1. Orange, Inc., a calendar-year C corporation, has $800,000 of qualified production activities income (QPAI) and $950,000 of total taxable income in 2017. All of the QDPAI was produced by Orange’s manufacturing plant, which relies mainly on a temporary employment agency for its workforce, employing only two W-2 employees who in aggregate earned $140,000 in 2017. Orange also has an office in Mexico, which is unrelated to its domestic manufacturing plant and which employs one W-2 employee, who earned $75,000 in 2017. What amount of Domestic Production Activities Deduction may Orange claim on its 2017 corporate tax return?

a) $73,350

b) $72,000

c) Depends on wages paid by employment agency.

d) $70,000

a) Incorrect. The DPAD is calculated at 9% of the lesser of QPAI, $800,000, or taxable income, $940,000. The deduction, 9% x $800,000 or $72,000 is limited, however, to 50% of W-2 wages paid to domestic employees. Orange paid a total of $140,000 in W-2 wages allocable to the QPAI, limiting the DPAD to $70,000.

b) Incorrect. The DPAD is calculated at 9% of the lesser of QPAI, $800,000, or taxable income, $940,000. The deduction, 9% x $800,000 or $72,000 is limited, however, to 50% of W-2 wages paid to domestic employees. Orange paid a total of $140,000 in W-2 wages allocable to the QPAI, limiting the DPAD to $70,000.

c) Incorrect. The DPAD is calculated at 9% of the lesser of QPAI, $800,000, or taxable income, $940,000. The deduction, 9% x $800,000 or $72,000 is limited, however, to 50% of W-2 wages paid to domestic employees. Orange paid a total of $140,000 in W-2 wages allocable to the QPAI, limiting the DPAD to $70,000.

**d) Correct!** The DPAD is calculated at 9% of the lesser of QPAI, $800,000, or taxable income, $940,000. The deduction, 9% x $800,000 or $72,000 is limited, however, to 50% of W-2 wages paid to domestic employees. Orange paid a total of $140,000 in W-2 wages allocable to the QPAI, limiting the DPAD to $70,000.

1. Regarding the Domestic Production Activities Deduction (DPAD), which of the following statements is true?

a) For C corporations only, the DPAD cannot exceed 50% of allocable W-2 wages.

b) Qualified Production Activities Income (QPAI) is calculated by applying a percentage based on specific criteria to a company’s total taxable income.

c) S Corporations are ineligible for the DPAD.

d) For a sole proprietorship, the DPAD is limited to Adjusted Gross Income (AGI).

a) Incorrect. Sole proprietorships, partnerships, S corporations, and LLCs all qualify for the DPAD with the amount limited to AGI. The deduction may not exceed 50% of allocable W-2 wages for all entities, not only corporations.

b) Incorrect. Sole proprietorships, partnerships, S corporations, and LLCs all qualify for the DPAD with the amount limited to. QPAI is the excess of domestic production gross receipts (DPGR) over the total cost of sales allocated to DPGR, not a percentage of taxable income.

c) Incorrect. Sole proprietorships, partnerships, S corporations, and LLCs all qualify for the DPAD with the amount limited to AGI.

**d) Correct!** Sole proprietorships, partnerships, S corporations, and LLCs all qualify for the DPAD with the amount limited to AGI. The deduction may not exceed 50% of allocable W-2 wages for all entities, not only corporations. QPAI is the excess of domestic production gross receipts (DPGR) over the total cost of sales allocated to DPGR, not a percentage of taxable income.

1. Regarding the Personal Holding Company (PHC) tax, which of the following statements is true?

a) The tax can be avoided on some undistributed PHC income if the PHC can demonstrate a business need for keeping the income.

b) Income from certain types of municipal bonds is included in personal holding company income for the purposes of the PHC tax.

c) The PHC tax cannot be imposed on an S corporation.

d) The PHC is a penalty tax that is only paid when the IRS assesses the tax during an audit.

a) Incorrect. Since an S corporation is a pass-through entity and does not pay federal income tax, the PHC tax cannot be imposed on an S corporation. PHC tax can only be avoided by either paying an actual dividend or as a result of a consent dividend, which is a hypothetical dividend the corporation pays taxes on but does not actually distribute to shareholders.

b) Incorrect. Since an S corporation is a pass-through entity and does not pay federal income tax, the PHC tax cannot be imposed on an S corporation. Since the purpose of the PHC tax is to prevent taxpayers from being able to pay tax on investment income at a lower corporate rate than if taxed individually, it does not apply to interest income on municipal bonds, which is tax exempt.

**c) Correct!** Since an S corporation is a pass-through entity and does not pay federal income tax, the PHC tax cannot be imposed on an S corporation. PHC tax can only be avoided by either paying an actual dividend or as a result of a consent dividend, which is a hypothetical dividend the corporation pays taxes on but does not actually distribute to shareholders. Since the purpose of the PHC tax is to prevent taxpayers from being able to pay tax on investment income at a lower corporate rate than if taxed individually, it does not apply to interest income on municipal bonds, which is tax exempt. The PHC tax is a self-assessed penalty tax and does not require an IRS assessment.

d) Incorrect. Since an S corporation is a pass-through entity and does not pay federal income tax, the PHC tax cannot be imposed on an S corporation. The PHC tax is a self-assessed penalty tax and does not require an IRS assessment.

1. Regarding the Accumulated Earnings Tax (AET), which of the following statements is true?

a) Corporations determine AET by filing Form 1120-AET along with the corporate tax return.

b) Paying the Personal Holding Company tax in a given tax year eliminates any need to pay AET for that year.

c) A domestic manufacturer with less than $2.5 million in gross receipts is automatically exempt from consideration for AET.

d) Loans to suppliers, customers and shareholders are considered reasonable business needs for the purpose of assessing AET.

a) Incorrect. Since both the AET and the PHC tax are taxes on undistributed earnings, a PHC taxpayer can avoid the AET by paying the PHC tax, which is self-assessed. The AET tax is assessed as a result of a tax audit, not as a result of the taxpayer filing a form.

**b) Correct!** Since both the AET and the PHC tax are taxes on undistributed earnings, a PHC taxpayer can avoid the AET by paying the PHC tax, which is self-assessed. The AET tax is assessed as a result of a tax audit, not as a result of the taxpayer filing a form. There is no automatic exemption from AET for manufacturers with gross receipts under $2.5 million. Although loans to suppliers and customers may be considered reasonable business needs when evaluating the AET, loans to shareholders are not.

c) Incorrect. Since both the AET and the PHC tax are taxes on undistributed earnings, a PHC taxpayer can avoid the AET by paying the PHC tax, which is self-assessed. There is no automatic exemption from AET for manufacturers with gross receipts under $2.5 million.

d) Incorrect. Since both the AET and the PHC tax are taxes on undistributed earnings, a PHC taxpayer can avoid the AET by paying the PHC tax, which is self-assessed. Although loans to suppliers and customers may be considered reasonable business needs when evaluating the AET, loans to shareholders are not.

1. Identify any item or items below which are added to Alternative Minimum Taxable Income (AMTI) in order to compute the Adjusted Current Earnings (ACE) adjustment.
2. Dividends-received deduction on dividends received from a 20%-owned corporation.
3. Municipal bond interest, excluding any municipal bond interest already included in AMTI.
4. Life insurance proceeds on the death of a key employee.
5. I and III only.
6. I, II and III.
7. I and II only.
8. II and III only.

a) Incorrect. In calculating the ACE adjustment, AMTI is increased by the 70% dividends received deduction, which applies to investments representing ownership of less than 20%; municipal bond interest that is not already included in AMTI; and life insurance proceeds resulting from the death of a key employee. The 80% dividends received deduction, on an investment representing ownership of 20% or more, is not added.

b) Incorrect. In calculating the ACE adjustment, AMTI is increased by the 70% dividends received deduction, which applies to investments representing ownership of less than 20%; municipal bond interest that is not already included in AMTI; and life insurance proceeds resulting from the death of a key employee. The 80% dividends received deduction, on an investment representing ownership of 20% or more, is not added.

c) Incorrect. In calculating the ACE adjustment, AMTI is increased by the 70% dividends received deduction, which applies to investments representing ownership of less than 20%; municipal bond interest that is not already included in AMTI; and life insurance proceeds resulting from the death of a key employee. The 80% dividends received deduction, on an investment representing ownership of 20% or more, is not added.

**d) Correct!** In calculating the ACE adjustment, AMTI is increased by the 70% dividends received deduction, which applies to investments representing ownership of less than 20%; municipal bond interest that is not already included in AMTI; and life insurance proceeds resulting from the death of a key employee. The 80% dividends received deduction, on an investment representing ownership of 20% or more, is not added.