CHAPTER 2

CORPORATIONS: INTRODUCTION AND OPERATING RULES

SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

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

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

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

3. (LO 1, 7) Art should consider operating the business as a sole proprietorship (or a single-member LLC) for the first three years. If he works 15 hours per week in the business, he will exceed the minimum number of hours required to be a material participant (52 × 15 = 780) under the passive activity loss rules. [An individual is treated as materially participating in an activity if he or she participates in the activity for more than 500 hours during the year. Reg. § 1.469-5T(a)(1).] Therefore, he will be able to deduct the losses against his other income. When the business becomes profitable, Art should consider incorporating. If he reinvests the profits in the business, the value of the stock should grow accordingly, and he should be able to sell his stock in the corporation for long-term capital gain.

4. (LO 1, 2)

   a. If Catbird Company is an LLC: A single-member LLC is generally taxed as a proprietorship. Thus, Janice will report the $100,000 operating income (Schedule C), $15,000 long-term capital gain (Schedule D), and if she itemizes, $5,000 charitable contribution (Schedule A) on her tax return. The $70,000 withdrawal would have no effect on Janice's individual tax return.

   b. If Catbird Company is an S corporation: An S corporation is a tax reporting entity (Form 1120S), and its income, gains, deductions, and losses are passed through to and reported by the shareholders on their tax returns. Separately stated items (e.g., long-term capital gain and charitable contribution) retain their character at the shareholder level. Consequently, Janice will report the $100,000 operating income (Schedule E), $15,000 long-term capital gain (Schedule D), and if she itemizes, $5,000 charitable contribution (Schedule A) on her tax return. The $70,000 withdrawal would have no effect on Janice's individual tax return.

   c. If Catbird Company is a C corporation: A C corporation is a separate taxable entity, and its taxable income has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Thus, Catbird Company will report taxable income of $110,000 ($100,000 operating income + $15,000 LTCG – $5,000 charitable contribution) on its Form 1120. Corporations receive no preferential tax rate on long-term capital gains. Janice will report dividend income of $70,000 (Schedule B) on her individual tax return.

5. (LO 1, 2)

   - If Joel buys the warehouse and rents it to the corporation, he can charge the corporation the highest amount of rent that is *reasonable*. The rental operation can help bail some profits out of the corporation and avoid double taxation on corporate income. Joel would have rent income but Manatee would have a deduction for rent expense.

   - The depreciation and other expenses incurred in connection with the warehouse will be deductible by Joel, which should enable him to offset some or all of the rental income. If the rental property produces a loss, Joel can use the loss to offset any passive activity income he might have.

- Upon future sale of the warehouse, Joel will not be subject to the § 291 additional depreciation recapture provision that would be applicable to Manatee Corporation.

- Any § 1231 gain resulting from the sale of the warehouse would qualify for the preferential tax rate on long-term capital gains. C corporations do not receive any preferential tax rate on long-term capital gains.

6. (LO 1) Yes, most states allow for single-member LLCs. Under the default rules of the check-the-box Regulations, a single-member LLC is taxed as a sole proprietor. A single-member LLC can elect to be taxed instead as a corporation by filing Form 8832 (Entity Classification Election).

7. (LO 1) The statement is correct. Because no Form 8832 was filed, the LLC will be taxed as a partnership, the default classification for multi-member LLCs under the check-the-box Regulations. A Form 8832 is required to be filed only if the taxpayer wants to elect to have the entity classified as a corporation for Federal tax purposes.

8. (LO 2) A C corporation is relatively unrestricted as to the choice of accounting periods, and generally may choose either a fiscal year or a calendar year. It is not necessary for a new C corporation to obtain consent of the IRS with regard to its choice of an accounting period. Personal service corporations, however, can elect a fiscal year only under one of the following circumstances:

   - A business purpose for the year can be demonstrated.

   - The year results in a deferral of not more than three months' income. An election under § 444 is required, and the PSC will be subject to the deduction limitations of § 280H.

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

9. (LO 2) In general, a corporation is *not* allowed to use the cash method of accounting for Federal tax purposes. However, S corporations, qualified personal service corporations, and C corporations engaged in the trade or business of farming or timber are exceptions to this rule. Further, a C corporation with $5 million or less of average gross receipts over the past three years is allowed to use the cash method.

   a. Jade Corporation has $4.8 million of average gross receipts over the 2013–2015 period. Thus, Jade satisfies the gross receipts exception and may use the cash method of accounting.

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

10. (LO 2) A corporation that uses the accrual method cannot claim a deduction for an expense involving a related party (e.g., a more than 50% shareholder) until the recipient reports that amount as income. Lupe, a cash basis taxpayer, must report the $100,000 bonus in 2017, the year he receives the payment. Jasper Corporation may deduct the $100,000 bonus in 2017, the year Lupe is required to report it as income.

11. (LO 2) Both corporations and individuals include recognized capital gains in their taxable income. For a corporate taxpayer, there is no preferential tax rate applicable to long-term capital gains. Instead, the capital gain is taxed at Parrot's normal tax rate of 25%. The preferential tax rate of 15% would apply to Jeanette's long-term capital gain.

12. (LO 2) John and Eagle Corporation each net the $10,000 LTCG against the $18,000 STCL, resulting in an $8,000 net capital loss. John reports the capital transactions on his individual tax return, deducts $3,000 of the net capital loss in the current year, and carries forward to next year a $5,000 STCL for the remainder of the net capital loss. Eagle reports the capital transactions on its corporate tax return, but none of the $8,000 net capital loss is deductible in the current year. Instead, Eagle carries back an $8,000 STCL three years and, if necessary, forward five years, to be offset against capital gains in such years.

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

14. (LO 2)

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

b. A closely held corporation that is not a personal service corporation can offset passive activity losses against net active income but not against portfolio income. Therefore, Osprey can deduct $100,000 of the passive activity loss in the current year. The remaining $20,000 of passive activity loss is carried forward.

15. (LO 2) In order to be deductible by an accrual basis corporation in the year authorized by its board of directors, a charitable contribution must be paid within 3 1/2 months of the end of the year of authorization (April 15, 2017, in this case). Because payment was made within the required time period, the charitable contribution is deductible in 2016.

16. (LO 2, 7) The following tax issues should be considered.

- Is Orange an accrual method taxpayer and, if so, will the contribution be made by April 15, 2017, so as to obtain a deduction in 2016?
- Will the contribution consist of property or cash?
- If the contribution consists of property, what is the character of the property (capital gain or ordinary income property) and amount of the contribution deduction?
- What is the current year's taxable income limitation on the deductibility of charitable contributions?
- In what tax year did the charitable contribution carryover originate and when does the 5-year period for such carryover expire?
- If the $45,000 sum of the current year's contribution plus the carryover amount exceeds the taxable income limitation, should the current year's gift be deferred to the subsequent tax year?

17. (LO 2) The domestic production activities deduction is equal to 9% of the *lesser* of the taxpayer's (1) qualified production activities income or (2) taxable income. However, the deduction cannot exceed 50% of the corporation's W–2 wages related to qualified production activities income.

18. (LO 2, 3, 7) As a general rule, an NOL is carried back 2 years and forward 20 years to offset taxable income in such carryover years. However, a taxpayer can (irrevocably) elect to forgo the carryback period and just carry the NOL forward. In determining whether Gold should make the election, some of the relevant issues are:

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

19. (LO 1, 3) Otter Corporation will be allowed a dividends received deduction equal to 70% of the $15,000 dividend it received from Marmot (subject to taxable income limitation described in Example 26). It will pay tax at the applicable corporate tax rate of 25% on the remaining portion of the dividend. Gerald must include in income the entire $15,000 dividend he received from Marmot, and he will pay tax at the 15% rate applicable to individuals.

20. (LO 3) A corporation that owns stock in another corporation is allowed a dividends received deduction. The deduction percentage is based on the percentage of ownership that the recipient corporation has in the corporation paying the dividend. Currently, with Mustard's 15% ownership interest in Burgundy, the deduction percentage is 70%. If the stock purchase increases Mustard's ownership interest in Burgundy to 20% or more, but less than 80%, then the deduction percentage is 80%. If the stock purchase increases Mustard's ownership interest in Burgundy to 80% or more, then the deduction percentage is 100%.

21. (LO 3)
    a. Organizational expenditures.
    b. Organizational expenditures.
    c. Organizational expenditures.
    d. Startup expenditures.
    e. Neither.

22. (LO 5) Plum Corporation and Ivory Corporation are members of a controlled group of corporations (related corporations) and subject to a special income tax liability computation. The special computation limits the amount of a controlled group's taxable income that is taxed at rates lower than 35% to that amount the corporations in the group would have if they were one corporation. As a result, Omar's plan will be ineffective in lowering the overall corporate income tax liability of the two corporations.

23. (LO 6) 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 (if that year was a 12-month tax year, the return filed showed a tax liability, and the corporation is not a large corporation).

24. (LO 6) The starting point on Schedule M–1 is net income per books. Additions and subtractions are entered for items that affect net income per books and taxable income differently. An example of an addition is Federal income tax expense, which is deducted in computing net income per books but is disallowed in computing taxable income. An example of a subtraction is a charitable contributions carryover that was deducted for book purposes in a prior year but deducted in the current year for tax purposes.

ADDITIONS
c. Federal income tax per books.
d. Capital loss in excess of capital gain.
e. Charitable contributions in excess of taxable income limitation.
f. Premiums paid on life insurance policies covering executives (corporation is beneficiary).

SUBTRACTIONS
a. Life insurance proceeds received upon death of covered executive.
b. Tax depreciation in excess of book tax depreciation.
g. Domestic production activities deduction.

25. (LO 6) Corporations with total assets of *$10 million or more* are required to file Schedule M–3; thus, Woodpecker, with $8.5 million of assets, is not required to file the form. If a Schedule M–3 is filed by Woodpecker, the amortization is reported on line 28, Part III as follows: $40,000 book amortization in column (a), $15,000 temporary difference in column (b), and $55,000 tax return amortization in column (d).

COMPUTATIONAL EXERCISES

26. (LO 2)
a. Zero. Corporations can deduct capital losses against capital gains but not ordinary income. Instead, net capital losses are first carried back to the three preceding years and then carried forward for five years, to be offset against net capital gains in such carryover years.

b. $7,000. Of the $12,000 net capital loss, $5,000 is carried back to 2015 and deductible against the $5,000 net capital gain of that year. The remaining $7,000 ($12,000 – $5,000) of the net capital loss is carried forward to 2017. (Since a net capital loss is carried back only three years, the 2016 loss cannot be carried back to tax year 2012.)

27. (LO 2)
a. $589,765. The gain is computed as follows: $1,500,000 amount realized – $910,235 adjusted basis ($1,000,000 – $89,765 accumulated depreciation) = $589,765 recognized gain.

b. Section 1231 gain of $571,812 and § 1250 recapture (ordinary income) of $17,953. Under § 1250, recapture is limited to the excess of accelerated depreciation over straight-line depreciation. However, under § 291, corporations have additional § 1250 recapture (ordinary income) equal to 20% of the excess of the amount that would be treated as ordinary income if the property was § 1245 property (i.e., the accumulated depreciation amount of $89,765) over the amount that would be treated as ordinary income under § 1250 without regard to § 291 (i.e., $0). Thus, under § 291, Aqua has § 1250 recapture of $17,953 [20% × ($89,765 – $0)]. The remaining $571,812 of recognized gain ($589,765 – $17,953) is § 1231 gain.

28. (LO 2) $15,000. A closely held C corporation that is not a personal service corporation can offset a passive activity loss against net active income, but not against portfolio income. Hummingbird can

deduct only \$40,000 of the \$45,000 passive activity loss. Thus, Hummingbird's taxable income is \$15,000 (\$40,000 + \$15,000 – \$40,000).

29. (LO 2)

a. \$27,000. The contribution qualifies for the increased deduction amount for certain inventory gifts (i.e., contribution of inventory for use in the organization's exempt function and such use is the care of the needy). Thus, the deduction amount is equal to the lesser of (1) the sum of the property's basis plus 50% of the appreciation on the property [\$24,000 + .50(\$30,000 – \$24,000) = \$27,000] or (2) twice the property's basis (2 × \$24,000 = \$48,000).

b. \$32,000. This is a contribution of capital gain property; thus, the deduction amount is the property's fair market value. (Stock is intangible personal property; thus, the qualified organization's use of the stock is not relevant.)

c. \$130,000. This is a contribution of capital gain property; thus, the deduction amount is the property's fair market value. (Tangible personal property that is put to a use related to the qualified organization's exempt function.)

30. (LO 3)

a. \$70,000. The NOL rule applies, as deducting \$70,000 (70% × \$100,000 dividends received) results in an NOL for Crane [\$180,000 + \$100,000 – \$255,000 – \$70,000 = (\$45,000) NOL].

b. \$154,000. The taxable income limitation applies to the amount of the deduction [70% × (\$300,000 + \$230,000 – \$310,000) = \$154,000].

31. (LO 3) \$3,650. Generally, the first \$5,000 of organizational expenditures are expensed, and the remaining costs are amortized over a 180-month period (beginning with the month the corporation begins business). However, the \$5,000 expensing amount is reduced dollar-for-dollar for the amount of organizational expenditures in excess of \$50,000. Thus, Cherry will deduct \$1,000 [\$5,000 – (\$54,000 – \$50,000)] plus \$2,650 [(\$54,000 – \$1,000) ÷ 180 × 9], or \$3,650.

32. (LO 4)

a. \$12,000 [(15% × \$50,000) + (25% × \$18,000)].

b. \$3,680,000 [(34% × \$10,000,000) + (35% × \$800,000)].

c. \$59,500 (35% × \$170,000). Personal service corporations are subject to a flat rate of 35% on taxable income.

PROBLEMS

33. (LO 1, 2)

a. Income, gains, deductions, and losses of a proprietorship are reported on the individual tax return of the sole proprietor (Form 1040), regardless of whether any amounts are actually withdrawn from the business during the year. Consequently, Roger reports the \$45,000 net operating profit (\$220,000 operating income – \$175,000 operating expenses) and \$10,000 long-term capital loss on his tax return. The LTCL will be subject to the capital loss limitations applicable to individual taxpayers. Riflebird Company, as a proprietorship, files no entity Federal income tax return for the year.

b. A C corporation is a separate taxable entity which files a corporate income tax return. Riflebird Company will report taxable income of \$45,000 (\$220,000 operating income – \$175,000 operating expenses) on its Form 1120. A corporation cannot currently deduct a net capital loss. Instead, the LTCL is subject to the corporate capital loss carryover rules (carried back three years and forward five years, as STCL). Riflebird Company's taxable income has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Therefore, Roger does not report Riflebird's net profit or long-term capital loss on his individual return.

34. (LO 1, 2)

a. Otter, a partnership, is not a taxpaying entity. Its profit (loss) and separate items flow through to the partners. The partnership's Form 1065 reports net profit of $110,000 ($320,000 income – $210,000 expenses). The partnership also reports the $15,000 long-term capital gain as a separately stated item on Form 1065. Ellie and Linda each receive a Schedule K–1 reflecting net profit of $55,000 and separately stated long-term capital gain of $7,500, which each reports on her own return. The 0/15/20% preferential tax rate applies to the LTCG. The withdrawals do not affect taxable income but decrease their basis in the partnership (but not below zero).

b. Otter, an S corporation, is not a taxpaying entity. Its profit (loss) and separate items flow through to the shareholders. The S corporation's Form 1120S reports net profit of $110,000 ($320,000 income – $210,000 expenses). The S corporation also shows the $15,000 long-term capital gain as a separately stated item on Form 1120S. Ellie and Linda each receive a Schedule K–1 reporting net profit of $55,000 and separately stated long-term capital gain of $7,500, which each reports on her own return (subject to capital loss limitation). The 0/15/20% preferential tax rate applies to the LTCG. The withdrawals do not affect taxable income but decrease their basis in the S corporation (but not below zero).

c. Otter, a C corporation, is a taxpaying entity. Otter's Form 1120 reports taxable income of $125,000 ($320,000 income – $210,000 expenses + $15,000 LTCG). Corporations do not received a preferential tax rate on LTCG income. Ellie and Linda report dividend income of $25,000 each. The dividend income is subject to the 0/15/20% preferential tax rate.

35. (LO 1, 2)

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

b. Since dividend distributions are not deductible, the income tax consequences to Azure Company, a C corporation, are the same as in part a. above (i.e., corporate income tax of $119,000). Sasha incurs income tax of $15,000 ($75,000 × 20%) with respect to the dividends she received during the year.

c. The salary paid to Sasha is deducible by Azure Company, resulting in taxable income of $275,000 ($350,000 net operating income – $75,000 salary) and corporate income tax of $90,500 (see Exhibit 2.1). Sasha incurs income tax of $29,700 ($75,000 × 39.6%) with respect to the salary she received during the year. (Payroll taxes on the salary would also apply to Azure and Sasha.)

d. There is no Federal income tax applicable to businesses formed as sole proprietorships. Instead, the income and expenses of a proprietorship retain their character and are reported on the individual income tax return of the proprietor. Sasha therefore incurs income tax of $138,600 ($350,000 net operating income × 39.6% marginal tax rate) with respect to Azure Company. (Sasha would also be subject to self-employment tax on her net self-employment income.)

e. The result would be the same as in part d. above. Sasha must pay tax on the net operating income of Azure Company, regardless of the amount she withdraws. (Sasha would also be subject to self-employment tax on her net self-employment income.)

36. (LO 1, 2)

a. An S corporation is not a taxable entity. Its profit (loss) and separately stated items flow through to the shareholders. Taupe Corporation's Form 1120S reports ordinary business income of $420,000 and separately stated long-term capital gain of $30,000. Torsten receives a Schedule K–1 reporting ordinary business income of $420,000 and separately stated long-term capital gain of $30,000. Torsten will report ordinary business income of $420,000 and long-term capital gain of $30,000 on his individual income tax return (Form 1040), regardless of how much of the income was withdrawn from Taupe. Torsten's income tax liability with respect to the income from Taupe is $172,320 [($420,000 ordinary business income × 39.6% marginal tax rate) + ($30,000 LTCG × 20% preferential tax rate)].

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

37. (LO 1) If Purple Company is a proprietorship, Kirsten must report net income of $200,000, regardless of the amount she withdraws. If the company is a C corporation, it must pay corporate tax on its taxable income and Kirsten must report any dividends she receives from the company as income.

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

Income from proprietorship	$200,000
Less deductions ($6,300 standard deduction + $4,050 exemption)	(10,350)
Taxable income	$189,650
Tax on $189,650 (see Appendix A for Tax Rate Schedules)	$ 46,139
After-tax income ($200,000 – $46,139)	$153,861

b. Tax on corporation's net income of $200,000:

Tax on $200,000 (see Exhibit 2.1)	$ 61,250
Corporation's after-tax income ($200,000 – $61,250)	$138,750
Kirsten's taxable income ($138,750 dividend – $6,300 standard deduction – $4,050 exemption)	$128,400
Kirsten's tax on $128,400 at rates applicable to dividends [($37,650 × 0%) + .15($128,400 – $37,650)]	$ 13,613
Kirsten's after-tax income ($138,750 – $13,613)	$125,137

c. The corporation will have taxable income of $61,250 ($200,000 net income before compensation deduction – $138,750 salary). Kirsten will have taxable income of $128,400 ($138,750 – $6,300 standard deduction – $4,050 exemption). Her tax will be $28,989, and her after-tax income will be $109,761 ($138,750 – $28,989).

38. (LO 2)

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

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

39. (LO 1, 4, 7)

a.

Gross income	$395,000	
Ordinary deductions	(245,000)	
Taxable income (to owner of proprietorship)	$150,000	
Tax @ 33%		$49,500

b.

Gross income of corporation	$395,000	
Ordinary deductions	(245,000)	
Salary	(100,000)	
Taxable income	$ 50,000	
Corporate tax @ 15%		$ 7,500
Gross income of shareholder		
Salary	$100,000	
Tax @ 33%		33,000
Total tax		$40,500

c.

Gross income of corporation	$395,000	
Ordinary deductions	(245,000)	
Taxable income	$150,000	
Corporate tax [$22,250 + (39% × $50,000)]		$41,750

d.

Gross income of corporation	$395,000	
Ordinary deductions	(245,000)	
Salary	(100,000)	
Taxable income	$ 50,000	
Corporate tax @ 15%		$ 7,500
Tax paid by shareholder		
On salary ($100,000 × 33%)	$ 33,000	
On dividend [($50,000 – $7,500) × 15%]	6,375	39,375
Total tax		$46,875

e.

Hoffman, Raabe, Maloney, & Young, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 2, 2016

Mr. Robert Benton
1121 Monroe Street
Ironton, OH 45638

Dear Mr. Benton:

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

COMPUTATION 1

Total tax on $150,000 taxable income if you continue as a proprietorship (33% tax rate)	$49,500

Total tax if you incorporate:	
Individual tax on $100,000 salary @ 33%	$33,000
Corporate tax on $50,000 corporate taxable income	7,500
Total	$40,500

Although this analysis appears to favor incorporating, it is important to consider that there will be additional tax on the $42,500 of income left in the corporation if you withdraw that amount as a dividend in the future, as calculated below:

COMPUTATION 2

After-tax income left in corporation ($50,000 taxable income – $7,500 corporate tax)	$42,500
Tax on $42,500 @ 15%	$6,375
Total tax paid if you incorporate ($40,500 + $6,375)	$46,875

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

COMPUTATION 3

After-tax income left in corporation ($50,000 taxable income – $7,500 corporate tax)	$42,500
Tax on $42,500 @ 15% LTCG rate	$6,375
Total tax paid if you incorporate ($40,500 + $6,375)	$46,875

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

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

Sincerely,

Jon Thomas, CPA

40. (LO 2, 4)

a. The salary for the deferral period (October 1 through December 31) must be at least proportionate to the employee's salary received for the prior fiscal year. The amount that Carmine Corporation must pay Juan during the period October 1 through December 31, 2016, to permit Carmine to continue to use its fiscal year without negative tax effects, is $84,000 ($336,000 × 3/12).

b. Carmine Corporation, a PSC, is subject to a tax rate of 35% on all of its taxable income. The corporation would pay tax of $33,250 ($95,000 × 35%) for the tax year ending September 30, 2016. To illustrate the negative tax impact of classification as a PSC, compare this amount to the $20,550 (see Exhibit 2.1) a corporation that is not a PSC would pay on taxable income of $95,000.

41. (LO 2)

a. Under the cash method of accounting, the salaries are deductible in the year that they are paid by Broadbill. Thus, Broadbill deducts $440,000 ($220,000 × 2), the amount of salaries paid by the corporation in 2016. The $40,000 of salaries paid by Broadbill in 2017 is deductible by the corporation in 2017.

b. An accrual method corporation cannot claim a deduction for an accrual with respect to a related party (e.g., more-than-50% shareholder). Instead, the deduction is deferred until such time the recipient reports that amount as income. Thus, Broadbill deducts $460,000 [$220,000 (salary paid in 2016 to related party Marcia) + $240,000 (salary paid and accrued to unrelated party Zack)]. The $20,000 of Marcia's 2016 salary that is accrued by Broadbill on December 31, 2016, is deductible by the corporation in 2017 (the year it is paid to Marcia).

42. (LO 1, 2, 4)

a. Under the check-the-box Regulations, a single-member LLC is treated as a sole proprietorship unless corporate status is elected by filing a proper Form 8332 (Entity Classification Election). If Lemon Company is a proprietorship, then $10,500 ($70,000 × 15%) of individual income tax results in the current year for Jonathan. The income (or loss) of a proprietorship is reported on the proprietor's individual return (Form 1040). Individuals in the 33% marginal tax bracket receive a preferential tax rate of 15% on LTCGs.

b. If Lemon is a C corporation, then $12,500 of corporate income tax results in the current year. Corporations do not receive a preferential tax rate for LTCGs, and such income is taxed at the normal corporate rates resulting in a tax of $12,500 [($50,000 × 15%) + ($20,000 × 25%)].

43. (LO 2, 4)

a. $105,000 taxable income = $480,000 (operating income) – $390,000 (operating expenses) + $55,000 (LTCG) – $40,000 (STCL). The tax on $105,000 of taxable income is $24,200 [($50,000 × 15%) + ($25,000 × 25%) + ($25,000 × 34%) + ($5,000 × 39%)]. Corporations include LTCGs in taxable income and do not receive a preferential tax rate with respect to such income.

b. $90,000 taxable income = $480,000 (operating income) – $390,000 (operating expenses) + $15,000 (LTCG) – $15,000 (STCL). No deduction is allowed for the $25,000 net capital loss. Instead, the net capital loss is carried back three years and forward five years. The tax on $90,000 of taxable income is $18,850 [($50,000 × 15%) + ($25,000 × 25%) + ($15,000 × 34%)].

44. (LO 2)

a. If Goshawk is a proprietorship, only $21,000 of the $40,000 long-term capital loss can be deducted in the current year. The loss will offset the short-term capital gain of $18,000 first; then, an additional $3,000 of the loss may be utilized as a deduction against ordinary income. The remaining $19,000 net capital loss is carried forward to next year and years thereafter until completely deducted. The capital loss carryover retains its character as long term.

b. If Goshawk is a C corporation, only $18,000 of the long-term capital loss can be deducted in the current year. The loss deduction is limited to the amount of capital gains ($18,000 STCG). A corporation cannot claim a net capital loss as a deduction against ordinary income. The $22,000 net capital loss can be carried back to the three preceding years to reduce any net capital gains in those years. (The loss is carried back three years and forward five years.) Any loss not offset against net capital gains in the three previous years can be carried forward for five years, to offset capital gains in those years. The long-term capital loss will be treated as a short-term capital loss as it is carried back and forward.

45. (LO 2)

a.

Net short-term capital gain	$ 15,000
Net long-term capital loss	(105,000)
Net capital loss	($ 90,000)

Gorilla cannot deduct the net capital loss of $90,000 on its 2016 return, but must carry it back to the three preceding years, applying it against net capital gains in 2013, 2014, and 2015, in that order. The net capital loss is carried back or forward as a short-term capital loss.

b.

2016 net capital loss	($90,000)
Offset against	
2013 (net long-term capital gains)	$18,000
2014 (net short-term capital gains)	25,000
2015 (net long-term capital gains)	20,000
Total carrybacks	$63,000

c. $27,000 ($90,000 – $63,000) STCL carryforward to 2017, 2018, 2019, 2020, and 2021, in that order.

d. These transactions are netted with the taxpayer's other capital transactions for 2016. Assuming these are the only capital transactions in 2016, the taxpayer offsets $15,000 of capital gains against the capital losses and deducts an additional $3,000 in capital losses. The remaining $87,000 ($105,000 – $15,000 – $3,000) is carried forward indefinitely (as long-term capital loss).

46. (LO 2)

a. Under § 291, a corporation will incur an additional amount of depreciation recapture (ordinary income) upon a disposition of § 1250 property for a gain. The § 291 adjustment is equal to 20% of the excess of the amount of depreciation recapture that would arise if the property was § 1245 property over the amount of deprecation recapture computed under § 1250 (without regard to § 291). The solution follows Example 14 in the text.

First, determine the recognized gain:

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

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

Third, determine the normal § 1250 recapture amount:

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

Fourth, determine the additional § 291 amount:

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

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

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

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

47. (LO 2)

a. A closely held C corporation that is a personal service corporation is subject to the passive activity loss rules and, as a result, Plum cannot deduct any of the $75,000 passive activity loss in the current year. Therefore, Plum's taxable income is $430,000 ($410,000 net active income + $20,000 portfolio income – $0 passive activity loss).

b. A closely held C corporation that is *not* a personal service corporation is subject to the passive activity loss rules, but it can deduct a passive activity loss against net active income (but not portfolio income). Thus, Plum's taxable income is $355,000 [$410,000 (net active income) + $20,000 (portfolio income) – $75,000 (passive activity loss)].

48. (LO 2) The total amount of Aquamarine's charitable deduction for the year is $118,500. The painting is capital gain property, but it is tangible personal property which was not used for a purpose related to the qualified organization's exempt function. Thus, the amount of the contribution is limited to the painting's basis, or $15,000. The Apple stock is capital gain property and the amount of the contribution is the stock's fair market value, or $90,000. The canned groceries are ordinary income property but the donation qualifies for the enhanced deduction for corporate contributions of inventory. As such, the amount of the contribution of the inventory is equal to the lesser of (1) the sum of the property's basis plus 50% of the appreciation on the property, or (2) twice the property's basis. Thus, the amount of the contribution of the canned groceries is $13,500 [$10,000 (basis) + 0.5($17,000 – $10,000)].

49. (LO 2, 7)

Hoffman, Raabe, Maloney, & Young, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 10, 2016

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

Dear Mr. Thompson:

I have evaluated the proposed alternatives for your 2016 year-end contribution to the University of Maine (University). I recommend that you sell the Brown Corporation stock and donate the proceeds to the University. The four alternatives are discussed below.

Donation of cash, the unimproved land, or the Brown Corporation stock each will result in a $200,000 charitable contribution deduction. Donation of the Maize Corporation stock will result in only a $140,000 charitable contribution deduction.

Contribution of the Brown Corporation stock will result in a less desirable outcome from a tax perspective. However, you will benefit in two ways if you sell the stock and give the $200,000 in proceeds to the University. Donation of the proceeds will result in a $200,000 charitable contribution deduction. In addition, sale of the stock will result in a $160,000 long-term capital loss. If Jay Corporation had capital gains of at least $160,000 and paid corporate income tax in the past three years, the entire loss can be carried back and Jay will receive tax refunds for the carryback years. If Jay Corporation had no capital gains in the carryback years, the capital loss can be carried forward and offset against capital gains of the corporation for up to five years.

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

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

Sincerely,

Richard Stinson, CPA

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

50. (LO 2, 7) Gray Corporation should defer the gift of the land until 2017. This would allow Gray to fully deduct in 2016 the carryover contribution amount of $75,000. If, instead, Gray gifted the land in 2016, the corporation would lose any otherwise allowable deduction as to the $75,000 carryover amount. This occurs because current year gifts are applied against the taxable income limitation before application of any carryover amounts. Thus, the taxable income limitation for 2016 would be completely exhausted by the gift of land in 2016. Since 2016 represents the fifth and last year of the carryover period, a gift of the land in 2016 precludes any deduction for the $75,000. A gift of appreciated land held for more than one year as an investment results in a charitable deduction equal to the land's fair market value (subject to the taxable income limitation).

Assuming a gift of the land in 2017

2016 taxable income limitation: 10% × $1,000,000 = $100,000.

2016 charitable contribution deduction: $75,000 (carryover from 2011 gift).

2017 taxable income limitation: 10% × $1,200,000 = $120,000.

2017 charitable contribution deduction: $120,000 (gift of land; excess contribution of $130,000 is carried forward for up to five years).

Assuming a gift of the land in 2016

2016 taxable income limitation: 10% × $1,000,000 = $100,000.

2016 charitable contribution deduction: $100,000 (gift of land; excess contribution of $150,000 is carried forward for up to five years). Carryover from 2011 gift ($75,000) disappears, as 2016 is the last year of the carryover period.

2017 taxable income limitation: 10% × $1,200,000 = $120,000.

2017 charitable contribution deduction: $120,000 (carryover from 2016 gift; remaining $30,000 of carryover from 2016 gift carries over to 2018).

51. (LO 2, 7)

Hoffman, Raabe, Maloney, & Young, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 17, 2016

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

Dear Mr. Simms:

On December 12 you asked me to advise you on the timing of a contribution by Simms Corporation to the University of Washington. My calculations show that the corporation will maximize its tax savings by making the contribution in 2016.

If the corporation makes the contribution in 2016, it can deduct \$25,000 as a charitable contribution, which will save \$9,750 (39% tax rate × \$25,000 deduction) in Federal income tax. However, if the corporation makes the contribution in 2017, the percentage limitations applicable to corporations will limit the 2017 deduction to \$10,000 (\$100,000 projected profit × 10% limit). The corporation will save \$3,400 (34% tax rate × \$10,000 deduction) in taxes as a result of this deduction. The corporation may carry the remaining \$15,000 forward for five years or until exhausted. If the corporation continues at the 2017 profit level, it will save an additional \$5,100, for a total tax savings of \$8,500.

This analysis makes it clear that the corporation will save \$1,250 more (\$9,750 – \$8,500) if it makes the contribution in 2016. In addition, all of the savings will occur in 2016. If the corporation makes the contribution in 2017, its tax savings will be split among several years. My advice is that the corporation should make the contribution immediately so ownership of the stock can be transferred by December 31.

Sincerely,

Alicia Gomez, CPA

52. (LO 2)

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

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

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

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

53. (LO 2, 3)

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

Gross income:		
From operations	$660,000	
Dividends	240,000	$900,000
Less: Expenses from operations		(720,000)
Income before the dividends received deduction		$180,000
Dividends received deduction (70% × $180,000)		(126,000)
Taxable income		$ 54,000

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

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

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

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

54. (LO 3) Following the procedure used in Example 26 in the text, proceed as follows:

	Almond Corporation	Blond Corporation	Cherry Corporation
Step 1			
70% × $100,000 (dividend received)	$70,000		
70% × $100,000 (dividend received)		$70,000	
70% × $100,000 (dividend received)			$70,000
Step 2			
70% × $200,000 (taxable income before DRD)	$140,000		
70% × $50,000 (taxable income before DRD)		$35,000	
70% × $90,000 (taxable income before DRD)			$63,000
Step 3			
Lesser of Step 1 or Step 2	$70,000		$63,000
Generates a net operating loss (use Step 1)		$70,000	

Consequently, the dividends received deduction for Almond Corporation is $70,000 under the general rule. Blond Corporation also claims a dividends received deduction of $70,000 because a net operating loss results when the Step 1 amount ($70,000) is subtracted from 100% of taxable income before DRD ($50,000). Cherry Corporation, however, is subject to the taxable income limitation and is allowed only $63,000 as a dividends received deduction.

55. (LO 3)

a. For 2016, the deduction for organizational expenditures is $5,422 {$5,000 (amount that can be immediately expensed) + [($43,000 – $5,000) ÷ 180 months × 2 months]}. Except for the expenses related to the printing and sale of the stock certificates, all other expenses qualify for the § 248 amortization election. Thus, organizational expenditures total $43,000 ($21,000 + $3,000 + $19,000). To qualify for the election, the expenditure must be *incurred* before the end of the taxable year in which the corporation begins business. Since the legal fees were incurred in 2016, the $19,000 qualifies as organizational expenditures.

b. Organizational expenditures now total $52,000 ($21,000 + $3,000 + $28,000). Since organizational expenditures exceed $50,000, the $5,000 first-year expensing limit is reduced to $3,000 [$5,000 – ($52,000 – $50,000)]. Thus, the 2016 deduction for organizational expenditures is $3,544 {$3,000 (amount immediately expensed) + [($52,000 – $3,000) ÷ 180 months × 2 months]}.

56. (LO 3) All $41,500 of the expenditures are startup expenditures. Egret can elect under § 195 to currently write off the first $5,000 and to amortize the remaining amount of such expenditures over a 180-month period beginning with the month in which it begins business (i.e., July 1, 2016). Thus, Egret's deduction in 2016 for startup expenditures is $6,217 {$5,000 + $1,217 [($41,500 – $5,000) ÷ 180 months × 6 months]}. Egret makes the § 195 election simply by claiming the deduction on its 2016 tax return. (If Egret decides to forgo the § 195 election, the $41,500 must be capitalized and is deductible only when the corporation ceases to do business and liquidates.)

57. (LO 4)

Purple Corporation:	
Tax on—$65,000	
Tax on $50,000 × 15%	$ 7,500
Tax on $15,000 × 25%	3,750
Total tax	$ 11,250
Azul Corporation:	
Tax on—$290,000	
Tax on $100,000	$ 22,250
Tax on $190,000 × 39%	74,100
Total tax	$ 96,350
Pink Corporation:	
Tax on—$12,350,000	
Tax on $10 million	$3,400,000
Tax on $2,350,000 × 35%	822,500
Total tax	$4,222,500
Turquoise Corporation:	
Tax on $19,000,000 × 35%	$6,650,000
Teal Corporation (a personal service corporation):	
Tax on $130,000 × 35%	$ 45,500

58. (LO 5) Since Red and White are members of a controlled group of corporations, and since they did not consent to an apportionment plan, the marginal tax brackets are apportioned equally to the two entities. As such, Red Corporation's income tax liability is $42,325 [($25,000 × 15%) + ($12,500 × 25%) + ($12,500 × 34%) + ($80,000 × 39%)], and White Corporation's income tax liability is $69,625 [($25,000 × 15%) + ($12,500 × 25%) + ($12,500 × 34%) + ($150,000 × 39%)]. (Note that the combined tax liability of $111,950 for the two corporations is equal to the tax liability they would have incurred if they were taxed as one corporation with their combined taxable income of $330,000.)

59. (LO 6) Grouse, a large corporation, may use the prior year's tax liability exception only for purposes of its first estimated tax payment for 2016. Any shortfall from not using the current year's (2016) tax liability for the first installment must be paid in conjunction with the second installment payment. As such, Grouse's installment payment dates and amounts are as follows:

Payment	Amount
April 15, 2016	$ 59,500*
June 15, 2016	212,500**
September 15, 2016	136,000
December 15, 2016	136,000
Total	$544,000

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

**Based on current year's tax, for remaining installments: [$1,600,000 taxable income × 34% (see Exhibit 2.1)] = $544,000 ÷ 4 = $136,000. Second installment must include shortfall from first installment: [$136,000 + ($136,000 – $59,500)] = $212,500.

60. (LO 6) Emerald's net income per books is reconciled to taxable income as follows:

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

61. (LO 6) Sparrow's net income per books is reconciled to taxable income as follows:

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

62. (LO 6) Dove's unappropriated retained earnings per books, as of December 31, 2016, is determined as follows:

Balance at beginning of year	$ 796,010
Plus:	
Net income (loss) per books	386,250
Subtotal	$ 1,182,260
Minus:	
Cash dividend distributions	(150,000)
Balance at end of year	$ 1,032,260

63. (LO 6) Pelican, Inc., reports the meals and entertainment expenditures on line 11, Part III as follows: book expense of $10,000 in column (a), permanent difference of ($5,000) in column (c), and tax return deduction of $5,000 in column (d). This problem illustrates reporting procedures when book expenses are greater than tax return deductions. It also illustrates the reporting of permanent differences.

64. (LO 6) Pelican, Inc., reports the fines and penalties on line 12, Part III as follows: book expense of $50,000 in column (a), permanent difference of ($50,000) in column (c), and tax return deduction of $0 in column (d). Further, Pelican, Inc., reports the depreciation on line 31, Part III as follows: book expense of $245,000 in column (a), temporary difference of $65,000 in column (b), and tax return deduction of $310,000 in column (d). This problem illustrates the Schedule M–3 reporting when book expenses are both more than and less than tax return deductions. It also illustrates the reporting of both temporary and permanent differences.

65. (LO 6) These amounts must be reported on line 32, Part III as follows: $190,000 book bad debt expense in column (a), ($130,000) temporary difference in column (b), and $60,000 tax return bad debt expense in column (d). This problem illustrates reporting procedures when book expenses are greater than tax return deductions. It also illustrates the reporting of temporary differences.

66. (LO 2, 3, 7) Organizational expenditures and startup expenditures were incurred in January, February, and March. For both types of expenditures, the corporation can elect to expense the first $5,000 of qualifying expenditures and amortize the remaining balance over a period of 180 months. Don and Steve should identify the organizational and startup expenditures that qualify, and decide whether to make the elections. Since the elections are deemed to be made, a decision to forgo either would require a statement to that effect attached to the corporation's return.

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

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

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

RESEARCH PROBLEMS

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

Reasons sufficient to satisfy the business purpose standard:

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

Reasons *insufficient* to satisfy the business purpose standard:

- Deferral of income to shareholders [§ 441(i); Reg. § 1.442-1(b)(2)];
- The use of a particular year for regulatory or financial accounting purposes;
- The hiring patterns of a particular business;
- The use of a particular year for administrative purposes;

- The fact that a particular business involves the use of price lists, model years, or other items that change on an annual basis;
- The use of a particular year by related entities; and
- The use of a particular year by competitors [Rev.Proc. 2002-39, 2002-1 C.B. 1046].

2. TAX FILE MEMORANDUM

Date: September 17, 2016

From: Leticia Ramirez

Subject: Startup expenditures of John's Premium Steakhouse, Inc.

Today, I talked with John Dobson regarding the tax treatment of startup expenditures related to the opening of a new restaurant. Mr. Dobson recently formed John's Premium Steakhouse, Inc., with a contribution of cash in exchange for 100% of the corporation's stock. The corporation has since entered in leases for a building and restaurant equipment. Mr. Dobson requested guidance on the tax treatment of the various operating expenses the corporation expects to incur prior to the opening of the restaurant.

At issue: What is the correct tax treatment of startup expenditures?

Conclusion: Section 195 governs the deductibility of startup expenditures. Under § 195(c)(1), "startup expenditures" include amounts paid or incurred in connection with (1) investigating the creation or acquisition of an active business or (2) creating an active business. In addition, startup expenditures must be amounts that would be deductible as business expenses (under § 162) if incurred in connection with the operation of an existing active business. Startup expenditures that John's Premium Steakhouse might incur include rent or lease expense, licensing fees, utilities, employee salaries and benefits (e.g., for training and other work performed during the pre-opening period), advertising, and food costs (e.g., testing menu items during the pre-opening period). Startup expenditures do not include amounts paid for the purchase of depreciable property. Startup expenditures also do not include organizational expenditures, but such amounts are deductible (under § 248) in the same manner as startup expenditures.

Under § 195(b), a taxpayer can elect to deduct the first $5,000 of startup expenditures and amortize the remainder of expenditures over the 180-month period beginning with the month the business begins. The $5,000 expensing amount is reduced to the extent startup expenditures exceed $50,000. Under Reg. § 1.195-1(b), the election to deduct startup expenditures is deemed made by claiming the proper deduction amount on the corporation's tax return for the year in which the business begins. (Alternatively, the corporation can forgo the election by including with the tax return a statement that clearly indicates an election to capitalize startup expenditures. Capitalized expenditures are deductible when the corporation ceases business and liquidates.)

The determination of when a business begins is important for two reasons. First, startup expenditures are not deductible until such time the business begins. Second, once a business has begun, the startup phase is done and further operating expenditures are deductible as trade or business expenses (under § 162). The IRS is authorized to prescribe regulations on when a business begins under § 195, but to date no such regulations have been issued [§ 195(c)(2)(A)]. However, the deduction for organizational expenditures has the same commencement of business requirement [see § 248(a)], and Reg. § 1.248-1(d) provides that a "corporation begins business when it starts the business operations for which it was organized." Further, the courts have held that for purposes of § 195, a taxpayer is not engaged in a business until such time the business has begun to operate as a going concern and performed the activities for which it was formed. See, *Richmond Television Corp. v. U.S.*, 65-1 USTC ¶9395, 15 AFTR 2d 880, 345 F.2d 901 (CA-4, 1965), vacated and remanded on other grounds, 86 S.Ct. 233 (USSC, 1965); and *Yuri G. Glotov*, 93 TCM 1339, T.C.Memo 2007-147. In the case of John's Premium Steakhouse, the startup phase would terminate and the active business would commence when the restaurant begins serving meals to customers in the normal course of business.

3. TAX FILE MEMORANDUM

Date: May 2, 2016

From: Jonathan Smith

Subject: Tern Corporation

Facts: Tern Corporation, a calendar year C Corporation, is solely owned by Jessica Ramirez. Tern's only business since its incorporation in 2013 has been land surveying services. In Tern's state of incorporation, land surveying can be performed only by a licensed surveyor. Jessica, Tern's only employee, is a licensed surveyor. Jessica is not a licensed engineer. Upon audit of Tern's 2013 and 2014 tax returns, the IRS asserted tax deficiencies stemming from its conclusion that the corporation was a personal service corporation subject to the flat tax rate of 35%. Jessica believes that the IRS's determination is incorrect and she has requested advice on how to proceed.

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

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

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

Research Problems 4 to 7

The Internet Activity research problems require that students utilize online resources to research and answer the questions. As a result, solutions may vary among students and courses. You should determine the skill and experience levels of the students before assigning these problems, coaching where necessary. Encourage students to explore all parts of the Web in this research process, including tax research databases, as well as the websites of the IRS, newspapers, magazines, businesses, tax professionals, other government agencies, and political outlets. Students should also work with resources such as blogs, Twitter feeds, and other interest-oriented technologies to research their answers.

CHECK FIGURES

26.a. Zero.
26.b. $7,000.
27.a. $589,765.
27.b. Section 1231 gain of $571,812 and § 1250 recapture of $17,953.
28. $15,000.
29.a. $27,000.
29.b. $32,000.
29.c. $130,000.
30.a. $70,000.
30.b. $154,000.
31. $3,650.
32.a. $12,000.
32.b. $3,680,000.
32.c. $59,500.
33.a. Roger will report profit $45,000 and long-term capital loss $10,000.
33.b. Riflebird taxable income $45,000 and $10,000 STCL carryback. Roger no consequences.
34.a. Each partner reports $55,000 net profit and long-term capital gain $7,500.
34.b. Same as part a.
34.c. Corporation reports $125,000 income. Shareholders each report $25,000 dividend income.
35.a. Azure tax of $119,000; Sasha $0 tax.
35.b. Azure tax of $119,000; Sasha $15,000 tax.
35.c. Azure tax of $90,500; Sasha $29,700 tax.
35.d. Azure tax of $0; Sasha $138,600 tax.
35.e. Azure tax of $0; Sasha $138,600 tax.
36.a. Taupe tax of $0; Torsten tax of $172,320.
36.b. Taupe tax of $153,000; Torsten $0 tax.
37.a. After-tax income $153,861.
37.b. After-tax income $125,137.
37.c. After-tax income $109,761.
38.a. $17,400 itemized deduction.
38.b. $40,000.
39.a. $49,500.
39.b. $40,500.
39.c. $41,750.
39.d. $46,875.
40.a. $84,000.
40.b. $33,250.
41.a. $440,000.
41.b. $460,000.
42.a. $10,500.
42.b. $12,500.
43.a. $105,000 taxable income; $24,200 tax.
43.b. $90,000 taxable income; $18,850 tax.
44.a. $21,000 deducted; $19,000 carried forward.
44.b. $18,000 deducted; $22,000 carried back 3 years and forward 5 years.
45.a. Offset short-term capital gain of $15,000 against net long-term capital loss of $105,000. The $90,000 net capital loss must be carried back 3 years against net capital gains.
45.b. Total carryback $63,000.
45.c. $27,000; carry forward to 2017, etc.
45.d. Deduct $18,000 in 2016, $87,000 carried forward indefinitely.
46.a. Ordinary income of $57,498 and § 1231 gain of $429,994.
46.b. Section 1231 gain of $487,492.
47.a. $430,000.
47.b. $355,000.
48. $118,500.
49. Sell Brown stock and donate proceeds.
50. Gift land in 2017.
51. 2016.
52.a. $81,000.
52.b. $75,000.
53.a. $54,000.
53.b. ($12,000).
54. Almond $70,000; Blond $70,000; Cherry $63,000.
55.a. $5,422.
55.b. $3,544.
56. $6,217.
57. Purple $11,250; Azul $96,350; Pink $4,222,500; Turquoise $6,650,000; Teal $45,500.
58. Red $42,325; White $69,625.
59. April 15, $59,500; June 15, $212,500; September 15, $136,000; December 15, $136,000.
60. Taxable income of $150,000.
61. Taxable income of $265,000.
62. $1,032,260.

SOLUTION TO ETHICS & EQUITY FEATURE

Pushing the Envelope on Year-End Planning (p. 2-19). Currently, Lark Corporation's dividends received deduction is $98,700, as limited by the taxable income limitation ($497,000 – $556,000 + $200,000 = $141,000 taxable income before the dividends received deduction × 70% = $98,700). The NOL rule does not currently apply since subtracting $140,000 ($200,000 × 70%) does not yield a negative number. However, if the tax department's recommendation is implemented and deductible expenditures are increased by $1,001 by year end, the NOL rule would apply: $141,000 – $1,001 = $139,999 revised taxable income before the dividends received deduction – $140,000 dividends received deduction = ($1) NOL. Thus, an additional $1,001 of deductible expenditures would increase Lark's dividends received deduction by $41,300 ($140,000 – $98,700). There is nothing unethical about this year-end tax planning strategy. As long as the additional expenditures satisfy the requirements for a trade or business deduction, the strategy should be successful in taking advantage of the NOL rule. If Congress is concerned about year-end tax planning techniques such as this, it certainly has the authority to amend the dividends received deduction provisions (see, e.g., holding period and debt-financed stock restrictions). Until such time, however, taxpayers should not be faulted for taking advantage of legitimate tax saving opportunities.

SOLUTIONS TO ROGER CPA REVIEW QUESTIONS

Detailed answer feedback for Roger CPA Review questions is available on the instructor companion site (www.cengage.com/login).

1.	d	5.	c
2.	b	6.	b
3.	d	7.	d
4.	a		

TAX RETURN PROBLEMS

Problem 1: Pet Kingdom Corporate Tax Return

Form **1120** — Department of the Treasury, Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2015 or tax year beginning _______________ , ending _______________

► Information about Form 1120 and its separate instructions is at *www.irs.gov/form1120*.

OMB No. 1545-0123 — **2015**

A Check if: 1a Consolidated return (attach Form 851) ☐	Name: Pet Kingdom, Inc.	B Employer identification number: 11-1111111
b Life/nonlife consolidated return ☐	Number, street, and room or suite no. If a P.O. box, see instructions.: 1010 Northwest Parkway	C Date incorporated: 11/1/2006
2 Personal holding co. (attach Sch. PH) ☐	City or town: Dallas; State: TX; ZIP code: 75225	D Total assets (see instructions)
3 Personal service corp. (see instructions) ☐	Foreign country name; Foreign province/state/county; Foreign postal code	$ 13,802,727
4 Schedule M-3 attached ☒	E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change	

TYPE OR PRINT

Income	1a	Gross receipts or sales	1a	5,750,000		
	b	Returns and allowance	1b	200,000		
	c	Balance. Subtract line 1b from line 1a			1c	5,550,000
	2	Cost of goods sold (attach Form 1125-A)			2	2,300,000
	3	Gross profit. Subtract line 2 from line 1c			3	3,250,000
	4	Dividends (Schedule C, line 19)			4	43,750
	5	Interest			5	20,000
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	
	10	Other income (see instructions—attach statement)			10	
	11	**Total income.** Add lines 3 through 10 ►			11	3,313,750
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ►			12	525,000
	13	Salaries and wages (less employment credits)			13	725,000
	14	Repairs and maintenance			14	140,000
	15	Bad debts			15	
	16	Rents			16	109,000
	17	Taxes and licenses			17	238,000
	18	Interest			18	207,000
	19	Charitable contributions			19	38,000
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	136,000
	21	Depletion			21	
	22	Advertising			22	58,000
	23	Pension, profit-sharing, etc., plans			23	
	24	Employee benefit programs			24	60,000
	25	Domestic production activities deduction (attach Form 8903)			25	
	26	Other deductions (attach statement)			26	
	27	**Total deductions.** Add lines 12 through 26 ►			27	2,236,000
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	1,077,750
	29a	Net operating loss deduction (see instructions)	29a			
	b	Special deductions (Schedule C, line 20)	29b	30,625		
	c	Add lines 29a and 29b			29c	30,625
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28 (see instructions)			30	1,047,125
	31	Total tax (Schedule J, Part I, line 11)			31	356,023
	32	Total payments and refundable credits (Schedule J, Part II, line 21)			32	360,000
	33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ► ☐			33	
	34	**Amount owed.** If line 32 is smaller than the total of lines 31 and 33, enter amount owed			34	0
	35	**Overpayment.** If line 32 is larger than the total of lines 31 and 33, enter amount overpaid			35	3,977
	36	Enter amount from line 35 you want: **Credited to 2016 estimated tax** ►		**Refunded** ►	36	3,977

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer ____ Date ____ Title ____

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	SELF-PREPARED RETURN			
Firm's name ►			Firm's EIN ►	
Firm's address ►			Phone no.	
City	State		ZIP code	

For Paperwork Reduction Act Notice, see separate instructions. Form **1120** (2015)

HTA

Form 1120 (2015) Pet Kingdom, Inc. 11-1111111 Page 2

Schedule C Dividends and Special Deductions (see instructions)	(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1 Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)	43,750	70	30,625
2 Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	0
3 Dividends on debt-financed stock of domestic and foreign corporations		see instructions	0
4 Dividends on certain preferred stock of less-than-20%-owned public utilities		42	0
5 Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	0
6 Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	0
7 Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	0
8 Dividends from wholly owned foreign subsidiaries		100	0
9 **Total.** Add lines 1 through 8. See instructions for limitation			30,625
10 Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	0
11 Dividends from affiliated group members		100	0
12 Dividends from certain FSCs		100	0
13 Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14 Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15 Foreign dividend gross-up			
16 IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17 Other dividends			
18 Deduction for dividends paid on certain preferred stock of public utilities			
19 **Total dividends.** Add lines 1 through 17. Enter here and on page 1, line 4 ►	43,750		
20 **Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ►			30,625

Form 1120 (2015)

Form 1120 (2015) Pet Kingdom, Inc. 11-1111111 Page 3

Schedule J **Tax Computation and Payment** (see instructions)

Part I–Tax Computation

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)) ▶ ☐				
2	Income tax. Check if a qualified personal service corporation (see instructions) ▶ ☐			2	356,023
3	Alternative minimum tax (attach Form 4626)			3	
4	Add lines 2 and 3			4	356,023
5a	Foreign tax credit (attach Form 1118)	5a			
b	Credit from Form 8834 (see instructions)	5b			
c	General business credit (attach Form 3800)	5c			
d	Credit for prior year minimum tax (attach Form 8827)	5d			
e	Bond credits from Form 8912	5e			
6	**Total credits.** Add lines 5a through 5e			6	0
7	Subtract line 6 from line 4			7	356,023
8	Personal holding company tax (attach Schedule PH (Form 1120))			8	
9a	Recapture of investment credit (attach Form 4255)	9a			
b	Recapture of low-income housing credit (attach Form 8611)	9b			
c	Interest due under the look-back method—completed long-term contracts (attach Form 8697)	9c			
d	Interest due under the look-back method—income forecast method (attach Form 8866)	9d			
e	Alternative tax on qualifying shipping activities (attach Form 8902)	9e			
f	Other (see instructions—attach statement)	9f			
10	**Total.** Add lines 9a through 9f			10	0
11	**Total tax.** Add lines 7, 8, and 10. Enter here and on page 1, line 31			11	356,023

Part II–Payments and Refundable Credits

12	2014 overpayment credited to 2015			12	
13	2015 estimated tax payments			13	360,000
14	2015 refund applied for on Form 4466			14	( )
15	Combine lines 12, 13, and 14			15	360,000
16	Tax deposited with Form 7004			16	
17	Withholding (see instructions)			17	
18	**Total payments.** Add lines 15, 16, and 17			18	360,000
19	Refundable credits from:				
a	Form 2439	19a			
b	Form 4136	19b			
c	Form 8827, line 8c	19c			
d	Other (attach statement—see instructions)	19d			
20	**Total credits.** Add lines 19a through 19d			20	0
21	**Total payments and credits.** Add lines 18 and 20. Enter here and on page 1, line 32			21	360,000

Schedule K **Other Information** (see instructions)

		Yes	No
1	Check accounting method: a ☐ Cash b ☒ Accrual c ☐ Other (specify) ▶		
2	See the instructions and enter the:		
a	Business activity code no. ▶ 453910		
b	Business activity ▶ Retail Trade		
c	Product or service ▶ Pet and Pet Supplies Store		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? If "Yes," enter name and EIN of the parent corporation ▶		X
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		X
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G)	X	

Form **1120** (2015)

Form 1120 (2015) Pet Kingdom, Inc. 11-1111111 Page 4

Schedule K **Other Information** *continued* (see instructions)

		Yes	No
5	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851,** Affiliations Schedule? For rules of constructive ownership, see instructions . .		X
	If "Yes," complete (i) through (iv) below.		

(i) Name of Corporation	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Incorporation	**(iv)** Percentage Owned in Voting Stock

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions . .		X
	If "Yes," complete (i) through (iv) below.		

(i) Name of Entity	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Organization	**(iv)** Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.)		X
	If "Yes," file **Form 5452,** Corporate Report of Nondividend Distributions. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.		
7	At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of **(a)** the total voting power of all classes of the corporation's stock entitled to vote or **(b)** the total value of all classes of the corporation's stock?		X
	For rules of attribution, see section 318. If "Yes," enter: **(i)** Percentage owned ► ______ and **(ii)** Owner's country ► ______ **(c)** The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ► ______		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount . . . . ► ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
9	Enter the amount of tax-exempt interest received or accrued during the tax year ► $ 15,000		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ► 2		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here . . . . ► ☐ If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.		
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ► $ ______		
13	Are the corporation's total receipts (page 1, line 1a, plus lines 4 through 10) for the tax year **and** its total assets at the end of the tax year less than $250,000?		X
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ► $ ______		
14	Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement (see instructions)?		X
	If "Yes," complete and attach Schedule UTP.		
15a	Did the corporation make any payments in 2015 that would require it to file Form(s) 1099?	X	
b	If "Yes," did or will the corporation file required Forms 1099?	X	
16	During this tax year, did the corporation have an 80% or more change in ownership, including a change due to redemption of its own stock?		X
17	During or subsequent to this tax year, but before the filing of this return, did the corporation dispose of more than 65% (by value) of its assets in a taxable, non-taxable, or tax deferred transaction?		X
18	Did the corporation receive assets in a section 351 transfer in which any of the transferred assets had a fair market basis or fair market value of more than $1 million?		X

Form **1120** (2015)

Form 1120 (2015) Pet Kingdom, Inc. 11-1111111 Page 5

Schedule L Balance Sheets per Books

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash		1,200,000		1,037,750
2a Trade notes and accounts receivable	2,062,500		2,147,000	
b Less allowance for bad debts	( )	2,062,500	( )	2,147,000
3 Inventories		2,750,000		3,030,000
4 U.S. government obligations				
5 Tax-exempt securities (see instructions)		375,000		375,000
6 Other current assets (attach statement)		400,000		403,977
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach statement)		1,125,000		1,125,000
10a Buildings and other depreciable assets	5,455,000		5,455,000	
b Less accumulated depreciation	(606,000)	4,849,000	(712,000)	4,743,000
11a Depletable assets				
b Less accumulated depletion	( )	0	( )	0
12 Land (net of any amortization)		812,500		812,500
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )	0	( )	0
14 Other assets (attach statement)		140,000		128,500
15 Total assets		13,714,000		13,802,727
Liabilities and Shareholders' Equity				
16 Accounts payable		2,284,000		1,975,000
17 Mortgages, notes, bonds payable in less than 1 year				
18 Other current liabilities (attach statement)		175,000		155,000
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more		4,625,000		4,575,000
21 Other liabilities (attach statement)				
22 Capital stock: a Preferred stock				
b Common stock	2,500,000	2,500,000	2,500,000	2,500,000
23 Additional paid-in capital				
24 Retained earnings—Appropriated (attach statement)				
25 Retained earnings—Unappropriated		4,130,000		4,597,727
26 Adjustments to shareholders' equity (attach statement)				
27 Less cost of treasury stock		( )		( )
28 Total liabilities and shareholders' equity		13,714,000		13,802,727

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return

Note: The corporation may be required to file Schedule M-3 (see instructions).

1 Net income (loss) per books		7 Income recorded on books this year not included on this return (itemize): Tax-exempt interest $	0
2 Federal income tax per books			
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize):	0	8 Deductions on this return not charged against book income this year (itemize): a Depreciation $ b Charitable contributions $	0
5 Expenses recorded on books this year not deducted on this return (itemize): a Depreciation $ b Charitable contributions $ c Travel and entertainment $	0	9 Add lines 7 and 8	0
6 Add lines 1 through 5	0	10 Income (page 1, line 28)—line 6 less line 9	0

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1 Balance at beginning of year	4,130,000	5 Distributions: a Cash	250,000
2 Net income (loss) per books	717,727	b Stock	
3 Other increases (itemize):		c Property	
		6 Other decreases (itemize):	
	0	7 Add lines 5 and 6	250,000
4 Add lines 1, 2, and 3	4,847,727	8 Balance at end of year (line 4 less line 7)	4,597,727

Form **1120** (2015)

Form **1125-A**
(Rev. December 2012)
Department of the Treasury
Internal Revenue Service

Cost of Goods Sold

▶ Attach to Form 1120, 1120-C, 1120-F, 1120S, 1065, or 1065-B.
▶ Information about Form 1125-A and its instructions is at *www.irs.gov/form1125a*.

OMB No. 1545-2225

Name: Pet Kingdom, Inc.
Employer identification number: 11-1111111

1	Inventory at beginning of year	1	2,750,000
2	Purchases	2	2,580,000
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	**Total.** Add lines 1 through 5	6	5,330,000
7	Inventory at end of year	7	3,030,000
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return (see instructions)	8	2,300,000

9 a Check all methods used for valuing closing inventory:
- *(i)* ☐ Cost
- *(ii)* ☒ Lower of cost or market
- *(iii)* ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO — 9d

e If property is produced or acquired for resale, do the rules of section 263A apply to the entity (see instructions)? ☐ Yes ☒ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☒ No

For Paperwork Reduction Act Notice, see instructions. Form **1125-A** (Rev. 12-2012)
HTA

SCHEDULE G
(Form 1120)
(Rev. December 2011)
Department of the Treasury
Internal Revenue Service

Information on Certain Persons Owning the Corporation's Voting Stock

▶ **Attach to Form 1120.**
▶ **See instructions on page 2.**

OMB No.1545-0123

Name	Employer identification number (EIN)
Pet Kingdom, Inc.	11-1111111

Part I **Certain Entities Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4a). Complete columns (i) through (v) below for any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Percentage Owned in Voting Stock

Part II **Certain Individuals and Estates Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4b). Complete columns (i) through (iv) below for any individual or estate that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

(i) Name of Individual or Estate	(ii) Identifying Number (if any)	(iii) Country of Citizenship (see instructions)	(iv) Percentage Owned in Voting Stock
Janet Morton	123-45-6789	United States	50.000%
Kim Wong	987-65-4321	United States	50.000%

For Paperwork Reduction Act Notice, see the Instructions for Form 1120.
1833

Schedule G (Form 1120) (Rev. 12-2011)

SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More

►Attach to Form 1120 or 1120-C. ►Information about Schedule M-3 (Form 1120) and its separate instructions is available at *www.irs.gov/form1120*.

OMB No. 1545-0123

2015

Name of corporation (common parent, if consolidated return): Pet Kingdom, Inc.

Employer identification number: 11-1111111

Check applicable box(es): (1) [X] Non-consolidated return (2) [ ] Consolidated return (Form 1120 only)

(3) [ ] Mixed 1120/L/PC group (4) [ ] Dormant subsidiaries schedule attached

Part I Financial Information and Net Income (Loss) Reconciliation (see instructions)

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
[ ] **Yes.** Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
[X] **No.** Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.

b Did the corporation prepare a certified audited non-tax-basis income statement for that period?
[ ] **Yes.** Skip line 1c and complete lines 2a through 11 with respect to that income statement.
[X] **No.** Go to line 1c.

c Did the corporation prepare a non-tax-basis income statement for that period?
[X] **Yes.** Complete lines 2a through 11 with respect to that income statement.
[ ] **No.** Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4a.

2a Enter the income statement period: Beginning 1/1/2015 Ending 12/31/2015

b Has the corporation's income statement been restated for the income statement period on line 2a?
[ ] **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
[X] **No.**

c Has the corporation's income statement been restated for any of the five income statement periods immediately preceding the period on line 2a?
[ ] **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
[X] **No.**

3a Is any of the corporation's voting common stock publicly traded?
[ ] **Yes.**
[X] **No.** If "No," go to line 4a.

b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock . . . .

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock . . . .

4a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4a	717,727
b	Indicate accounting standard used for line 4a (see instructions): (1) [X] GAAP (2) [ ] IFRS (3) [ ] Statutory (4) [ ] Tax-basis (5) [ ] Other (specify) ________		
5a	Net income from nonincludible foreign entities (attach statement)	5a	( )
b	Net loss from nonincludible foreign entities (attach statement and enter as a positive amount)	5b	
6a	Net income from nonincludible U.S. entities (attach statement)	6a	( )
b	Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	6b	
7a	Net income (loss) of other includible foreign disregarded entities (attach statement)	7a	
b	Net income (loss) of other includible U.S. disregarded entities (attach statement)	7b	
c	Net income (loss) of other includible entities (attach statement)	7c	
8	Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	8	
9	Adjustment to reconcile income statement period to tax year (attach statement)	9	
10a	Intercompany dividend adjustments to reconcile to line 11 (attach statement)	10a	
b	Other statutory accounting adjustments to reconcile to line 11 (attach statement)	10b	
c	Other adjustments to reconcile to amount on line 11 (attach statement)	10c	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10 . . .	11	717,727

Note: Part I, line 11, must equal Part II, line 30, column (a) or Schedule M-1, line 1 (see instructions).

12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines.

		Total Assets	Total Liabilities
a	Included on Part I, line 4 . . . . ►	13,802,727	6,705,000
b	Removed on Part I, line 5 . . . . ►		
c	Removed on Part I, line 6 . . . . ►		
d	Included on Part I, line 7 . . . . ►		

For Paperwork Reduction Act Notice, see the Instructions for Form 1120. **Schedule M-3 (Form 1120) 2015**

HTA

Schedule M-3 (Form 1120) 2015 Page **2**

Name of corporation (common parent, if consolidated return)	**Employer identification number**
Pet Kingdom, Inc.	11-1111111

Check applicable box(es): **(1)** ☐ Consolidated group **(2)** ☐ Parent corp **(3)** ☐ Consolidated eliminations **(4)** ☐ Subsidiary corp **(5)** ☐ Mixed 1120/L/PC group

Check if a sub-consolidated: **(6)** ☐ 1120 group **(7)** ☐ 1120 eliminations

Name of subsidiary (if consolidated return)	**Employer identification number**

Part II **Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return** (see instructions)

	Income (Loss) Items (Attach statements for lines 1 through 12)	**(a)** Income (Loss) per Income Statement	**(b)** Temporary Difference	**(c)** Permanent Difference	**(d)** Income (Loss) per Tax Return
1	Income (loss) from equity method foreign corporations				
2	Gross foreign dividends not previously taxed				
3	Subpart F, QEF, and similar income inclusions				
4	Section 78 gross-up				
5	Gross foreign distributions previously taxed				
6	Income (loss) from equity method U.S. corporations				
7	U.S. dividends not eliminated in tax consolidation	43,750			43,750
8	Minority interest for includible corporations				
9	Income (loss) from U.S. partnerships				
10	Income (loss) from foreign partnerships				
11	Income (loss) from other pass-through entities				
12	Items relating to reportable transactions				
13	Interest income (see instructions)	35,000		(15,000)	20,000
14	Total accrual to cash adjustment				
15	Hedging transactions				
16	Mark-to-market income (loss)				
17	Cost of goods sold (see instructions)	(2,300,000)			(2,300,000)
18	Sale versus lease (for sellers and/or lessors)				
19	Section 481(a) adjustments				
20	Unearned/deferred revenue				
21	Income recognition from long-term contracts				
22	Original issue discount and other imputed interest				
23a	Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b	Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c	Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d	Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e	Abandonment losses				
f	Worthless stock losses (attach statement)				
g	Other gain/loss on disposition of assets other than inventory				
24	Capital loss limitation and carryforward used				
25	Other income (loss) items with differences (attach statement)				
26	**Total income (loss) items.** Combine lines 1 through 25	(2,221,250)	0	(15,000)	(2,236,250)
27	**Total expense/deduction items** (from Part III, line 38)	(756,023)	(30,000)	405,023	(381,000)
28	Other items with no differences	3,695,000			3,695,000
29a	Mixed groups, see instructions. All others, combine lines 26 through 28	717,727	(30,000)	390,023	1,077,750
b	PC insurance subgroup reconciliation totals				
c	Life insurance subgroup reconciliation totals				
30	**Reconciliation totals.** Combine lines 29a through 29c	717,727	(30,000)	390,023	1,077,750

Note: Line 30, column (a), must equal Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

Schedule M-3 (Form 1120) 2015

Schedule M-3 (Form 1120) 2015 Page 3

Name of corporation (common parent, if consolidated return): Pet Kingdom, Inc.

Employer identification number: 11-1111111

Check applicable box(es): (1) ☐ Consolidated group (2) ☐ Parent corp (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corp (5) ☐ Mixed 1120/L/PC group

Check if a sub-consolidated: (6) ☐ 1120 group (7) ☐ 1120 eliminations

Name of subsidiary (if consolidated return)

Employer identification number

Part III **Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items** (see instructions)

	Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1	U.S. current income tax expense	356,023		(356,023)	
2	U.S. deferred income tax expense				
3	State and local current income tax expense				
4	State and local deferred income tax expense				
5	Foreign current income tax expense (other than foreign withholding taxes)				
6	Foreign deferred income tax expense				
7	Foreign withholding taxes				
8	Interest expense (see instructions)	216,000		(9,000)	207,000
9	Stock option expense				
10	Other equity-based compensation				
11	Meals and entertainment				
12	Fines and penalties				
13	Judgments, damages, awards, and similar costs				
14	Parachute payments				
15	Compensation with section 162(m) limitation				
16	Pension and profit-sharing				
17	Other post-retirement benefits				
18	Deferred compensation				
19	Charitable contribution of cash and tangible property	38,000			38,000
20	Charitable contribution of intangible property				
21	Charitable contribution limitation/carryforward				
22	Domestic production activities deduction				
23	Current year acquisition or reorganization investment banking fees				
24	Current year acquisition or reorganization legal and accounting fees				
25	Current year acquisition/reorganization other costs				
26	Amortization/impairment of goodwill				
27	Amortization of acquisition, reorganization, and start-up costs				
28	Other amortization or impairment write-offs				
29	Reserved				
30	Depletion				
31	Depreciation	106,000	30,000		136,000
32	Bad debt expense				
33	Corporate owned life insurance premiums	40,000		(40,000)	
34	Purchase versus lease (for purchasers and/or lessees)				
35	Research and development costs				
36	Section 118 exclusion (attach statement)				
37	Other expense/deduction items with differences (attach statement)				
38	**Total expense/deduction items.** Combine lines 1 through 37. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive	756,023	30,000	(405,023)	381,000

Schedule M-3 (Form 1120) 2015

Form **1125-E**
(Rev. December 2013)
Department of the Treasury
Internal Revenue Service

Compensation of Officers

▶ Attach to Form 1120, 1120-C, 1120-F, 1120-REIT, 1120-RIC, or 1120S
▶ Information about Form 1125-E and its separate instructions is at *www.irs.gov/form1125e.*

OMB No. 1545-2225

Name: Pet Kingdom, Inc.

Employer identification number: 11-1111111

Note. Complete Form 1125-E only if total receipts are $500,000 or more. See instructions for definition of total receipts.

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of stock owned (d) Common	Percent of stock owned (e) Preferred	(f) Amount of compensation
1	Janet Morton	123-45-6789	100.00%	50.00%	%	262,500
	Kim Wong	987-65-4321	100.00%	50.00%	%	262,500
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
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			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	

2	Total compensation of officers	2	525,000
3	Compensation of officers claimed on Form 1125-A or elsewhere on return	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1120, page 1, line 12 or the appropriate line of your tax return	4	525,000

For Paperwork Reduction Act Notice, see separate instructions. Form **1125-E** (Rev. 12-2013)
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Form **8916-A**

Department of the Treasury
Internal Revenue Service

Supplemental Attachment to Schedule M-3

► Attach to Schedule M-3 for Form 1065, 1120, 1120-L, 1120-PC, or 1120S.
► Information about Form 8916-A and its instructions is at *www.irs.gov/form1120.*

OMB No. 1545-0123

2015

Name of common parent	Employer identification number
Pet Kingdom, Inc.	11-1111111
Name of subsidiary	Employer identification number

Part I Cost of Goods Sold

	Cost of Goods Sold Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1	Amounts attributable to cost flow assumptions . .				
2	Amounts attributable to:				
a	Stock option expense				
b	Other equity based compensation				
c	Meals and entertainment				
d	Parachute payments				
e	Compensation with section 162(m) limitation . . .				
f	Pension and profit sharing				
g	Other post-retirement benefits				
h	Deferred compensation				
i	Reserved				
j	Amortization				
k	Depletion				
l	Depreciation				
m	Corporate owned life insurance premiums				
n	Other section 263A costs				
3	Inventory shrinkage accruals				
4	Excess inventory and obsolescence reserves . . .				
5	Lower of cost or market write-downs				
6	Other items with differences (attach statement) . .				
7	Other items with no differences	2,300,000			2,300,000
8	**Total cost of goods sold.** Add lines 1 through 7 in columns a, b, c, and d. Enter totals on the applicable Schedule M-3. See instructions	2,300,000	0	0	2,300,000

For Paperwork Reduction Act Notice, see instructions. Form **8916-A** (2015)

HTA

Form 8916-A (2015) Pet Kingdom, Inc. 11-1111111 Page **2**

Part II Interest Income

	Interest Income Item	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1	Tax-exempt interest income	15,000		-15,000	
2	Interest income from hybrid securities				
3	Sale/lease interest income				
4a	Intercompany interest income — From outside tax affiliated group				
4b	Intercompany interest income — From tax affiliated group				
5	Other interest income	20,000			20,000
6	Total interest income. Add lines 1 through 5 in columns a, b, c, and d. Enter total on the applicable Schedule M-3. See instructions.	35,000	0	-15,000	20,000

Part III Interest Expense

	Interest Expense Item	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1	Interest expense from hybrid securities				
2	Lease/purchase interest expense				
3a	Intercompany interest expense — Paid to outside tax affiliated group				
3b	Intercompany interest expense — Paid to tax affiliated group				
4	Other interest expense	216,000		-9,000	207,000
5	Total interest expense. Add lines 1 through 4 in columns a, b, c, and d. Enter total on the applicable Schedule M-3. See instructions.	216,000	0	-9,000	207,000

Form **8916-A** (2015)

Pet Kingdom, Inc. 11-1111111

Line 6, Sch L (1120) - Other Current Assets

			Beginning	End
1	Certificates of Deposit	1	400,000	400,000
2	Federal Income Tax Refund Due	2		3,977
3	Total other current assets	3	400,000	403,977

Line 9, Sch L (1120) - Other Investments

			Beginning	End
1	Stock Investments	1	1,125,000	1,125,000
2	Total other investments	2	1,125,000	1,125,000

Line 14, Sch L (1120) - Other Assets

			Beginning	End
1	Other Assets	1	140,000	128,500
2	Total other assets	2	140,000	128,500

Line 18, Sch L (1120) - Other Current Liabilities

			Beginning	End
1	Other Current Liabilities	1	175,000	155,000
2	Total other current liabilities	2	175,000	155,000

Problem 2: Kingfisher Corporate Tax Return

Form **1120** — Department of the Treasury, Internal Revenue Service

U.S. Corporation Income Tax Return

OMB No. 1545-0123 — **2015**

For calendar year 2015 or tax year beginning _______________ , ending _______________

► Information about Form 1120 and its separate instructions is at *www.irs.gov/form1120* .

A Check if:
1a Consolidated return (attach Form 851) ☐
b Life/nonlife consolidated return ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 attached ☐

TYPE OR PRINT

Name: Kingfisher Corporation

Number, street, and room or suite no. If a P.O. box, see instructions: 1717 Main Street

City or town: Ely — State: MN — ZIP code: 55731

Foreign country name — Foreign province/state/county — Foreign postal code

B Employer identification number: 11-1111111

C Date incorporated: 2/12/2003

D Total assets (see instructions): $ 2,564,100

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income	1a	Gross receipts or sales	1a	2,408,000		
	b	Returns and allowance	1b	80,000		
	c	Balance. Subtract line 1b from line 1a			1c	2,328,000
	2	Cost of goods sold (attach Form 1125-A)			2	920,000
	3	Gross profit. Subtract line 2 from line 1c			3	1,408,000
	4	Dividends (Schedule C, line 19)			4	12,000
	5	Interest			5	10,000
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	
	10	Other income (see instructions—attach statement)			10	
	11	**Total income.** Add lines 3 through 10 ►			11	1,430,000
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ►			12	320,000
	13	Salaries and wages (less employment credits)			13	290,000
	14	Repairs and maintenance			14	56,000
	15	Bad debts			15	
	16	Rents			16	68,000
	17	Taxes and licenses			17	85,000
	18	Interest			18	12,000
	19	Charitable contributions			19	15,000
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	40,000
	21	Depletion			21	
	22	Advertising			22	6,000
	23	Pension, profit-sharing, etc., plans			23	
	24	Employee benefit programs			24	24,000
	25	Domestic production activities deduction (attach Form 8903)			25	
	26	Other deductions (attach statement)			26	
	27	**Total deductions.** Add lines 12 through 26 ►			27	916,000
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	514,000
	29a	Net operating loss deduction (see instructions)	29a			
	b	Special deductions (Schedule C, line 20)	29b	8,400		
	c	Add lines 29a and 29b			29c	8,400
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28 (see instructions)			30	505,600
	31	Total tax (Schedule J, Part I, line 11)			31	171,904
	32	Total payments and refundable credits (Schedule J, Part II, line 21)			32	175,000
	33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ► ☐			33	
	34	**Amount owed.** If line 32 is smaller than the total of lines 31 and 33, enter amount owed			34	0
	35	**Overpayment.** If line 32 is larger than the total of lines 31 and 33, enter amount overpaid			35	3,096
	36	Enter amount from line 35 you want: **Credited to 2016 estimated tax** ►		Refunded ►	36	3,096

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

► Signature of officer — Date — ► Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	SELF-PREPARED RETURN			

Firm's name ► — Firm's EIN ►
Firm's address ► — Phone no.
City — State — ZIP code

For Paperwork Reduction Act Notice, see separate instructions. Form **1120** (2015)

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Form 1120 (2015) Kingfisher Corporation 11-1111111 Page 2

Schedule C **Dividends and Special Deductions** (see instructions)

		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)	12,000	70	8,400
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	0
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructions	0
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	0
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	0
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	0
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	0
8	Dividends from wholly owned foreign subsidiaries		100	0
9	**Total.** Add lines 1 through 8. See instructions for limitation			8,400
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	0
11	Dividends from affiliated group members		100	0
12	Dividends from certain FSCs		100	0
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on page 1, line 4 ►	12,000		
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ►			8,400

Form **1120** (2015)

Form 1120 (2015) Kingfisher Corporation 11-1111111 Page 3

Schedule J **Tax Computation and Payment** (see instructions)

Part I–Tax Computation

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)) ▶ ☐				
2	Income tax. Check if a qualified personal service corporation (see instructions) ▶ ☐			2	171,904
3	Alternative minimum tax (attach Form 4626)			3	
4	Add lines 2 and 3			4	171,904
5a	Foreign tax credit (attach Form 1118)	5a			
b	Credit from Form 8834 (see instructions)	5b			
c	General business credit (attach Form 3800)	5c			
d	Credit for prior year minimum tax (attach Form 8827)	5d			
e	Bond credits from Form 8912	5e			
6	**Total credits.** Add lines 5a through 5e			6	0
7	Subtract line 6 from line 4			7	171,904
8	Personal holding company tax (attach Schedule PH (Form 1120))			8	
9a	Recapture of investment credit (attach Form 4255)	9a			
b	Recapture of low-income housing credit (attach Form 8611)	9b			
c	Interest due under the look-back method—completed long-term contracts (attach Form 8697)	9c			
d	Interest due under the look-back method—income forecast method (attach Form 8866)	9d			
e	Alternative tax on qualifying shipping activities (attach Form 8902)	9e			
f	Other (see instructions—attach statement)	9f			
10	**Total.** Add lines 9a through 9f			10	0
11	**Total tax.** Add lines 7, 8, and 10. Enter here and on page 1, line 31			11	171,904

Part II–Payments and Refundable Credits

12	2014 overpayment credited to 2015			12	
13	2015 estimated tax payments			13	175,000
14	2015 refund applied for on Form 4466			14	( )
15	Combine lines 12, 13, and 14			15	175,000
16	Tax deposited with Form 7004			16	
17	Withholding (see instructions)			17	
18	**Total payments.** Add lines 15, 16, and 17			18	175,000
19	Refundable credits from:				
a	Form 2439	19a			
b	Form 4136	19b			
c	Form 8827, line 8c	19c			
d	Other (attach statement—see instructions)	19d			
20	**Total credits.** Add lines 19a through 19d			20	0
21	**Total payments and credits.** Add lines 18 and 20. Enter here and on page 1, line 32			21	175,000

Schedule K **Other Information** (see instructions)

		Yes	No
1	Check accounting method: a ☐ Cash b ☒ Accrual c ☐ Other (specify) ▶		
2	See the instructions and enter the:		
a	Business activity code no. ▶ 451110		
b	Business activity ▶ Retail Sporting Goods		
c	Product or service ▶ Fishing Tackle		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? If "Yes," enter name and EIN of the parent corporation ▶		X
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		X
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G)	X	

Form **1120** (2015)

Form 1120 (2015) Kingfisher Corporation 11-1111111 Page **4**

Schedule K **Other Information** *continued* (see instructions)

		Yes	No
5	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851,** Affiliations Schedule? For rules of constructive ownership, see instructions . .		X
	If "Yes," complete (i) through (iv) below.		

(i) Name of Corporation	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Incorporation	**(iv)** Percentage Owned in Voting Stock

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions . .		X
	If "Yes," complete (i) through (iv) below.		

(i) Name of Entity	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Organization	**(iv)** Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.)		X
	If "Yes," file **Form 5452,** Corporate Report of Nondividend Distributions. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.		
7	At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of **(a)** the total voting power of all classes of the corporation's stock entitled to vote or **(b)** the total value of all classes of the corporation's stock?		X
	For rules of attribution, see section 318. If "Yes," enter: **(i)** Percentage owned ► ______ and **(ii)** Owner's country ► ______		
	(c) The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ► ______		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount . . . . ► ☐		
	If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
9	Enter the amount of tax-exempt interest received or accrued during the tax year ► $ 14,000		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ► 2		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here . . . . ► ☐		
	If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.		
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ► $ ______		
13	Are the corporation's total receipts (page 1, line 1a, plus lines 4 through 10) for the tax year **and** its total assets at the end of the tax year less than $250,000?		X
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ► $ ______		
14	Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement (see instructions)?		X
	If "Yes," complete and attach Schedule UTP.		
15a	Did the corporation make any payments in 2015 that would require it to file Form(s) 1099?	X	
b	If "Yes," did or will the corporation file required Forms 1099?	X	
16	During this tax year, did the corporation have an 80% or more change in ownership, including a change due to redemption of its own stock?		X
17	During or subsequent to this tax year, but before the filing of this return, did the corporation dispose of more than 65% (by value) of its assets in a taxable, non-taxable, or tax deferred transaction?		X
18	Did the corporation receive assets in a section 351 transfer in which any of the transferred assets had a fair market basis or fair market value of more than $1 million?		X

Form **1120** (2015)

Form 1120 (2015) Kingfisher Corporation 11-1111111 Page **5**

Schedule L **Balance Sheets per Books**

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash		380,000		335,524
2a Trade notes and accounts receivable	308,400		480,280	
b Less allowance for bad debts	( )	308,400	( )	480,280
3 Inventories		900,000		1,012,000
4 U.S. government obligations				
5 Tax-exempt securities (see instructions)		160,000		160,000
6 Other current assets (attach statement)				3,096
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach statement)		440,000		440,000
10a Buildings and other depreciable assets	240,000		240,000	
b Less accumulated depreciation	(88,800)	151,200	(128,800)	111,200
11a Depletable assets				
b Less accumulated depletion	( )	0	( )	0
12 Land (net of any amortization)		20,000		20,000
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )	0	( )	0
14 Other assets (attach statement)		3,600		2,000
15 Total assets		2,363,200		2,564,100
Liabilities and Shareholders' Equity				
16 Accounts payable		300,000		299,104
17 Mortgages, notes, bonds payable in less than 1 year				
18 Other current liabilities (attach statement)		80,300		40,000
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more		210,000		200,000
21 Other liabilities (attach statement)				
22 Capital stock: a Preferred stock				
b Common stock	500,000	500,000	500,000	500,000
23 Additional paid-in capital				
24 Retained earnings—Appropriated (attach statement)				
25 Retained earnings—Unappropriated		1,272,900		1,524,996
26 Adjustments to shareholders' equity (attach statement)				
27 Less cost of treasury stock		( )		( )
28 Total liabilities and shareholders' equity		2,363,200		2,564,100

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return**

Note: The corporation may be required to file Schedule M-3 (see instructions).

1 Net income (loss) per books	332,096	7 Income recorded on books this year not included on this return (itemize): Tax-exempt interest $ 14,000	14,000
2 Federal income tax per books	171,904		
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize):	0	8 Deductions on this return not charged against book income this year (itemize): a Depreciation $ b Charitable contributions $	0
5 Expenses recorded on books this year not deducted on this return (itemize): a Depreciation $ b Charitable contributions $ c Travel and entertainment $ State Bond Interest Expense 8,000 Life Insurance Premiums 16,000	24,000	9 Add lines 7 and 8	14,000
6 Add lines 1 through 5	528,000	10 Income (page 1, line 28)—line 6 less line 9	514,000

Schedule M-2 **Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)**

1 Balance at beginning of year	1,272,900	5 Distributions: a Cash	80,000
2 Net income (loss) per books	332,096	b Stock	
3 Other increases (itemize):		c Property	
		6 Other decreases (itemize):	
	0	7 Add lines 5 and 6	80,000
4 Add lines 1, 2, and 3	1,604,996	8 Balance at end of year (line 4 less line 7)	1,524,996

Form **1120** (2015)

Form **1125-A**
(Rev. December 2012)
Department of the Treasury
Internal Revenue Service

Cost of Goods Sold

▶ **Attach to Form 1120, 1120-C, 1120-F, 1120S, 1065, or 1065-B.**
▶ **Information about Form 1125-A and its instructions is at *www.irs.gov/form1125a*.**

OMB No. 1545-2225

Name: Kingfisher Corporation
Employer identification number: 11-1111111

1	Inventory at beginning of year	1	900,000
2	Purchases	2	1,032,000
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	**Total.** Add lines 1 through 5	6	1,932,000
7	Inventory at end of year	7	1,012,000
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return (see instructions)	8	920,000

9 a Check all methods used for valuing closing inventory:
- *(i)* ☐ Cost
- *(ii)* ☒ Lower of cost or market
- *(iii)* ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO **9d**

e If property is produced or acquired for resale, do the rules of section 263A apply to the entity (see instructions)? ☐ Yes ☒ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☒ No

For Paperwork Reduction Act Notice, see instructions.
HTA

Form **1125-A** (Rev. 12-2012)

SCHEDULE G (Form 1120)
(Rev. December 2011)
Department of the Treasury
Internal Revenue Service

Information on Certain Persons Owning the Corporation's Voting Stock

▶ **Attach to Form 1120.**
▶ **See instructions on page 2.**

OMB No.1545-0123

Name	Employer identification number (EIN)
Kingfisher Corporation	11-1111111

Part I **Certain Entities Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4a). Complete columns (i) through (v) below for any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Percentage Owned in Voting Stock

Part II **Certain Individuals and Estates Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4b). Complete columns (i) through (iv) below for any individual or estate that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

(i) Name of Individual or Estate	(ii) Identifying Number (if any)	(iii) Country of Citizenship (see instructions)	(iv) Percentage Owned in Voting Stock
Nancy Trout	123-45-6789	United States	50.000%
Delores Lake	987-65-4321	United States	50.000%

For Paperwork Reduction Act Notice, see the Instructions for Form 1120.
1833

Schedule G (Form 1120) (Rev. 12-2011)

Form **1125-E** (Rev. December 2013) Department of the Treasury Internal Revenue Service

Compensation of Officers

▶ Attach to Form 1120, 1120-C, 1120-F, 1120-REIT, 1120-RIC, or 1120S
▶ Information about Form 1125-E and its separate instructions is at *www.irs.gov/form1125e.*

OMB No. 1545-2225

Name	Employer identification number
Kingfisher Corporation	11-1111111

Note. Complete Form 1125-E only if total receipts are $500,000 or more. See instructions for definition of total receipts.

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of stock owned (d) Common	(e) Preferred	(f) Amount of compensation
1	Nancy Trout	123-45-6789	100.00%	50.00%	%	160,000
	Delores Lake	987-65-4321	100.00%	50.00%	%	160,000
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
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			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	

2	Total compensation of officers	2	320,000
3	Compensation of officers claimed on Form 1125-A or elsewhere on return	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1120, page 1, line 12 or the appropriate line of your tax return	4	320,000

For Paperwork Reduction Act Notice, see separate instructions. Form **1125-E** (Rev. 12-2013)

HTA

Kingfisher Corporation 11-1111111

Line 6, Sch L (1120) - Other Current Assets

			Beginning	End
1	Federal Income Tax Refund Due	1		3,096
2	Total other current assets	2	0	3,096

Line 9, Sch L (1120) - Other Investments

			Beginning	End
1	Certificates of Deposit	1	140,000	140,000
2	Stock Investments	2	300,000	300,000
3	Total other investments	3	440,000	440,000

Line 14, Sch L (1120) - Other Assets

			Beginning	End
1	Other Assets	1	3,600	2,000
2	Total other assets	2	3,600	2,000

Line 18, Sch L (1120) - Other Current Liabilities

			Beginning	End
1	Other Current Liabilities	1	80,300	40,000
2	Total other current liabilities	2	80,300	40,000

NOTES