1

Income Taxation of Corporations

Solutions to Tax Research Problems

TAX RESEARCH PROBLEMS

1-35 Linda is correct in her assessment that the regular corporate form will not be a suitable vehicle for holding her investment property. This option is not viable because losses will remain within the corporation for possible future use against corporate income. Because she can qualify for the $25,000 exception to the passive activity loss rules for actively managed rental realty, she will want the losses passed through to her for use on her individual return.

Linda is also correct with respect to using an S corporation as a vehicle for holding her investment. Although use of an S corporation would appear ideal because losses flow through to the shareholders, the total amount of deductible losses allowed to her would be limited to the basis in her capital account ($40,000). Given the high rate of interest on her loan and the riskiness of her investment, her basis could be reduced to zero within several years.

Linda's third option is interesting and, according to the Supreme Court case of *Bollinger*, viable. If the corporation can be formed as a regular corporation and be treated for Federal income purposes as Linda's agent, all losses will pass through to her and may be used against her total basis in the investment of $240,000. Her basis in her investment includes the nonrecourse note because the investment in realty was acquired with a nonrecourse loan from a qualified lender [see § 465 (b)(6)].

There are, however, a number of precautions for ensuring acceptability of this third option by the IRS. According to the Supreme Court in *Bollinger,* the corporate-agent relationship is established if (1) the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, (2) the corporation functions as the agent and not the principal with respect to the asset for all purposes, and (3) the corporation is held out as the agent and not the principal in all dealings with third parties relating to the asset.

If Linda follows the Supreme Court guidelines, it is very likely she will obtain her objectives. What specifically can she do? The *Bollinger* case provides a model of specific steps to take to establish an agency relationship. Bollinger formed an agency relationship with his corporation and stipulated that the corporation was formed solely to obtain financing, that the corporation was not liable for maintenance of the property or for repayment of any promissory notes, and that Bollinger would indemnify and hold the corporation harmless from any liability it might sustain as his agent.

Note: Solutions to tax return problems 1-33 and 1-34 are located after the test bank and answers.

1

Income Taxation of Corporations

Test Bank

True or False

________ 1. The proprietorship uses gross ordinary income as the basis for calculating any self-employment tax due.

________ 2. In contrast to a regular corporation, an S corporation's pass-through of income and deductions to its shareholders allows it to avoid double taxation of the same source of income.

________ 3. In transactions between the partners and the partnership, the parties are generally treated like unrelated parties.

________ 4. Section 11 of the Code imposes a tax on all corporations, including nonprofit organizations.

________ 5. A corporation is an artificial "person" created by Federal law.

________ 6. If an individual taxpayer creates a legal corporation under state law, the government (i.e., the IRS) cannot disregard the entity and tax the individual taxpayer on the income.

________ 7. Although recognized as partnerships under state law, certain partnerships are treated and taxed as corporations for Federal income tax purposes.

________ 8. All bad debts of a corporation are treated as business rather than nonbusiness bad debts.

________ 9. A corporation is allowed a dividends-received deduction only if the corporation is a member of an affiliated group and the dividends are received from another member of the same group.

________ 10. In computing a corporation's limitation on the dividends-received deduction, its taxable income is determined without the deductions for dividends received, net operating loss carryovers, and capital loss carrybacks.

________ 11. Where a dividends-received deduction adds to or creates a net operating loss, the taxable income limitation decreases from 70 percent to 34 percent.

_________ 12. At its election, a corporation can *either* deduct all organizational costs paid during the current year *or* amortize the expenditures over a period not less than 180 months.

_________ 13. Because organizational costs are assets with indefinite lives (i.e., they have value for the life of the corporation), they may not be expensed or amortized.

_________ 14. Organizational expenses incurred by an accrual basis corporation in its first year of existence but paid in a later year will not qualify for amortization.

_________ 15. If an accrual basis corporation incurs an additional expense in setting up its accounting system after the close of its first tax year but before the due date of its initial return, the expense qualifies as an organizational expense and may be amortized.

_________ 16. A corporation is not allowed a dividends-received deduction in computing its net operating loss for any given year.

_________ 17. A corporation's annual charitable contribution deduction is limited to 10 percent of its taxable income without reduction for charitable contributions, the dividends-received deduction, net operating loss carrybacks, and capital loss carrybacks.

_________ 18. In planning for its annual charitable contributions, a corporation should take into account any net operating loss or capital loss *carryforwards* since such items reduce the corporation's taxable income base for purposes of the annual deduction limitation.

_________ 19. Unlike individuals, corporations with excess capital losses in the current year are allowed to carry these losses back five years and forward three years to offset capital gains in the carryback or carryforward years.

_________ 20. A corporation may be required to recapture (as ordinary income) a greater portion of its gain on the sale of depreciable real property than would an individual taxpayer.

_________ 21. An accrual basis corporation must use the cash method in claiming deductions for amounts paid to its cash basis sole shareholder.

_________ 22. The 2012 Federal income tax rate for a calendar year corporation with taxable income of $335,000 up to $10 million is 34 percent.

_________ 23. Corporation A is equally owned by 10 unrelated individual shareholders. Corporation B is 100 percent owned by *one* of the shareholders that owns stock of Corporation A. As a result of this common stock ownership, Corporations A and B are members of a brother-sister controlled group.

________ 24. A personal service corporation with taxable income of $10,000 for its 2012 calendar year will have a regular Federal income tax liability of $3,500 before credits or prepayments.

________ 25. A corporation with alternative minimum taxable income of $20,000 will be subject to an alternative minimum tax of $4,000.

Multiple Choice

________ 26. Which of the following is *not* true?

a. Because all activities of a corporation are considered to be business activities, a corporation cannot have a nonbusiness bad debt.

b. The proprietorship, partnership, and S corporation pass through to individuals, partners, and shareholders all items of income, deduction, gain, loss, or credit for Federal income tax purposes.

c. Unlike individuals, a corporation's charitable deduction is limited to 10 percent of taxable income figured before certain deductions.

d. A corporation is allowed to deduct 70 percent of dividends paid to shareholders provided that it is a taxable domestic corporation.

e. By making a proper election on its tax return for the year of the loss, a corporation may forgo the two-year carryback and, instead, carry its net operating loss forward up to 20 years.

________ 27. Which of the following is *not* a corporate characteristic?

a. Free transferability

b. Ability to sue and be sued

c. Continuity of life

d. Centralized management

e. Limited liability

________ 28. Which of the following is treated the same for individuals and corporations?

a. Depreciation recapture

b. Charitable contributions

c. Capital losses

d. Depreciation

e. Bad debts

________ 29. R Corporation had 2012 gross income of $200,000, including $100,000 of dividends received from a less than 20 percent owned taxable domestic corporation. R had deductible business expenses of $110,000 before considering its dividends-received deduction. What is R Corporation's dividends-received deduction for 2012, assuming no restrictions other than the taxable income limitation may apply?

a. $63,000

b. $68,000

c. $70,000

d. $80,000

e. $100,000

________ 30. For its taxable year ending December 31, 2012, T Corporation has the following taxable income and deductible expenses:

Gross income from operations	$205,000
Deductible expenses of operations	218,000
Dividends received	35,000

The dividends were received from a taxable domestic corporation in which T owns 15 percent of the stock (not debt-financed). What is T Corporation's dividends-received deduction for 2012?

a. $0

b. $15,400

c. $21,000

d. $24,500

e. $35,000

________ 31. Corporations A, B, and C are *taxable domestic corporations.* All are members of an affiliated group. Corporation A pays a $50,000 dividend to B and a $50,000 dividend to C. Corporations B and C are each entitled to a dividends-received deduction of

a. $35,000

b. $40,000, subject to the taxable income limitation

c. $50,000

d. $0

e. None of the above

_________ 32. New Corporation was organized and began active business on January 7, 2012. New incurred the following expenses in connection with opening the business:

Legal fees for drafting the charter and bylaws $ 750

Legal fees for the transfer of the ownership titles of assets from shareholders to the corporation 100

State incorporation fees 250

Printing cost for stock certificates175

Fees paid to temporary directors for first two organization meetings 300

Accounting fees to set up initial recordkeeping system 400

Total $1,975

Assuming New Corporation adopts a calendar year for tax purposes, what is the maximum amount of organizational expenses that may be deducted on the corporation's initial tax return?

a. $0

b. $

c. $1,800

d. $1,975

_________ 33. A newly formed corporation elected to use a fiscal year ending June 30. On July 17, 2012, the corporation began business and incurred $8,000 of qualified organizational expenses. Assuming that the corporation properly elected to deduct/amortize these costs, what is the amount of organization expenses that it should deduct on its tax return for the fiscal year ending June 30, 2012.

a. $0

b. $533

c. $5,000

d. $5,200

________ 34. X Corporation, which files its tax return on a cash basis, incurred organizational costs (not to a related party) of $5,000 during its first year. $1,875 of these expenses were *paid* in the fourth month after the close of its taxable year. What is the maximum deduction the corporation is entitled to claim on its first tax return if that tax return is for a period of 1½ months and a proper election is made?

a. $0, because organizational costs have an indefinite life

b. $200

c. $3,125

d. $5,000

________ 35. The charitable deduction for a corporation is limited both by type of property contributed and an annual maximum amount. Which of the following is *a false* statement?

a. An accrual basis corporation may deduct contributions authorized during the tax year but actually paid within two and one-half months after the close of the tax year.

b. The annual maximum amount of charitable deduction for a corporation is 10 percent of taxable income calculated before certain deductions.

c. Generally, a corporation is allowed a deduction for the fair market value of capital gain and ordinary income property.

d. In certain cases where a corporation donates capital gain property, the allowable deduction is limited to the fair market value, reduced by the amount of unrealized appreciation (i.e., the deduction is limited to the property's adjusted basis).

________ 36. Which *one* of the following statements is *true* for a regular corporation?

a. Charitable contributions in excess of the 10 percent limitation may be carried over to subsequent years indefinitely.

b. A contribution carryover is allowed as a deduction even if it increases a net operating loss.

c. Charitable contributions in excess of the 10 percent limitation may, subject to limitations, be carried back to each of the preceding three years.

d. Charitable contributions in excess of the 10 percent limitation may, subject to limitations, be carried over to each of the following five years.

e. Subject to the 10 percent limitation, a carryover of excess contributions is used before the contributions made in the carryover year.

________ 37. T Corporation's taxable income for 2012 was $100,000, computed by erroneously deducting the corporation's total charitable contributions of $12,000. The *correct* contribution deduction for T Corporation is

a. $6,000

b. $8,800

c. $10,000

d. $11,200

e. $12,000

________ 38. During its first year of operation, K Corporation had a gross profit from operations of $180,000 and deductions of $250,000 before considering its dividend income or dividends-received deduction. K received dividends of $50,000 from a taxable domestic corporation in which K owned 4.5 percent of the stock. Assuming its ownership of the dividend-paying corporation's stock is not debt financed, what is K Corporation's net operating loss for the year?

a. $20,000

b. $49,000

c. $55,000

d. $65,000

e. $70,000

________ 39. Z Corporation had 2012 taxable income of $600,000 before considering the following:

Gain on the sale of equipment	$15,000
Loss on the sale of equipment	(29,000)
Gain on the sale of land used in the business	70,000
Loss on the sale of investment held five months	(5,000)
Loss on the sale of investment held two years	(18,000)

The equipment sold at a gain originally cost $150,000, and $90,000 of depreciation had been claimed. What is Z Corporation's taxable income for 2012?

a. $618,000

b. $633,000

c. $647,000

d. $671,000

e. $685,000

_________ 40. Which of the following is different for corporations than it is for individuals?

a. The definition of capital asset

b. The determination of holding period for capital assets

c. The capital gain and loss netting process

d. The treatment of capital loss carryovers

_________ 41. T Corporation sold a commercial building for $200,000 on January 2, 2012 (purchased for $150,000 on December 16, 2007). The building was depreciated using the straight-line method, and depreciation in the amount of $20,000 has been taken. The amount and nature of the gain upon sale is

a. $70,000 §1231 gain

b. $50,000 § 1231 gain and $20,000 ordinary income

c. $66,000 § 1231 gain and $4,000 ordinary income

d. $70,000 ordinary income

e. None of the above

________ 42. J is a 60 percent shareholder in the JS Corporation. In 2009, he sold property to the corporation for $60,000 (basis in his hands of $70,000). In 2012, the corporation sold the property for $65,000 to an unrelated party. The amount of gain or loss the JS Corporation must recognize in 2012 is

a. $(5,000)

b. $0

c. $5,000

d. $10,000

________ 43. Which of the following is a *false* statement regarding transactions between corporations and their shareholders?

a. Corporations are not allowed to deduct a loss incurred in a transaction between related parties.

b. A shareholder owning 50 percent of a corporation's outstanding stock is a related party according to the general rule.

c. In the case of a personal service corporation, any employer-owner that owns any of the corporation's stock is a related party under certain conditions.

d. The sale of property at a gain between a corporation and its controlling shareholders is not affected by the related parties rules.

________ 44. Z Corporation's 2012 calendar year taxable income is $2,000,000. The corporation's 2012 Federal income tax liability before credits and prepayments is

a. $680,000

b. $769,460

c. $899,740

d. $920,000

e. $1,020,000

________ 45. A regular corporation and a personal service corporation each have taxable income of $20,000 for the 2012 calendar year. Ignoring the alternative minimum tax provisions, which *one* of the following statements is true regarding the Federal income tax liabilities of these two corporations?

a. Both corporations will have the same tax liability before credits or prepayments.

b. The regular corporation will have a slightly lower tax liability before credits or prepayments.

c. The personal service corporation will have a slightly lower tax liability before credits or prepayments.

d. The regular corporation's tax liability will be exactly $2,000 less than the tax liability of the personal service corporation.

e. The regular corporation's tax liability will be less than half that of the personal service corporation.

________ 46. The principal activity of several corporations is shown below. Which of the following could *not* be classified as a personal service corporation?

a. Engineering

b. Actuarial science

c. Performing arts

d. Manufacture of personal computers

e. Veterinary medicine

________ 47. Two personal service corporations (PSCs) are properly determined to be a brother-sister controlled group. Corporation A has taxable income of $75,000, and Corporation B has a loss of $50,000. Which of the following is a *true* statement?

a. Corporation A may owe $13,750 in Federal income taxes before credits, depending on lower tax rate bracket allocation.

b. Corporations A and B are permitted to allocate the use of the lower tax rates in any manner they so elect, provided that both A and B agree to the allocation.

c. The corporations will pay a combined tax on the first $25,000 of taxable income at 15 percent, or $3,750.

d. Corporation A will owe $26,250 in taxes before credits.

e. Both a. and b.

________ 48. A brother-sister controlled group consists of two or more corporations connected through the stock ownership of certain types of shareholders, including

a. Regular corporations, but not S corporations

b. S corporations, but not regular corporations

c. Individuals and estates, but not trusts

d. Individuals, estates, or trusts

e. Regular or S personal service corporations

________ 49. Two or more corporations owned by five or fewer noncorporate shareholders, who collectively own more than 50 percent of the stock of each corporation, would best describe

a. Brother-sister controlled group

b. Association

c. S corporation pending proper election

d. Parent-subsidiary controlled group

e. Controlled group

________ 50. Which of the following statements about the corporate alternative minimum tax is *false?*

a. Generally, the tax is computed at a 20 percent rate on alternative minimum taxable income (AMTI) in excess of $40,000.

b. Alternative minimum tax (AMT) liability exists only if the corporation's tentative AMT (reduced by allowable credits) exceeds its regular tax liability for the year. The difference is called the AMT.

c. AMT adjustments simply reflect timing differences between allowed deductions and gain recognition reporting methods for regular tax purposes and for AMT purposes.

d. AMT preference items act only to increase tentative AMTI.

e. The $40,000 exemption is reduced by 25 percent of the amount of AMTI in excess of $150,000 and is completely phased out for AMT in excess of $250,000.

________ 51. B Corporation reported taxable income in 2012 of $1 million. Additional information concerning B's 2012 tax return is as follows:

Alternative minimum taxable income (without regard to the ACE adjustment item) $1.2 million

Adjusted current earnings (ACE)   2.0 million

B Corporation's alternative minimum tax for 2012 is

a. $20,000

b. $240,000

c. $320,000

d. None of the above

________ 52. Which of the corporations below are required to use the accrual method of accounting for tax purposes?

a. Corporations with average annual gross receipts of $5 million or less in all prior taxable years.

b. Corporations with average annual gross receipts of $5 million or more in all prior taxable years.

c. S corporations.

d. Personal service corporations.

e. Choices a., c., and d. above, but not b.

________ 53. Which of the following statements is *not* true?

a. A corporation is generally allowed to choose either a calendar year or fiscal year for its reporting period.

b. A personal service corporation must use a fiscal year unless it can satisfy IRS requirements that there is a business purpose for a calendar year.

c. S corporations must generally use a calendar year.

d. Because corporations are "persons" only in the legal sense of the word, they are not entitled to the earned income credit.

e. None; all are true.

________ 54. Which of the following is a positive adjustment to income per books on

Schedule M-1 of Form 1120?

a. Proceeds of key person life insurance

b. Excess of capital losses over capital gains

c. Excess of tax depreciation over book depreciation

d. Tax-exempt interest

________ 55. Which of the following is *not* true of Schedule M-2 of the corporate tax return (Form 1120)?

a. This schedule reconciles opening and closing retained earnings.

b. This schedule uses tax rather than accounting data.

c. Retained earnings will be increased by net book income and decreased by dividends.

d. Both a. and b. are not true.

e. None of the above; all are true.

________ 56. A calendar year corporation is required to file its Federal tax return by

a. March 15

b. April 15

c. May 15

d. June 15

e. none of the above

________ 57. Which of the following is *not* true concerning the obligation of a corporation to make estimated tax payments?

a. The estimates are due the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.

b. One-fourth of the estimated tax due is to be paid on each payment date.

c. Generally, unless each payment is for 25 percent or more of the tax (after credits) shown on Form 1120, an underpayment penalty will be imposed.

d. A corporation whose tax liability for the year is less than $500 is not subject to the underpayment penalty.

e. None; all are true.

________ 58. Which of the following is *not* true for purposes of the corporate estimated tax payments?

a. A "large" corporation is one with taxable income of $1 million or more in any of the three preceding taxable years.

b. All timely paid estimated tax installments for a "large" corporation will avoid a penalty if they are for 25 percent of the tax shown on the prior year's return if it was for a period of 12 months and showed a tax liability.

c. Both "small" and "large" corporations can use the annualized income exception.

d. None; all are true.

________ 59. Large Corporation, with over $1 million in taxable income for each of the last several years, paid estimated tax payments of $30,000 each quarter for the current year. The actual tax liability for the current year is $160,000; last year's tax liability was $145,000. Income is earned evenly throughout the year. What is the quarterly amount that may be subject to the underestimation penalty?

a. There is no underpayment amount subject to penalty.

b. $6,250

c. $10,000

d. $40,000

________ 60. X Corporation determines it cannot meet the filing deadline for Form 1120 (U.S. Corporation Income Tax Return) and files an extension on Form 7004. Which of the following is *not* true?

a. The corporation claims an automatic six-month extension of time to file the tax return and to pay the tax due.

b. With permission of the IRS, corporations may be granted an additional three-month extension to submit Form 1120.

c. The corporation extension (Form 7004) must be filed on or before the 15th day of the 3rd month following the close of the taxable year.

d. None; all are true.

1

Income Taxation of Corporations

Solutions to Test Bank

True or False

1. False. *Net* ordinary income is the basis for calculating any self-employment tax due for a proprietorship (Seep. 1-2.)

2. True. The tax return of the S corporation is generally a reporting vehicle that details the distribution of the income and expenses to the shareholders. Tax liability is determined at the shareholder level. (See pp. 1-3 and 1-4.)

3. True. The partners and the partnership are generally treated as unrelated. Remember that tax liability is determined at the partner level. (See p. 1-3.)

4. True. Although § 11 requires all corporations to pay tax, other provisions in the law specifically exempt certain types of corporations from taxation. [See p. 1-4 and § 882(a).]

5. False. Corporations are formed under state law. (See p. 1-4.)

6. False. It is the Internal Revenue Code that will be applied in determining the status of an entity for tax purposes. (See p. 1-6 and Reg. § 301.7701-2.)

7. True. Unless specifically exempted from the rule, a publicly traded partnership organized after December 17, 1987 will be treated *and* taxed as a corporation. (See pp. 1-5 and 1-6.)

8. True. Because all activities of a corporation are considered business activities, all bad debts are considered to be business bad debts. (See p. 1-8 and § 166.)

9. False. A corporation is allowed a dividends-received deduction whether or not it is a member of an affiliated group, provided it receives the dividends from a qualifying domestic corporation. (See p. 1-8.)

10. True. The 70 percent dividends-received deduction may not exceed 70 percent of the corporation's taxable income as defined in § 246(b). (See Exhibit 1-3, Examples 4 through 6, and pp. 1-8 through 1-13.)

11. False. There is *no* taxable income limitation where a dividends-received deduction adds to or creates a net operating loss. [See Exhibit 1-3, Examples 6 and 14, pp. 1-11 and 1-15, and § 246(b)(2).]

12. False. In general, organizational expenses of a corporation may not be deducted in

full in the corporation's first tax year. However, a corporation may elect to deduct organizational costs in a special way—$5,000 during the first tax year with the remainder amortized over 180 months. Thus, only those corporations with expenses of $5,000 or less can expense the full amount in the current tax year. Note that the $5,000 amount is subject to a phase-out when organizational expenses exceed $50,000. (See pp. 1-13 and 1-14.)

13. False. In general, organizational expenses of a corporation may not be deducted in full in the corporation's first tax year. However, a corporation may elect to deduct organizational costs in a special way—$5,000 during the first tax year with the remainder amortized over 180 months. Thus, only those corporations with expenses of $5,000 or less can expense the full amount in the current tax year. Note that the $5,000 amount is subject to a phase-out when organizational expenses exceed $50,000. (See p. 1-13 and § 248.)

14. False. Neither the taxable year of actual payment nor the corporation's method of accounting (i.e., cash or accrual) affect the qualification of organizational expenses. As long as the expenses are *incurred* during the corporation's first tax year, they qualify for amortization. (See p. 1-13 and § 248.)

15. False. Whether the corporation is a cash basis or accrual basis taxpayer is irrelevant. Only those organizational expenses *incurred* by the corporation before the end of its first taxable year will qualify for §248. (Seep. 1-13 and §248.)

16. False. In computing a corporation's net operating loss for any given year, the dividends-received deduction is not limited to taxable income. Thus, the dividends-received deduction can create or increase a corporation's net operating loss for any given year. [See Exhibit 1-3, Examples 6 and 14, pp. 1-11 and 1-15, and §246(b)(2).]

17. True. The annual limitation is 10 percent of taxable income determined without reduction for charitable contributions, the dividends-received deduction, net operating loss carrybacks, and capital loss carrybacks. [See pp. 1-16 through 1-18 and § 170(b)(2).]

18. True. Only net operating loss and capital loss *carrybacks* are ignored in computing a corporation's taxable income base for purposes of the annual limitation. (See p. 1-17.)

19. False. The carryback period is *three* years and the carryforward period is *five* years. (See Example 20 and pp. 1-19 and 1-20.)

20. True. A corporation must treat as ordinary income 20 percent of any § 1231 gain that would have been ordinary income if § 1245 rather than § 1250 applied to the sale of certain depreciable realty. (See Example 21, pp. 1-20 and 1-21, and §291.)

21. True. [See p. 1-21 and § 267(a)(2).]

22. True. A regular corporation is subject to a 5 percent surtax on all income in excess of $100,000 until the benefit of the graduated corporate income tax rate structure is eliminated. The elimination of the benefits of the lower corporate tax rates occurs when taxable income exceeds $335,000 (up to $10 million, at which point the marginal rate increases to 35 percent). (See Example 24 and pp. 1-22 and 1-23.)

23. False. Because only one of the shareholders of Corporation A owns stock in *both* corporations, the total lowest identical ownership is only 10%. Therefore, a brother-sister controlled group does not exist. (See Examples 28 and 29 and pp. 1-25 through 1-27.)

24. True. A personal service corporation (PSC) is not allowed to use the graduated corporate tax rates. Instead, a PSC is subject to a flat tax rate of 35 percent, and its tax liability before credits or prepayments would be $3,500 ($10,000 taxable income × 35%). (See p. 1-23.)

25. False. A corporation is subject to the AMT only to the extent it *exceeds* the corporation's regular tax. More importantly here, because a corporation is entitled to a $40,000 exemption, this corporation would not be subject to the AMT. (See Exhibit 1-8 and pp. 1-28 and 1-29.)

Multiple Choice

26. d. While a corporation is allowed to deduct a portion of qualifying dividends received from taxable domestic corporations, there currently is *no* deduction for dividends *paid* to shareholders. (See p. 1-8.)

27. b. The ability to sue or be sued is not one of the corporate characteristics. (See p. 1-5.)

28. d. Corporations and individuals are subject to the same rules regarding depreciation deductions. Corporations are subject to the possibility of additional depreciation recapture (i.e., § 291), while individuals are not. Corporations are more limited in their charitable contribution deductions than individuals, and corporations are not allowed to deduct capital losses against ordinary income (i.e., a capital loss deduction). Finally, all bad debts of a corporation are considered to be business bad debts. [See Examples 15 through 21, pp. 1-16 through 1-21, and §§ 291 and 170(b)(2).]

29. a. The corporation's dividends received deduction is computed as follows:

Gross income	$200,000	
Business expenses	(110,000)	
Taxable income before dividends received deduction		$90,000
Lower of this taxable income, or $ 100,000 qualifying dividends		

$90,000

× 70%

Dividends-received deduction $63,000

(See Exhibit 1-3, Example 4, and pp. 1-8 through 1-13.)

30. d. The 70 percent dividends-received deduction under § 243(a) results in a deduction of $24,500 ($35,000 qualifying dividends × 70%), but § 246(b)(1) limits the deduction to 70 percent of taxable income computed without the dividends-received deduction [i.e., $15,400 (70% × $22,000)] *unless* the taxpayer has a net operating loss before the deduction, or will have a net operating loss as a result of the regular § 243(a) deduction. This is the case here ($205,000 + $35,000 – $218,000 = $22,000 net income – $24,500 § 243(a) deduction = $2,500 NOL). (See Exhibit 1-3, Example 6, and pp. 1-8 through 1-13.)

31. c. Members of an affiliated group are allowed to deduct 100 percent of the dividends that are received from another member of the same group. A group of organizations is considered affiliated when at least 80 percent of the stock of each corporation is owned by other members of the group. [See p. 1-8 and §§ 243(a)(3), 243(b)(5), and 1504.]

32. c. All of the expenses except the printing cost for stock certificates qualify as organizational expenses ($750 + $100 + $250 + $300 + $400 = $1,800 total). If New Corporation makes the election on a timely filed return (plus extensions), it will be allowed to deduct the full amount in 2012. (See Example 11 and pp. 1-13 and 1-14.)

33. d. Because the fiscal year ending June 30, 2013 has 12 full months, the allowed deduction is $5,200 [$5,000 + $200 ($3,000/180 = $16.67 per month × 12 months)]. (See Example 12 and pp. 1-13 and 1-14.)

34. d. Neither the taxable year of the actual payment nor the corporation's method of accounting affect the calculation. (See Example 11, and pp. 1-13 and 1-14.)

35. c. The charitable deductions for ordinary income property generally may not exceed the corporation's basis in the property. (See pp. 1-16 and 1-17.)

36. d. Excess charitable contributions may be carried over to each of the succeeding five years, subject to certain limitations. Since (1) the carryover period is limited to five years, (2) a charitable contribution deduction is allowed only if the corporation has taxable income, (3) excess contributions cannot be carried back, and (4) contributions made in the carryover year must be deducted before considering any carryovers, only answer d is true. (See Examples 18 and 19 and pp. 1-17 and 1-18.)

37. d. Because the charitable contributions were erroneously deducted in full to arrive at an incorrect taxable income number of $100,000, the first thing that must be done is to add back the $12,000 of deductions. Thus, taxable income before the charitable

contribution deduction is correctly $112,000. T Corporation's correct contribution deduction, therefore, is limited to $11,200 [($100,000 + $12,000 = $112,000 correct taxable income before deduction) × 10%]. The remaining $800 of charitable contributions must be carried forward. (See Examples 18 and 19 and pp. 1-17 and 1-18.)

38. c. K Corporation's net operating loss is $55,000, computed as follows:

Gross profit from operations		$180,000
Dividends received		+ 50,000
Gross income		$230,000
Less: Ordinary deductions	(250,000)	
Dividends received deduction ($50,000 × 70%)	(35,000)	
Net operating loss		$(55,000)

*Recall that a corporation's dividends-received deduction is not subject to the taxable income limitation if it adds to, or creates, a net operating loss for the year.

(See Exhibit 1-3, Example 14, and p. 1-15.)

39. b. Z Corporation's taxable income is $633,000, computed as follows:

Taxable income before capital and § 1231 gains and losses		$600,000
§ 1245 depreciation recapture from gain on sale of equipment treated as ordinary income		+ 15,000
§1231 gains and losses:		
Gain on sale of land	$70,000	
Less: Loss on sale of equipment	(29,000)	
Net §1231 gain treated as long-term capital gain	$41,000	
Long-term capital loss	(18,000)	
Net long-term capital gain	$23,000	
Less: Short-term capital loss	(5,000)	
Net capital gain		+ 18,000

Taxable income	$633,000

(See pp. 1-18 and 1-19.)

40. d. Unlike individuals, corporations must treat all capital loss carryovers as short-term losses. (See p. 1-19.)

41. c. Gain upon sale is calculated as follows:

Sales price			$200,000
Less: Cost		$150,000	
(Depreciation taken)	(20,000)		
Adjusted basis	(130,000)		
Gain			$ 70,000

Under § 1250, there is no depreciation recapture. If § 1245 depreciation recapture applied to this sale, gain would be ordinary income to the extent of depreciation taken ($20,000), and the remainder would be taxed as § 1231 gain ($50,000). The § 291 depreciation recapture calculation is

Amount that would be treated as ordinary income under § 1245	$20,000
Less: Amount that would be treated as ordinary income under § 1250	(0)
Equals: Difference between recapture amounts	$20,000
Times: Rate specified in § 291	× 20%
Equals: Amount treated as ordinary income	$ 4,000

Therefore, of the $70,000 total gain, $4,000 is ordinary and the remainder ($66,000) is § 1231 gain. (See Example 21 and pp. 1-20 and 1-21.)

42. b. Under § 267, J was not allowed to recognize his loss of $10,000 in 2009 (J was a greater than 50% shareholder in the JS Corporation). This loss may be carried over and used to offset gain when the related party sells the property in a taxable transaction to an unrelated party. Therefore, the corporation's realized gain of $5,000 ($65,000 sales price less its $60,000 basis) is not recognized. Note, however, that the suspended loss may not be used to create a recognized loss in the hands of the corporation. As a result, $5,000 of the loss disappears. (See p. 1-21.)

43. b. With respect to the matching of income and deduction, a related party is any person owning directly or indirectly *more than* 50 percent of the corporation's outstanding stock. (See pp. 1-21 and 1-22.)

44. a. The correct amount is $680,000 ($2,000,000 × 34%). Because Z Corporation's taxable income exceeds $335,000, it is taxed at the flat rate of 34 percent. (See Example 24 and pp. 1-22 and 1-23.)

45. e. A regular corporation's tax on $20,000 of taxable income will be $3,000 ($20,000 × 15%). A personal service corporation (PSC) is not allowed to use the lower corporate tax rates. Instead, a PSC is subject to a flat rate of 35 percent. Consequently, the PSC's tax on $20,000 of income will be $7,000 ($20,000 × 35%). (Seep. 1-23.)

46. d. The manufacture of personal computers is not specifically included in the definition of a personal service corporation. [See p. 1-23 and § 448(d)(2).]

47. d. Congress denied the benefits of the *lower* tax rates to personal service corporations for taxable years after 1987 (Revenue Act of 1987). As a result, the taxable income of a PSC is subject to a flat rate of 35 percent. [Seep. 1-23 and § 11(b)(2).]

48. d. A brother-sister controlled group consists of two or more corporations connected through the stock ownership of certain *noncorporate* shareholders—individuals, estates, or trusts. (See p. 1-25.)

49. a. This is a description of the brother-sister type of controlled group. [See p. 1-25 and § 1563(a).]

50. e. The phaseout of the $40,000 exemption occurs at $310,000, *not* at $250,000. $40,000 – 25% = $160,000; $160,000 + $150,000 = $310,000. [See pp. 1-28 through 1-33 and § 55(d)(3)(A).]

51. a. First, calculate the adjusted current earnings (ACE) adjustment. This is $600,000 [($2 million ACE less $1.2 million AMTI) × 75%]. This results in AMTI of $1.8 million ($1.2 million tentative AMTI + $600,000). Then calculate the tentative AMT. This equals $360,000 ($1.8 million × 20% AMT rate). Note that the exemption is fully phased out when AMTI exceeds $310,000. Finally, calculate the regular tax of $340,000 ($1 million taxable income × 34% rate). Because the tentative AMT exceeds the regular tax, the AMT is $20,000 ($360,000 – $340,000). (See Example 35 and p. 1-32.)

52. b. Answers a, c, and d are the three basic *exceptions* to the general rule that denies the use of the cash method of accounting for tax purposes to most corporations. (See p. 1-33.)

53. b. A personal service corporation must use a *calendar* year unless it can satisfy IRS requirements that there is a business purpose for *a fiscal* year. [See p. 1-33, and § 441(I).]

54. b. Net capital losses are not currently deductible for Federal income tax purposes. The other items are all subtractions from income per books. (See Example 37 and

pp. 1-34 and 1-35.)

55. b. Schedule M-2 reconciles *book* opening and closing retained earnings—using accounting rather than tax data. (See Example 39, and p. 1-37.)

56. a. The corporate taxpayer is required to file its tax return by March 15. [See p. 1-41 and § 6072(b).]

57. e. All are true statements concerning the obligation of a corporation to make estimated tax payments. (See pp. 1-41 and 1-42.)

58. b. A "large" corporation is not allowed to use this exception except for its first installment of the taxable year. (Seep. 1-42.)

59. c. Large Corporation was required to pay $40,000 each quarter ($160,000/4 quarters × 100%). Because Large paid only $30,000 each quarter, the quarterly underpayment is $10,000. Large may not, except for its first quarterly installment, base its payments on last year's tax liability (it is a "large" corporation) and may not use the annualization method (income is earned evenly). (See Example 41 on p. 1-42.)

60. a. Form 7004 allows a corporation a six-month extension of time to file—not of time to pay the tax. Any tax balance due must be paid with the extension. (See p. 1-41.)

1

Income Taxation of Corporations

Comprehensive Problems

FACTS FOR COMPREHENSIVE PROBLEMS

X Corporation had the following items of income, expense, gain, loss, credit and prepayment for its 2012 calendar year. X Corporation files Form 1120 using a calendar year. The figures shown below were prepared by X Corporation's controller using the accrual method of accounting.

Net income from operations (calculated without regard to the following items)	$520,000
Dividends received (from less than 20% owned corporation; held for 30 days and then sold)	10,000
Dividends received (from Y Corporation; X owns 90% of Y and Y owns 80% of X)	15,000
Capital gains: long-term	5,000
short-term	7,500

Capital losses: long-term	3,000
short-term	8,500
Capital loss carryover from 2011 (short-term)	10,000
Charitable contributions (declared by Board of Directors, but paid before 2½ months of year close)	75,000
Charitable contribution carryover from 2011	20,000
Net operating loss carryovers: 2011	12,000
2010	8,000
2009	22,000
Dividends paid (to Y Corporation)	50,000
General business credit carryover from 2011	6,500
Estimated tax payments (timely paid in four equal amounts of $36,000 each)	144,000

COMPREHENSIVE PROBLEMS

1. Calculate the following, showing your work.
   a. Taxable income for the charitable deduction limit
   b. 2012 charitable deduction for taxes
   c. Carryover amount of 2011 charitable contributions to 2013, if any
   d. Carryover amount of 2010 charitable contributions to 2013, if any
2. Calculate the following, showing your work.
   a. Net long-term capital gain/loss
   b. Net short-term capital gain/loss
   c. Net capital gain/loss
   d. Amount and year of any capital loss carryover to 2013
3. Calculate the following, showing your work.
   a. Deduction for dividends received from less than 20% owned corporation, if any

b. Deduction for dividends received from Y corporation, if any

c. Deduction for dividends paid to Y corporation, if any

4. Calculate the following, showing your work.

a. Taxable income for 2012

b. Income tax liability before credits and prepayments

c. Net tax due with tax return, if any

*d. Estimated tax underpayment, if any

*e. Estimated tax overpayment, if any

*Relative to amount needed to meet minimum requirement

Solutions to Comprehensive Problems

1.

a. Net income from operations $520,000

Add in all dividends received 25,000

Subtract NOL carryovers (42,000)

Taxable income for the charitable deduction limit $503,000

Note: Taxable income for the charitable deduction is figured without reduction for charitable contributions, the dividends-received deduction, net operating loss carrybacks, or capital loss carrybacks.

b. Taxable income for the charitable deduction limit $503,000

Apply limit × 10%

Dollar maximum for charitable deduction for 2012 $ 50,300

Because the $75,000 of actual contributions exceed this limit, the 2012 contribution deduction allowed for taxes is $50,300.

c. The 2012 carryover to 2013 is $75,000 – $50,300 = $24,700.

d. Because current year contributions are used first for deduction purposes, the contribution carryover from 2011 to 2013 remains the same, $20,000.

2.

a. Long-term capital gain $ 5,000

Long-term capital loss – 3,000

Net long-term capital gain $ 2,000

b. Short-term capital gain $ 7,500

Short-term capital loss – 8,500

Net short-term capital loss $ 1,000

c. Net long-term capital gain $ 2,000

Net short-term capital loss – 1,000

Net long-term capital gain $ 1,000

d. Capital loss carryover from 2011 to 2013 $10,000

Amount used in 2012– 1,000

Capital loss carryover from 2011 to 2013 $ 9,000

Note: There is no effect on taxable income for 2012 from capital gains.

3.

a. Because this stock was held for less than 46 days, there is *no* dividends-received deduction.

b. X and Y Corporations qualify as affiliated corporations since each owns 80% or more of the stock of the other. A 100% dividends-received deduction is allowed = $15,000.

c. There is *no* deduction for dividends paid.

4.

a. Net income from operations $520,000

Plus: All dividends received 25,000

Less: Allowable charitable contributions (50,300)

NOL carryovers (42,000)

Dividends-received deduction (15,000)

Taxable income for 2012 $437,700

b. Taxable income for 2012 $437,700

Applicable tax rate × 34%

Income tax liability before credits and prepayments $148,818

c. Income tax liability before credits and prepayments $ 148,818

Less general business credit (6,500)

Income tax liability before prepayments $ 142,318

Less estimated tax payments (134,000)

Income tax due with return $ 8,318

d. Income tax liability before prepayments $142,318

Apply 100% rate × 100%

Minimum requirement $142,318

Because all four estimated tax payments ($36,000 each) were made timely and in equal amounts, it is evident at this point that *no* estimated tax underpayment exists.

$142,318 ÷ 4 = $35,580

Each of the four estimated tax payments exceeded the amount due.

e. Estimated tax payments made S 144,000

Less: Minimum requirement (142,318)

Amount in excess of minimum requirement $ 1,682

1

Income Taxation of Corporations

Solutions to Tax Return Problems

1-33 Form 1120 is shown on the following pages. Note that the underpayment tax penalty rate used in this solution is assumed to be 6 percent. The actual penalty rate may be different.

[Insert UNF here]

[Insert UNF here]

[Insert UNF here]

[Insert UNF here]

[Insert UNF here]

[Insert UNF here]

[Insert UNF here]

[Insert UNF here]

[Insert UNF here]

[Insert UNF here]

[Insert UNF here]

1-34 Although the calculations in this problem are relatively simple and straightforward, many students may overlook the importance of the AMT credit in answering the question regarding the choice of depreciation methods.

If Paul Schroeder chooses to depreciate the personalty acquired by ABC using MACRS, the corporation will pay an AMT tax of $11,750 and a total tax of $92,500, and will have an AMT credit carry forward of $11,750.

Net income (before depreciation) $300,000

Less: MACRS depreciation (50,000)

Regular taxable income $250,000

Tax on regular taxable income $ 80,750

Regular taxable income $250,000

Plus: Depreciation adjustment ($50,000 – $37,500) 12,500

Other AMT adjustments 200,000

AMTI $462,500

Less: AMT exemption (0)

AMTI subject to tax $462,500

Tax on AMTI (20% rate) $ 92,500

The AMT is $11,750 ($92,500 – $80,750); the total tax paid is $92,500; and the AMT credit carryforward is $11,750.

If Paul Schroeder chooses to depreciate the personalty acquired by ABC using AMT ADS, the corporation will pay an AMT tax of $6,875 ($92,500 – $85,625) and a total tax of $92,500, and will have an AMT credit carryforward of $6,875.

Net income (before depreciation)		$300,000
Less: AMT ADS depreciation		(37,500)
Regular taxable income	$262,500	
Tax on regular taxable income		$ 85,625
Regular taxable income	$262,500	
Plus: Other AMT adjustments		200,000
AMTI	$462,500	
Less: AMT exemption	(0)	
AMTI subject to tax	$462,500	
Tax on AMTI (20% rate)	$ 92,500	

ABC Corporation pays the same total tax either way. So which method of depreciation should be selected? If MACRS is selected, the AMT credit carryover is $4,875 greater than the credit generated if AMT ADS is selected ($11,750 — $6,875). If this credit can be used in the near future to reduce the regular tax, this is a real advantage for choosing MACRS. However, if the corporation stays in an AMT situation indefinitely, the method of depreciation will not matter.

[Insert UNF here]

[Insert UNF here]