000 of qualified organizational expenditures that it may elect to amortize.

True False

32. Lilac Corporation incurred \$4,700 of legal and accounting fees associated with its incorporation. The \$4,700 is deductible as startup expenditures on Lilac's tax return for the year in which it begins business.

True False

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

True False

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

True False

35. A calendar year C corporation can receive an automatic 6-month extension to file its 2012 corporate return (Form 1120) by filing Form 7004 by March 15, 2013.

True False

36. The due date (not including extensions) for filing a 2012 Federal income tax return for a calendar year C corporation (Form 1120) is April 15, 2013.

True False

37. For purposes of the estimated tax payment rules, a "large corporation" is defined as a corporation that had an average taxable income of \$1 million or more in any of the three preceding years.

True False

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

True False

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

True False

40. On December 31, 2012, Flamingo, Inc., a calendar year, accrual method C corporation, accrues a bonus of \$50,000 to its president (a cash basis taxpayer), who owns 75% of the corporation's outstanding stock. The \$50,000 bonus is paid to the president on February 1, 2013. For Flamingo's 2012 Form 1120, the \$50,000 bonus will be a subtraction item on Schedule M-1.

True False

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

True False

42. Schedule M-2 is used to reconcile unappropriated retained earnings at the beginning of the year with unappropriated retained earnings at the end of the year.

True False

43. A corporation with \$5 million or more in assets must file Schedule M-3 (instead of Schedule M-1).

True False

44. Schedule M-3 is similar to Schedule M-1 in that the form is designed to reconcile net income per books with taxable income. However, an objective of Schedule M-3 is more transparency between financial statements and tax returns than that provided by Schedule M-1.

True False

45. Juanita owns 60% of the stock in a C corporation that had a profit of \$200,000 in 2012. Carlos owns a 60% interest in a partnership that had a profit of \$200,000 during the year. The corporation distributed \$45,000 to Juanita, and the partnership distributed \$45,000 to Carlos. Which of the following statements relating to 2012 is *incorrect*?

- A. Juanita must report \$120,000 of income from the corporation.
- B. The corporation must pay corporate tax on \$200,000 of income.
- C. Carlos must report \$120,000 of income from the partnership.
- D. The partnership is not subject to a Federal entity-level income tax.
- E. None of the above.

46. Bjorn owns a 60% interest in an S corporation that earned \$150,000 in 2012. He also owns 60% of the stock in a C corporation that earned \$150,000 during the year. The S corporation distributed \$30,000 to Bjorn and the C corporation paid dividends of \$30,000 to Bjorn. How much income must Bjorn report from these businesses?

- A. \$0 income from the S corporation and \$30,000 income from the C corporation.
- B. \$30,000 income from the S corporation and \$30,000 of dividend income from the C corporation.
- C. \$90,000 income from the S corporation and \$0 income from the C corporation.
- D. \$90,000 income from the S corporation and \$30,000 income from the C corporation.
- E. None of the above.

47. Luis is the sole shareholder of a C corporation, and Eduardo owns a sole proprietorship. Both businesses were started in 2012, and each business has a long-term capital gain of \$20,000 for the year. Neither business made any distributions during the year. With respect to this information, which of the following statements is *incorrect*?

- A. Eduardo must report a \$20,000 long-term capital gain on his 2012 tax return.
- B. Luis's corporation does not receive a preferential tax rate on the \$20,000 long-term capital gain.
- C. Luis must report a \$20,000 long-term capital gain on his 2012 tax return.
- D. Eduardo receives a preferential tax rate on a long-term capital gain of \$20,000.
- E. None of the above.

48. Norma formed Hyacinth Enterprises, a proprietorship, in 2012. In its first year, Hyacinth had operating income of \$400,000 and operating expenses of \$240,000. In addition, Hyacinth had a long-term capital loss of \$10,000. Norma, the proprietor of Hyacinth Enterprises, withdrew \$75,000 from Hyacinth during the year. Assuming Norma has no other capital gains or losses, how does this information affect her taxable income for 2012?

- A. Increases Norma's taxable income by \$157,000 (\$160,000 ordinary business income – \$3,000 long-term capital loss).
- B. Increases Norma's taxable income by \$150,000 (\$160,000 ordinary business income – \$10,000 long-term capital loss).
- C. Increases Norma's taxable income by \$75,000.
- D. Increases Norma's taxable income by \$160,000.
- E. None of the above.

49. Francisco is the sole owner of Rose Company. For 2012, the only income of Rose was a long-term capital gain of \$25,000. The business made no distributions during the year to Francisco. Irrespective of Rose Company, Francisco's marginal tax rate is 35% and he has no capital asset transactions. Which of the following statements is *incorrect*?

- A. If Rose Company is a sole proprietorship or S corporation, Francisco must report the \$25,000 long-term capital gain on his personal income tax return.
- B. If Rose Company is a C corporation, Francisco will report none of the \$25,000 long-term capital gain on his personal income tax return.
- C. If Rose Company is a sole proprietorship or S corporation, a preferential tax rate applies to the \$25,000 long-term capital gain.
- D. If Rose Company is a C corporation, a preferential tax rate does not apply to the \$25,000 long-term capital gain.
- E. None of the above.

50. Lucinda is a 60% shareholder in Rhea Corporation, a calendar year S corporation. During the year, Rhea Corporation had gross income of \$550,000 and operating expenses of \$380,000. In addition, the corporation sold land that had been held for investment purposes for a short-term capital gain of \$30,000. During the year, Rhea Corporation distributed \$50,000 to Lucinda. With respect to this information, which of the following statements is correct?

- A. Rhea Corporation will pay tax on taxable income of \$200,000.
- B. Lucinda reports ordinary income of \$50,000.
- C. Lucinda reports ordinary income of \$120,000.
- D. Lucinda reports ordinary income of \$102,000 and a short-term capital gain of \$18,000.
- E. None of the above.

51. Elk, a C corporation, has \$370,000 operating income and \$290,000 operating expenses during the year. In addition, Elk has a \$10,000 long-term capital gain and a \$17,000 short-term capital loss. Elk's taxable income is:

- A. \$63,000.
- B. \$73,000.
- C. \$80,000.
- D. \$90,000.
- E. None of the above.

52. Flycatcher Corporation, a C corporation, has two equal individual shareholders, Nancy and Pasqual. In the current year, Flycatcher earned \$100,000 net profit and paid a dividend of \$10,000 to each shareholder. Regardless of any tax consequences resulting from their interests in Flycatcher, Nancy is in the 33% marginal tax bracket and Pasqual is in the 15% marginal tax bracket. With respect to the current year, which of the following statements is *incorrect*?

- A. Flycatcher cannot avoid the corporate tax altogether by paying out all \$100,000 of net profit as dividends to the shareholders.
- B. Nancy incurs income tax of \$1,500 on her dividend income.
- C. Pasqual incurs income tax of \$1,500 on his dividend income.
- D. Flycatcher pays corporate tax of \$22,250.
- E. None of the above.

53. Which of the following statements is *incorrect* about LLCs and the check-the-box Regulations?

- A. If a limited liability company with more than one owner does not make an election, the entity is taxed as a corporation.
- B. All 50 states have passed laws that allow LLCs.
- C. An entity with more than one owner and formed as a corporation cannot elect to be taxed as a partnership.
- D. If a limited liability company with one owner does not make an election, the entity is taxed as a sole proprietorship.
- E. A limited liability company with one owner can elect to be taxed as a corporation.

54. Patrick, an attorney, is the sole shareholder of Gander Corporation. Gander is a personal service corporation with a fiscal year ending November 30. The corporation paid Patrick a salary of \$180,000 during its fiscal year ending November 30, 2012. How much salary must Gander pay Patrick during the period December 1 through December 31, 2012, to permit the corporation to continue to use its fiscal year without negative tax effects?

- A. \$0.
- B. \$30,000.
- C. \$165,000.
- D. \$180,000.
- E. None of the above.

55. Jason, an architect, is the sole shareholder of Purple Corporation, a personal service corporation. The corporation paid Jason a salary of \$225,000 during its fiscal year ending October 31, 2012. How much salary must Purple pay Jason during the period November 1 through December 31, 2012, to permit the corporation to continue to use its fiscal year without negative tax effects?

- A. \$18,750.
- B. \$37,500.
- C. \$187,500.
- D. \$225,000.
- E. None of the above.

56. Copper Corporation, a C corporation, had gross receipts of \$5 million in 2009, \$6 million in 2010, and \$3 million in 2011. Gold Corporation, a personal service corporation (PSC), had gross receipts of \$4 million in 2009, \$7 million in 2010, and \$5 million in 2011. Which of the corporations will be allowed to use the cash method of accounting in 2012?

- A. Copper Corporation only.
- B. Gold Corporation only.
- C. Both Copper Corporation and Gold Corporation.
- D. Neither Copper Corporation nor Gold Corporation.
- E. None of the above.

57. Ivory Corporation, a calendar year, accrual method C corporation, has two cash method, calendar year shareholders who are unrelated to each other. Craig owns 55% of the stock, and Oscar owns the remaining 45%. During 2012, Ivory paid a salary of \$200,000 to each shareholder. On December 31, 2012, Ivory accrued a bonus of \$50,000 to each shareholder. Assuming that the bonuses are paid to the shareholders on February 1, 2013, compute Ivory Corporation's 2012 deduction for the above amounts.

- A. \$0.
- B. \$250,000.
- C. \$400,000.
- D. \$450,000.
- E. \$500,000.

58. On December 31, 2012, Peregrine Corporation, an accrual method, calendar year taxpayer, accrued a performance bonus of \$100,000 to Charles, a cash basis, calendar year taxpayer. Charles is president and sole shareholder of the corporation. When can Peregrine deduct the bonus?

- A. In 2012, if the bonus was authorized by the Board of Directors and payment was made on or before March 15, 2013.
- B. In 2013, if payment was made at any time during that year.
- C. In 2012, if payment was made on or before March 15, 2013.
- D. In 2013, but only if payment was made on or before March 15, 2013.
- E. None of the above.

59. Bear Corporation has a net short-term capital gain of \$35,000 and a net long-term capital loss of \$200,000 during 2012. Bear Corporation has taxable income from other sources of \$600,000. Prior years' transactions included the following:

2008	Net short-term capital gain	\$45,000
2009	Net long-term capital gain	20,000
2010	Net short-term capital gain	55,000
2011	Net long-term capital gain	30,000

Compute the amount of Bear's capital loss carryover to 2013.

- A. \$0.
- B. \$60,000.
- C. \$105,000.
- D. \$165,000.
- E. \$200,000.

60. In 2012, Bluebird Corporation had net income from operations of \$75,000. Further, Bluebird recognized a long-term capital loss of \$30,000, and a short-term capital gain of \$10,000. Which of the following statements is correct?

- A. Bluebird Corporation may use the capital loss to offset the capital gain and must carry the net capital loss of \$20,000 forward five years as a long-term capital loss.
- B. Bluebird Corporation may deduct \$13,000 of the capital loss in 2012 and may carry forward the remainder of the capital loss indefinitely to offset capital gains.
- C. Bluebird Corporation will have taxable income in 2012 of \$55,000.
- D. Bluebird Corporation will have taxable income in 2012 of \$75,000 and will have a net capital loss of \$20,000 that can be carried back 3 years and forward 5 years.
- E. None of the above.

61. Jade Corporation, a C corporation, had \$100,000 operating income and \$40,000 operating expenses during the year. In addition, Jade had a \$2,000 long-term capital gain and a \$10,000 short-term capital loss. Compute Jade's taxable income for the year.

- A. \$52,000.
- B. \$57,000.
- C. \$60,000.
- D. \$62,000.
- E. None of the above.

62. Beige Corporation, a C corporation, purchases a warehouse on August 1, 1996, for \$1 million. Straight-line depreciation is taken in the amount of \$411,750 before the property is sold on June 11, 2012, for \$1.2 million. What is the amount and character of the gain recognized by Beige on the sale of the realty?

- A. Ordinary income of \$0 and § 1231 gain of \$611,750.
- B. Ordinary income of \$411,750 and § 1231 gain of \$200,000.
- C. Ordinary income of \$82,350 and § 1231 gain of \$529,400.
- D. Ordinary income of \$117,650 and § 1231 gain of \$494,100.
- E. None of the above.

63. During the current year, Thrasher, Inc., a closely held personal service corporation, has \$67,500 of active business income, \$52,500 of portfolio income, and \$120,000 of passive loss. How much of the passive loss can Thrasher deduct in the current year?

- A. \$0.
- B. \$52,500.
- C. \$67,500.
- D. \$120,000.
- E. None of the above.

64. Erin Corporation, a personal service corporation, had \$230,000 of active income, \$40,000 of portfolio income, and a \$250,000 passive loss during the year. How much is Erin's taxable income?

- A. \$20,000.
- B. \$40,000.
- C. \$270,000.
- D. \$520,000.
- E. None of the above.

65. Grebe Corporation, a closely held corporation that is not a PSC, had \$75,000 of active income, \$60,000 of portfolio income, and a \$105,000 passive loss during the year. How much of the passive loss can Grebe deduct in the current year?

- A. \$0.
- B. \$60,000.
- C. \$105,000.
- D. \$135,000.
- E. None of the above.

66. During the current year, Violet, Inc., a closely held corporation (not a PSC), has \$130,000 of passive loss, \$90,000 of active business income, and \$70,000 of portfolio income. How much is Violet's taxable income for the current year?

- A. \$30,000.
- B. \$70,000.
- C. \$90,000.
- D. \$160,000.
- E. None of the above.

67. During the current year, Owl Corporation (a C corporation), a retailer of children's apparel, made the following donations to qualified charitable organizations.

	<u>Adjusted Basis</u>	<u>Fair Market Value</u>
Children's clothing held as inventory, to Haven for Hope	\$10,000	\$15,000
Stock in Exxon Corporation acquired two years ago and held as an investment, to City University	5,000	3,000
Land acquired four years ago and held as an investment, to Humane Society	50,000	75,000

How much qualifies for the charitable contribution deduction?

- A. \$63,000.
- B. \$65,000.
- C. \$90,500.
- D. \$92,500.
- E. None of the above.

68. In the current year, Plum Corporation, a computer manufacturer, donated 100 laptop computers to a local school district (a qualified educational organization). The computers were constructed by Plum earlier this year, and the school district allocated the computers among its various schools where they will be used for educational purposes. Plum's basis in the computers is \$50,000, and their fair market value is \$120,000. What is Plum's deduction for the contribution of the computers (ignoring the taxable income limitation)?

- A. \$0.
- B. \$50,000.
- C. \$85,000.
- D. \$100,000.
- E. \$120,000.

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

Income from operations	\$200,000
Expenses from operations	140,000
Dividends received (15% ownership)	15,000
Domestic production activities deduction	2,000

On October 1, Kingbird Corporation made a contribution to a qualified charitable organization of \$9,000 in cash (not included in any of the above items). Determine Kingbird's charitable contribution deduction for the current year.

- A. \$9,000.
- B. \$7,500.
- C. \$6,650.
- D. \$6,450.
- E. None of the above.

70. Hippo, Inc., a calendar year C corporation, manufactures golf gloves. For 2012, Hippo had taxable income (before DPAD) of \$900,000, qualified domestic production activities income of \$750,000, and W-2 wages related to qualified production activities income of \$140,000. Hippo's domestic production activities deduction for 2012 is:

- A. \$0.
- B. \$12,600.
- C. \$67,500.
- D. \$70,000.
- E. None of the above.

71. In the current year, Amber, Inc., a calendar C corporation, has income from operations of \$200,000 and operating deductions of \$225,000. Amber also had \$30,000 of dividends from a 25% stock ownership in a domestic corporation. Which of the following statements is *incorrect* with respect to Amber's net operating loss deduction?

- A. The NOL is carried back 3 years and forward 10 years by Amber.
- B. Amber's NOL is \$19,000.
- C. A dividends received deduction is allowed in computing Amber's NOL.
- D. Amber can elect to forgo the carryback period and only carry forward the NOL.
- E. None of the above.

72. Which of the following statements is *incorrect* with respect to the treatment of net operating losses by corporations?

- A. A corporation may elect to forgo the carryback period and just carryforward an NOL.
- B. A corporation may claim a dividends received deduction in computing an NOL.
- C. An NOL is generally carried back 2 years and forward 20 years.
- D. Unlike individuals, corporations do not adjust their NOLs for net capital losses or nonbusiness deductions.
- E. None of the above.

73. Red Corporation, which owns stock in Blue Corporation, had net operating income of \$200,000 for the year. Blue pays Red a dividend of \$40,000. Red takes a dividends received deduction of \$28,000. Which of the following statements is correct?

- A. Red owns 80% of Blue Corporation.
- B. Red owns 20% or more, but less than 80% of Blue Corporation.
- C. Red owns 80% or more of Blue Corporation.
- D. Red owns less than 20% of Blue Corporation.
- E. None of the above.

74. Eagle Corporation owns stock in Hawk Corporation and has taxable income of \$100,000 for the year before considering the dividends received deduction. Hawk Corporation pays Eagle a dividend of \$130,000, which was considered in calculating the \$100,000. What amount of dividends received deduction may Eagle claim if it owns 25% of Hawk's stock?

- A. \$0.
- B. \$80,000.
- C. \$100,000.
- D. \$104,000.
- E. None of the above.

75. Copper Corporation owns stock in Bronze Corporation and has net operating income of \$900,000 for the year. Bronze Corporation pays Copper a dividend of \$150,000. What amount of dividends received deduction may Copper claim if it owns 85% of Bronze stock (assuming Copper's dividends received deduction is not limited by its taxable income)?

- A. \$97,500.
- B. \$105,000.
- C. \$120,000.
- D. \$150,000.
- E. None of the above.

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

- A. \$9,000.
- B. \$42,000.
- C. \$48,000.
- D. \$60,000.
- E. None of the above.

77. Which of the following statements is *incorrect* regarding the dividends received deduction?

- A. A corporation must hold stock for more than 90 days in order to qualify for a deduction with respect to dividends on such stock.
- B. The taxable income limitation does not apply with respect to the 100% deduction available to members of an affiliated group.
- C. If a stock purchase is financed 75% by debt, the deduction for dividends on such stock is reduced by 75%.
- D. The taxable income limitation does not apply if the normal deduction (i.e., 70% or 80% of dividends) results in a net operating loss for the corporation.
- E. None of the above.

78. Emerald Corporation, a calendar year C corporation, was formed and began operations on April 1, 2012. The following expenses were incurred during the first tax year (April 1 through December 31, 2012) of operations:

Expenses of temporary directors and of organizational meetings	\$27,000
Fee paid to the state of incorporation	1,000
Accounting services incident to organization	15,500
Legal services for drafting the corporate charter and bylaws	9,500
Expenses incident to the printing and sale of stock certificates	6,000

Assuming a § 248 election, what is the Emerald's deduction for organizational expenditures for 2012?

- A. \$0.
- B. \$4,550.
- C. \$5,000.
- D. \$7,400.
- E. None of the above.

79. During 2012, Sparrow Corporation, a calendar year C corporation, had operating income of \$425,000, operating expenses of \$280,000, a short-term capital loss of \$10,000, and a long-term capital gain of \$25,000. How much is Sparrow's tax liability for 2012?

- A. \$42,650.
- B. \$42,800.
- C. \$45,650.
- D. \$62,400.
- E. None of the above.

80. George Judson is the sole shareholder and employee of Black Corporation, a C corporation that is engaged exclusively in engineering services. During the year, Black has gross revenues of \$420,000 and operating expenses (excluding salary) of \$200,000. Further, Black Corporation pays George a salary of \$190,000. The salary is reasonable in amount and George is in the 35% marginal tax bracket irrespective of any income from Black. Assuming that Black Corporation distributes all after-tax income as dividends, how much total combined income tax do Black and George pay in the current year? (Ignore any employment tax considerations.)

- A. \$66,675.
- B. \$79,925.
- C. \$83,325.
- D. \$87,500.
- E. None of the above.

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

- A. Similar to those applicable to individuals, the marginal tax rate brackets for corporations are adjusted for inflation.
- B. Taxable income of a personal service corporation is taxed at a flat rate of 35%.
- C. A tax return must be filed whether or not the corporation has taxable income.
- D. The highest corporate marginal tax rate is 39%.
- E. None of the above.

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

- A. Schedule M-2 is used to reconcile net income as computed for financial accounting purposes with taxable income reported on the corporation's tax return.
- B. The corporate return is filed on Form 1120S.
- C. Corporations can receive an automatic extension of nine months for filing the corporate return by filing Form 7004 by the due date for the return.
- D. A corporation with total assets of \$7.5 million or more is required to file Schedule M-3.
- E. None of the above.

83. Robin Corporation, a calendar year C corporation, had taxable income of \$1.9 million, \$1.2 million, and \$900,000 for 2009, 2010, and 2011, respectively. Robin has taxable income of \$1.5 million for 2012. The minimum 2012 estimated tax installment payments for Robin are:

- A. April 15, 2012, \$76,500; June 15, 2012, \$76,500; September 15, 2012, \$76,500; December 15, 2012, \$76,500.
- B. April 15, 2012, \$110,500; June 15, 2012, \$127,500; September 15, 2012, \$127,500; December 15, 2012, \$127,500.
- C. April 15, 2012, \$127,500; June 15, 2012, \$127,500; September 15, 2012, \$127,500; December 15, 2012, \$127,500.
- D. April 15, 2012, \$76,500; June 15, 2012, \$178,500; September 15, 2012, \$127,500; December 15, 2012, \$127,500.
- E. None of the above.

84. Schedule M-1 of Form 1120 is used to reconcile financial net income with taxable income reported on the corporation's income tax return as follows: net income per books + additions – subtractions = taxable income. Which of the following items is an *addition* on Schedule M-1?

- A. Premiums paid on key employee life insurance.
- B. Proceeds of life insurance paid on death of key employee.
- C. Charitable contributions carryover from previous year.
- D. Tax-exempt interest.
- E. None of the above.

85. Schedule M-1 of Form 1120 is used to reconcile financial net income with taxable income reported on the corporation's income tax return as follows: net income per books + additions – subtractions = taxable income. Which of the following items is a *subtraction* on Schedule M-1?

- A. Book depreciation in excess of tax depreciation.
- B. Excess of capital losses over capital gains.
- C. Proceeds on key employee life insurance.
- D. Income subject to tax but not recorded on the books.
- E. None of the above.

86. During the current year, Waterthrush Company had operating income of \$510,000 and operating expenses of \$400,000. In addition, Waterthrush had a long-term capital gain of \$30,000. How does Lucinda, the sole owner of Waterthrush Company, report this information on her individual income tax return under following assumptions?

- a. Waterthrush is a proprietorship, and Lucinda does not withdraw any funds from the company during the year.
- b. Waterthrush is an LLC, and Lucinda does not withdraw any funds from the company during the year.
- c. Waterthrush is an S corporation, and Lucinda does not withdraw any funds from the company during the year.
- d. Waterthrush is a regular corporation, and Lucinda does not withdraw any funds from the company during the year.

87. Amber Company has \$400,000 in net income in 2012 before deducting any compensation or other payment to its sole owner, Alfredo. Assume that Alfredo is in the 35% marginal tax bracket. Discuss the tax aspects of each of the following independent arrangements. (Assume that any salaries are reasonable in amount and ignore any employment tax considerations.)

- a. Alfredo operates Amber Company as a proprietorship.
- b. Alfredo incorporates Amber Company and pays himself a salary of \$200,000 and no dividend.
- c. Alfredo incorporates Amber Company and pays himself a \$200,000 salary and a dividend of \$138,750 (\$200,000 – \$61,250 corporate income tax).
- d. Alfredo incorporates Amber Company and pays himself a salary of \$400,000.

88. During the current year, Shrike Company had \$220,000 net profit from operations. Carlos, the sole owner of Shrike, is in the 35% marginal tax bracket. Determine the combined tax burden for Shrike and Carlos under the following two independent situations. (Ignore any employment taxes.)

- a. Shrike Company is a C corporation and all of its after-tax income is distributed to Carlos.
- b. Shrike Company is a proprietorship and all of its after-tax income is withdrawn by Carlos.

89. Canary Corporation, an accrual method C corporation, uses the calendar year for tax purposes. Leticia, a cash method taxpayer, is both a shareholder of Canary and the corporation's CFO. On December 31, 2012, Canary has accrued a \$75,000 bonus to Leticia. Describe the tax consequences of the bonus to Canary and to Leticia under the following independent situations.

- a. Leticia owns 35% of Canary Corporation's stock and the corporation pays the bonus to Leticia on February 1, 2013.
- b. Leticia owns 75% of Canary Corporation's stock and the corporation pays the bonus to Leticia on April 1, 2013.
- c. Leticia owns 75% of Canary Corporation's stock and the corporation pays the bonus to Leticia on February 1, 2013.

90. Ostrich, a C corporation, has a net short-term capital gain of \$20,000 and a net long-term capital loss of \$90,000 during 2012. Ostrich also has taxable income from other sources of \$1 million. Prior years' transactions included the following:

2008 net short-term capital gains	\$20,000
2009 net long-term capital gains	15,000
2010 net short-term capital gains	25,000
2011 net long-term capital gains	5,000

- a. How are the capital gains and losses treated on Ostrich's 2012 tax return?
- b. Determine the amount of the 2012 net capital loss that is carried back to each of the previous years.
- c. Compute the amount of capital loss carryover, if any, and indicate the years to which the loss may be carried.
- d. If Ostrich were a proprietorship, how would Ellen, the owner, report these transactions on her 2012 tax return?

91. Tonya, an actuary, is the sole shareholder of Shrike Corporation, a professional corporation. The corporation paid Tonya a salary of \$360,000 during its fiscal year ending September 30, 2012.

- a. How much salary must Shrike Corporation pay Tonya during the period October 1 through December 31, 2012, to enable the corporation to continue to use its fiscal year without negative tax effects?
- b. If Shrike Corporation had taxable income of \$75,000 for the year ending September 30, 2012, what is its tax liability?

92. During the current year, Lavender Corporation, a C corporation in the business of manufacturing tangible research equipment, made charitable contributions to qualified organizations as follows:

- Research equipment (basis of \$70,000, fair market value of \$110,000), held as inventory, to a qualified educational organization that uses the property for research training. The inventory was produced by Lavender earlier in the current year.
- Stock (basis of \$30,000, fair market value of \$65,000) in Olive Corporation, held for seventeen months as an investment, to United Way. (United Way plans on selling the stock.)
- Land (basis of \$180,000, fair market value of \$220,000), held for three years as an investment, to State University. (State University plans on using the land for new dormitories.)

Lavender Corporation's taxable income (before any charitable contribution deduction) is \$2.5 million.

- a. What is the total amount of Lavender's charitable contributions for the year?
- b. What is the amount of Lavender's charitable contribution deduction in the current year, and what happens to any excess charitable contribution, if any?

93. On December 28, 2012, the board of directors of Taupe Corporation, a calendar year, accrual method C corporation, authorized a contribution of land to a qualified charitable organization. The land (basis of \$75,000, fair market value of \$125,000) was acquired five years ago and held as an investment. For purposes of the taxable income limitation applicable to charitable deductions, Taupe has taxable income of \$800,000 and \$950,000 for 2012 and 2013, respectively. Describe the tax consequences to Taupe Corporation under the following independent situations.

- a. The donation is made on February 21, 2013.
- b. The donation is made on April 11, 2013.

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

Income from operations	\$450,000
Expenses from operations	500,000
Dividends received from ABC Corporation	100,000

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

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

Income from operations	\$260,000
Expenses from operations	285,000
Dividends received from Roadrunner Corporation	115,000

- a. Coyote owns 5% of Roadrunner Corporation's stock. How much is Coyote Corporation's taxable income (loss) for the year?
- b. Would your answer change if Coyote owned 25% of Roadrunner Corporation's stock?

96. Warbler Corporation, an accrual method regular corporation, was formed and began operations on March 1, 2012. The following expenses were incurred during its first year of operations (March 1 - December 31, 2012):

Expenses of temporary directors and organizational meetings	\$25,000
Incorporation fee paid to state	2,000
Expenses incurred in printing and selling stock certificates	10,000
Accounting services incident to organization	12,000

- a. Assuming a valid election under § 248 to amortize organizational expenditures, what is the amount of Warbler's deduction for 2012?
- b. Same as a., except that Warbler also incurred in 2012 legal fees of \$15,000 for the drafting of the corporate charter and bylaws. What is the amount of Warbler's 2012 deduction for organizational expenditures?

97. In each of the following independent situations, determine the corporation's income tax liability. Assume that all corporations use a calendar year and that the year involved is 2012.

	<b><u>Taxable Income</u></b>
Violet Corporation	\$ 22, 000
Indigo Corporation	90,000
Orange Corporation	220,000
Blue Corporation	5,100,00 0
Green Corporation	19,800,0 00

98. Almond Corporation, a calendar year C corporation, had taxable income of \$900,000, \$1.1 million, and \$1.2 million for 2009, 2010, and 2011, respectively. Almond's taxable income is \$2 million for 2012. Compute the minimum estimated tax payments for 2012 for Almond Corporation.

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

Net income per books (after-tax)	\$239,700
Taxable income	195,000
Federal income tax liability	59,300
Interest income from tax-exempt bonds	5,000
Interest paid on loan incurred to purchase tax-exempt bonds	2,000
Life insurance proceeds received as a result of death of Heron's president	100,000
Premiums paid on policy on life of Heron's president	4,500
Excess of capital losses over capital gains	2,000
Retained earnings at beginning of year	375,000
Cash dividends paid	90,000
Tax depreciation in excess of book depreciation	7,500

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

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

101. A taxpayer is considering the formation of a business that would derive some amounts of tax-exempt interest, qualified dividends, and capital gains. Explain how these income categories would be reported and taxed under the various types of entity forms discussed in the chapter. Consider the tax implications both to the entities and to their owners.

102. Adrian is the president and sole shareholder of Pigeon Corporation. He also lends money and rents a building to the corporation. Discuss how these business relationships between Adrian and Pigeon Corporation can help avoid double taxation. What limitations are there on the use of such relationships?

103. Nancy is a 40% shareholder and president of Robin Corporation, a regular corporation. The board of directors of Robin has decided to pay Nancy a \$175,000 bonus for the year based on her outstanding performance. The directors want to pay the \$175,000 as salary, but Nancy would prefer to have it paid as a dividend. If both Robin Corporation and Nancy are in a 35% marginal tax bracket irrespective of the treatment of the bonus, discuss which form of payment would be most beneficial for each party. (Ignore any employment tax considerations.)

104. Red Corporation, a C corporation that has two equal shareholders, earned \$450,000 during 2012. Orange Company, a partnership that has two equal partners, earned \$450,000 during the year. Red did not make any distributions to its shareholders, and Orange's partners did not make any withdrawals. Contrast the tax treatment of the shareholders of Red Corporation and the partners of Orange Company.

105. What is a limited liability company? What favorable nontax and tax attributes does the LLC entity form offer taxpayers?

106. Compare the taxation of C corporations with that of individual taxpayers. Provide several examples of similarities and differences in your discussion.

107. Explain the rules regarding the accounting periods available to corporate taxpayers.

108. Jessica, a cash basis individual, is a 60% shareholder of Crow Corporation, a regular corporation. On January 1, 2012, Jessica loaned Crow \$300,000, with the principal due in 5 years and 6% interest due each January 1. Crow, an accrual method, calendar year taxpayer, accrued \$18,000 of interest expense on the loan on December 31, 2012, and paid the \$18,000 to Jessica on January 1, 2013. How much is Crow's deduction for interest on this loan for 2012? Would your answer change if Jessica was a 25% shareholder of Crow?

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

110. Briefly describe the charitable contribution deduction rules applicable to C corporations.

111. Mallard Corporation, a C corporation that is not a PSC, incorporated in December 2012 and expects to have substantial organizational expenditures. Discuss tax planning strategies that Mallard should consider in order to maximize the deduction for organizational expenditures.

112. What is the annual required estimated tax payment for a C corporation? What are the rules regarding payment of the estimated tax?

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

114. What is the purpose of Schedule M-3? Which corporations are required to file Schedule M-3?

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

1. Tomas owns a sole proprietorship, and Lucy is the sole shareholder of a C corporation. In the current year both businesses make a net profit of \$60,000. Neither business distributes any funds to the owners in the year. For the current year, Tomas must report \$60,000 of income on his individual tax return, but Lucy is not required to report any income from the corporation on her individual tax return.

**TRUE**

2. Rose is a 50% partner in Wren Partnership. During the year, Wren earned net profit of \$100,000 (\$210,000 gross income – \$110,000 operating expenses) and distributed \$20,000 to each partner. Rose must report Wren Partnership profit of \$20,000 on her Federal income tax return.

**FALSE**

3. Rajib is the sole shareholder of Robin Corporation, a calendar year S corporation. Robin earned net profit of \$350,000 (\$520,000 gross income – \$170,000 operating expenses) and distributed \$80,000 to Rajib. Rajib must report Robin Corporation profit of \$350,000 on his Federal income tax return.

**TRUE**

4. Donald owns a 60% interest in a partnership that earned \$230,000 in the current year. He also owns 60% of the stock in a C corporation that earned \$230,000 during the year. Donald received \$50,000 in distributions from each of the two entities during the year. With respect to this information, Donald must report \$188,000 of income on his individual income tax return for the year.

**TRUE**

5. Quail Corporation is a C corporation with net income of \$125,000 during the current year. If Quail paid dividends of \$25,000 to its shareholders, the corporation must pay tax on \$100,000 of net income. Shareholders must report the \$25,000 of dividends as income.

**FALSE**

6. Eagle Company, a partnership, had a short-term capital loss of \$10,000 during the year. Aaron, who owns 25% of Eagle, will report \$2,500 of Eagle's short-term capital loss on his individual tax return.

**TRUE**

7. Katherine, the sole shareholder of Purple Corporation, a calendar year C corporation, has the corporation pay her a salary of \$450,000 in the current year. The Tax Court has held that \$150,000 represents unreasonable compensation. Purple Corporation's taxable income is unaffected by the Tax Court's determination.

**FALSE**

8. Double taxation of corporate income results because dividend distributions are included in a shareholder's gross income but are not deductible by the corporation.

**TRUE**

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

**FALSE**

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

**FALSE**

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

**FALSE**

12. Employment taxes apply to all entity forms of operating a business. As a result, employment taxes are a neutral factor in selecting the most tax effective form of operating a business.

**FALSE**

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

**FALSE**

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

**TRUE**

15. A calendar year C corporation with average annual gross receipts of \$5 million or less must use the cash method of accounting.

**FALSE**

16. On December 31, 2012, Lavender, Inc., an accrual basis C corporation, accrues a \$90,000 bonus to Barry, its vice president and a 70% shareholder. Lavender pays the bonus to Barry, who is a cash basis taxpayer, on March 15, 2013. Lavender can deduct the bonus in 2013, the year in which it is included in Barry's gross income.

**TRUE**

17. Azure Corporation, a C corporation, had a long-term capital gain of \$50,000 in the current year. The maximum amount of tax applicable to the capital gain is \$7,500 ( $\$50,000 \times 15\%$ ).

**FALSE**

18. Albatross, a C corporation, had \$140,000 net income from operations and a \$25,000 short-term capital loss in the current year. Albatross Corporation's taxable income is \$140,000.

**TRUE**

19. If a C corporation uses straight-line depreciation on real estate (§ 1250 property), no gain on the sale of the property will be recaptured as ordinary income.

**FALSE**

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

**TRUE**

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

**FALSE**

22. On December 20, 2012, the directors of Quail Corporation (an accrual basis, calendar year taxpayer) authorized a cash donation of \$5,000 to the American Cancer Society, a qualified charity. The payment, which is made on April 10, 2013, may be claimed as a deduction for tax year 2012.

**FALSE**

23. In the current year, Oriole Corporation donated a painting worth \$30,000 to the Texas Art Museum, a qualified public charity. The museum included the painting in its permanent collection. Oriole Corporation purchased the painting 5 years ago for \$10,000. Oriole's charitable contribution deduction is \$30,000 (ignoring the taxable income limitation).

**TRUE**

24. Crow Corporation, a C corporation, donated scientific property (basis of \$30,000, fair market value of \$50,000) to State University, a qualified charitable organization, to be used in research. Crow had held the property for four months as inventory. Crow Corporation may deduct \$50,000 for the charitable contribution (ignoring the taxable income limitation).

**FALSE**

25. Heron Corporation, a calendar year C corporation, had an excess charitable contribution for 2011 of \$5,000. In 2012, Heron made a further charitable contribution of \$20,000. Heron's 2012 deduction is limited to \$15,000 (10% of taxable income). The current year's contribution must be applied first against the \$15,000 limitation.

**TRUE**

26. For a corporation in 2012, the domestic production activities deduction is equal to 9% of the higher of (1) qualified production activities income or (2) taxable income. However, the deduction cannot exceed 50% of the W-2 wages related to qualified production activities income.

**FALSE**

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

**FALSE**

28. Azul Corporation, a calendar year C corporation, received a dividend of \$50,000 from Naranja Corporation. Azul owns 10% of the Naranja Corporation stock. Assuming it is not subject to the taxable income limitation, Azul's dividends received deduction is \$35,000.

**TRUE**

29. Because of the taxable income limitation, no dividends received deduction is allowed if a corporation has an NOL for the current taxable year.

**FALSE**

30. No dividends received deduction is allowed unless the corporation has held the stock for more than 90 days.

**FALSE**

31. Black Corporation, an accrual basis taxpayer, was formed and began operations on February 1, 2012. During its first year of operations (February 1 – December 31, 2012), Black incurred the following expenses: fee paid to state of incorporation of \$2,000, accounting and legal services incident to organization of \$9,000, and expenses related to the printing and sale of stock certificates of \$10,000. Black has \$11,000 of qualified organizational expenditures that it may elect to amortize.

**TRUE**

32. Lilac Corporation incurred \$4,700 of legal and accounting fees associated with its incorporation. The \$4,700 is deductible as startup expenditures on Lilac's tax return for the year in which it begins business.

**FALSE**

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

**FALSE**

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

**FALSE**

35. A calendar year C corporation can receive an automatic 6-month extension to file its 2012 corporate return (Form 1120) by filing Form 7004 by March 15, 2013.

**TRUE**

36. The due date (not including extensions) for filing a 2012 Federal income tax return for a calendar year C corporation (Form 1120) is April 15, 2013.

**FALSE**

37. For purposes of the estimated tax payment rules, a "large corporation" is defined as a corporation that had an average taxable income of \$1 million or more in any of the three preceding years.

**TRUE**

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

**TRUE**

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

**FALSE**

40. On December 31, 2012, Flamingo, Inc., a calendar year, accrual method C corporation, accrues a bonus of \$50,000 to its president (a cash basis taxpayer), who owns 75% of the corporation's outstanding stock. The \$50,000 bonus is paid to the president on February 1, 2013. For Flamingo's 2012 Form 1120, the \$50,000 bonus will be a subtraction item on Schedule M-1.

**FALSE**

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

**TRUE**

42. Schedule M-2 is used to reconcile unappropriated retained earnings at the beginning of the year with unappropriated retained earnings at the end of the year.

**TRUE**

43. A corporation with \$5 million or more in assets must file Schedule M-3 (instead of Schedule M-1).

**FALSE**

44. Schedule M-3 is similar to Schedule M-1 in that the form is designed to reconcile net income per books with taxable income. However, an objective of Schedule M-3 is more transparency between financial statements and tax returns than that provided by Schedule M-1.

**TRUE**

45. Juanita owns 60% of the stock in a C corporation that had a profit of \$200,000 in 2012. Carlos owns a 60% interest in a partnership that had a profit of \$200,000 during the year. The corporation distributed \$45,000 to Juanita, and the partnership distributed \$45,000 to Carlos. Which of the following statements relating to 2012 is *incorrect*?

- A.** Juanita must report \$120,000 of income from the corporation.
- B. The corporation must pay corporate tax on \$200,000 of income.
- C. Carlos must report \$120,000 of income from the partnership.
- D. The partnership is not subject to a Federal entity-level income tax.
- E. None of the above.

46. Bjorn owns a 60% interest in an S corporation that earned \$150,000 in 2012. He also owns 60% of the stock in a C corporation that earned \$150,000 during the year. The S corporation distributed \$30,000 to Bjorn and the C corporation paid dividends of \$30,000 to Bjorn. How much income must Bjorn report from these businesses?

- A. \$0 income from the S corporation and \$30,000 income from the C corporation.
- B. \$30,000 income from the S corporation and \$30,000 of dividend income from the C corporation.
- C. \$90,000 income from the S corporation and \$0 income from the C corporation.
- D.** \$90,000 income from the S corporation and \$30,000 income from the C corporation.
- E. None of the above.

47. Luis is the sole shareholder of a C corporation, and Eduardo owns a sole proprietorship. Both businesses were started in 2012, and each business has a long-term capital gain of \$20,000 for the year. Neither business made any distributions during the year. With respect to this information, which of the following statements is *incorrect*?

- A. Eduardo must report a \$20,000 long-term capital gain on his 2012 tax return.
- B. Luis's corporation does not receive a preferential tax rate on the \$20,000 long-term capital gain.
- C.** Luis must report a \$20,000 long-term capital gain on his 2012 tax return.
- D. Eduardo receives a preferential tax rate on a long-term capital gain of \$20,000.
- E. None of the above.

48. Norma formed Hyacinth Enterprises, a proprietorship, in 2012. In its first year, Hyacinth had operating income of \$400,000 and operating expenses of \$240,000. In addition, Hyacinth had a long-term capital loss of \$10,000. Norma, the proprietor of Hyacinth Enterprises, withdrew \$75,000 from Hyacinth during the year. Assuming Norma has no other capital gains or losses, how does this information affect her taxable income for 2012?

- A.** Increases Norma's taxable income by \$157,000 (\$160,000 ordinary business income – \$3,000 long-term capital loss).
- B. Increases Norma's taxable income by \$150,000 (\$160,000 ordinary business income – \$10,000 long-term capital loss).
- C. Increases Norma's taxable income by \$75,000.
- D. Increases Norma's taxable income by \$160,000.
- E. None of the above.

49. Francisco is the sole owner of Rose Company. For 2012, the only income of Rose was a long-term capital gain of \$25,000. The business made no distributions during the year to Francisco. Irrespective of Rose Company, Francisco's marginal tax rate is 35% and he has no capital asset transactions. Which of the following statements is *incorrect*?

- A. If Rose Company is a sole proprietorship or S corporation, Francisco must report the \$25,000 long-term capital gain on his personal income tax return.
- B. If Rose Company is a C corporation, Francisco will report none of the \$25,000 long-term capital gain on his personal income tax return.
- C. If Rose Company is a sole proprietorship or S corporation, a preferential tax rate applies to the \$25,000 long-term capital gain.
- D. If Rose Company is a C corporation, a preferential tax rate does not apply to the \$25,000 long-term capital gain.
- E.** None of the above.

50. Lucinda is a 60% shareholder in Rhea Corporation, a calendar year S corporation. During the year, Rhea Corporation had gross income of \$550,000 and operating expenses of \$380,000. In addition, the corporation sold land that had been held for investment purposes for a short-term capital gain of \$30,000. During the year, Rhea Corporation distributed \$50,000 to Lucinda. With respect to this information, which of the following statements is correct?

- A. Rhea Corporation will pay tax on taxable income of \$200,000.
- B. Lucinda reports ordinary income of \$50,000.
- C. Lucinda reports ordinary income of \$120,000.
- D.** Lucinda reports ordinary income of \$102,000 and a short-term capital gain of \$18,000.
- E. None of the above.

51. Elk, a C corporation, has \$370,000 operating income and \$290,000 operating expenses during the year. In addition, Elk has a \$10,000 long-term capital gain and a \$17,000 short-term capital loss. Elk's taxable income is:

- A. \$63,000.
- B. \$73,000.
- C.** \$80,000.
- D. \$90,000.
- E. None of the above.

52. Flycatcher Corporation, a C corporation, has two equal individual shareholders, Nancy and Pasqual. In the current year, Flycatcher earned \$100,000 net profit and paid a dividend of \$10,000 to each shareholder. Regardless of any tax consequences resulting from their interests in Flycatcher, Nancy is in the 33% marginal tax bracket and Pasqual is in the 15% marginal tax bracket. With respect to the current year, which of the following statements is *incorrect*?

- A. Flycatcher cannot avoid the corporate tax altogether by paying out all \$100,000 of net profit as dividends to the shareholders.
- B. Nancy incurs income tax of \$1,500 on her dividend income.
- C.** Pasqual incurs income tax of \$1,500 on his dividend income.
- D. Flycatcher pays corporate tax of \$22,250.
- E. None of the above.

53. Which of the following statements is *incorrect* about LLCs and the check-the-box Regulations?

- A.** If a limited liability company with more than one owner does not make an election, the entity is taxed as a corporation.
- B. All 50 states have passed laws that allow LLCs.
- C. An entity with more than one owner and formed as a corporation cannot elect to be taxed as a partnership.
- D. If a limited liability company with one owner does not make an election, the entity is taxed as a sole proprietorship.
- E. A limited liability company with one owner can elect to be taxed as a corporation.

54. Patrick, an attorney, is the sole shareholder of Gander Corporation. Gander is a personal service corporation with a fiscal year ending November 30. The corporation paid Patrick a salary of \$180,000 during its fiscal year ending November 30, 2012. How much salary must Gander pay Patrick during the period December 1 through December 31, 2012, to permit the corporation to continue to use its fiscal year without negative tax effects?

- A. \$0.
- B. \$30,000.
- C. \$165,000.
- D. \$180,000.
- E.** None of the above.

55. Jason, an architect, is the sole shareholder of Purple Corporation, a personal service corporation. The corporation paid Jason a salary of \$225,000 during its fiscal year ending October 31, 2012. How much salary must Purple pay Jason during the period November 1 through December 31, 2012, to permit the corporation to continue to use its fiscal year without negative tax effects?

- A. \$18,750.
- B.** \$37,500.
- C. \$187,500.
- D. \$225,000.
- E. None of the above.

56. Copper Corporation, a C corporation, had gross receipts of \$5 million in 2009, \$6 million in 2010, and \$3 million in 2011. Gold Corporation, a personal service corporation (PSC), had gross receipts of \$4 million in 2009, \$7 million in 2010, and \$5 million in 2011. Which of the corporations will be allowed to use the cash method of accounting in 2012?

- A. Copper Corporation only.
- B. Gold Corporation only.
- C. Both Copper Corporation and Gold Corporation.**
- D. Neither Copper Corporation nor Gold Corporation.
- E. None of the above.

57. Ivory Corporation, a calendar year, accrual method C corporation, has two cash method, calendar year shareholders who are unrelated to each other. Craig owns 55% of the stock, and Oscar owns the remaining 45%. During 2012, Ivory paid a salary of \$200,000 to each shareholder. On December 31, 2012, Ivory accrued a bonus of \$50,000 to each shareholder. Assuming that the bonuses are paid to the shareholders on February 1, 2013, compute Ivory Corporation's 2012 deduction for the above amounts.

- A. \$0.
- B. \$250,000.
- C. \$400,000.
- D. \$450,000.**
- E. \$500,000.

58. On December 31, 2012, Peregrine Corporation, an accrual method, calendar year taxpayer, accrued a performance bonus of \$100,000 to Charles, a cash basis, calendar year taxpayer. Charles is president and sole shareholder of the corporation. When can Peregrine deduct the bonus?

- A. In 2012, if the bonus was authorized by the Board of Directors and payment was made on or before March 15, 2013.
- B. In 2013, if payment was made at any time during that year.**
- C. In 2012, if payment was made on or before March 15, 2013.
- D. In 2013, but only if payment was made on or before March 15, 2013.
- E. None of the above.

59. Bear Corporation has a net short-term capital gain of \$35,000 and a net long-term capital loss of \$200,000 during 2012. Bear Corporation has taxable income from other sources of \$600,000. Prior years' transactions included the following:

2008	Net short-term capital gain	\$45,000
2009	Net long-term capital gain	20,000
2010	Net short-term capital gain	55,000
2011	Net long-term capital gain	30,000

Compute the amount of Bear's capital loss carryover to 2013.

- A. \$0.
- B. \$60,000.**
- C. \$105,000.
- D. \$165,000.
- E. \$200,000.

60. In 2012, Bluebird Corporation had net income from operations of \$75,000. Further, Bluebird recognized a long-term capital loss of \$30,000, and a short-term capital gain of \$10,000. Which of the following statements is correct?

- A. Bluebird Corporation may use the capital loss to offset the capital gain and must carry the net capital loss of \$20,000 forward five years as a long-term capital loss.
- B. Bluebird Corporation may deduct \$13,000 of the capital loss in 2012 and may carry forward the remainder of the capital loss indefinitely to offset capital gains.
- C. Bluebird Corporation will have taxable income in 2012 of \$55,000.
- D. Bluebird Corporation will have taxable income in 2012 of \$75,000 and will have a net capital loss of \$20,000 that can be carried back 3 years and forward 5 years.**
- E. None of the above.

61. Jade Corporation, a C corporation, had \$100,000 operating income and \$40,000 operating expenses during the year. In addition, Jade had a \$2,000 long-term capital gain and a \$10,000 short-term capital loss. Compute Jade's taxable income for the year.

- A. \$52,000.
- B. \$57,000.
- C. \$60,000.**
- D. \$62,000.
- E. None of the above.

62. Beige Corporation, a C corporation, purchases a warehouse on August 1, 1996, for \$1 million. Straight-line depreciation is taken in the amount of \$411,750 before the property is sold on June 11, 2012, for \$1.2 million. What is the amount and character of the gain recognized by Beige on the sale of the realty?

- A. Ordinary income of \$0 and § 1231 gain of \$611,750.
- B. Ordinary income of \$411,750 and § 1231 gain of \$200,000.
- C. Ordinary income of \$82,350 and § 1231 gain of \$529,400.**
- D. Ordinary income of \$117,650 and § 1231 gain of \$494,100.
- E. None of the above.

63. During the current year, Thrasher, Inc., a closely held personal service corporation, has \$67,500 of active business income, \$52,500 of portfolio income, and \$120,000 of passive loss. How much of the passive loss can Thrasher deduct in the current year?

- A.** \$0.
- B. \$52,500.
- C. \$67,500.
- D. \$120,000.
- E. None of the above.

64. Erin Corporation, a personal service corporation, had \$230,000 of active income, \$40,000 of portfolio income, and a \$250,000 passive loss during the year. How much is Erin's taxable income?

- A. \$20,000.
- B. \$40,000.
- C.** \$270,000.
- D. \$520,000.
- E. None of the above.

65. Grebe Corporation, a closely held corporation that is not a PSC, had \$75,000 of active income, \$60,000 of portfolio income, and a \$105,000 passive loss during the year. How much of the passive loss can Grebe deduct in the current year?

- A. \$0.
- B. \$60,000.
- C. \$105,000.
- D. \$135,000.
- E.** None of the above.

66. During the current year, Violet, Inc., a closely held corporation (not a PSC), has \$130,000 of passive loss, \$90,000 of active business income, and \$70,000 of portfolio income. How much is Violet's taxable income for the current year?

- A. \$30,000.
- B.** \$70,000.
- C. \$90,000.
- D. \$160,000.
- E. None of the above.

67. During the current year, Owl Corporation (a C corporation), a retailer of children's apparel, made the following donations to qualified charitable organizations.

	<u>Adjusted Basis</u>	<u>Fair Market Value</u>
Children's clothing held as inventory, to Haven for Hope	\$10,000	\$15,000
Stock in Exxon Corporation acquired two years ago and held as an investment, to City University	5,000	3,000
Land acquired four years ago and held as an investment, to Humane Society	50,000	75,000

How much qualifies for the charitable contribution deduction?

- A. \$63,000.
- B. \$65,000.
- C. \$90,500.**
- D. \$92,500.
- E. None of the above.

68. In the current year, Plum Corporation, a computer manufacturer, donated 100 laptop computers to a local school district (a qualified educational organization). The computers were constructed by Plum earlier this year, and the school district allocated the computers among its various schools where they will be used for educational purposes. Plum's basis in the computers is \$50,000, and their fair market value is \$120,000. What is Plum's deduction for the contribution of the computers (ignoring the taxable income limitation)?

- A. \$0.
- B. \$50,000.
- C. \$85,000.**
- D. \$100,000.
- E. \$120,000.

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

Income from operations	\$200,000
Expenses from operations	140,000
Dividends received (15% ownership)	15,000
Domestic production activities deduction	2,000

On October 1, Kingbird Corporation made a contribution to a qualified charitable organization of \$9,000 in cash (not included in any of the above items). Determine Kingbird's charitable contribution deduction for the current year.

- A. \$9,000.
- B. \$7,500.**
- C. \$6,650.
- D. \$6,450.
- E. None of the above.

70. Hippo, Inc., a calendar year C corporation, manufactures golf gloves. For 2012, Hippo had taxable income (before DPAD) of \$900,000, qualified domestic production activities income of \$750,000, and W-2 wages related to qualified production activities income of \$140,000. Hippo's domestic production activities deduction for 2012 is:

- A. \$0.
- B. \$12,600.
- C. \$67,500.**
- D. \$70,000.
- E. None of the above.

71. In the current year, Amber, Inc., a calendar C corporation, has income from operations of \$200,000 and operating deductions of \$225,000. Amber also had \$30,000 of dividends from a 25% stock ownership in a domestic corporation. Which of the following statements is *incorrect* with respect to Amber's net operating loss deduction?

- A. The NOL is carried back 3 years and forward 10 years by Amber.**
- B. Amber's NOL is \$19,000.
- C. A dividends received deduction is allowed in computing Amber's NOL.
- D. Amber can elect to forgo the carryback period and only carry forward the NOL.
- E. None of the above.

72. Which of the following statements is *incorrect* with respect to the treatment of net operating losses by corporations?

- A. A corporation may elect to forgo the carryback period and just carryforward an NOL.
- B. A corporation may claim a dividends received deduction in computing an NOL.
- C. An NOL is generally carried back 2 years and forward 20 years.
- D. Unlike individuals, corporations do not adjust their NOLs for net capital losses or nonbusiness deductions.
- E. None of the above.**

73. Red Corporation, which owns stock in Blue Corporation, had net operating income of \$200,000 for the year. Blue pays Red a dividend of \$40,000. Red takes a dividends received deduction of \$28,000. Which of the following statements is correct?

- A. Red owns 80% of Blue Corporation.
- B. Red owns 20% or more, but less than 80% of Blue Corporation.
- C. Red owns 80% or more of Blue Corporation.
- D. Red owns less than 20% of Blue Corporation.**
- E. None of the above.

74. Eagle Corporation owns stock in Hawk Corporation and has taxable income of \$100,000 for the year before considering the dividends received deduction. Hawk Corporation pays Eagle a dividend of \$130,000, which was considered in calculating the \$100,000. What amount of dividends received deduction may Eagle claim if it owns 25% of Hawk's stock?

- A. \$0.
- B. \$80,000.
- C. \$100,000.
- D. \$104,000.**
- E. None of the above.

75. Copper Corporation owns stock in Bronze Corporation and has net operating income of \$900,000 for the year. Bronze Corporation pays Copper a dividend of \$150,000. What amount of dividends received deduction may Copper claim if it owns 85% of Bronze stock (assuming Copper's dividends received deduction is not limited by its taxable income)?

- A. \$97,500.
- B. \$105,000.
- C. \$120,000.
- D. \$150,000.**
- E. None of the above.

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

- A. \$9,000.
- B. \$42,000.**
- C. \$48,000.
- D. \$60,000.
- E. None of the above.

77. Which of the following statements is *incorrect* regarding the dividends received deduction?

- A.** A corporation must hold stock for more than 90 days in order to qualify for a deduction with respect to dividends on such stock.
- B. The taxable income limitation does not apply with respect to the 100% deduction available to members of an affiliated group.
- C. If a stock purchase is financed 75% by debt, the deduction for dividends on such stock is reduced by 75%.
- D. The taxable income limitation does not apply if the normal deduction (i.e., 70% or 80% of dividends) results in a net operating loss for the corporation.
- E. None of the above.

78. Emerald Corporation, a calendar year C corporation, was formed and began operations on April 1, 2012. The following expenses were incurred during the first tax year (April 1 through December 31, 2012) of operations:

Expenses of temporary directors and of organizational meetings	\$27,000
Fee paid to the state of incorporation	1,000
Accounting services incident to organization	15,500
Legal services for drafting the corporate charter and bylaws	9,500
Expenses incident to the printing and sale of stock certificates	6,000

Assuming a § 248 election, what is the Emerald's deduction for organizational expenditures for 2012?

- A. \$0.
- B. \$4,550.**
- C. \$5,000.
- D. \$7,400.
- E. None of the above.

79. During 2012, Sparrow Corporation, a calendar year C corporation, had operating income of \$425,000, operating expenses of \$280,000, a short-term capital loss of \$10,000, and a long-term capital gain of \$25,000. How much is Sparrow's tax liability for 2012?

- A. \$42,650.
- B. \$42,800.
- C. \$45,650.**
- D. \$62,400.
- E. None of the above.

80. George Judson is the sole shareholder and employee of Black Corporation, a C corporation that is engaged exclusively in engineering services. During the year, Black has gross revenues of \$420,000 and operating expenses (excluding salary) of \$200,000. Further, Black Corporation pays George a salary of \$190,000. The salary is reasonable in amount and George is in the 35% marginal tax bracket irrespective of any income from Black. Assuming that Black Corporation distributes all after-tax income as dividends, how much total combined income tax do Black and George pay in the current year? (Ignore any employment tax considerations.)

- A. \$66,675.
- B. \$79,925.**
- C. \$83,325.
- D. \$87,500.
- E. None of the above.

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

- A.** Similar to those applicable to individuals, the marginal tax rate brackets for corporations are adjusted for inflation.
- B. Taxable income of a personal service corporation is taxed at a flat rate of 35%.
- C. A tax return must be filed whether or not the corporation has taxable income.
- D. The highest corporate marginal tax rate is 39%.
- E. None of the above.

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

- A. Schedule M-2 is used to reconcile net income as computed for financial accounting purposes with taxable income reported on the corporation's tax return.
- B. The corporate return is filed on Form 1120S.
- C. Corporations can receive an automatic extension of nine months for filing the corporate return by filing Form 7004 by the due date for the return.
- D. A corporation with total assets of \$7.5 million or more is required to file Schedule M-3.
- E.** None of the above.

83. Robin Corporation, a calendar year C corporation, had taxable income of \$1.9 million, \$1.2 million, and \$900,000 for 2009, 2010, and 2011, respectively. Robin has taxable income of \$1.5 million for 2012. The minimum 2012 estimated tax installment payments for Robin are:

- A. April 15, 2012, \$76,500; June 15, 2012, \$76,500; September 15, 2012, \$76,500; December 15, 2012, \$76,500.
- B. April 15, 2012, \$110,500; June 15, 2012, \$127,500; September 15, 2012, \$127,500; December 15, 2012, \$127,500.
- C. April 15, 2012, \$127,500; June 15, 2012, \$127,500; September 15, 2012, \$127,500; December 15, 2012, \$127,500.
- D.** April 15, 2012, \$76,500; June 15, 2012, \$178,500; September 15, 2012, \$127,500; December 15, 2012, \$127,500.
- E. None of the above.

84. Schedule M-1 of Form 1120 is used to reconcile financial net income with taxable income reported on the corporation's income tax return as follows: net income per books + additions – subtractions = taxable income. Which of the following items is an *addition* on Schedule M-1?

- A.** Premiums paid on key employee life insurance.
- B. Proceeds of life insurance paid on death of key employee.
- C. Charitable contributions carryover from previous year.
- D. Tax-exempt interest.
- E. None of the above.

85. Schedule M-1 of Form 1120 is used to reconcile financial net income with taxable income reported on the corporation's income tax return as follows: net income per books + additions – subtractions = taxable income. Which of the following items is a *subtraction* on Schedule M-1?

- A. Book depreciation in excess of tax depreciation.
- B. Excess of capital losses over capital gains.
- C. Proceeds on key employee life insurance.**
- D. Income subject to tax but not recorded on the books.
- E. None of the above.

86. During the current year, Waterthrush Company had operating income of \$510,000 and operating expenses of \$400,000. In addition, Waterthrush had a long-term capital gain of \$30,000. How does Lucinda, the sole owner of Waterthrush Company, report this information on her individual income tax return under following assumptions?

- a. Waterthrush is a proprietorship, and Lucinda does not withdraw any funds from the company during the year.
  - b. Waterthrush is an LLC, and Lucinda does not withdraw any funds from the company during the year.
  - c. Waterthrush is an S corporation, and Lucinda does not withdraw any funds from the company during the year.
  - d. Waterthrush is a regular corporation, and Lucinda does not withdraw any funds from the company during the year.
- 
- a. Revenues, expenses, gains, and losses of a proprietorship flow through to the proprietor. Consequently, Lucinda reports the \$110,000 operating profit and \$30,000 long-term capital gain on her individual return. The preferential tax rate on LTCG applies with respect to the \$30,000 gain.
  - b. A single-member LLC is taxed as a proprietorship. Consequently, Lucinda reports the \$110,000 operating profit and \$30,000 long-term capital gain on her individual return. The preferential tax rate on LTCG applies with respect to the \$30,000 gain.
  - c. Revenues, expenses, gains, and losses of an S corporation flow through to the shareholders. Separately stated items (e.g., capital gains and losses), retain their character at the shareholder level. Consequently, Lucinda reports the \$110,000 operating profit and \$30,000 long-term capital gain on her individual return. The preferential tax rate on LTCG applies with respect to the \$30,000 gain.
  - d. Shareholders of a regular (C) corporation report income from the corporation to the extent of dividends received. Therefore, Lucinda does not report any of Waterthrush's operating profit or capital gain on her individual return. [Waterthrush Company would report taxable income of \$140,000 (\$110,000 operating profit + \$30,000 long-term capital gain) on its corporate return (Form 1120). C corporations do not receive preferential tax rate treatment with respect to LTCGs.]

87. Amber Company has \$400,000 in net income in 2012 before deducting any compensation or other payment to its sole owner, Alfredo. Assume that Alfredo is in the 35% marginal tax bracket. Discuss the tax aspects of each of the following independent arrangements. (Assume that any salaries are reasonable in amount and ignore any employment tax considerations.)

- a. Alfredo operates Amber Company as a proprietorship.
- b. Alfredo incorporates Amber Company and pays himself a salary of \$200,000 and no dividend.
- c. Alfredo incorporates Amber Company and pays himself a \$200,000 salary and a dividend of \$138,750 (\$200,000 – \$61,250 corporate income tax).
- d. Alfredo incorporates Amber Company and pays himself a salary of \$400,000.

a.	Alfredo's tax on \$400,000 at 35%	<u>\$140,000</u>
b.	Alfredo's tax on \$200,000 at 35%	\$ 70,000
	Amber's tax on \$200,000 at corporate rates	<u>61,250</u>
	Total tax	<u>\$131,250</u>
c.	Amber's tax on \$200,000 at corporate rates	\$ 61,250
	Alfredo's tax on \$138,750 dividend distributed at 15%	20,813
	Alfredo's tax on \$200,000 salary at 35%	<u>70,000</u>
	Total tax	<u>\$152,063</u>
d.	Alfredo's tax on \$400,000 at 35%	<u>\$140,000</u>

88. During the current year, Shrike Company had \$220,000 net profit from operations. Carlos, the sole owner of Shrike, is in the 35% marginal tax bracket. Determine the combined tax burden for Shrike and Carlos under the following two independent situations. (Ignore any employment taxes.)

- a. Shrike Company is a C corporation and all of its after-tax income is distributed to Carlos.
- b. Shrike Company is a proprietorship and all of its after-tax income is withdrawn by Carlos.

- a. If Shrike Company is a C corporation, the \$220,000 is taxable at the corporate level, resulting in corporate tax of \$69,050. The after-tax dividend distribution of \$150,950 (\$220,000 – \$69,050) to Carlos will result in tax of \$22,642.50 (\$150,950 × 15%). Total taxes amount to \$91,692.50 (\$69,050 + \$22,642.50).
- b. If Shrike Company is a proprietorship, there is no entity level Federal income tax. Instead, the income of the proprietorship is reported on Carlos's personal tax return, resulting in tax of \$77,000 (\$220,000 × 35%). Carlos's withdrawal of the after-tax income has no income tax consequences.

89. Canary Corporation, an accrual method C corporation, uses the calendar year for tax purposes. Leticia, a cash method taxpayer, is both a shareholder of Canary and the corporation's CFO. On December 31, 2012, Canary has accrued a \$75,000 bonus to Leticia. Describe the tax consequences of the bonus to Canary and to Leticia under the following independent situations.

- a. Leticia owns 35% of Canary Corporation's stock and the corporation pays the bonus to Leticia on February 1, 2013.
- b. Leticia owns 75% of Canary Corporation's stock and the corporation pays the bonus to Leticia on April 1, 2013.
- c. Leticia owns 75% of Canary Corporation's stock and the corporation pays the bonus to Leticia on February 1, 2013.

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

- a. Leticia is not a related party for purposes of the § 267(a)(2) limitation; thus, Canary deducts the bonus, under the accrual method, in 2012.
- b. Since Leticia, a cash method related party, does not include the bonus in her income until its receipt in 2013, Canary's deduction for the bonus occurs in 2013.
- c. Again, Leticia is a cash method related party who does not include the bonus in her income until its receipt in 2013; thus, Canary's deduction for the bonus is deferred until 2013. The fact that the payment to Leticia occurs prior to the filing date for Canary's 2012 tax return is of no consequence.

90. Ostrich, a C corporation, has a net short-term capital gain of \$20,000 and a net long-term capital loss of \$90,000 during 2012. Ostrich also has taxable income from other sources of \$1 million. Prior years' transactions included the following:

2008 net short-term capital gains	\$20,000
2009 net long-term capital gains	15,000
2010 net short-term capital gains	25,000
2011 net long-term capital gains	5,000

- a. How are the capital gains and losses treated on Ostrich's 2012 tax return?
- b. Determine the amount of the 2012 net capital loss that is carried back to each of the previous years.
- c. Compute the amount of capital loss carryover, if any, and indicate the years to which the loss may be carried.
- d. If Ostrich were a proprietorship, how would Ellen, the owner, report these transactions on her 2012 tax return?

a.	Net short-term capital gain	\$ 20,000
	Net long-term capital loss	<u>(90,000)</u>
	Net capital loss	<u>(\$70,000)</u>

The net capital loss of \$70,000 is not deductible in 2012 but must be carried back to the three preceding years, applying it to 2009, 2010, and 2011, in that order. Such net capital loss is carried back or forward as a short-term capital loss.

b.	2012 net capital loss	<u>(\$70,000)</u>
	Offset against—	
	2009 net long-term capital gains	\$15,000
	2010 net short-term capital gains	25,000
	2011 net long-term capital gains	<u>5,000</u>
	Total carrybacks	<u>\$45,000</u>

c. \$25,000 (\$70,000 – \$45,000) STCL carryover to 2013, 2014, 2015, 2016, and 2017, in that order.

d. Ellen would net these transactions with all other capital transactions for 2012. Assuming these were her only capital transactions in 2012, she would offset \$20,000 of capital losses against the capital gains and deduct an additional \$3,000 in capital losses on her return. The remaining \$67,000 (\$90,000 – \$20,000 – \$3,000) would be carried forward indefinitely as a LTCL.

91. Tonya, an actuary, is the sole shareholder of Shrike Corporation, a professional corporation. The corporation paid Tonya a salary of \$360,000 during its fiscal year ending September 30, 2012.

- How much salary must Shrike Corporation pay Tonya during the period October 1 through December 31, 2012, to enable the corporation to continue to use its fiscal year without negative tax effects?
- If Shrike Corporation had taxable income of \$75,000 for the year ending September 30, 2012, what is its tax liability?

- The salary for the deferral period (October 1 through December 31) must be at least proportionate to the employee's salary received for the fiscal year. The amount that Shrike Corporation must pay Tonya during the period October 1 through December 31, 2012, to permit the continued use of its fiscal year without negative tax effects, is \$90,000 ( $\$360,000 \div 3/12$ ).
- As a PSC is subject to a tax rate of 35%, Shrike's tax is \$26,250 ( $\$75,000 \times 35\%$ ). To illustrate the negative tax impact of classification as a PSC, compare this amount to the \$13,750 that a regular (non-PSC) corporation would pay.

92. During the current year, Lavender Corporation, a C corporation in the business of manufacturing tangible research equipment, made charitable contributions to qualified organizations as follows:

- Research equipment (basis of \$70,000, fair market value of \$110,000), held as inventory, to a qualified educational organization that uses the property for research training. The inventory was produced by Lavender earlier in the current year.
- Stock (basis of \$30,000, fair market value of \$65,000) in Olive Corporation, held for seventeen months as an investment, to United Way. (United Way plans on selling the stock.)
- Land (basis of \$180,000, fair market value of \$220,000), held for three years as an investment, to State University. (State University plans on using the land for new dormitories.)

Lavender Corporation's taxable income (before any charitable contribution deduction) is \$2.5 million.

- a. What is the total amount of Lavender's charitable contributions for the year?
- b. What is the amount of Lavender's charitable contribution deduction in the current year, and what happens to any excess charitable contribution, if any?

- a. Lavender's total amount of charitable contributions is \$375,000 [\$90,000 (inventory) + \$65,000 (stock) + \$220,000 (land)], computed as follows:

Inventory: this qualifies for the enhanced contribution amount available with respect to certain inventory, since it consists of tangible research property contributed to a qualified educational organization that uses the property for research training. The contribution amount is equal to the lesser of (1) the sum of the property's basis plus 50% of the appreciation on the property [\$90,000 = \$70,000 basis + 50%(\$110,000 fair market value – \$70,000 basis)] or (2) twice the property's basis (\$140,000 = 2 × \$70,000 basis). Thus, the amount of the contribution is \$90,000.

Stock: this is capital gain property, since a sale of the stock would result in long-term capital gain for Lavender. Thus, the amount of the contribution is the stock's fair market value, or \$65,000.

Land: this is capital gain property, since a sale of the land would result in a long-term capital gain for Lavender. Thus, the amount of the contribution is the land's fair market value, or \$220,000.

- b. Lavender's current year charitable deduction is limited to \$250,000 [10% × \$2.5 million (taxable income before charitable deduction)], and the excess charitable contribution of \$125,000 (\$375,000 – \$250,000) is carried forward to the five succeeding tax years.

93. On December 28, 2012, the board of directors of Taupe Corporation, a calendar year, accrual method C corporation, authorized a contribution of land to a qualified charitable organization. The land (basis of \$75,000, fair market value of \$125,000) was acquired five years ago and held as an investment. For purposes of the taxable income limitation applicable to charitable deductions, Taupe has taxable income of \$800,000 and \$950,000 for 2012 and 2013, respectively. Describe the tax consequences to Taupe Corporation under the following independent situations.

- a. The donation is made on February 21, 2013.
- b. The donation is made on April 11, 2013.

In general, charitable contributions are deductible in the year made. However, in the case of an accrual method corporation, a deduction can be claimed in the current year for a charitable contribution made in the subsequent year if (1) the contribution is approved by the board of directors of the corporation in the current year, and (2) the contribution is made on or before the fifteenth day of the third month of the subsequent year. The land is capital gain property; thus, the amount of the charitable contribution is the land's fair market value of \$125,000.

- a. The requirements for an accrual of the charitable deduction are satisfied; thus, the \$125,000 contribution is deductible by Taupe in 2012, subject to the taxable income limitation. For 2012, the taxable income limitation for charitable deductions is \$80,000 (10% of \$800,000). The excess contribution amount of \$45,000 carries forward to 2013 (five-year carryover limit).
- b. The requirements for an accrual of the charitable deduction are not satisfied; thus, the \$125,000 contribution is deductible by Taupe in 2013 (the year the contribution is made), subject to the taxable income limitation. For 2013, the taxable income limitation for charitable deductions is \$95,000 (10% of \$950,000). The excess contribution amount of \$30,000 carries forward to 2014 (five-year carryover limit).

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

Income from operations	\$450,000
Expenses from operations	500,000
Dividends received from ABC Corporation	100,000

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

Quartz has an NOL, computed as shown below:

Gross income:		
From operations	\$450,000	
Dividends	<u>100,000</u>	\$550,000
Less:		
Expenses from operations	\$500,000	
Dividends received deduction (\$100,000 × 70%)	<u>70,000</u>	<u>(570,000)</u>
Net operating loss		<u>(\$ 20,000)</u>

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

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

Income from operations	\$260,000
Expenses from operations	285,000
Dividends received from Roadrunner Corporation	115,000

- a. Coyote owns 5% of Roadrunner Corporation's stock. How much is Coyote Corporation's taxable income (loss) for the year?
- b. Would your answer change if Coyote owned 25% of Roadrunner Corporation's stock?

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

Gross income:		
From operations	\$260,000	
Dividends	<u>115,000</u>	\$375,000
Less: Expenses from operations		<u>(285,000)</u>
Taxable income before the dividends received deduction		\$ 90,000
Dividends received deduction (70% × \$90,000)		<u>(63,000)</u>
Taxable income		<u>\$ 27,000</u>

The dividends received deduction is limited to 70% of taxable income because taking 70% of \$115,000 (\$80,500) would not create an NOL.

- b. If Coyote Corporation owns 25% of Roadrunner Corporation's stock, the percentage for calculating the dividends received deduction is 80%. Under these circumstances, taking the full dividends received deduction would create an NOL.

Gross income:		
From operations	\$260,000	
Dividends	<u>115,000</u>	\$375,000
Less: Expenses from operations		<u>(285,000)</u>
Taxable income before the dividends received deduction		\$ 90,000
Dividends received deduction (80% × \$115,000)		<u>(92,000)</u>
Net operating loss		<u>(\$ 2,000)</u>

96. Warbler Corporation, an accrual method regular corporation, was formed and began operations on March 1, 2012. The following expenses were incurred during its first year of operations (March 1 - December 31, 2012):

Expenses of temporary directors and organizational meetings	\$25,000
Incorporation fee paid to state	2,000
Expenses incurred in printing and selling stock certificates	10,000
Accounting services incident to organization	12,000

- a. Assuming a valid election under § 248 to amortize organizational expenditures, what is the amount of Warbler's deduction for 2012?
- b. Same as a., except that Warbler also incurred in 2012 legal fees of \$15,000 for the drafting of the corporate charter and bylaws. What is the amount of Warbler's 2012 deduction for organizational expenditures?

- a. Warbler has qualifying organizational expenditures of \$39,000 [\$25,000 (expenses of temporary directors and organizational meetings) + \$2,000 (incorporation fee) + \$12,000 (accounting fees)]. Expenses related to the printing or selling of stock or other securities do not qualify as organizational expenditures. Warbler's 2012 deduction for the organizational expenditures is \$6,889  $\{ \$5,000 + [(\$39,000 - \$5,000)/180 \times 10 \text{ months}] \}$ .
- b. Warbler now has qualifying organizational expenditures of \$54,000 [\$39,000 (as computed in a., above) + \$15,000 (legal fees)]. Warbler's 2012 deduction for the organizational expenditures is \$3,944  $\{ \$1,000 + [(\$54,000 - \$1,000)/180 \times 10 \text{ months}] \}$ . The \$5,000 immediate expensing amount is reduced to the extent qualifying organizational expenditures exceed \$50,000; thus, only \$1,000 of the expenditures are immediately deductible, and the remainder of the expenditures are amortized over 180 months.

97. In each of the following independent situations, determine the corporation's income tax liability. Assume that all corporations use a calendar year and that the year involved is 2012.

	<b>Taxable Income</b>
Violet Corporation	\$ 22, 000
Indigo Corporation	90,000
Orange Corporation	220,000
Blue Corporation	5,100,00 0
Green Corporation	19,800,0 00

Violet  
Corporation:

Tax on \$22,000 at 15%	<u>\$3,300</u>
------------------------	----------------

Indigo  
Corporation:

Tax on \$90,000	
—	
\$50,000 at 15%	\$ 7,500
\$25,000 at 25%	6,250
\$15,000 at 34%	<u>5,100</u>
Total tax	<u>\$18,850</u>

Orange  
Corporation:

Tax on \$220,000	
—	
\$100,000	\$22,250
\$120,000 at 39%	<u>46,800</u>
Total tax	<u>\$69,050</u>

Blue  
Corporation:

Tax on \$5,100,000	
—	
\$335,000	\$ 113,900
\$4,765,000 at 34%	<u>1,620,100</u>
Total tax	<u>\$1,734,000</u>

Green  
Corporation:

Tax on	<u>\$6.9</u>
\$19,800,0	<u>30.0</u>
00 × 35%	<u>00.0</u>
	<u>00</u>

98. Almond Corporation, a calendar year C corporation, had taxable income of \$900,000, \$1.1 million, and \$1.2 million for 2009, 2010, and 2011, respectively. Almond's taxable income is \$2 million for 2012. Compute the minimum estimated tax payments for 2012 for Almond Corporation.

A corporation that had taxable income of \$1 million or more in any of the three preceding years is a "large corporation" for purposes of utilizing the prior year's tax exception for estimated tax payments. As such, Almond Corporation can use the prior year's tax exception for computing its first 2012 estimated tax payment only, and any shortfall as a result of such use must be paid with the second installment.

<u>Payment</u>	<u>Amount</u>
April 15, 2012	\$102,000*
June 15, 2012	238,000**
September 15, 2012	170,000
December 15, 2012	<u>170,000</u>
Total	<u>\$680,000</u>

\*Based on preceding year's tax, for first installment only: [\$1.2 million taxable income × 34% (see Exhibit 2.1)] ÷ 4 = \$102,000.

\*\*Based on current year's tax, for remaining installments: [\$2 million taxable income × 34% (see Exhibit 2.1)] ÷ 4 = \$170,000. Second installment must include shortfall from first installment: [\$170,000 + (\$170,000 - \$102,000)] = \$238,000.

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

Net income per books (after-tax)	\$239,700
Taxable income	195,000
Federal income tax liability	59,300
Interest income from tax-exempt bonds	5,000
Interest paid on loan incurred to purchase tax-exempt bonds	2,000
Life insurance proceeds received as a result of death of Heron's president	100,000
Premiums paid on policy on life of Heron's president	4,500
Excess of capital losses over capital gains	2,000
Retained earnings at beginning of year	375,000
Cash dividends paid	90,000
Tax depreciation in excess of book depreciation	7,500

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

Net income per books (after tax)	\$239,700
Plus: Items that decreased net income per books but did not affect taxable income	
+ Federal income tax liability	59,300
+ Excess of capital losses over capital gains	2,000
+ Interest paid on loan incurred to purchase tax-exempt bonds	2,000
+ Premiums paid on policy on life of president of the corporation	<u>4,500</u>
Subtotal	\$307,500
Minus: Items that increased net income per books but did not affect taxable income	
– Interest income from tax-exempt bonds	(5,000)
– Life insurance proceeds received as a result of the death of the corporate president	(100,000)
– Tax depreciation in excess of book depreciation	<u>(7,500)</u>
Taxable income	<u>\$195,000</u>

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

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

The correct answers are shaded.

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

101. A taxpayer is considering the formation of a business that would derive some amounts of tax-exempt interest, qualified dividends, and capital gains. Explain how these income categories would be reported and taxed under the various types of entity forms discussed in the chapter. Consider the tax implications both to the entities and to their owners.

For certain business entity forms, the entity is not subject to a Federal income tax. This is the case with the sole proprietorship, partnership, and (generally) S corporation entity forms. The owners of these three entity forms would benefit from any preferential tax treatment associated with tax-exempt income (i.e., exclusion), qualified dividends (i.e., 15%/0% tax rate), and capital gains (i.e., offset against capital losses and, in the case of LTTCG, 15%/0% tax rate). For a sole proprietorship, tax-exempt interest, qualified dividends, and capital gains would all retain their character and be reported as such on the proprietor's tax return (Form 1040, Schedule C). In the case of a partnership (including an LLC treated as a partnership) or S corporation, tax-exempt interest, qualified dividends, and capital gains would be separately reported items on the entity return and retain their character when reported (Schedule K-1) and taxed to the partner or shareholder. The partner or shareholder would include the tax-exempt interest, qualified dividends, and capital gains on the partner's or shareholder's tax return.

In the case of a regular (C) corporation, tax-exempt interest, qualified dividends, and capital gains would be reported as such on the corporate tax return (Form 1120). A corporation would exclude tax-exempt interest from gross income and offset capital gains against capital losses, but corporate taxpayers do not receive any preferential tax rate with respect to qualified dividends or LTTCG. Further, the tax attributes of income do not pass through the corporation to the shareholders. Instead, corporate distributions to shareholders generally are taxed as dividend income.

102. Adrian is the president and sole shareholder of Pigeon Corporation. He also lends money and rents a building to the corporation. Discuss how these business relationships between Adrian and Pigeon Corporation can help avoid double taxation. What limitations are there on the use of such relationships?

As president of Pigeon Corporation, Adrian can have the corporation pay him a salary. As a creditor, he can have the corporation pay him interest on the loans. As a landlord, he can have the corporation pay him rent. All of these expenses can be deducted by the corporation. In order to avoid disallowance of any of these deductions at the corporate level, the payments to Adrian must be reasonable in amount. Payments deemed to be unreasonable in amount will be treated as corporate dividends to Adrian and nondeductible by Pigeon. However, to the extent the payments are reasonable in amount and deductible by Pigeon Corporation, the corporate tax is avoided on such amounts. The payments received by Adrian would be income (i.e., salary, interest, and rent) to him and taxed as such, but this would be the only tax incurred on such amounts (i.e., double taxation is avoided to the extent of any payments deductible by Pigeon).

103. Nancy is a 40% shareholder and president of Robin Corporation, a regular corporation. The board of directors of Robin has decided to pay Nancy a \$175,000 bonus for the year based on her outstanding performance. The directors want to pay the \$175,000 as salary, but Nancy would prefer to have it paid as a dividend. If both Robin Corporation and Nancy are in a 35% marginal tax bracket irrespective of the treatment of the bonus, discuss which form of payment would be most beneficial for each party. (Ignore any employment tax considerations.)

Robin Corporation prefers treating the payment as salary, as a \$175,000 deduction for such would provide the corporation with a tax savings of \$61,250 [ $\$175,000 \text{ (salary deduction)} \times 35\% \text{ (marginal tax rate)}$ ]. If, instead, the payment were treated as a dividend, none of the \$175,000 would be deductible by Robin.

Nancy prefers treating the payment as a dividend, as a preferential tax rate of 15% would apply to the \$175,000 and result in only \$26,250 of tax. If, instead, the payment were treated as salary, Nancy would incur tax of \$61,250 [ $\$175,000 \text{ (salary)} \times 35\% \text{ (marginal tax rate)}$ ]. Thus, Nancy would save \$35,000 of tax if the payment were treated as a dividend instead of salary.

104. Red Corporation, a C corporation that has two equal shareholders, earned \$450,000 during 2012. Orange Company, a partnership that has two equal partners, earned \$450,000 during the year. Red did not make any distributions to its shareholders, and Orange's partners did not make any withdrawals. Contrast the tax treatment of the shareholders of Red Corporation and the partners of Orange Company.

A C corporation is a separate taxable entity, so 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, Red Corporation will be taxed on \$450,000 and the shareholders have no tax consequences. On the other hand, the income of a partnership is passed through to and reported by the partners on their tax returns. Thus, each partner will receive a passthrough of \$225,000 of income from Orange Company ( $\$450,000 \div 2 \text{ partners}$ ).

105. What is a limited liability company? What favorable nontax and tax attributes does the LLC entity form offer taxpayers?

Similar to the corporate entity form, a limited liability company is an entity created under the laws of a specific state (or the District of the Columbia) and, pursuant to such laws, an LLC has the corporate feature of limited liability. This is the primary nontax characteristic that makes LLC status attractive. Other nontax attributes that are available with the LLC entity form include centralized management, continuity of life, and free transferability of ownership interests. Which of these nontax attributes are allowed will be dependent on the laws of the state of LLC organization. The principal tax advantage of the LLC entity form is the ability to avoid double taxation of the entity's profits. Most LLCs will be taxed as either partnerships (two or more owner LLCs) or sole proprietorships (one owner LLCs), although the check-the-box Regulations do provide the opportunity to have an LLC taxed as a corporation.

106. Compare the taxation of C corporations with that of individual taxpayers. Provide several examples of similarities and differences in your discussion.

#### Similarities:

- Gross income is defined the same for both types of taxpayers.
- Some exclusions are available to both types of taxpayers (e.g., life insurance proceeds, municipal bond interest).
- Capital asset is defined the same for both types of taxpayers.
- Nontaxable exchange provisions (e.g., like-kind exchanges, involuntary conversions) are applicable to both types of taxpayers.
- Depreciation recapture under § 1245 is the same for both types of taxpayers.
- Some loss disallowance provisions apply to both types of taxpayers (e.g., wash sales, related party losses).
- Treatment of business expenditures is similar for both types of taxpayers.
- Some credits are available to both types of taxpayers (e.g., foreign tax credit).

#### Differences:

- Tax rates are different.
- Certain exclusions apply only to individuals (e.g., employer provided benefits), while others apply only to corporations (e.g., contributions to capital).
- Depreciation recapture under § 1250 differs between the two types of taxpayers.
- Corporations do not have nonbusiness deductions, itemized deductions, standard deductions, personal or dependency exemptions, or adjusted gross income.
- Computation of casualty losses differs between the two types of taxpayers.
- Some credits available to individual taxpayers are not available to corporations (e.g., child tax credit, earned income credit).

107. Explain the rules regarding the accounting periods available to corporate taxpayers.

In general, a corporate taxpayer may select a calendar year or a fiscal year for tax return reporting purposes. A newly formed corporation generally can select its initial reporting period without having to obtain IRS consent. However, certain types of corporate taxpayers are subject to restrictions on their reporting period. In general, personal service corporations (PSCs) and S corporations are required to use the calendar year for tax reporting. Exceptions to this rule apply, and a fiscal year can be elected by a PSC (or S corporation), under any of the following conditions:

- A business purpose for the year can be demonstrated.
- The PSC tax year results in a deferral of not more than three months' income. An election under § 444 is required, and the PSC will be subject to the deduction limitations of § 280H. The corporation must pay the shareholder-employee's salary during the portion of the calendar year after the close of the fiscal year. In addition, the salary for that period must be at least proportionate to the employee's salary for the fiscal year. (For an S corporation electing a § 444 deferral, the required payments provision of § 7519 must be satisfied. See Chapter 12.)
- The PSC (or S corporation) 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 (or § 7519, in the case of an S corporation).

108. Jessica, a cash basis individual, is a 60% shareholder of Crow Corporation, a regular corporation. On January 1, 2012, Jessica loaned Crow \$300,000, with the principal due in 5 years and 6% interest due each January 1. Crow, an accrual method, calendar year taxpayer, accrued \$18,000 of interest expense on the loan on December 31, 2012, and paid the \$18,000 to Jessica on January 1, 2013. How much is Crow's deduction for interest on this loan for 2012? Would your answer change if Jessica was a 25% shareholder of Crow?

Crow Corporation and Jessica are related parties under § 267 (corporation and a more-than-50% shareholder). As a result, the interest expense on the loan is deductible by Crow in the year it is actually paid to Jessica, or 2013. Thus, Crow has no deduction for interest expense on the loan for 2012. If Jessica was a 25% shareholder, the related party provisions of § 267 would not apply to the interest expense accrual, and Crow would have a \$18,000 deduction for such in 2012.

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

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

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

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

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

110. Briefly describe the charitable contribution deduction rules applicable to C corporations.

**Tax year of deduction:** In general, a charitable contribution is deductible only in the year the gift is made. For an accrual basis corporation, however, a charitable contribution can be deducted in the current year for a contribution that is (1) approved by the corporation's board of directors by the end of such year and (2) paid on or before the fifteenth day of the third month of the next year.

**Amount of contribution:** In addition to cash gifts, property contributions to qualified charitable organizations are also deductible. For property that is depreciated (fair market value less than basis), the amount of the contribution is the property's fair market value. For property that is appreciated (fair market value greater than basis), the amount of the contribution depends on whether the property is "capital gain property" or "ordinary income property." Capital gain property is property that, if sold, would result in a long-term capital gain or § 1231 gain. A contribution of capital gain property generally results in a deductible amount equal to the property's fair market value. If the capital gain property is tangible personal property and the charitable organization's use of the property is unrelated to its exempt function, the amount of the contribution is equal to the property's basis. (Contributions of capital gain property to certain private foundations are similarly limited to the property's basis.) Ordinary income property is property that, if sold, would not result in a long-term capital gain or § 1231 gain. Typically, the deduction for a contribution of ordinary income property is equal to the property's basis. However, charitable contributions of certain inventory property by corporations can result in an enhanced deduction amount. For such inventory property, the deductible amount 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.

**Annual limitation on deduction:** A corporate taxpayer's charitable deduction is limited to 10% of taxable income (determined without regard to the charitable contribution deduction, any net operating loss carryback or capital loss carryback, dividends received deduction, and domestic production activities deduction). Any contributions in excess of the 10% limitation may be carried forward for five years. In any tax year for which there is a charitable contribution carryover, current year's gifts are applied against the 10% limitation first, with carryover amounts deducted in order of time.

111. Mallard Corporation, a C corporation that is not a PSC, incorporated in December 2012 and expects to have substantial organizational expenditures. Discuss tax planning strategies that Mallard should consider in order to maximize the deduction for organizational expenditures.

Mallard should incur all of its organizational expenditures in its first taxable year. Such expenditures need not be paid in the first year, even if Mallard uses the cash method of accounting. Since Mallard is commencing operations late in the calendar year, the corporation should consider adopting a fiscal year that will close after it has incurred all of its organizational expenditures. A corporation may freely select a fiscal year by filing a timely return.

112. What is the annual required estimated tax payment for a C corporation? What are the rules regarding payment of the estimated tax?

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. Estimated payments are made quarterly, due on or before the 15th day of the 4th, 6th, 9th, and 12th month of the taxable year. Underpayment of estimated tax penalty can be avoided if the quarterly payments are filed timely and equal to the corporation's tax liability for the prior year (or tax liability computed on an annualized method). A corporation with taxable income of \$1 million or more in any of its three preceding years can use the prior year's tax liability for computing only the first installment payment. In such cases, the corporation's second installment payment must include any shortfall resulting from using the prior year's liability for the first installment (instead of the current year's liability).

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

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

114. What is the purpose of Schedule M-3? Which corporations are required to file Schedule M-3?

Schedule M-3 was created, in part, in response to financial reporting scandals, such as Enron and WorldCom. Schedule M-3 requires corporations to report much more information regarding the differences between financial net income (loss) and taxable income than is required of Schedule M-1. This greater transparency should allow the IRS to more easily identify corporations that engage in aggressive tax practices, as those transactions generally result in book/tax differences that must be reported on Schedule M-3. Entities with total assets of \$10 million or more must file Schedule M-3 (in lieu of Schedule M-1). The financial figures (e.g., amount of total assets, net income or loss) required of the Schedule M-3 are drawn from the corporation's Form 10-K. If Form 10-K is not filed, then another financial source, e.g., certified financial statements, is used.