CHAPTER 1

UNDERSTANDING AND WORKING WITH THE FEDERAL TAX LAW

SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

1. (LO 1) When enacting tax legislation, Congress often is guided by the concept of revenue neutrality so that any changes neither increase nor decrease the net revenues raised under the prior rules. Revenue neutrality does not mean that any one taxpayer's tax liability remains the same. Since this liability depends upon the circumstances involved, one taxpayer's increased tax liability could be another's tax saving. Revenue-neutral tax reform does not reduce deficits, but at least it does not aggravate the problem.

2. (LO 2) Economic, social, equity, and political factors play a significant role in the formulation of tax laws. Furthermore, the IRS and the courts have had impacts on the evolution of tax laws. For example, control of the economy has been an important economic consideration in passing a number of laws (e.g., rapid depreciation, changes in tax rates).

3. (LO 2) The tax law encourages technological progress by allowing immediate (or accelerated) deductions and tax credits for research and development expenditures.

4. (LO 2) Saving leads to capital formation and thus makes funds available to finance home construction and industrial expansion. For example, the tax laws provide incentives to encourage savings by giving private retirement plans preferential treatment.

5. (LO 2)
   a. Section 1244 allows ordinary loss treatment on the worthlessness of small business corporation stock. Since such stock normally would be a capital asset, the operation of § 1244 converts a less desirable capital loss into a more attractive ordinary loss. Such tax treatment was designed to aid small businesses in raising needed capital through the issuance of stock.

   b. The corporate income tax rates favor those corporations with taxable income under $75,000. On a relative basis, it is the smaller corporations that will benefit the most from the graduated corporate tax rates. Further, the $11,750 in tax savings that result from the graduated rate structure is phased out for corporations with taxable income in excess of $100,000.

   c. By allowing corporations to split or combine (i.e., merge or consolidate) without adverse tax consequences, small corporations are in a position to compete more effectively with larger counterparts.

6. (LO 2) Reasonable persons can, and often do, disagree about what is fair or unfair. In the tax area, moreover, equity is generally tied to a particular taxpayer's personal situation. For example, one equity difference relates to how a business is organized (i.e., partnership versus corporation). Two businesses may be equal in size, similarly situated, and competitors in the production of goods or services, but they may not be comparably treated under the tax law if one is a partnership and the other is a corporation. The corporation is subject to a separate Federal income tax; the partnership is

not. The tax law can and does make a distinction between these business forms. Equity, then, is not what appears fair or unfair to any one taxpayer or group of taxpayers. It is, instead, what the tax law recognizes.

7. (LO 2) This deduction can be explained by social considerations. The deduction shifts some of the financial and administrative burden of socially desirable programs from the public (the government) sector to the private (the citizens) sector.

8. (LO 2) Private retirement plans' preferential treatment encourages saving. Not only are contributions to Keogh (H.R. 10) plans and certain Individual Retirement Plans (IRA) deductible, but income from these contributions accumulates on a tax-free basis.

9. (LO 2) The availability of percentage depletion on the extraction and sale of oil and gas and specified mineral deposits and a write-off (rather than capitalization) of certain exploration costs encourage the development of natural resources.

10. (LO 2) Favorable treatment of corporate reorganizations provides an economic benefit. By allowing corporations to combine and split without adverse consequences, corporations are in a position to more effectively compete with other businesses.

11. (LO 2) Although the major objective of the Federal tax law is the raising of revenue, other considerations explain many provisions. In particular, economic, social, equity, and political factors play a significant role. Added to these factors is the impact the Treasury Department, Internal Revenue Service, and the courts have had and will continue to have on the evolution of Federal tax law.

12. (LO 2) The deduction allowed for Federal income tax purposes for state and local income taxes is not designed to neutralize the effect of multiple taxation on the same income. At most, this deduction provides only partial relief. Only the allowance of a full tax credit would achieve complete neutrality.

    a. With the standard deduction, a taxpayer is, *indirectly*, obtaining the benefit of a deduction for any state or local income taxes he or she may have paid. This is so because the standard deduction is in lieu of itemized deductions, which include the deductions for state and local income taxes.

    b. If the taxpayer is in the 10% tax bracket, one dollar of a deduction for state or local taxes would save ten cents of Federal income tax liability. In the 33% tax bracket, the saving becomes thirty-three cents. The deduction approach (as opposed to the allowance of a credit) favors high bracket taxpayers.

13. (LO 2) Under the general rule, a transfer of a partnership's assets to a new corporation could result in a taxable gain. However, if certain conditions are met, § 351 postpones the recognition of any gain (or loss) on the transfer of property by Heather to a controlled corporation.

    The wherewithal to pay concept recognizes the inequity of taxing a transaction when Heather lacks the means with which to pay any tax. Besides, Heather's economic position would not change significantly as a result of such a transfer. Heather owned the assets before the transfer and still would own the assets after a transfer to a controlled corporation.

14. (LO 2) Yes, once incorporated, the business may be subject to the Federal corporate income tax. However, the corporate tax rates *might* be lower than Heather's individual tax rates, especially if dividends are not paid to Heather.

    The corporate income tax could be avoided altogether by electing to be an S corporation. An S corporation is generally not taxed at the corporate level; instead, the income flows through the corporate veil and is taxed at the shareholder level. An S election allows a business to operate as a corporation but be taxed like a partnership.

15. (LO 2) Examples include like-kind exchanges, involuntary conversions, transfers of property to a controlled corporation, transfers of property to a partnership, and tax-free reorganization.

16. (LO 2) Generally, a recognized (taxable) gain cannot exceed the realized gain.

17. (LO 2) Recognition of gain ultimately occurs when the property is disposed of.

18. (LO 2) One year.

19. (LO 2) The installment method on the sale of property permits the gain to be recognized over the payout period.

20. (LO 2) Requiring a taxpayer to make a contribution to a Keogh retirement plan by the end of the year would force an accurate determination of net self-employment income long before the income tax return must be prepared and filed.

21. (LO 2) The difference between common law and community property systems centers around the property rights possessed by married persons. In a common law system, each spouse owns whatever he or she earns. Under a community property system, one-half of the earnings of each spouse is considered owned by the other spouse. Assume, for example, Harold and Ruth are husband and wife, and their only income is the $80,000 annual salary Harold receives. If they live in New York (a common law state), the $80,000 salary belongs to Harold. If, however, they live in Texas (a community property state), the $80,000 salary is divided equally, in terms of ownership, between Harold and Ruth.

22. (LO 2) Deterrence provisions include:

    - Alternative minimum tax.
    - Imputed interest rules.
    - Limitation on the deductibility of interest on investment indebtedness.
    - Gift and estate tax.
    - Unreasonable accumulated earnings tax.
    - Personal holding company tax.

23. (LO 4) Primarily concerned with business readjustments, the continuity of interest concept permits tax-free treatment only if the taxpayer retains a substantial continuing interest in the property transferred to the new business. Due to the continuing interest retained, the transfer should not have tax consequences because the position of the taxpayer has not changed. This concept applies to transfers to controlled corporations (Chapter 4), corporate reorganizations (Chapter 7), and transfers to partnerships (Chapter 10).

24. (LO 3) Under § 482 the IRS has the authority to allocate income and deductions among businesses owned or controlled by the same interests when the allocation is necessary to prevent the evasion of taxes or to clearly reflect the income of each business. Pursuant to § 482, therefore, the IRS might allocate interest income to White Corporation even though none was provided for in the loan agreement.

25. (LO 5) False. Federal tax legislation generally originates in the House of Representatives, where it is first considered by the House Ways and Means Committee. Tax bills can originate in the Senate only when they are attached as riders to other legislative proposals as was the case with the American Taxpayer Relief Act of 2012.

26. (LO 5) A president's veto can be overridden by a two-thirds vote in both the House and Senate.

27. (LO 5)

§ 1563 (a) (1) (A)

Abbreviation of "Section"
Section number
Subsection number
Paragraph designation
Subparagraph designation

28. (LO 5) Yes, some Code Sections omit the subsection designation and use, instead, the paragraph designation as the first subpart [e.g., §§ 212(1) and 1221(1)].

29. (LO 5) When the 1954 Code was drafted, the omission of some Code section numbers was intentional. This omission provided flexibility to incorporate later changes into the Code without disrupting its organization. This technique is retained in the 1986 code.

30. (LO 6) Proposed, final, and Temporary Regulations are published in the *Federal Register* and are reproduced in major tax services. Final Regulations are issue as Treasury Decisions (TDs).

31. (LO 6)
    a. A Temporary Regulation, with 1 referring to the type of regulation (i.e., income tax), 428 is the related code section number, (7) is the subsection number, T means temporary, b is the paragraph designation, and (4) is the subparagraph designation.
    b. Revenue Ruling number 11, appearing on page 174 of Volume 1 of the *Cumulative Bulletin* issued in 1960.
    c. Technical Advice Memorandum number 3 issued during the 37th week of 1988.

32. (LO 5) Hoffman, Raabe, Maloney, & Young, CPAs
5191 Natorp Boulevard
Mason, OH 45040

October 12, 2016

Ms. Jennifer Olde
3246 Highland Drive
Clifton, VA 20124

Dear Ms. Olde:

In response to your recent request, the fact-finding determination of a lower trial court is binding on a Federal Court of Appeals. A Federal Court of Appeals is limited to a review of the record of trial compiled by a trial court. Rarely will an appellate court disturb a lower court's fact-finding determination.

Should you need more information, do not hesitate to contact me.

Sincerely,

Marilyn S. Crumbley
Tax Partner

33. (LO 5)
TAX FILE MEMORANDUM

DATE: September 12, 2016

FROM: Sarah Flinn

RE: Telephone conversation with Will Thomas regarding the failure of the IRS to appeal

I explained to Mr. Thomas that there were numerous reasons why the IRS may decide not to appeal a decision it loses in a District Court. For example, the work load may be too heavy. Or the IRS may have decided that this particular case is not a good decision to appeal (e.g., sympathetic taxpayer). Third, the IRS might not wish to appeal this case to the appropriate Court of Appeals. I stressed that the failure to appeal does not necessarily mean that the IRS agrees with the results reached.

34. (LO 5, 8)

a. If the taxpayer decides to choose a District Court as the trial court for litigation, the District Court of Utah would be the forum to hear the case. Unless the prior decision has been reversed on appeal, one would expect the same court to follow its earlier holding.

b. If the taxpayer decides to choose the Court of Federal Claims as the trial court for litigation, the decision previously rendered by this Court should have a direct bearing on the outcome. If the taxpayer selects a different trial court (i.e., the appropriate U.S. District Court or the U.S. Tax Court), the decision rendered by the Court of Federal Claims would be persuasive but not controlling. It is assumed that the results reached by the Court of Federal Claims were not reversed on appeal.

c. The decision of a Court of Appeals will carry more weight than one rendered by a trial court. Since the taxpayer lives in California, however, any appeal from a District Court or the U.S. Tax Court would go to the Ninth Court of Appeals. Although the Ninth Court of Appeals might be influenced by what the Second Court of Appeals has decided, it is not compelled to follow such holding.

d. Since the U.S. Supreme Court is the top appellate court, complete reliance can be placed on its decisions. Nevertheless, one should investigate any decision to see whether or not the Code has been modified to change the results reached. There also exists the rare possibility that the Court may have changed its position in a later decision.

e. When the IRS acquiesces in a decision of the Tax Court, it agrees with the results reached. As long as such acquiescence remains in effect, taxpayers can be assured that this represents the position of the IRS on the issue involved. Keep in mind, however, that the IRS can change its mind and can, at any time, withdraw the acquiescence and substitute a nonacquiescence.

f. The issuance of a nonacquiescence reflects that the IRS does not agree with the results reached by a Tax Court decision. Consequently, taxpayers are placed on notice that the IRS will continue to challenge the issue involved.

35. (LO 6) Mack Rogers has a number of approaches available, depending upon the available materials. One approach is to begin with the keyword index in an online tax research service. Since the subject matter "§ 1244 stock" is somewhat self-contained, he could also start with the Internal Revenue Code and Treasury Regulations. The text identifies the major tax services which Mr. Rogers could consult.

Another approach for Mr. Rogers is to use CCH's *Federal Tax Articles*. After looking up "§ 1244 stock" in the subject index, Mr. Rogers should be able to find a number of articles written about this subject. In addition, Thomson Reuters publishes the *Index to Federal Tax Articles* that is organized using RIA's paragraph index system. He also should check Bloomberg BNA *Tax Management Portfolios*.

36. (LO 7) Some tax researchers begin with a keyword search on an online tax service. If the problem is not complex, the researcher may bypass a tax service and turn directly to the Internal Revenue Code and the Treasury Regulations (both are available online; see Exhibit 1.7). For the beginner, this process saves time and will solve many of the basic problems. If the researcher does not have access to the Code or Regulations, the resources of a tax service may be necessary. Several of the major tax services publish paperback editions of the Code and Treasury Regulations that can be purchased at modest prices.

37. (LO 8)
    a. Primary source.

    b. Secondary source.

    c. Primary source.

    d. Secondary source, but substantial authority for purposes of the accuracy-related penalty in § 6662.

    e. Secondary source, but substantial authority for purposes of the accuracy-related penalty in § 6662.

38. (LO 9) Key components of effective tax planning are:

- Avoid the recognition of income (usually by resorting to a nontaxable source or nontaxable event).

- Defer recognition of income (or accelerate deductions).

- Convert the classification of income (or deductions) to a more advantageous form (e.g., ordinary income into capital gain).

- Choose the business entity with the desired tax attributes.

- Preserve formalities by generating and maintaining supporting documentation.

- Act in a manner consistent with the intended objective.

Don't only focus on tax considerations. Keep sound business judgment and overall economic outcomes in mind as well.

39. (LO 10) Simulations are small case studies designed to test a candidate's tax knowledge and skills using real-life, work-related situations. Simulations include a four-function, pop-up calculator, a blank spreadsheet with some elementary functionality, and authoritative literatures appropriate to the subject matter. The taxation database includes authoritative excerpts (e.g., Internal Revenue Code and Regulations, IRS publications, and Federal tax forms) that are necessary to complete the tax case study simulations.

PROBLEMS

40. (LO 2)

a. Bart has a realized gain of $200,000 determined as follows:

Amount received on the exchange:		
Real estate worth	$900,000	
Cash	100,000	$1,000,000
Amount given up on the exchange:		
Basis of real estate		(800,000)
Realized gain		$ 200,000

Bart's recognized gain is limited to the *lesser* of realized gain of $200,000 or the other property (boot) received of $100,000. Thus, the recognized gain is limited to other property (boot) received of $100,000 [the amount of cash (boot) received by Bart]. § 1031

b. Roland has a realized loss of $300,000, determined as follows:

Amount received on the exchange		$1,000,000
Amount given up on the exchange:		
Real estate with a basis of	$1,200,000	
Cash	100,000	
Basis of property given up		(1,300,000)
Realized loss		$ (300,000)

None of Roland's realized loss can be recognized.

c. Under the wherewithal to pay concept, forcing Bart to recognize a gain of $100,000 makes sense. Because of the $100,000 cash received, not only has Bart's economic position changed, but he now has the means to pay the tax on the portion of the realized gain that is recognized.

The disallowance of Roland's realized loss is consistent with the usual approach of the wherewithal to pay concept. Not only is this the price that must be paid for tax-free treatment, but also a carryover basis and adjustment under § 1031(d) prevents a deterioration of Roland's tax position. Note: After the exchange, Roland has a basis of $1,300,000 in the real estate received from Bart [i.e., $1,200,000 (basis in the real estate given up) + $100,000 (cash given up)].

41. (LO 2, 3)

a. W. Wherewithal to pay concept.

b. CE. Control of the economy.

c. ESB. Encouragement of small business.

d. SC. Social considerations.

e. EI. Encouragement of certain industries.

f. AF. Administrative feasibility.

g. SC. Social considerations.

42. (LO 2)

a. Louisiana, community property.

b. Virginia, common law.

c. Arizona, community property.

d. Rhode Island, common law.

e. Alaska, community property may be elected by spouses.

f. California, community property.

43. (LO 4) The real question is whether the parties acted in an arm's length manner. In other words, was the $100,000 selling price the true value of the property?

a. Where the parties to a transaction are related to each other, the IRS is quick to apply the arm's length concept. It might, for example, find that the value of the property was less than $100,000. In this event, the difference probably is dividend income to Benny.

b. The same danger exists even if Benny (the seller) is not a shareholder in Jet Corporation (the purchaser) as long as he is related to the one in control. If the value of the property is less than $100,000, the IRS could find a constructive dividend to Benny's father of any difference. Because Benny ended up with the benefit, it follows that the father has made a gift to the son of such difference. (Chapter 5)

c. Since Benny is neither a shareholder in Jet Corporation nor related to any of its shareholders, it is doubtful that the IRS would question the $100,000 selling price or the substance of the sale.

44. (LO 5)

a. Letter rulings are issued for a fee by the National Office of the IRS upon a taxpayer's request and describe how the IRS will treat a proposed transaction for tax purposes. In general, they apply only to the taxpayer who asks for and obtains the ruling, but post-1984 rulings may be substantial authority for purposes of avoiding the accuracy-related penalties.

b. The National Office of the IRS releases technical advice memoranda (TAMs) weekly. TAMs resemble letter rulings in that they give the IRS's determination of an issue. Letter rulings, however, are responses to requests by taxpayers, whereas TAMs are issued by the National Office of the IRS in response to questions raised by taxpayers or IRS field personnel during audits. TAMs deal with completed rather than proposed transactions and are often requested for questions relating to exempt organizations and employee plans. Although TAMs are not officially published and may not be cited or used as precedent, post-1984 TAMs may be substantial authority for purposes of the accuracy-related penalties.

45. (LO 5)

a. Revenue Procedure number 10, appearing on page 272 of Volume 1 of the *Cumulative Bulletin* for 2001.

b. Revenue Ruling number 14 appearing on page 31 of the 27th weekly issue of the *Internal Revenue Bulletin* for 2011.

c. The 30th letter ruling issued during the 25th week of 2011.

46. (LO 6)
  a. IRC.

  b. FR, IRB, CB.

  c. IRB, CB.

  d. FR, IRB, CB.

  e. IRB, CB.

  f. NA, a court decision.

  g. NA, a letter ruling.

47. (LO 5)
  a. Fifth Circuit.

  b. Tenth Circuit.

  c. Eleventh Circuit.

  d. Ninth Circuit.

  e. Second Circuit.

48. (LO 5)
  a. A

  b. T

  c. U

  d. T

  e. T

  f. C

  g. N

  h. D

49. (LO 6)
  a. *United States Tax Reporter* is published by Research Institute of America (formerly published as *Federal Taxes* by Prentice-Hall, Inc.).

  b. *Standard Federal Tax Reporter* is published by Commerce Clearing House, Inc.

  c. *Federal Tax Coordinator 2d* is published by Research Institute of America.

  d. *Mertens Law of Federal Income Taxation* is published by West Group.

  e. *Tax Management Portfolios* is published by Bloomberg BNA.

  f. *CCH Tax Research Consultant* is published by Commerce Clearing House, Inc.

50. (LO 5, 8)

a. P.

b. P.

c. P.

d. P.

e. S.

f. P.

g. S.

h. P.

i. B. Primary to the taxpayer to whom issued, but secondary for all other taxpayers.

j. P.

k. S. Cannot be cited as precedent.

l. P.

m. S.

n. S. Courts generally do not recognize proposed regulations.

51. (LO 5)

a. For a regular decision of the U.S. Tax Court that was issued in 1970. The decision can be found in Volume 54, page 1514, of the *Tax Court of the United States Reports*, published by the U.S. Government Printing Office.

b. For a decision of the U.S. Second Circuit Court of Appeals that was rendered in 1969. The decision can be found in Volume 408, page 1117, of the *Federal Reporter*, Second Series (F. 2d), published by West Publishing Company.

c. For a decision of the U.S. Second Circuit Court of Appeals that was rendered in 1969. The decision can be found in Volume 1 for 1969, paragraph 9319, of the *U.S. Tax Cases*, published by Commerce Clearing House.

d. For a decision of the U.S. Second Circuit Court of Appeals that was rendered in 1969. The decision can be found in Volume 23, page 1090, of the Second Series of *American Federal Tax Reports*, now published by RIA (formerly P-H).

[Note that the citations that appear in parts b., c., and d. are for the same case.]

e. For a decision of the U.S. District Court of Mississippi that was rendered in 1967. The decision can be found in Volume 293, page 1129, of the *Federal Supplement Series*, published by West Publishing Company.

f. For a decision of the U.S. District Court of Mississippi that was rendered in 1967. The decision can be found in Volume 1 for 1967, paragraph 9253, of the *U.S. Tax Cases*, published by Commerce Clearing House.

g. For a decision of the U.S. District Court of Mississippi that was rendered in 1967. The decision can be found in Volume 19, page 647, of the Second Series of *American Federal Tax Reports*, now published by RIA (formerly P-H).

[Note that the citations that appear in parts e., f., and g. are for the same case.]

h. For a decision of the U.S. Supreme Court that was rendered in 1935. The decision can be found in Volume 56, page 289, of the *Supreme Court Reporter*, published by West Publishing Company.

i. For a decision of the U.S. Supreme Court that was rendered in 1935. The decision can be found in Volume 1 for 1936, paragraph 9020, of the *U.S. Tax Cases*, published by Commerce Clearing House.

j. For a decision of the U.S. Supreme Court that was rendered in 1935. The decision can be found in Volume 16, page 1274, of the *American Federal Tax Reports*, now published by RIA (formerly P-H).

[Note that the citations that appear in parts h., i., and j. are for the same case.]

k. For a decision of the former U.S. Court of Claims that was rendered in 1970. The decision can be found in Volume 422, page 1336, of the *Federal Reporter*, Second Series, published by West Publishing Company. This court is the Claims Court (renamed the Court of Federal Claims effective October 30, 1992) and current cases are in the *Federal Claims Reporter*.

RESEARCH PROBLEMS

1. a. An environmental tax on corporations is imposed on modified alternative minimum taxable income of a corporation in excess of $2 million.

   b. For purposes of the 5-year deferral, 10-year estate tax installment payment provision, a holding company is any corporation holding stock in another company. [Reg. § 1.6166(a)(8)(D)(i)]

   c. This letter ruling deals with a C corporation that switched to S status (and is subject to the 10-year, built-in gain (BIG) recognition period). In a subsequent switch back to the C status (as a real estate investment trust), the 10-year BIG recognition period includes the time the corporation was an S corporation.

   d. This field service advice involves the application of § 83 to the taxation of nonqualified stock options exercised after a transfer under a divorce.

2. a. *rev'd* 929 F.2d 1252 (CA-8, 1991).

   b. *aff'd* 734 F.2d 20 (CA-9, 1984), *cert. den.*, 469 U.S. 857 (1984).

   c. *aff'd* 341 F.2d 341 (CA-5,1965).

   d. *aff'd per curiam*, 487 F.2d 515 (CA-8, 1973).

   e. *rev'd* 335 F.2d 507 (CA-6, 1964).

3. The vacation may not be 100% free. Australia will pay around $2.7 million of the costs for the 300 vacations, but the trip is considered a taxable prize or award under IRC § 74(a) and not a nontaxable gift. Reg. § 1.74-1(a)(1) requires all amounts received as prizes and awards (unless such prizes or awards qualify as an exclusion from gross) to be included in gross income. Prizes and awards which are includible in gross income include amounts received from radio and television giveaway shows. Reg. § 1.74-1(a)(2) further states that, if the prize or award is not made in money but is made in goods or services, the fair market value of the goods or services is the amount to be included in income. Thus, the lucky recipients would have to pay taxes on the fair market value of the trip, not the amount actually paid for the trip by the Oprah show.

   Oprah states that she is paying any taxes of the lucky fans. Under *Old Colony Trust Co.*, 279 U.S. 716 (1929), the amount of any tax liability paid by Oprah is also taxable income. See Reg. § 1.61-14. If the initial tax liability is paid, another amount is taxable. Thus, an infinite amount of taxes would need to be paid by Oprah to make the vacation trip totally tax-free. The only way to make the prize tax-free is for Oprah to "gross up" the prize for any taxes due. Keep in mind there are also probably state taxes to be paid. All in all, this tax problem should create a lot of work for the accountant Oprah chose to handle the tax problems of the 300 taxpayers.

Research Problems 4 and 5

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

40.a. Realized gain $200,000; recognized gain $100,000.

40.b. Realized loss $300,000; recognized loss $0.

SOLUTION TO ETHICS & EQUITY FEATURE

Choosing Cases for Appeal (p. 1-40). The issue is whether it is appropriate for the Government to select a case to appeal because of its potential for success (i.e., a reversal on appeal) rather than purely on its merits.

Without a question, the tax laws treat taxpayers differently and often unfairly. Many laws are passed as the result of pressure from various groups (i.e., lobbying). "Don't tax you, don't tax me, tax that fellow behind the tree" is an appropriate statement of tax law development in many circumstances.

Part of the IRS's function is to maximize revenue with the limited time and budget resources at its disposal. By litigating specific cases in order to develop judicial law, the IRS does "save" taxpayers' dollars by avoiding marginal issues. And, if the IRS position is sustained on appeal in Virginia, the judicial precedent might be important should the IRS choose to appeal the Iowa decision.

Certainly, there is an unfairness in such an approach. If the IRS decides to appeal the Virginia case, the CPA must bear the burden of litigation expenses (rather than the minister). Further, should the IRS position be sustained on appeal, the CPA's trusts would be collapsed, while the minister's trusts may be allowed to remain—even though the tax issues are identical.

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 ($52 \times 15 = 780$) 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

<u>Note to instructor</u>: 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).

<u>Assuming a gift of the land in 2017</u>
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).

<u>Assuming a gift of the land in 2016</u>
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
2. b
3. d
4. a
5. c
6. b
7. d

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:	TYPE OR PRINT		B Employer identification number
1a Consolidated return (attach Form 851) ☐	Name: Pet Kingdom, Inc.		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		

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)

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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 . . If "Yes," complete (i) through (iv) below.		X

(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 . . If "Yes," complete (i) through (iv) below.		X

(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)	(b)	End of tax year (c)	(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 $	
2 Federal income tax per books			
3 Excess of capital losses over capital gains			0
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):	
5 Expenses recorded on books this year not deducted on this return (itemize):		a Depreciation $	
a Depreciation $		b Charitable contributions $	
b Charitable contributions $			
c Travel and entertainment $			0
	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	Employer identification number
Pet Kingdom, Inc.	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.
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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): 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 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)	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 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	Employer identification number
Pet Kingdom, Inc.	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		(f) Amount of compensation
			(d) Common	(e) Preferred	
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)

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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

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:		TYPE OR PRINT		B Employer identification number
1a Consolidated return (attach Form 851)	☐	Name	Kingfisher Corporation	11-1111111
b Life/nonlife consolidated return	☐	Number, street, and room or suite no. If a P.O. box, see instructions.	1717 Main Street	C Date incorporated: 2/12/2003
2 Personal holding co. (attach Sch. PH)	☐	City or town / State / ZIP code	Ely / MN / 55731	D Total assets (see instructions)
3 Personal service corp. (see instructions)	☐	Foreign country name / Foreign province/state/county / Foreign postal code		$ 2,564,100
4 Schedule M-3 attached	☐	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?		X
	If "Yes," enter name and EIN of the parent corporation ▶		
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 . . If "Yes," complete (i) through (iv) below.		X

(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 . . If "Yes," complete (i) through (iv) below.		X

(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)? . . . . If "Yes," complete and attach Schedule UTP.		X
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	Employer identification number
Kingfisher Corporation	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: Kingfisher Corporation

Employer identification number (EIN): 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

CHAPTER 2

CORPORATIONS: INTRODUCTION AND OPERATING RULES

LECTURE NOTES

OVERVIEW

For Federal income tax purposes, the distinctions among forms of business organization are critical. This chapter discusses the tax treatment of sole proprietorships, partnerships, regular corporations, and limited liability companies. Main topics include: (1) tax treatment of various business forms, (2) an introduction to the income taxation of corporations, (3) determining the corporate income tax liability, (4) procedural matters, and (5) tax planning.

SUMMARY OF CHANGES IN THE CHAPTER

The following are notable changes in the chapter from the 2016 Edition. For major changes, see the Preface to the Instructor's Edition of the text.

- Added a Concept Summary comparing the tax attributes of various forms of business entities.
- Added a Concept Summary on Schedule M–1 (Form 1120).
- Added a new Tax in the News feature and a new Global Tax Issues feature.
- Updated text to reflect new filing due dates for corporations.
- Updated text and examples throughout the chapter.

The Big Picture

Samantha Johnson owns Skylark Bakery, a sole proprietorship, which generates an annual operating profit of $100,000. In addition, the bakery earns annual dividends of $5,000 from investing excess working capital in the stock of publicly traded corporations. Samantha is in the 33% marginal tax rate bracket irrespective of the bakery. In the past, Samantha has withdrawn $50,000 annually from the bakery.

If Samantha conducts the business as a regular C corporation, what would be the annual income tax savings (or cost)? For purposes of this analysis, use the 2016 tax rates and ignore any employment tax or state tax considerations.

2.1 TAX TREATMENT OF VARIOUS BUSINESS FORMS

1. Business forms include sole proprietorships, partnerships (covered in Chapters 10 and 11), trusts and estates (covered in Chapter 20), S corporations (covered in Chapter 12), regular corporations, and limited liability companies.

Sole Proprietorships

2. A sole proprietorship is not a taxable entity separate from its owner. Net income or loss from the proprietorship is computed on Schedule C and reported as part of the proprietor's income on Form 1040. Thus, the proprietor pays tax on the profits of the proprietorship.

3. The proprietor reports all of the net profit from the business, regardless of the amount actually withdrawn during the year.

4. Income and expenses retain their character when reported by the proprietor.

   Example: Sweet operates a candy store as a sole proprietorship. He earned a profit of $75,000 during the year and withdrew $40,000 from the proprietorship. Sweet must report the $75,000 as net income from the proprietorship on his personal tax return.

Partnerships

5. Partnerships are tax-reporting, but not taxpaying, entities. A partnership reports its income on Form 1065.

6. Each partner receives a Schedule K–1 that reports the partner's share of ordinary business income (loss) along with each separately reported pass-through item. Schedule K–1 items are reported on each partner's tax return. (Example 2)

Corporations

7. There are two types of corporations for tax purposes: corporations governed by Subchapter C (C corporations) and corporations governed by Subchapter S (S corporations).

8. S corporations have the following characteristics:

   a. Generally do not pay Federal income taxes.

   b. Similar to partnerships in that operating income (loss) flows through to the shareholders. Like partnerships, all income and expense items are not aggregated when computing ordinary business income (loss). Certain items retain their separate character.

   c. Income and expense items "pass through" to shareholders, who report their share of the partnership items on their own returns. Items are allocated to shareholders according to their stock ownership interests.

9. Regular C corporations are subject to entity-level taxation. Other characteristics include:

a. C corporation reports its income and expenses on Form 1120.

b. Dividends paid are not deductible by the corporation.

Example: A C corporation has revenues of $80,000, has operating expenses of $60,000, and paid dividends of $10,000. Net income for the year is $20,000, since the dividends are not deductible by the corporation.

c. When a corporation distributes its income, the shareholders report dividend income on their own returns. Since the corporation pays tax on corporate income, this entity-level tax, along with the tax paid by shareholders on the distribution of that income as a dividend, results in income earned by a C corporation being subject to “double taxation.” (Examples 3 and 4)

10. Taxation of Dividends.

a. Closely held corporations may attempt to avoid the double taxation by disguising a dividend distribution as some other purported transaction.

(1) One common way is to pay excessive compensation to shareholder-employees.

(2) The IRS scrutinizes compensation and other economic transactions (e.g., salaries, interest, or rents) between closely held corporations and their shareholders for reasonableness.

b. Dividend eligibility for the capital gains rates alleviates some of the double taxation effect.

(1) The current tax rate applicable to qualified dividend income (and long-term capital gains) is 15% or, for taxpayers in the 39.6% marginal tax bracket, 20% (0% for taxpayers in the 10% or 15% marginal tax brackets).

(2) A 3.8% Medicare surtax applies to net investment income in excess of modified adjusted gross income of $200,000 ($250,000 if married filing jointly), thus increasing the double taxation of dividend income for high-income taxpayers.

ADDITIONAL LECTURE RESOURCE

According to the Tax Policy Blog, the official blog of the Tax Foundation (“U.S. Corporate Revenue Is Low Because High Taxes Have Shrunk the Corporate Sector,” September 18, 2014, William McBide):

"Pass-through businesses are subject to just one layer of tax, the individual income tax, while C corporations face double taxation due to the corporate tax and shareholder taxes on dividends and capital gains. The U.S. corporate tax rate is the highest in the developed world, at 39% including state corporate taxes.

Pass-through businesses have grown dramatically such that more than 90% of U.S. businesses are pass-through entities, mainly S corporations, partnerships and sole proprietorships. While the number of pass-through businesses has been growing, the number of C corporations has been shrinking over the last 27 years. The Tax Reform Act of 1986 reduced the corporate tax rate, but reduced the individual tax rate further, and raised taxes on corporations in other ways. That marked the peak of U.S. C corporations, at 2.6 million in 1986. As of 2011 (most recent data), there are now 1 million fewer corporations, at 1.6 million. In contrast, S corporations grew from about 800 thousand in 1986 to 4.2 million in 2011, and partnerships grew from 1.7 million to 3.3 million."

---

11. Comparison of Corporations and Other Forms of Doing Business.

    a. Consideration of tax factors requires an examination of corporate rate structure (Exhibit 2.1).

        (1) The marginal tax rate for corporations ranges from 15% to 35%. The marginal rates for individuals range from 15% to 39%. Therefore, in many cases, the tax burden will be greater if a business is operated as a corporation.

        (2) In other cases, when the corporate marginal tax rate is lower than the individual marginal rate, the corporate form of doing business presents tax savings opportunities. (Example 6) Be sure to consider the double taxation effect (including the preferential rate for dividend income) and the character of business income, employment taxes, and other tax issues. (Example 7)

    b. With a C corporation.

        (1) Tax attributes of the income and expense items do not pass through to the shareholders. As a result, if the business is expected to generate tax-favored income (e.g., tax-exempt income or long-term capital gains), one of the other (non-C corporation) forms of business may be desirable.

        (2) Since C corporation losses have no effect on the taxable income of the shareholders, one of the non-C corporation forms of business may be desirable if business losses are anticipated. (Example 8)

c. The combined corporation-employee payroll tax burden should be compared with the self-employment tax associated with the proprietorship and partnership forms of business.

(1) Income of a proprietorship subject to self-employment tax. Deduction available to individual for part of self-employment taxes paid.

(2) Wages paid to a shareholder-employee of a C or S corporation are subject to payroll taxes.

d. At the entity level:

(1) State corporate income taxes and/or franchise taxes are applicable to corporations.

(2) No entity-level Federal taxes on S corporations, limited liability companies, or partnerships. But can be state income or franchise taxes.

(3) State income tax laws may not have rate preference for dividends from corporate distributions.

12. Nontax Considerations.

a. Nontax considerations may override tax considerations. Factors to consider include:
- Limited liability for corporate shareholders. Unlimited liability for sole proprietors and general partners in partnerships.
- Ability to raise large amounts of capital using the corporate form.
- Free transferability of ownership interests in corporation.
- Continuity of life for the corporate form of business.
- Centralized management of a corporation. Limited partnerships may also have centralized management, which is essential for the smooth operation of a widely held business.

Limited Liability Companies

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

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

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

c. LLC owners are called members.

14. Entity Classification.

    The IRS eased the entity classification problem by issuing check-the-box Regulations.

    a. Regulations enable taxpayers to choose the tax status of a business entity without regard to its corporate or noncorporate characteristics.

    b. Under these Regulations, an unincorporated entity with more than one owner is by default classified as a partnership.

    c. An unincorporated entity with only one owner is, by default, classified as a disregarded entity (DRE) and treated as a sole proprietor.

    d. If an entity wants to use its default status, it simply files the appropriate tax return.

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

    f. If the entity wants to use a status other than the default status, or if it wants to change its status, Form 8832 (Entity Classification Election) is used to "check the box" (Reg. §§ 301.7701–1 through –4 and –7).

        (1) An LLC can therefore be taxed as a C corporation or S corporation.

        (2) Since LLCs are not treated as being incorporated under state law, they default to partnership or DRE status.

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

2.2 AN INTRODUCTION TO THE INCOME TAXATION OF CORPORATIONS

An Overview of Corporate versus Individual Income Tax Treatment

15. There are similarities and differences between the taxation of corporations and individuals. See Exhibit 2.2—Tax Formulas.

16. Similarities:

    a. Gross income is computed in much the same manner for corporations and individuals.

        (1) Both are entitled to exclusions from income. Corporate taxpayers are allowed fewer exclusions.

b. Tax rules applying to property transactions of corporations and noncorporate taxpayers are similar.

(1) The definition of capital assets (§ 1221) does not differ across taxpayers.

(2) Deferral on like-kind exchanges and involuntary conversion are also available to both types of taxpayers.

(3) The exclusion permitted by § 121 (the sale of a personal residence) does not apply to corporations. This last point seems simple enough, but consider the following example:

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

(4) Disallowance of losses on sales of property to related parties and on wash sales of securities applies to both individuals and corporations.

c. Business deductions for corporations parallel those available to individuals.

(1) No distinction between business and nonbusiness interest or business and nonbusiness bad debts for corporations.

d. Credits that are personal in nature (child care, earned income) are naturally not available to corporations.

17. Dissimilarities:

a. Different tax rates apply to corporations and individuals.

b. All allowable corporate deductions are treated as business deductions.

(1) AGI has no relevance to corporations.

(2) Corporations have no itemized deductions, no standard deduction, and no personal and dependency exemptions.

Specific Provisions Compared

18. See Concept Summary 2.2 for a comparison of the income taxation of individuals and corporations.

Accounting Periods and Methods

19. Accounting Periods.

    a. C corporations generally may choose a calendar year or a fiscal year for reporting purposes.

    b. Corporations can have different tax years for their shareholders.

    c. A PSC must generally use a calendar year [§ 441(i)]. However, it may elect a fiscal year if:

        (1) It can show a business purpose (i.e., a natural business year); or

        (2) The PSC 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. Under the latter provision, a PSC's deduction for shareholder-employee salaries will be limited if payment of those salaries is disproportionately postponed beyond December 31. (Examples 9 and 10)

        (3) A PSC has as its principal activity the performance of personal services, and such services are substantially performed by shareholder-employees. The performance of services must be in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting [§ 448(d)(2)(A) and Reg. § 1.441–3(d)(1)].

ADDITIONAL LECTURE RESOURCE

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

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

ADDITIONAL LECTURE RESOURCE

What Year-End Do Corporations Use? McDonald's Corporation and Ford Motor Corporation, along with the majority of corporations, have a calendar year-end. Best Buy and Macy's, both retailers, have January year-ends, closing out their books after the rush of the busy holiday season. Vail Resorts, Inc., which operates ski resorts in Colorado, Minnesota, and Utah, has a July 31 year-end, the slowest time of the year for its business.

20. Accounting Methods.

    a. The cash method of accounting, available to individuals, is not available to most regular corporations (§ 448). Cash method is allowed for:

        (1) S corporations.

        (2) Qualified PSCs.

        (3) Corporations with average annual gross receipts of $5 million or less for the most recent three-year period.

    b. Regardless of these exceptions, most individuals and corporations that maintain inventory for sale to customers are required to use the accrual method of accounting for determining sales and cost of goods sold.

        (1) As a matter of administrative convenience, the IRS will permit many taxpayers to use the cash method for determining sales and cost of goods sold.

        (2) This includes any entity with average annual gross receipts of not more than $1 million for the most recent three-year period, and some entities with average annual gross receipts of not more than $10 million for the same three-year period (Rev.Proc. 2001–10, 2001–1 C.B. 272 and Rev.Proc. 2002–28, 2002–1 C.B. 815).

    c. If a corporation uses the accrual method of accounting, and it has an accrual outstanding at the end of any taxable year with respect to a related party, it cannot claim a deduction until the related party reports the amount as income [§ 267(a)(2)]. (Example 11)

ADDITIONAL LECTURE RESOURCE

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

Example: Three brothers (cash-basis, calendar year taxpayers) own all of the stock in Brown Corporation (accrual-basis, calendar year taxpayer) and are its principal employees. After a particularly profitable year, in December 2016, Brown declares a bonus payable to each of its employees. Brown also accrues interest owed on amounts borrowed from its shareholders. The bonuses and interest are not paid until January 2017. Under the stock attribution rules of § 267, each of the brothers is deemed to own 100% of the stock of Brown. As a result, the bonuses attributable to the brothers and all of the interest are not deductible by Brown Corporation until 2017.

Return to the Big Picture

(Example 11) Samantha incorporates her business as Skylark Bakery, Inc., a calendar year, accrual method C corporation. Samantha, a cash method taxpayer, owns 100% of the corporation's stock at the end of 2015. On December 31, 2015, Skylark Bakery has accrued a $10,000 bonus to Samantha. Samantha receives the bonus in 2016 and reports it on her 2016 tax return. Because of the special rule dealing with cash-basis-related parties, Skylark Bakery cannot claim a deduction for $10,000 until 2016.

Capital Gains and Losses

21. Differences exist in corporate and individual taxpayers' treatment of capital gains and losses.

    a. Net capital gains of corporations are not eligible for lower rates, as are net capital gains of individuals.

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

    c. Excess corporate capital losses are carried back three and forward five years to offset capital gains, while capital losses of individuals are carried forward indefinitely. When corporations carry over capital losses, they are treated as short term. For individuals, capital losses retain their original status as long term or short term [§ 1211(a) and 1212(a)]. (Examples 12 and 13)

Recapture of Depreciation

22. § 291 requires additional § 1250 depreciation recapture by corporations.

    a. The corporation will have additional ordinary income 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.

    b. The result is a recharacterization of what would otherwise be § 1231 gain as ordinary income. (Example 14)

Passive Activity Losses

23. Passive activity loss limitations apply to individuals, closely held C corporations, and personal service corporations (PSCs).

    a. For S corporations and partnerships, the passive activity loss rules are applied at the owner level.

    b. A corporation is closely held if, at any time during the last half of the taxable year, more than 50% of the value of the corporation's outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

        (1) Closely held C corporations can offset passive activity losses against net active income, but not portfolio income.

    c. PSCs generally cannot deduct passive activity losses against either active income or portfolio income. (Example 15)

Charitable Contributions

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

    a. For accrual-basis corporations, there is an exception to the rule that deductions for charitable contributions are allowed only for the year in which payment is made. Corporations may deduct charitable contributions in the year preceding payment if the contribution is authorized by the board of directors by the end of that year and is paid on or before the fifteenth day of the third month of the next year. (Example 16)

Example: ABC Corporation uses the accrual method of accounting and the calendar year as its tax year. The board of directors authorizes a cash contribution on November 3, 2016, that the corporation pays on March 10, 2017. The corporation can deduct the contribution in 2016. If the contribution is not paid until April 1, 2017, the corporation cannot deduct the contribution until 2017.

b. The general rule that measures the amount of the deduction as fair market value on the date of the donation for long-term capital gain property and adjusted basis (or fair market value, if lower) for ordinary income property (appreciated property that, if sold, would not result in long-term capital gain) applies to corporations as well as individuals. However, there are exceptions to the general rule. (Example 18)

(1) If a corporation contributes tangible personal property and the charitable organization puts it to an unrelated use, the deduction is limited to the basis of the property. (Examples 19 and 20)

(2) Contributions of capital gain property to certain private nonoperating foundations are limited to the basis of the property donated.

(3) Contributions of inventory by corporations to charities for use in their exempt purpose and solely for the care of the ill, needy, or infants, or where the property is used for research purposes under specified conditions are subject to special rules. The deduction is measured by the adjusted basis of the property plus 50% of the appreciation on the property. (Examples 17 and 21)

Example: Rose Instruments, Inc., a scientific equipment manufacturer, donates inventory (basis of $30,000, fair market value of $70,000) to a qualified nonprofit university that will use the equipment in its scientific research endeavors. The amount of the charitable contribution is $50,000 [$30,000 basis + 0.5($70,000 fair market value – $30,000 basis)], which is less than the ceiling of $60,000 (2 × $30,000 basis).

c. The annual deduction for corporations is limited to 10% of taxable income computed without regard to the charitable contribution deduction, net operating loss or capital loss carrybacks, dividends received deduction, and domestic production activities deduction.

(1) Any contribution in excess of the 10% limitation is carried forward for five years.

(2) Any carryforward must be added to subsequent contributions and is subject to the 10% limit. The current year's contributions must be deducted first, with carryover amounts from previous years deducted in order of time. (Examples 22 and 23)

ADDITIONAL LECTURE RESOURCE

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

Domestic Production Activities Deduction

25. Domestic production activities deduction (DPAD) is based on the income from manufacturing activities (§ 199) (see Chapter 3 for a detailed discussion).

    a. DPAD is the lower of the following (Example 24):
        - 9% of qualified production activities income.
        - 9% of taxable income (modified adjusted gross income for individuals).
        - 50% of W–2 wages related to the qualified production activities income.

ADDITIONAL LECTURE RESOURCE

What Business Activities Are Eligible for the DPAD? Many taxpayers think that they must be in a manufacturing business in order to be eligible for the DPAD. Not true! According to IRC § 980D, some of the industries that qualify include any qualified film produced by a taxpayer in the United States; electricity, natural gas, or potable water produced in the United States; construction performed in the United States; and engineering or architectural services performed in the United States for construction projects located in the United States [§ 199(c)(4)]. Unfortunately, the sale of food and beverages prepared by the taxpayer at a retail establishment does not apply.

Net Operating Losses

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

a. Corporations do not adjust their tax losses for capital losses, because they are not permitted a deduction for net capital losses.

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

c. Corporations include their dividends received deduction in computing the NOL. (Example 25)

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

Deductions Available Only to Corporations

27. The dividends received deduction (DRD) is for dividend distributions received from other domestic corporations. Dividends from foreign corporations generally do not qualify—see § 245(a).

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

b. The amount of the DRD is determined as follows:

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

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

c. The DRD is limited to a percentage of its taxable income.

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

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

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

d. The taxable income limitation does not apply if the DRD would create or increase a net operating loss for the current taxable year or in the case of the 100% DRD available to members of an affiliated group.

e. In working with this myriad of rules, the following steps are useful:
- Multiply the dividends received by the deduction percentage.
- Multiply the taxable income by the deduction percentage.
- DRD is limited to the lesser of step 1 or step 2, unless deducting the amount derived in step 1 results in an NOL. If so, the amount derived in step 1 should be used. This is referred to as the NOL rule (Example 26).

f. Dividends on stock held for 45 days or less during the 91-day period surrounding the ex-dividend date (90 days during the 181-day period surrounding the ex-dividend date if preferred stock) will not qualify for the DRD [§ 246(c)]. (Example 27)

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

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

(2) The reduction in the DRD cannot exceed the amount of the interest deduction allocable to the dividend.

ETHICS & EQUITY

Pushing the Envelope on Year-End Planning. Lark Corporation anticipates $141,000 of 2016 taxable income before considering the dividends received deduction. Its potential dividends received deduction of $140,000 ($200,000 dividend × 70%) would be limited to $98,000 (70% of $140,000 taxable income). Incurring an additional $1,001 of expenses would result in the dividends received deduction producing a loss, and avoiding the limitation, reducing its taxable income by an additional $42,000.

Accelerating $1,001 of deductible expenses to 2016 would be good, and ethical, tax planning as long as those expenses meet the requirements for deductibility under Lark's accounting method and do not constitute a sham. This may be fairly easy to do if Lark is a cash-basis taxpayer (e.g., by simply paying additional accounts payable). It may be more of a challenge if it is an accrual-basis taxpayer given the late date. However, it is probably still possible to accelerate an expense and still meet the all-events and economic performance tests (e.g., by accelerating maintenance and/or repairs, purchasing supplies or a depreciable asset, or making a charitable contribution). Accelerating or deferring the timing of real economic events for tax purposes is a common tax-planning technique.

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28. Organizational Expenditures Deduction.

    a. Organizational expenditures include legal services incident to organization, necessary accounting services, expenses of temporary directors and organizational meetings, and fees paid to the state for incorporation.

        (1) Costs connected with the issuing and selling of stock and other securities, or with transferring assets to a corporation, are not organizational costs. They reduce the amount of capital raised and are not deductible.

    b. No deduction is available for organizational expenses unless the taxpayer makes an election under § 248. Under § 248, the taxpayer may, starting in the month in which the business begins:

        (1) Immediately deduct the first $5,000 of organizational costs, reduced dollar for dollar for the amount these expenses exceed $50,000 and

        (2) Amortize the remainder of such expenses over a 180-month period. (Example 28)

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

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

        (1) No separate statement or specific identification of the deducted amount as organizational expenditures is required.

        (2) Generally, a corporation begins business when it starts the business operation for which it was organized [Reg. § 1248–1(d)].

    e. A corporation may choose to forgo the deemed election by clearly electing on a timely filed return to capitalize organizational expenditures for the taxable year in which the business begins. In this case, the organizational expenditures are not deductible until the corporation ceases to do business and liquidates.

f. Startup expenses (§ 195) (investigation and operating expenses incurred before the business begins producing income) are different from organizational costs. However, the amortization, immediate expensing, and deemed election rules that apply to organizational costs also apply to startup costs.

ADDITIONAL LECTURE RESOURCE

Determination of When Corporation Begins Business. According to Reg. § 1.248–1(d): The deduction allowed under Section 248 must be spread over a period beginning with the month in which the corporation begins business. The determination of the date the corporation begins business presents a question of fact which must be determined in each case in light of all the circumstances of the particular case. The words "begins business," however, do not have the same meaning as "in existence." Ordinarily, a corporation begins business when it starts the business operations for which it was organized; a corporation comes into existence on the date of its incorporation. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets that are necessary to the type of business contemplated may constitute the beginning of business.

2.3 DETERMINING THE CORPORATE INCOME TAX LIABILITY

Corporate Income Tax Rates

29. Corporations compute their Federal income tax liability using the rate structure contained in § 11(b) (the rate schedule is illustrated in Exhibit 2.1 and the inside front cover of the text). Corporate tax rates are not indexed for inflation. (Example 30)

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

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

        (2) PSCs are taxed at a flat 35% rate [§ 11(b)(2)].

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

Return to the Big Picture

(Example 30) Assume that Samantha incorporates her business as Skylark Bakery, Inc., a calendar year C corporation. The corporation pays Samantha a salary of $50,000 for the current year. Skylark Bakery has taxable income of $51,500 [$100,000 operating profit + $5,000 dividends − $50,000 salary expense – $3,500 dividends received deduction ($5,000 × 70%)]. Its income tax liability is $7,875, determined as follows:

Tax on $50,000 at 15%	$7,500
Tax on $1,500 at 25%	375
Tax liability	$7,875

Alternative Minimum Tax

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

Tax Liability of Related Corporations

31. A controlled group of corporations (related corporations) is entitled to one $250,000 accumulated earnings tax credit and one $40,000 exemption for the AMT and is limited to taxable income in each of the first two brackets as though the group was one corporation [§ 1561(a)]. (Examples 32 and 33) Controlled groups include parent-subsidiary corporations, brother-sister groups, combined groups, and certain insurance companies.

    a. If these restrictions did not exist, the shareholders of a corporation could gain significant tax advantages by splitting a single corporation into multiple corporations.

2.4 PROCEDURAL MATTERS

Filing Requirements for Corporations

32. Corporations must file a tax return (Form 1120 or Form 1120S) on or before the fifteenth day of the third month following the close of the tax year. Corporations receive an automatic extension of six months by filing Form 7004 by the due date of the return.

    a. Return is due even if the corporation has no taxable income.

b. Corporations that were not in existence throughout the entire annual accounting period are required to file a return for the portion of the year they were in existence.

c. A corporation is relieved of filing a tax return only when it ceases to do business and retains no assets [§ 6012(a)(2) and Reg. § 1.6012–2(a)].

Estimated Tax Payments

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

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

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

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

b. Estimated payments can be made in four installments due on or before the fifteenth day of the fourth month, the sixth month, the ninth month, and the twelfth month of the corporate taxable year (§ 6655).

(1) Therefore, for a calendar year corporation, estimated payments are due April 15, June 15, September 15, and December 15.

(2) A corporation failing to pay its required estimated payments will be subjected to a nondeductible penalty on the amount by which the installments are less than the tax due.

- There are exceptions to this underpayment penalty.
- The penalty is imposed on each installment. A corporation must pay one-fourth of its required annual payment by the due date of each installment.

c. Corporations having taxable income of at least $1 million in any of the prior three years (a "large" corporation) can use the prior year exception only for the first installment payment. Any shortfall of this payment must be remedied in the second installment payment. (Example 34)

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

Schedule M–1—Reconciliation of Income (Loss) per Books with Income per Return

34. Schedule M–1 of Form 1120 reconciles the net income per financial accounting (i.e., per books) with taxable income per the tax return. That is, Schedule M–1 reports the book to tax differences for the year.

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

    b. The starting point in the reconciliation process is net income (loss) per books.

        (1) The following are entered as additions:
        - Federal income tax per books.
        - The excess of capital losses over capital gains.
        - Income that is reported in the current year for tax purposes but is not reported in computing net income per books (e.g., prepaid income).
        - Various expenses that are deducted in computing net income per books but are not allowed in computing taxable income (e.g., charitable contributions in excess of the 10% ceiling applicable to corporations).

        (2) The following are entered as subtractions:
        - Income reported for financial accounting purposes but not included in taxable income (e.g., tax-exempt interest).
        - Deductions taken on the tax return but not expensed in computing net income per books (e.g., DPAD).

        (3) The result is taxable income before the dividends received deduction and the NOL deduction. (Example 35)

Schedule M–2—Analysis of Unappropriated Retained Earnings per Books

35. Schedule M–2 reconciles unappropriated retained earnings at the beginning of the year with unappropriated retained earnings at year-end. (Example 36)

    a. Corporations with less than $250,000 of gross receipts and less than $250,000 in assets do not have to complete Schedule L (balance sheet) and Schedules M–1 and M–2.

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

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

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

b. Objectives of Schedule M–3 are the following:

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

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

37. Schedule M–3 has three parts.

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

(1) Financial net income (loss) sources come from the SEC Form 10-K, financial statements, or the corporation's books and records. (Example 37)

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

b. Part II reconciles net income (loss) per income statement of includible corporations with taxable income on the return. Corporations included in the financial reporting group may differ from the tax reporting group. (Example 38)

c. Part III reconciles expense and deduction items. (Examples 39 and 40)

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

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

Effect of Taxes on the Financial Statements

38. For tax years beginning in 2014 and later, Schedule UTP must be filed by corporations with $10 million or more in assets. In general, it requires reporting tax positions taken on a current (or prior) year's Federal tax return and for which the corporation recorded a reserve for Federal income tax in its audited financial statements. See Chapter 14 for a discussion on financial reporting of tax positions.

Form 1120 Illustrated

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

Consolidated Returns

40. Corporations that are members of a parent-subsidiary affiliated group may be able to file a consolidated income tax return for a taxable year. See Chapter 8.

2.5 TAX PLANNING

Corporate versus Noncorporate Forms of Business Organization

41. The decision to use the corporate tax form must consider both tax and nontax issues. Close attention should be paid to:

    a. Operating as a C corporation results in the imposition of the corporate tax rate. Corporate taxable income is taxed twice. Dividends are not deductible by the corporation, and qualified dividends paid to an individual are subject to a lower tax rate.

    b. The difference in the Federal tax brackets between an individual and a corporation may not be substantial. Several state and local governments impose higher taxes on corporations than on individuals. Consequently, the tax ramifications of incorporating can be determined only on a case-by-case basis.

    c. Corporate source income loses its identity as it passes through to the shareholders.

    d. It may be difficult for shareholders to recover some or all of their investment in the corporation without an ordinary income result.

    e. Corporate losses cannot be passed through to the shareholders.

    f. The corporate form provides shareholders with the opportunity to be treated as employees for tax purposes if the shareholders render services to the corporation.

Operating the Corporation

42. Effective tax planning before year-end can cause income to be shifted to the next tax year and can produce deductions by incurring expenses in the current year. Focus on the following issues:

    a. Charitable contributions. Accrual-basis corporations can claim a deduction for contributions in the year preceding payment if certain conditions are met.

    b. Timing of capital gains and losses. Offset gains on sale of capital assets with capital losses. Monitor any already realized capital losses so they do not expire before they can be used.

    c. Net operating losses. In some situations, electing to forgo an NOL carryback may generate greater tax savings. (Example 41)

    d. Dividends received deduction. Consideration should be given to the proper timing of income and deductions to bring the NOL rule into play. (Example 42)

e. Organizational expenditures. Corporations formed late in the year should consider adopting a fiscal year to make sure that organizational expenditures are incurred in the first taxable year of the corporation. (Example 43)

f. Shareholder-employee payment of corporate expenses. Decide if corporate expenses should be kept at the corporate level or shifted to the shareholder-employee.

Return to the Big Picture

Conducting Skylark Bakery as a corporation would save Samantha $9,375 in income taxes annually, computed as follows:

Total income tax if the bakery is operated as a sole proprietorship, with an operating profit of $100,000	$33,750
If the bakery is operated as a regular corporation:	
Tax on corporate taxable income of $51,500	$ 7,875
Tax on Samantha's salary of $55,000 (33% rate)	16,500
Total income tax when operated as a C corporation	$24,375
Difference	$ 9,375

Note: See the text for computations of tax and corporate taxable income.

The above results occur when a high-income individual taxpayer takes advantage of the lower marginal tax rates of corporations. Other issues, such as employment tax considerations and the taxation of dividend distributions (income and Medicare surtax), also should be considered. Further, other potential entity options, such as the LLC and S corporation, should be evaluated.

What If?

What if the bakery in the first year it becomes a corporation generates a $10,000 short-term capital loss (STCL) on the disposition of some of its stock investments? Regular corporations can only deduct capital losses against capital gains; thus, the $10,000 STCL would not be deductible currently and would be carried forward for up to five years. If the bakery is operated as a sole proprietorship, Samantha would report the capital loss on her individual return. She could use the $10,000 STCL to offset any capital gains she may have and deduct up to $3,000 of the loss against ordinary income.

RESEARCH PROBLEMS

Solutions to end-of-chapter Research Problems are located in the Solutions Manual.

1. In general, what is the filing deadline for a C corporation in 2016?

    a. March 15
    b. April 15
    c. The 15th day of the 3rd month after year end
    d. The 15th day of the 4th month after year end

    a. Incorrect. In general, a C corporation is required to file its tax return by the 15th day of the 4th month after its year end, which would be April 15 for a calendar year corporation.
    b. Incorrect. In general, a C corporation is required to file its tax return by the 15th day of the 4th month after its year end, which would be April 15 for a calendar year corporation.
    c. Incorrect. In general, a C corporation is required to file its tax return by the 15th day of the 4th month after its year end, which would be April 15 for a calendar year corporation.
    d. **Correct!** In general, a C corporation is required to file its tax return by the 15th day of the 4th month after its year end, which would be April 15 for a calendar year corporation.

2. Keckye Co. is a calendar year C Corporation. When is Keckye's 2016 tax return due?

    a. March 15, 2017
    b. April 15, 2017
    c. June 15, 2017
    d. October 15, 2017

    a. Incorrect. In general, a C corporation is required to file its tax return by the 15th day of the 4th month after its year end, which would be April 15 for a calendar year corporation.
    b. **Correct!** In general, a C corporation is required to file its tax return by the 15th day of the 4th month after its year end, which would be April 15 for a calendar year corporation.
    c. Incorrect. In general, a C corporation is required to file its tax return by the 15th day of the 4th month after its year end, which would be April 15 for a calendar year corporation.
    d. Incorrect. In general, a C corporation is required to file its tax return by the 15th day of the 4th month after its year end, which would be April 15 for a calendar year corporation.

3. Keckye Co. is a C corporation with a fiscal year-end of September 30. When is Keckye's 2016 tax return due?

    a. March 15, 2017
    b. April 15, 2017
    c. December 15, 2016
    d. January 15, 2017

    a. Incorrect. A C corporation is required to file its tax return by the 15th day of the 3rd month after its year end, which would be March 15 for a calendar year corporation. A corporation with a September 30 year-end would be required to file by December 15.
    b. Incorrect. A C corporation is required to file its tax return by the 15th day of the 3rd month after its year end, which would be March 15 for a calendar year corporation. A corporation with a September 30 year-end would be required to file by December 15.

c. **Correct!** A C corporation is required to file its tax return by the 15th day of the 3rd month after its year end, which would be March 15 for a calendar year corporation. A corporation with a September 30 year-end would be required to file by December 15.
d. Incorrect. A C corporation is required to file its tax return by the 15th day of the 3rd month after its year end, which would be March 15 for a calendar year corporation. A corporation with a September 30 year-end would be required to file by December 15.

4. Identify which of the following **cannot** function as a pass-through entity for tax purposes.
   a) Sole proprietorship
   b) Limited Liability Company
   c) Partnership
   d) S-Corporation

   a) Correct! A pass-through entity is one that is a separate entity responsible for filing its own tax return but not subject to tax. Instead, its ordinary income and each category of its special income, deductions, gains, and losses are included in, or passed through to, the tax returns of the owners. A sole proprietorship does not file a separate information return but is rather included in the tax return of the proprietor.
   b) Incorrect. A pass-through entity is one that is a separate entity responsible for filing its own tax return but not subject to tax. Instead, its ordinary income and each category of its special income, deductions, gains, and losses are included in, or passed through to, the tax returns of the owners. A sole proprietorship does not file a separate information return but is rather included in the tax return of the proprietor.
   c) Incorrect. A pass-through entity is one that is a separate entity responsible for filing its own tax return but not subject to tax. Instead, its ordinary income and each category of its special income, deductions, gains, and losses are included in, or passed through to, the tax returns of the owners. A sole proprietorship does not file a separate information return but is rather included in the tax return of the proprietor.
   d) Incorrect. A pass-through entity is one that is a separate entity responsible for filing its own tax return but not subject to tax. Instead, its ordinary income and each category of its special income, deductions, gains, and losses are included in, or passed through to, the tax returns of the owners. A sole proprietorship does not file a separate information return but is rather included in the tax return of the proprietor.

5. The following chart shows ownership percentages of Devon Corp. in X, Y and Z Corporations, and dividends received by Devon from these corporations in 2016.

	Devon's Ownership %	**Dividend Received**
X Corp.	15%	$100,000
Y Corp.	20%	$120,000
Z Corp.	30%	$200,000

   Devon is a calendar-year corporation and received no other dividends in 2016. What amount of dividend income must be included by Devon on its 2016 corporate tax return?

   a) $126,000
   b) $114,000
   c) $94,000
   d) $106,000

a) Incorrect. A corporation is entitled to reduce its income by a dividends received deduction equal to a percentage of dividends received, with the percentage determined by ownership. When ownership is below 20%, as with X Corp. there is a 70% dividends received deduction making 30% of the $100,000 in dividends received, or $30,000, taxable. When ownership is at least 20% but is below 80%, as is the case with both Y and Z, the dividends received deduction is 80%, making 20% of the $320,000 in dividends received, or $64,000, taxable. Total taxable dividends will be $30,000 + $64,000 or $94,000.
b) Incorrect. A corporation is entitled to reduce its income by a dividends received deduction equal to a percentage of dividends received, with the percentage determined by ownership. When ownership is below 20%, as with X Corp. there is a 70% dividends received deduction making 30% of the $100,000 in dividends received, or $30,000, taxable. When ownership is at least 20% but is below 80%, as is the case with both Y and Z, the dividends received deduction is 80%, making 20% of the $320,000 in dividends received, or $64,000, taxable. Total taxable dividends will be $30,000 + $64,000 or $94,000.
c) Correct! A corporation is entitled to reduce its income by a dividends received deduction equal to a percentage of dividends received, with the percentage determined by ownership. When ownership is below 20%, as with X Corp. there is a 70% dividends received deduction making 30% of the $100,000 in dividends received, or $30,000, taxable. When ownership is at least 20% but is below 80%, as is the case with both Y and Z, the dividends received deduction is 80%, making 20% of the $320,000 in dividends received, or $64,000, taxable. Total taxable dividends will be $30,000 + $64,000 or $94,000.
d) Incorrect. A corporation is entitled to reduce its income by a dividends received deduction equal to a percentage of dividends received, with the percentage determined by ownership. When ownership is below 20%, as with X Corp. there is a 70% dividends received deduction making 30% of the $100,000 in dividends received, or $30,000, taxable. When ownership is at least 20% but is below 80%, as is the case with both Y and Z, the dividends received deduction is 80%, making 20% of the $320,000 in dividends received, or $64,000, taxable. Total taxable dividends will be $30,000 + $64,000 or $94,000.

6. Crimson Corp. was organized as a calendar year corporation in January 2016, incur- ring $51,000 in qualified organizational expenses, and began business in March 2016. What is the maximum amount Crimson may deduct for organizational expenditures on its 2016 corporate tax return?

a. $4,000
b) $6,611
c) $6,350
d) $7,133

a) Incorrect. Up to $5,000 in qualifying organizational expenses are deductible in the year incurred, with the amount reduced by the amount by which total organizational expenses exceed $50,000. With a total of $51,000, Crimson could deduct $4,000. In addition, the remaining $47,000 is amortized over 15 years, or 180 months, beginning in the period in which the entity commences operations. Since Crimson began operations in March 2016, amortization would be for 10 months or 10/180 x $47,000 =$2,611 and total deductible organizational expenses will be $4,000 + $2,611 or $6,611.

b) Correct! Up to $5,000 in qualifying organizational expenses are deductible in the year incurred, with the amount reduced by the amount by which total organizational expenses exceed $50,000. With a total of $51,000, Crimson could deduct $4,000. In addition, the remaining $47,000 is amortized over 15 years, or 180 months, beginning in the period in which the entity commences operations. Since Crimson began operations in March 2016, amortization would be for 10 months or 10/180 x $47,000 =$2,611 and total deductible organizational expenses will be $4,000 + $2,611 or $6,611.

c) Incorrect. Up to $5,000 in qualifying organizational expenses are deductible in the year incurred, with the amount reduced by the amount by which total organizational expenses exceed $50,000. With a total of $51,000, Crimson could deduct $4,000. In addition, the remaining $47,000 is amortized over 15 years, or 180 months, beginning in the period in which the entity commences operations. Since Crimson began operations in March 2016, amortization would be for 10 months or 10/180 x $47,000 =$2,611 and total deductible organizational expenses will be $4,000 + $2,611 or $6,611.

d) Incorrect. Up to $5,000 in qualifying organizational expenses are deductible in the year incurred, with the amount reduced by the amount by which total organizational expenses exceed $50,000. With a total of $51,000, Crimson could deduct $4,000. In addition, the remaining $47,000 is amortized over 15 years, or 180 months, beginning in the period in which the entity commences operations. Since Crimson began operations in March 2016, amortization would be for 10 months or 10/180 x $47,000 =$2,611 and total deductible organizational expenses will be $4,000 + $2,611 or $6,611.

7. When preparing Schedule M-1 of Form 1120, which of the following must be **added** to net income per books in order to compute taxable income?

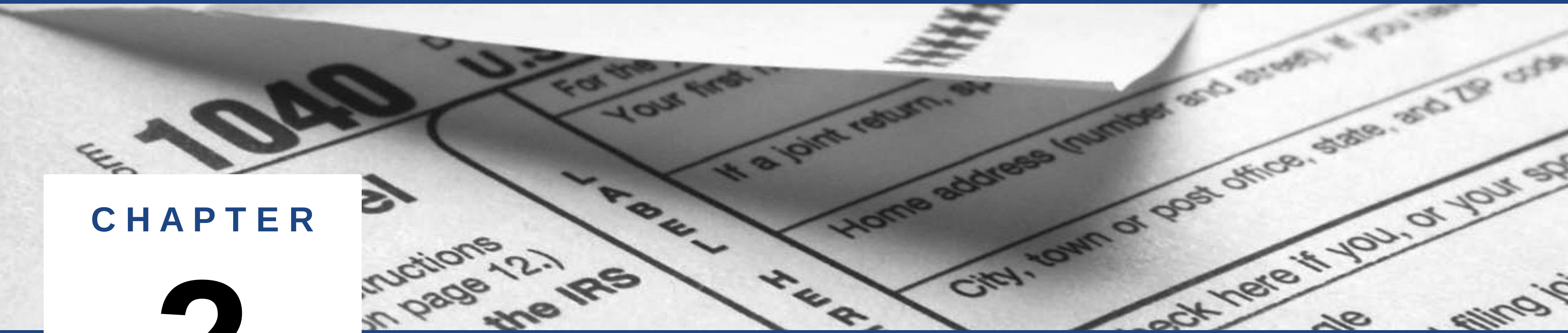
a) 100% of meals and entertainment expense
b) Municipal bond interest
c) Excess of tax vs. book depreciation
d) Accrued bad debt expense

a) Incorrect. To convert from book income to taxable income, bad debt expense, accrued in the period of sale, will have to be added back since it is not deductible until the account is written off. Half, not 100%, of meals and entertainment expense would be added back to book income to calculate taxable income.

b) Incorrect. To convert from book income to taxable income, bad debt expense, accrued in the period of sale, will have to be added back since it is not deductible until the account is written off. Municipal bond interest is not taxable and would be deducted from, not added to, book income to determine taxable income.

c) Incorrect. To convert from book income to taxable income, bad debt expense, accrued in the period of sale, will have to be added back since it is not deductible until the account is written off. The excess of tax over book depreciation is deducted from book income, not added to it.

d) Correct! To convert from book income to taxable income, bad debt expense, accrued in the period of sale, will have to be added back since it is not deductible until the account is written off. Half, not 100%, of meals and entertainment expense would be added back to book income to calculate taxable income. Municipal bond interest is not taxable and would be deducted from, not added to, book income to determine taxable income. The excess of tax over book depreciation is deducted from book income, not added to it.



CHAPTER

2

Corporations: Introduction and Operating Rules

Corporations, Partnerships, Estates & Trusts

SOUTH-WESTERN
FEDERAL TAXATION

The Big Picture (slide 1 of 2)

- Samantha Johnson owns Skylark Bakery
  - Currently, the bakery is operated as a sole proprietorship and generates an annual operating profit of $100,000
- In addition, the bakery earns annual dividends of $5,000 from investing excess working capital
  - These stock investments typically are held for a minimum of three to four months
- Due to income from other business ventures and investments, Samantha is in the 33% marginal tax rate bracket irrespective of the bakery

The Big Picture (slide 2 of 2)

- In the past, Samantha has withdrawn $50,000 annually from the bakery
  - She sees this as reasonable payment for her services
- Samantha has asked you about the tax consequences of conducting the business as a regular (C) corporation
  - Based on the given information, what would be the annual income tax savings (or cost) of operating the bakery as a corporation?
    - For purposes of this analysis, use the 2016 tax rates and ignore any employment tax or state tax considerations
- Read the chapter and formulate your response

Various Business Forms

- Business operations can be conducted in a number of different forms including
  - Sole proprietorships
  - Partnerships
  - Trusts and estates
  - S corporations (also called Subchapter S corps)
  - Regular corporations (also called C corps)
  - Limited liability companies

Sole Proprietorship

- Not a separate taxable entity
- Income reported on owner's Sch. C

The Big Picture – Example 1
Sole Proprietorships

- Return to the facts of The Big Picture on p. 2-1
- Samantha, the sole proprietor of Skylark Bakery, reports the $100,000 operating profit from the business on Schedule C of her individual tax return
  - Even though she withdrew only $50,000, Samantha reports all of the $100,000 operating profit from the business on Form 1040, where she computes taxable income for the year
- She also reports dividend income of $5,000 on Schedule B of Form 1040

Partnership (slide 1 of 2)

- Separate entity, but does not pay tax
  - Files information return (Form 1065)
- Most income and expense items are aggregated in computing the ordinary business income (loss) of the partnership
  - Certain income and expense items are reported separately to the partners
  - e.g., Interest and dividend income, long term capital gain, charitable contributions and investment expenses

Partnership (slide 2 of 2)

- Partnership ordinary business income (loss) and separately reported items are allocated to partners according to their profit and loss sharing ratios
  - Each partner receives a Schedule K–1
    - Reports partner's share of partnership ordinary business income (loss) and separately stated items
  - Each partner reports these items on his or her own tax return

S Corporation

- Separate entity, only pays special taxes (e.g., built-in gains)
  - Files information return Form 1120S
- Similar to partnership taxation
  - Ordinary business income (loss) flows through to the shareholders to be reported on their separate returns
  - Certain items flow through to the shareholders and retain their separate character when reported on the shareholders' returns
- The S corporation ordinary business income (loss) and the separately reported items are allocated to the shareholders according to their stock ownership interests

C Corporation

- C corporations are subject to an entity-level Federal income tax which results in what is known as a *double taxation* effect
  - C corporation reports its income and expenses and computes tax on the taxable income reported on its Form 1120
    - Uses tax rate schedule applicable to corporations
  - When corporation distributes its income, the corporation's shareholders report dividend income on their own tax returns
    - Thus, income that has already been taxed at the corporate level is also taxed at the shareholder level

Dividends

- Double taxation stems, in part, from the fact that dividend distributions are not deductible by the corporation
- To alleviate some of the double taxation effect, Congress reduced the tax rate applicable to dividend income of individuals
  - Generally, dividends are taxed at the same marginal rate applicable to a net capital gain
    - Thus, individuals otherwise subject to the 10% or 15% marginal tax rate pay 0% tax on qualified dividends received
    - Individuals subject to the 25, 28, 33, or 35 percent marginal tax rates pay a 15% tax on qualified dividends
    - Individuals subject to the 39.6% marginal tax rate pay a 20% tax on qualified dividends

Medicare Surtax

- Beginning in 2013, § 1411 imposes a 3.8% Medicare surtax on a taxpayer's net investment income in excess of modified adjusted gross income of $200,000 ($250,000 if married filing jointly)
  - Thus, for high-income taxpayers, the double taxation of dividend income is increased by this surtax

Corporate Income Tax Rates

EXHIBIT 2.1 Corporate Income Tax Rates

Taxable Income		Tax Is:	
Over—	**But Not Over—**		**Of the Amount Over—**
$ 0	$ 50,000	15%	$ 0
50,000	75,000	$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	—	35%	0

Nontax Issues in Selecting Entity Form (slide 1 of 3)

- Liability
  - Sole proprietors and some partners have *unlimited liability* for claims against the entity
- Capital-raising
  - Corporations and partnerships to a lesser extent can raise large amounts of capital for entity ventures

Nontax Issues in Selecting Entity Form (slide 2 of 3)

- Transferability
  - Corporate stock is easily sold, but partners must approve partnership interest transfer
- Continuity of life
  - Corporations exist indefinitely

Nontax Issues in Selecting Entity Form (slide 3 of 3)

- Centralized management
  - Corporate actions are governed by a board of directors
  - Partnership operations may be conducted by each partner without approval by other partners

Limited Liability Companies (LLC)

- LLCs have proliferated since 1988 when IRS ruled it would treat qualifying LLCs as partnerships
  - Major nontax advantage
    - Allows owners to avoid unlimited liability
  - Major tax advantage
    - Allows qualifying business to be treated as a partnership for tax purposes, thereby avoiding double taxation associated with C corporations

Entity Classification Prior to 1997 (slide 1 of 2)

- Sometimes difficult to determine if entity will be taxed as a corporation
  - If entity has a majority of corporate characteristics, it is taxed as a corporation
  - Most entities have the following characteristics:
    - Associates
    - Objective to carry on business and share profits

Entity Classification Prior to 1997 (slide 2 of 2)

- If entity has a majority of the following relevant corporate characteristics it is treated as a corporation:
  - Continuity of life
  - Centralized management
  - Limited liability to owners
  - Free transferability of ownership interests

Entity Classification After 1996 (slide 1 of 2)

- Check-the-box Regulations
  - Allows taxpayer to choose tax status of entity without regard to corporate or noncorporate characteristics
  - Entities with > 1 owner can elect to be classified as partnership or corporation
  - Entities with only 1 owner can elect to be classified as sole proprietorship or as corporation

Entity Classification After 1996 (slide 2 of 2)

- Check-the-box Regulations (cont'd)
  - If no election is made, multi-owner entities treated as partnerships, single person businesses treated as sole proprietorships
  - Election is not available to:
    - Entities incorporated under state law
    - Entities required to be corporations under federal law (e.g., certain publicly traded partnerships)

Comparison of Corporate and Individual Tax Treatment (slide 1 of 3)

- Similarities
  - Gross Income of a corporation and individual are very similar
    - Includes compensation for services, income from trade or business, gains from property, interest, dividends, etc
    - Corp taxpayers are allowed fewer exclusions
    - Nontaxable exchange treatment is similar
  - Business deductions of a corporation and individual also are very similar

Comparison of Corporate and Individual Tax Treatment (slide 2 of 3)

- Dissimilarities
  - Different tax rates apply
  - All deductions of corp are business deductions
    - Corp does not calculate AGI
    - Corp does not deduct standard deduction, itemized deductions, or personal and dependency exemptions
    - Corp does not reduce casualty and theft loss by $100 statutory floor and 10% of AGI

Comparison of Corporate and Individual Tax Treatment (slide 3 of 3)

FIGURE 2.1 Tax Formulas

Corporations	Individuals
Income (broadly conceived)	Income (broadly conceived)
(Exclusions)	(Exclusions)
Gross income	Gross income
(Deductions except for NOL and DRD)*	(Deductions for AGI)**
Taxable income before NOL and DRD	Adjusted gross income
(Net operating loss deduction)	(Greater of itemized or standard deductions)
(Dividends received deduction)	(Personal and dependency exemptions)
Taxable income	Taxable income
Tax on taxable income	Tax on taxable income
(Tax credits)	(Tax credits)
Tax due (or refund)	Tax due (or refund)

*NOL = net operating loss; DRD = dividends received deduction.
**AGI = adjusted gross income.

Specific Provisions Compared

- In comparing the income taxation of individuals and corporations the following areas warrant special discussion:
  - Accounting periods and methods
  - Capital gains and losses
  - Recapture of depreciation
  - Passive losses
  - Charitable contributions
  - Domestic production activities deduction
  - Net operating losses
  - Special deductions available only to corporations

Accounting Periods and Methods
(slide 1 of 2)

- Accounting periods
  - Most C corporations can use calendar year or fiscal year ending on last day of a calendar month (or 52-53 week year)
  - S corps and Personal Service Corporations (PSC) are limited in available year ends

Accounting Periods and Methods
(slide 2 of 2)

- Accounting methods
  - Cash method can't be used by C corp. unless:
    - In farming or timber business
    - Qualified PSC
    - "Ave. Annual Gross receipts" ≤ $5,000,000
  - As a matter of administrative convenience, the IRS will permit
    - Entities with ave. annual gross receipts of $1 million or less for the most recent 3 year period to use the cash method (even if buying and selling inventory)
    - Certain entities with ave. annual gross receipts greater than $1 million but not more than $10 million for the most recent 3 year period to use the cash method

The Big Picture – Example 11
Accrual Method Of Accounting And Cash Basis Related Parties (slide 1 of 2)

- Return to the facts of The Big Picture on p. 2-1
- Assume that Samantha incorporates her business as Skylark Bakery, Inc., a calendar year, *accrual* method C corporation.
  - Samantha, a *cash* method taxpayer, owns 100% of the corporation's stock at the end of 2016

The Big Picture – Example 10
Accrual Method Of Accounting And Cash Basis Related Parties (slide 2 of 2)

- On December 31, 2016, Skylark Bakery has accrued a $10,000 bonus to Samantha
  - Samantha receives the bonus in 2017 and reports it on her 2017 tax return
- Skylark Bakery cannot claim a deduction for the $10,000 until 2017

Capital Gains and Losses (slide 1 of 2)

- Individuals
  - Net capital gains subject to the following preferential tax treatment
    - Net short-term gains subject to regular tax rates
    - Net long-term gains max tax rate 20%
  - Net capital losses deductible up to $3,000 with remainder carried to future years
    - Carryovers do not lose their identity but remain either long term or short term

Capital Gains and Losses (slide 2 of 2)

- Corporations
  - No special tax rates apply to capital gains
    - Entire gain is included in income subject to normal corporate tax rates
  - Corp cannot take a deduction for net capital losses
    - Capital losses can be used only to offset capital gains
    - Unused capital losses are carried back 3 years and carried forward for 5 years
      - All carried over losses are treated as short-term

Depreciation Recapture

- In general, the recapture rules under §§ 1245 and 1250 are equally applicable to both individual and corporate taxpayers
  - However, corporations may have more depreciation recapture (ordinary income) on the disposition of § 1250 property than individuals
- Under § 291, a corporation has additional ordinary income equal to 20% percent of the excess of
  - Depreciation recapture that would arise if property was § 1245 property over depreciation recapture computed under § 1250 (without regard to § 291)

Passive Losses

- Passive loss rules apply to:
  - Individuals and personal service corps
    - Cannot offset passive losses against active or portfolio income
  - S corps and partnerships
    - Passive income and loss flows through to owners and rules applied at owner level
  - Closely held C corps
    - May offset passive losses against active income, but not portfolio income

Charitable Contributions
(slide 1 of 5)

- Both corporate and noncorporate taxpayers may deduct charitable contributions in year paid
  - Exception for accrual basis corporations allows deduction in year preceding payment if:
    - Authorized by the board of directors by the end of that year, and
    - Paid within 3 ½ months of year end

Charitable Contributions
(slide 2 of 5)

- Amount deductible for property contributions depends on type of property contributed
- Long-term capital gain property deduction = fair market value of property
  - Exception: Corp may only deduct basis if tangible personal property contributed and not used by charity in its exempt function

Charitable Contributions

(slide 3 of 5)

- Long-term capital gain property deduction = fair market value of property (cont'd)
  - Exception: Deduction for property contribution to certain private nonoperating foundations is limited to basis in property

Charitable Contributions
(slide 4 of 5)

- Ordinary income property deduction = basis in property
  - Exception: Basis plus 50 % of appreciation can be deducted if inventory or research property is contributed which is used by charity as required by Code
    - Deduction is limited to twice the property’s basis

Charitable Contributions
(slide 5 of 5)

- Corporate charitable contribution deduction is limited to 10% of taxable income before:
  - Charitable contribution deduction
  - NOL or capital loss carryback
  - Dividends received deduction, and
  - Domestic production activities deduction
- Contributions in excess of 10% limit can be carried forward for 5 years

Domestic Production Activities Deduction

- The American Jobs Creation Act of 2004 created a new deduction based on the income from manufacturing activities
  - The domestic production activities deduction is based on the following formula:
    - 9% × Lesser of
      - Qualified production activities income
      - Taxable (or adjusted gross) income
    - The deduction cannot exceed 50% of an employer's W–2 wages related to qualified production activities income

Net Operating Loss

- Net operating losses of corporations and individuals may be:
  - Carried back two years
  - Unused portion carried forward 20 years
- Unlike individuals, a corporation does not:
  - Adjust its tax loss for capital losses, since a corporation cannot deduct net capital losses
  - Make adjustments for any nonbusiness deductions
- A corporation is allowed to include the dividends received deduction (discussed below) in computing its NOL

Dividends Received Deduction

(slide 1 of 3)

- If corporation owns stock in another corporation and receives dividends, a portion of dividends may be deducted from income:

Percentage of Ownership by Corporate Shareholder	Deduction Percentage
Less than 20%	70%
20% or more (but less than 80%)	80%
80% or more*	100%

* The payor corporation must be a member of an affiliated group with the recipient corporation.

Dividends Received Deduction
(slide 2 of 3)

- The dividends received deduction is limited to a percentage of the taxable income of a corporation
  - For this purpose, taxable income is computed without regard to
    - The NOL deduction
    - The domestic production activities deduction
    - The dividends received deduction
    - Any capital loss carryback to the current tax year
  - The percentage of taxable income limitation corresponds to the deduction percentage
  - However, the taxable income limitation does not apply if the corporation has an NOL for the current taxable year

Dividends Received Deduction

(slide 3 of 3)

The following steps are useful in calculating the dividends received deduction

1. Multiply dividends received by deduction percentage
2. Multiply taxable income by deduction percentage
3. Subtract 1. from taxable income

   -If entity has income before DRD, but DRD creates NOL, amount in 1. is DRD (the NOL rule)

   -If DRD does not create NOL, deduction is limited to lesser of 1. or 2.

DRD Examples

Red, White, and Blue Corporations, three unrelated calendar year corporations, have the following information for the year:

	Red Corporation	White Corporation	Blue Corporation
Gross income from operations	$ 400,000	$ 320,000	$ 260,000
Expenses from operations	(340,000)	(340,000)	(340,000)
Dividends received from domestic corporations (less than 20% ownership)	200,000	200,000	200,000
Taxable income before the dividends received deduction	$ 260,000	$ 180,000	$ 120,000

In determining the dividends received deduction, use the three-step procedure described above:

	Red	White	Blue
Step 1 (70% × $200,000)	$140,000	$140,000	$140,000
Step 2			
70% × $260,000 (taxable income)	$182,000		
70% × $180,000 (taxable income)		$126,000	
70% × $120,000 (taxable income)			$ 84,000
Step 3			
Lesser of step 1 or step 2	$140,000	$126,000	
Deduction results in an NOL (use Step 1)			$140,000

Organizational Expenditures
(slide 1 of 2)

- A corporation may elect to amortize organizational expenses over a 180-month period beginning with the month in which the corporation begins business
- A special exception allows the corporation to immediately expense the first $5,000 of these costs
    - Phased out on a dollar-for-dollar basis when these expenses exceed $50,000

Organizational Expenditures
(slide 2 of 2)

- Organizational expenditures include the following:
  - Legal services incident to organization
  - Necessary accounting services
  - Expenses of temporary directors and of organizational meetings of directors and shareholders
  - Fees paid to the state of incorporation
- Expenditures connected with issuing or selling shares of stock or other securities or with the transfer of assets to a corporation do not qualify
  - Such expenditures reduce the amount of capital raised and are not deductible at all

Organizational Expenditures Example

- Wren Corp. incurs $53,000 of organizational costs
  - Wren can expense $2,000 of this amount
    [$5,000 - ($53,000 - $50,000)]
  - The $51,000 balance is amortized over 180 months

Start-up Expenditures
(slide 1 of 2)

- Start-up expenditures include:
  - Various investigation expenses involved in entering a new business
    - e.g., Travel, market surveys, financial audits, legal fees
  - Also includes operating expenses, such as rent and payroll, that are incurred by a corporation before it actually begins to produce any gross income

Start-up Expenditures
(slide 2 of 2)

- At the election of the taxpayer, such expenditures can be treated in the same manner as organizational expenditures
  – Up to $5,000 can be immediately expensed (subject to the dollar cap and excess-of-$50,000 phaseout)
  – Any remaining amounts are amortized over a period of 180 months

Corporate Tax Formula

Gross income

Less: Deductions (except charitable, Div. Rec'd, NOL carryback, STCL carryback)

Taxable income for charitable limitation

Less: Charitable contributions (<= 10% of above)

Taxable income for div. rec'd deduction

Less: Dividends received deduction

Taxable income before carrybacks

Less: NOL carryback and STCL carryback

TAXABLE INCOME

The Big Picture – Example 30
Corporate Income Tax Liability (slide 1 of 2)

- Return to the facts of The Big Picture on p. 2-1
- Assume that Samantha incorporates her business as Skylark Bakery, Inc., a calendar year C corporation
  - The corporation pays Samantha a salary of $50,000 for the year
- For 2016, Skylark Bakery has taxable income of $51,500
  - [$100,000 operating profit + $5,000 dividends – $50,000 salary expense – $3,500 dividends received deduction ($5,000 X 70%)]

The Big Picture – Example 30
Corporate Income Tax Liability (slide 2 of 2)

- Its income tax liability is $7,875, determined as follows:

Tax on $50,000 at 15%	$7,500
Tax on $1,500 at 25%	375
Tax liability	$7,875

Alternative Minimum Tax

- Corporations are subject to an alternative minimum tax (AMT) that is similar to the AMT applicable to individuals
  - Many of the adjustments and tax preference items are the same for individuals and corporations
  - The AMT rate and exemption amount for corporations are different from those applicable to individuals

Tax Liability of Related Corporations

- Subject to special rules for computing income tax, the accumulated earnings credit, and the AMT exemption
  - e.g., Limits controlled group's taxable income in tax brackets below 35% to amount corporations in group would have if they were one corporation
- Controlled group includes:
  - Parent-subsidiary groups
  - Brother-sister groups
  - Combined groups

Corporate Filing Requirements
(slide 1 of 2)

- Must file Form 1120 on or before the 15th day of 4th month following close of tax year even if it has no taxable income
  - Automatic 6 month extensions are available by filing Form 7004

Corporate Filing Requirements
(slide 2 of 2)

- Must make estimated tax payments equal to lesser of:
  - 100% of corporation’s tax for the current year
  - 100% of tax for preceding year
- No estimated tax payments required if tax liability expected to be less than $500

Schedule M-1

- Corporations must reconcile financial accounting income with taxable income on Sch M-1, Form 1120
  - Common reconciling items include:
    - Federal income tax per books
    - Net capital losses
    - Income reported for tax but not book income (e.g., prepaid income) and vice versa
    - Expenses deducted for book income but not tax (e.g., excess charitable contributions) and vice versa

Schedule M-2

- Corporations must reconcile retained earnings at beginning of year with retained earnings at end of year using Sch M-2, Form 1120
  - Schedule L (balance sheet), Schedules M–1 and M–2 of Form 1120 are not required for corporations with less than $250,000 of gross receipts and less than $250,000 in assets

Schedule M-3

- Corporate taxpayers with total assets of $10 million or more are now required to report much greater detail regarding differences in financial accounting income (loss) and taxable income (loss)
  - Reported on Schedule M–3
- Schedule M–3 should
  - Create greater transparency between corporate financial statements and tax returns
  - Help the IRS identify corporations that engage in aggressive tax practices

Consolidated Returns

- Corporations that are members of a parent-subsidiary affiliated group may be able to file a consolidated income tax return for a taxable year

Refocus On The Big Picture

(slide 1 of 5)

- Conducting Skylark Bakery as a corporation would save Samantha $9,375 in income taxes annually, computed as follows:

Bakery Operated as Sole Proprietorship

Operating profit of $100,000:	
Tax on $100,000 @ 33%	$33,000
Dividends of $5,000:	
Tax on $5,000 @ 15%	750
Withdrawals of $50,000:	
No tax	–0–
Total income tax when operated as sole proprietorship	$33,750

Refocus On The Big Picture

Tax - Bakery Operated as Regular Corporation

Corporate taxable income	$51,500
Tax on $50,000 @ 15%	$ 7,500
Tax on $1,500 @ 25%	375
Total corporate income tax	$ 7,875
Samantha's salary of $50,000:	
Tax on $50,000 @ 33%	16,500
Total income tax when operated as C corporation	$ 24,375

Refocus On The Big Picture

(slide 3 of 5)

- Computation of corporate taxable income:

Operating profit	$100,000
Dividends	5,000
Less: Salary to Samantha	(50,000)
Dividends rec'd deduction (70%)	(3,500)
Taxable income	$ 51,500

Refocus On The Big Picture
(slide 4 of 5)

- The example illustrates the tax savings available when a high-income individual takes advantage of the lower marginal tax rates of C corporations
- However, other issues also should be considered, such as
  - Employment tax considerations
  - Taxation of dividend distributions (income and Medicare surtax)
- Further, other potential entity options, such as the LLC and S corporation, also should be evaluated

Refocus On The Big Picture

(slide 5 of 5)

- What if the bakery becomes a corporation and generates a $10,000 short-term capital loss (STCL)?
  - Regular corporations can only deduct capital losses against capital gains
    - Thus, the $10,000 STCL would not be deductible currently by the corporation
    - Instead, it would be carried forward for up to 5 years.
  - If the bakery is operated as a sole proprietorship, Samantha would report the capital loss on her individual return
    - She could use the $10,000 STCL to offset any capital gains she may have, and deduct up to $3,000 of the loss against ordinary income

If you have any comments or suggestions concerning this PowerPoint Presentation for South-Western Federal Taxation, please contact:

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