

Chapter 9 Summary of End-of-Chapter Problem Revisions

2014 Edition Problem Number	2013 Edition Problem Number	2014 Edition Modifications
1	1	
2	2	
3	3	Solution modified
4	4	
5	5	
6	6	
7	7	
8	8	
9	9	
10	10	
11	11	
12	12	
13	13	
14	14	
15	15	
16	16	
17	17	
18	18	
19	19	
20	20	
21	21	
22	22	
23	23	
24	24	Solution modified
25	25	
26	26	Solution modified
27	27	
28	28	
29	29	
30	30	
31	31	
32	32	
33	33	
34	34	
35	35	
36	36	
37	37	
38	38	
39	39	
40	40	Solution updated
41	41	Solution updated

2 Solutions Manual for Taxation for Decision Makers

42	42	
43	43	
44	44	
45	45	
46	46	
47	47	
48	48	
49	49	
50	50	
51	51	
52	52	
53	53	
54	54	
55	55	
56	56	
57	57	
58	58	
59	59	
60	60	Form updated
61	61	
62	62	
63	63	
64	64	
65	65	
Appendix 9A		
1	1	
2	2	
3	3	
4	4	
5	5	
6	6	
7	7	
Appendix 9B		
1	1	
2	2	
3	3	
4	4	
5	5	
6	6	

Solutions to Chapter 9 Problem Assignments

Check Your Understanding

1. *Corporate Income*

Solution: Corporate income is taxed as regular income as it is earned by the corporation; it is taxed a second time when the corporation distributes that income as dividends to its shareholders.

2. *Corporate Characteristics*

Solution: 1. Limited liability for owners; 2. Ease of raising capital; 3. Ease of selling ownership interest (shares); 4. Ability of owner-shareholder to receive a salary deductible as an expense by the corporation; 5. Ability of owner-shareholder to participate in corporate fringe benefits. (There are benefits beyond these five.)

3. *Dividend Received Deduction*

Solution: When a corporation receives a dividend from another corporation, the dividend is included in the recipient corporation's income but then the corporation is allowed a deduction based on its ownership percentage in the paying corporation. The dividend received deduction is the amount (generally a percentage of the dividend received) that is allowed as a deduction from that corporation's income and, as a result, is not subject to tax.

A corporation that owns less than 20 percent of another corporation is entitled to a 70 percent dividend received deduction. A corporation that owns at least 20 percent but less than 80 percent is entitled to an 80 percent dividend received deduction. An affiliated corporation (80 percent or more ownership) is entitled to a 100 percent dividend received deduction.

A dividend received deduction is limited to 70/80% taxable income (determined after the dividend but before the dividend received deduction) if that is less than the normal 70/80% dividend received deduction— unless taking the full dividend received deduction (rather than the smaller 70/80% of taxable income) creates or increases a net operating loss for the corporation—then the full dividend received deduction is allowed.

4. *Charitable Contribution*

Solution: The contribution deduction is limited to 10 percent of taxable income before the dividend received deduction and after any net operating or capital loss carryforwards.

5. *NOL Carryovers*

Solution: The normal carryover periods for net operating losses allow them to be carried back 2 years and forward 20 years. The American Recovery and Reinvestment Act allowed a qualifying small business (one with average annual gross receipts of \$15 million for the last three years) to elect to carry back their NOLs for 3, 4, or 5 years for 2008 tax year only. Then the Worker, Homeownership, and Business Assistance Act of 2009 expanded the election to all U.S. businesses to elect to carryback NOLs

up to five years but with a 50% limit on the NOLs in the fifth year for 2009. Certain other restrictions applied to these carrybacks, however. The expanded carryback provisions were not extended past 2009 tax years.

6. *Book vs. Tax Income*

Solution: Life insurance proceeds, tax-exempt income, and financial accounting depreciation deductions that are lower than tax depreciation deductions are three items that cause book income to exceed tax income. The payment of fines and bribes, excess charitable contributions, and capital losses in excess of capital gains cause book income to be less than taxable income. (There are other items as well as these detailed in Table 9-2.)

7. *AMT*

Solution: The alternative minimum tax is a parallel tax calculation whereby a person or business with substantial real income in excess of its taxable income will be required to pay some tax on that income by disallowing certain exclusions and deductions that significantly reduce the determination of taxable income. The alternative minimum tax rate for corporations is 20 percent.

8. *Due Date*

Solution: May 15 is the corporation's regular due date for its return; its extended due date is November 15. It must make estimated payments in June, August, November, and February.

9. *Earnings and Profits*

Solution: Corporate earnings and profits is supposed to be the measure of how much a corporation can distribute to its shareholders as dividends without impairing the corporation's contributed capital. Taxable income is not used as a measure of dividend-paying ability because of the numerous deductions and exclusions allowed in determining taxable income results in taxable income not really reflecting the corporation's current dividend paying ability.

10. *Consolidated Returns*

Solution: When one corporation controls another corporation (80 percent or more ownership), they are permitted to file consolidated returns because it is similar to one corporation with two divisions rather than two separate entities.

11. *Consolidated Returns*

Solution: To file a consolidated return, one corporation (the parent) must own directly at least 80 percent (by voting rights and value) or more of another corporation (the subsidiary); additional corporations can be included in the group as long as one or more of the corporations in the group owns at least 80 percent (by voting rights and value) of these other corporations.

P owns 80 percent of S1; S1 owns 80 percent of S2; S2 owns 40 percent of S3; P also owns 40 percent of S3; S1 owns 50 percent of S4; and S3 owns 30 percent of S4. P, S1, S2, S3, S4 all form a consolidated group of corporations as P owns

directly 80 percent of S1 and all the other corporations are related through 80 percent or more ownership within the group.

12. *Redemptions*

Solution: A corporate redemption is the repurchase of its own shares by a corporation from a shareholder. In a qualifying redemption, a shareholder receives sale treatment, recognizing either gain or loss based on the basis of the shares redeemed and the redemption price. If the redemption is not a qualifying sale, the amount received is taxed as a dividend distribution to the extent of corporate E&P.

13. *Liquidations*

Solution: A corporate liquidation is the cessation of business by a corporation along with a sale of some or all of its assets followed by a distribution of its cash and remaining property to its shareholders in exchange for the shareholders' shares of the liquidating corporation. On a corporate liquidation, the corporation generally recognizes both gains and losses on both the sale and the distribution of its property to the shareholders. The shareholders receive sale treatment on the surrender of their shares in exchange for the cash or property distributed by the corporation.

14. *Controlled Groups*

Solution: The two types of controlled groups for corporations are parent-subsidiary controlled groups and brother-sister controlled groups.

15. *Earnings and Profits*

Solution: Positive adjustments include: Federal income tax refunds, dividends received deduction, proceeds of life insurance policies, NOL carryovers, capital loss carryovers, charitable contribution carryovers, excess of current year's installment gain over portion recognized, percentage depletion in excess of cost depletion, depreciation expense in excess of allowable E&P depreciation, and Section 179 expense in excess of allowable depreciation.

Negative adjustments include: Federal income taxes paid, capital losses in excess of capital gains, disallowed losses on sales to related parties, nondeductible fines and bribes, charitable contributions in excess of the 10 percent deduction limit, premiums on life insurance policies on which the corporation is the beneficiary, installment sale gain from a prior year's installment sale, and 20 percent of the cost of Section 179 items expensed in the four prior years. Table 9.3 lists additional adjustments.

Crunch the Numbers

16. *Corporate Tax*

Solution: \$658,500 total tax and 43.9% effective rate. $\$1,500,000 \times 34\% = \$510,000$ corporate income tax. After-tax income = \$990,000 (\$1,500,000 - \$510,000). $\$990,000 \times 15\% = \$148,500$ shareholder tax. $(\$510,000 + \$148,500)/\$1,500,000 = 43.9\%$ effective tax rate on the \$1,500,000 income.

17. *Cost of Debt*

Solution: \$73,125. $7.5\% (1 - .35) = 4.875\%$ effective after-tax interest rate. $\$1,500,000 \times 4.875\% = \$73,125$ effective annual after-tax interest expense.

18. *Financial and Taxable Incomes*

Solution: a. $\$289,000 - \$98,000 - \$20,000 - \$122,000 + \$21,000 = \$70,000$ taxable income.
b. $\$70,000 + (\$20,000 - \$5,000) - (\$21,000 - \$14,000) = \$78,000$ pretax financial accounting income.

19. *Dividend Received Deduction*

Solution: a. $\$459,000 + \$68,000 - (\$68,000 \times .70) = \$479,400$ taxable income.
b. $\$459,000 + \$68,000 - (\$68,000 \times .80) = \$472,600$ taxable income.

20. *Dividend Received Deduction*

Solution: \$9,000. $\$340,000 - \$350,000 + \$40,000 = \$30,000$ of taxable income before the dividend received deduction. The dividend received deduction is 70 percent of the lesser of taxable income ($\$30,000 \times 70\% = \$21,000$) or the dividend income ($\$40,000 \times 70\% = \$28,000$). Thus, taxable income = \$9,000 ($\$30,000 - \$21,000$).

21. *Income Tax*

Solution: a. $\$12,500 = (\$50,000 \times 15\%) + (\$20,000 \times 25\%)$.
b. $\$92,450 = \$22,250 + [(\$280,000 - \$100,000) \times 39\%]$.
c. $\$306,000 = \$900,000 \times 34\%$.
d. $\$765,000 = \$2,250,000 \times 34\%$.
e. $\$4,800,000 = \$3,400,000 + (\$4,000,000 \times 35\%)$.

22. *Income Tax*

Solution: a. $\$280,500 = \$825,000 \times 34\%$.
b. $\$288,750 = \$825,000 \times 35\%$ flat tax for PSC.

23. *Income Tax*

Solution: a. \$36,800 taxable income. $\$150,000 - \$60,000 + \$4,000 - \$15,000$ Section 179 deduction $- \$25,000 - \$10,000$ NOL = \$44,000 income before the dividend received and charitable contribution deductions. The charitable contribution deduction is limited to \$4,400 ($\$44,000 \times 10\%$). The DRD is \$2,800 ($\$4,000 \times 70\%$). $\$44,000 - \$4,400 - \$2,800 = \$36,800$ taxable income. (The \$10,000 capital gain offsets \$10,000 of the capital loss; the other \$5,000 of the capital loss cannot be deducted this year, but may be carried back three and then forward five years to offset gains in those years.)
b. \$5,520 income tax ($\$36,800 \times 15\%$).
c. Schedule M-1:
Net income per books = $\$150,000$ gross profit $- \$60,000$ operating expenses $+ \$4,000$ dividend income $+ \$10,000$ capital gain $- \$15,000$ capital loss $- \$22,000$ financial depreciation $- \$5,000$ charitable contributions $- \$5,520$ income tax = \$56,480 net income per books.
 $\$56,480$ net income per books $+ \$5,520$ income tax $+ \$5,000$ (\$15,000 capital loss

- \$10,000 capital gain) excess capital loss + \$600 (\$5,000 - \$4,400) excess charitable contributions - \$18,000 (\$15,000 Section 179 expensing + \$25,000 additional tax depreciation - \$22,000 financial depreciation) excess tax depreciation = \$49,600 taxable income before special deductions.

Schedule M-1		Reconciliation of Income (Loss) per Books With Income per Return (see instructions)			
1	Net income (loss) per books	56,480	7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books	5,520		Tax-exempt interest \$	
3	Excess of capital losses over capital gains	5,000		.....
4	Income subject to tax not recorded on books this year (itemize): .....			.....
	.....		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 \$ 18,000	
a	Depreciation \$		b	Charitable contributions \$	
b	Charitable contributions \$ 600			.....
c	Travel and entertainment \$ .....			.....	18,000
	.....	600	9	Add lines 7 and 8	18,000
6	Add lines 1 through 5	67,600	10	Income (page 1, line 28)—line 6 less line 9	49,600

\$36,800 taxable income + \$10,000 NOL + \$2,800 DRD = \$49,600 taxable income before special deductions.

24. Retained Earnings

Solution: \$102,000 + \$87,000 - \$45,000 = \$144,000 ending retained earnings.

25. General Business Credit

Solution: \$27,750. \$400,000 x 34% = \$136,000 gross tax liability. \$25,000 + [75% (\$136,000 - \$25,000)] = \$25,000 + \$83,250 = \$108,250 general business credit allowed. The net tax liability is \$27,750 (\$136,000 - \$108,250).

26. Book/Tax Differences

Solution: a. \$204,700. \$980,000 + \$4,000 (Div.) - \$420,000 - \$380,000 + \$6,000 (Ins. Prem.) + \$11,000 (½ M&E) + \$30,000 (Ch. Cont.) = \$231,000 tentative taxable income before the DRD and allowable charitable contribution; DRD = \$3,200 (80% DRD); Charitable contribution is limited to \$23,100 (10% of \$231,000); \$231,000 - \$3,200 - \$23,100 = \$204,700.
 b. \$63,083. \$22,250 + (.39 x 104,700) = \$63,083.
 c. \$57,818. \$980,000 + \$4,000 - 420,000 - \$380,000 - \$15,000 (excess tax depreciation) + \$6,000 (Ins. Prem.) + \$11,000 (½ M&E) + \$30,000 (Ch. Cont.) - = \$216,000 tentative taxable income before the DRD and allowable charitable contribution; DRD = \$3,200 (80%); Charitable contribution is limited to \$21,600 (10% of \$216,000). \$216,000 - \$3,200 - \$21,600 = \$191,200 taxable income, \$22,250 + (.39 x \$91,200) = \$57,818 tax.

27. Business Credits

Solution: \$76,750 allowable credit for the current year. \$25,000 + .75(\$94,000 - \$25,000) = \$76,750.
 \$7,250 credit carryover. \$54,000 + \$30,000 - \$76,750 = \$7,250.

28. *AMT*

Solution: AMTI = \$118,750; AMT = \$11,750

Tax on \$68,000 = $(\$50,000 \times 15\%) + (\$18,000 \times 25\%) = \$12,000$

AMT income before exemption = $\$68,000 + \$87,000 + 2,000 = \$157,000$;

AMT Exemption = $\$40,000 - [(\$157,000 - \$150,000) \times .25] = \$38,250$;

AMTI = $\$68,000 + \$87,000 + \$2,000 - \$38,250$ exemption = \$118,750;

Gross AMT = $\$118,750 \times 20\% = \$23,750$;

AMT = $\$23,750$ gross AMT - \$12,000 regular corporate tax = \$11,750.

29. *Estimated Payments*

Solution: $(\$575,000 \times 34\%)/4 = \$48,875$ each quarter.

30. *Earnings and Profits*

Solution: \$613,000. $\$668,000 + (\$45,000 \times 80\% = \$36,000 \text{ DRD}) + \$40,000 - \$68,000 - \$40,000 - \$23,000 = \$613,000$

31. *Earnings and Profits*

Solution: All \$6,000 is taxable as a dividend distribution. Amble has no remaining CE&P as all the CE&P and \$2,000 of AE&P were paid out as dividends. AE&P has a balance of \$21,000 $(\$23,000 - \$2,000)$ at the beginning of the next tax year.

32. *Property Distribution*

Solution: The total value of the distribution is \$92,000 $(4 \times \$23,000)$. Vanguard must recognize gain of \$24,000 $(\$92,000 - \$68,000)$. Each of the shareholders recognizes \$23,000 dividend income, the value of their distribution (assuming the corporation has sufficient E&P).

33. *Stock Dividend*

Solution: \$400 gain. Adjusted basis of the shares = $\$4,400/110 \text{ share} = \40 per share . $\$800 - (10 \times \$40) = \$400$ gain on the sale.

34. *Stock Rights*

Solution: \$9.375. Each right has a value of \$3 $(\$13 - \$10)$. \$30 value of ten rights/\$130 value of the ten shares = 23%; thus, basis must be allocated to the rights. The basis in the ten rights is $\$30/\$160 \text{ total} \times \$50 = \$9.375$.

35. *Redemptions*

Solution: a. \$15,000 dividend. $800/1500 = 53.3\%$ before redemption ownership; $53.3\% \times 80\% = 42.67\%$ after redemption ownership; $650/1350 = 48.15\%$ which is not less than 80% of the original ownership. Thus, Sheri will have to treat the \$15,000 received as dividend income.

b. \$24,000 capital gain. $500/1,200 = 41.67\%$ which is less than 80% of her original ownership of 53.3% $(800/1500)$. Thus, Sheri will receive sale treatment. Her \$24,000 capital gain is the difference between the \$30,000 received and her basis in the 300 shares of \$6,000 $(300 \times \$20)$.

c. Sheri will have dividend income (equal to the full amount received) in both instances because her father's shares are attributed to her so she owns 100% of the shares both before and after the sales, regardless of the number sold.

36. *Partial Liquidation*

Solution: a. Beacon will have a gain of \$600,000 (\$1,500,000 - \$900,000) on the sale of the assets on which it will pay a tax of \$204,000 (\$600,000 x 34%). The after-tax proceeds are \$1,296,000 (\$1,500,000 - \$204,000). When it distributes the \$648,000 (\$1,296,000 x 50%) to the shareholders, they will be able to treat this as a sale because it qualifies as a partial liquidation. The total gain is \$198,000 [\$648,000 - (\$45 x 10,000)]. Assuming the shareholders have all held their stock for more than one year, they will pay a tax of \$29,700 (\$198,000 x 15%). (Note: any corporate shareholders would receive dividend treatment for any proceeds that they receive and could qualify for the dividend received deduction.)

b. The corporation would have a \$300,000 Section 1231 loss (\$600,000 - \$900,000). This would reduce corporation taxes by \$102,000 (\$300,000 x 34%). Total proceeds available for distribution would be \$702,000 (\$600,000 + \$102,000). The shareholders would receive only half of this or \$351,000. They would then have capital losses on the partial liquidation of \$99,000 (\$351,000 - \$450,000). These capital losses may or may not be deductible depending upon whether the shareholders have other gains that can be offset with the losses.

37. *Liquidation*

Solution: \$2,000 net loss for Loser Corporation and \$89,000 capital loss for Bummer. Loser recognizes \$500 ordinary income on the distribution of the inventory, an \$11,000 (\$56,000 - \$67,000) Section 1231 loss on the building, and an \$8,500 (\$38,000 - \$29,500) Section 1231 and/or Section 1245 gain on the machines. As a result its net loss from these distributions is \$2,000 (\$500 ordinary income - \$11,000 Section 1231 loss + \$8,500 Section 1231 and/or Section 1245 gain). Bummer received property valued at \$98,000 (\$4,000 + \$56,000 + \$38,000) and has a capital loss on the surrender of his stock of \$89,000 (\$98,000 - \$187,000). Unless Bummer has capital gains with which to offset the \$89,000 capital loss, he will only be able to deduct losses of \$3,000 per year against his other income with the balance of the loss carried forward.

38. *Consolidated Groups*

Solution: P, S1, S2, and S3, form one consolidated group. S4 and S5 cannot be part of this group because S4 does not meet the ownership requirements (80%) by P, S1, S2 and S3. S4 and S5 can form their own consolidated group with S4 as the parent, however.

39. *Personal Holding Company*

Solution: Yes. Four of the nine shareholders own 36 percent in total with the tenth shareholder owning 19 (100% - [9 x 9%]) percent, a total of 55 percent for 5 shareholders. Thus, they meet the shareholder requirement to be a personal holding company because 5 or fewer shareholders own over 50 percent of the stock.

40. *Personal Holding Company Tax*

Solution: \$92,000. The corporation meets the shareholder requirement because any time there are less than 9 shareholders, five or fewer will own over 50 percent. $\$390,000/\$540,000 = 72\%$. Thus, the corporation also meets the income requirement to be a personal holding company. $\$460,000 \times 20\% = \$92,000$ personal holding company tax in addition to its regular tax.

41. *Accumulated Earnings Tax*

Solution: \$83,200. $\$178,000 \times 20\% = \$35,600$ accumulated earnings tax in addition to its regular tax of \$47,600 $[(\$165,000 - \$100,000) \times 39\% + \$22,250]$, for a total tax of \$83,200.

42. *Consolidated Returns*

Solution: a. $\$900,000 - \$685,000 = \$215,000$ separate taxable income.
b. General's capital loss, casualty loss and charitable contribution are all separately stated items; the total of each of these items must be determined on a consolidated basis.

43. *Controlled Group*

Solution: B, C, and D are brother-sister corporations.
Total ownership: A = 75%; B = 100%; C = 95%; D = 80%
Sum of minimum ownership = 15% + 10% + 20% + 10% = 55% but
A does not meet the 80% ownership requirement; thus, A, B, C, and D are not brother-sister corporations. B, C, and D, however, are brother-sister corporations as the sum of their minimum ownership in these three corporations remains 55 percent (15% + 10% + 20% + 10%).

Think Outside the Text

These questions require answers that are beyond the material that is covered in this chapter.

44. *Tax and Financial Accounting Differences*

Solution: When computing taxable income: 1. No deduction for federal taxes; 2. Section 179 expensing allowed; 3. Depreciation based on artificial lives; 4. Amortization of many intangible assets fixed; 5. Fines and bribes not deductible; 6. Capital losses in excess of gains nondeductible; 7. Taxpayers permitted carryovers of nondeductible capital losses; 7. Deduction for charitable contributions limited; 8. Net operating loss carryovers are permitted; 9. Corporations receive a dividend received deduction; 10. Requirements to file a consolidated return require a greater ownership percentage than required for accounting consolidation. (There are other differences besides the 10 listed here.)

45. *Attribution Rules*

Solution: Zero directly and 500 indirectly. Bob owns none of the shares of stock directly. Under Section 267 he is considered to own 200 shares through his one-half interest in the family partnership and he has the 100 shares that his grandfather owns attributed to him. He also owns through reattribution, the 200 shares that his sister

owns through her ownership in the partnership. Thus, he owns 500 shares indirectly. (There are a number of attribution sections in the Code applicable to specific transactions but Section 267 is one of the most commonly encountered.)

46. *Earnings and Profits*

Solution: \$41,700. The deficit in CE&P that has accrued up through the day before the distribution reduces the AE&P balance on that date. January 1 – April 29 = 119 days for the April 30 distribution and 333 days (January 1 – November 29) for the November 30 distribution.

April 30 distribution: $119/365 \times \$36,500 = \$11,900$ deficit in CE&P. $\$75,000$ AE&P - $\$11,900$ deficit = $\$63,100$ AE&P as of that date; thus all $\$40,000$ of the distribution is dividend.

November 30 distribution: $333/365 \times \$36,500 = \$33,300$ deficit in CE&P. $\$75,000$ - $\$33,300$ deficit - $\$40,000$ dividend on April 30 = $\$1,700$ AE&P; thus, $\$1,700$ of the $\$20,000$ distribution is dividend.

$\$41,700$ ($\$40,000 + \$1,700$) of the total distribution is a taxable dividend.

47. *Corporate Distributions*

Solution: Corporations are taxed fully on their gains. If they distributed loss property to shareholders and recognized the losses, they could “manufacture” these losses when necessary by these distributions—but the property would still be in the shareholders hands and the shareholder could then just rent the property back to the corporation. When the corporation liquidates, it ends its business operations. At that time, it can recognize both gains and losses as there is no more corporation for the shareholders to control.

48. *Controlled Groups*

Solution: (Examples will vary.) In a parent-subsidary controlled group, the parent must own directly at least 80 percent of the combined voting power of the subsidiary or 80 percent of the stock by value; other corporations that together meet these ownership requirements (voting or value) are included in the controlled group. In an affiliated group, the parent is the primary focus and must own directly at least 80 percent by vote *and* by value of one corporation with other corporations meeting these same 80 percent ownership requirements (voting *and* value) also included.

49. *Earnings and Profits*

Solution: Walter will have a $\$10,000$ dividend distribution; John will have a $\$5,000$ dividend distribution and a $\$5,000$ return of capital.

The CE&P is allocated proportionately to Walter and John based on their total dividend during the year; thus, each is allocated $\$2,500$ of CE&P ($\$5,000 \times \$10,000/\$20,000$). The $\$10,000$ of AE&P is allocated based on the time within the year the dividend was distributed with earlier dividends allocated AE&P first; thus, Walter is allocated $\$7,500$ of the $\$10,000$ of AE&P; John is then allocated the remaining $\$2,500$. As a result, Walter's entire $\$10,000$ is taxed as a dividend

distribution but John's \$10,000 distribution is classified as \$5,000 dividend and \$5,000 return of capital.

Identify the Issues

Identify the issues or problems suggested by the following situations. State each issue as a question.

50. *Attribution*

Solution: How will the redemption of these shares be treated for tax purposes? Will the fact that the brothers are estranged and have no contact affect this decision?

51. *Liquidation*

Solution: Will the contribution of loss assets 20 months prior to the formal adoption of a plan of liquidation affect the gains and losses realized and recognized by the corporation when it liquidates?

52. *Redemption*

Solution: Will acting as a consultant have any effect on the waiver of attribution that Joe signed with the IRS? Does he have to notify the IRS of this relationship?

53. *Constructive Dividend*

Solution: How much of the constructive dividend will be taxed to the owner given the small amount of earnings and profits? Will the use of these corporate funds in prior years to pay personal expenses affect the determination of earnings and profits when determining the amount of the constructive dividend?

54. *Partial Liquidation*

Solution: Will this qualify as a partial liquidation or will the new corporation be viewed as simply a continuation of the old corporation? What would be the difference in the tax consequences for each of these outcomes?

Develop Research Skills

Solutions to research problems are included in a separate file.

Search the Internet

59. *Corporation Tax Forms*

Solution: If a corporation has less than \$250,000 in total receipts and total assets at the end of the tax year, it is not required to complete Schedules L, M1 and M2 if the yes box on Schedule K, Question 13 is checked. It only needs to report the amount of cash distributions and the book value of other assets distributed during the tax year. Additionally, Schedule UTP (Uncertain Tax Positions) does not need to be filed for corporations with less than \$100 million in assets.

60. *Form 1120*

Solution: Sales	\$1,450,000
Less: Cost of goods sold	<u>625,000</u>
Equals: Total income	\$ 825,000
Less Expenses:	
Compensation of officers	\$ 187,000
Salaries and wages	266,000
Repairs and Maintenance	14,000
Rent	48,000
Taxes	87,000
Depreciation	34,000
Pension and profit sharing	28,000
Employee benefit programs	17,000
Other deductions	<u>91,000</u>
Total deductions	\$ <u>772,000</u>
Taxable income	\$ <u>53,000</u>
Total tax [\$7,500 + 25% (\$53,000 - \$50,000)]	\$ 8,250
Payments	<u>15,000</u>
Overpayment	\$ <u><u>6,750</u></u>

Schedule of Other Deductions:

Line 26:

50% of Meals and Entertainment	\$ 6,000
Utilities	21,000
Vehicle Expense	34,000
Insurance	<u>30,000</u>
Total	\$91,000

A filled-in form for 2012 is included at the end of this file.

61. *Change of Tax Year*

Solution: To elect a 52-53-week tax year, a corporation must attach a statement to its tax return that specifies the following: (1) The month in which the new 52-53-week tax year ends; (2) The day of the week on which the 52-53-week tax year always ends; and (3) The date on which the tax year ends. It can be either of the following dates on which the chosen day (a) last occurs in the month in (1) above or (b) occurs nearest the last day of the month in (1) above.

Develop Planning Skills62. *Asset Sales*

Solution: It should sell the loss asset.

If it sells the gain asset: Taxable income = \$2,000,000 + \$2,000,000 Section 1231 gain + \$1,750,000 asset gain = \$5,750,000. Tax = \$5,750,000 x 34% = \$1,955,000. Alternative minimum tax: \$5,750,000 + \$4,500,000 = \$10,250,000 AMTI. TAMT = \$10,250,000 x 20% = \$2,050,000; AMT = \$95,000 (\$2,050,000 - \$1,955,000)

If it sells the loss asset: Taxable income = \$2,000,000 + \$2,000,000 - \$300,000 loss = \$3,700,000. Tax = \$3,700,000 x 34% = \$1,258,000.

Alternative minimum tax: $\$3,700,000 + \$4,500,000 = \$8,200,000$ AMTI. $TAMT = \$8,200,000 \times 20\% = \$1,640,000$. $AMT = \$1,640,000 - \$1,258,000 = \$382,000$ AMT

With either sale, the corporation will have to pay some alternative minimum tax. The AMT is less selling the gain asset, but from a total tax standpoint, selling the loss assets results in taxes that are \$410,000 less than selling the gain asset. On the general principle that taxes should be postponed, the loss asset should be sold. In addition, if the gain asset is sold in the near future, the AMT credit (the AMT paid this year when the loss asset is sold) potentially can be used as a credit against the regular tax in the year the gain asset is sold.

63. *Shareholder Alternatives*

Solution: The corporation should redeem approximately 11% of Gene's stock.

If Gene could find a buyer for his stock, he would only have to recognize the gain on the sale and pay taxes on the gain. The stock appears to be closely held, however, and an outside buyer may not be available. He may also be prevented from obtaining a loan outside the company using his stock as collateral because it may not be acceptable collateral if closely held. He could approach his brother to buy the stock, but his brother may not have the funds to do so. His best alternative would be to have the corporation redeem at least 10 percent of the stock. His ownership (both direct and indirect) before a redemption is 35 percent and 80 percent of that is 28 percent. To receive sale treatment, his direct and indirect ownership must be less than 80 percent after the redemption. If the corporation redeems 10 percent, he would then own 25% of the 90% of the stock that remains outstanding; $25/90 = 27.78\%$ and is less than 80 percent of his previous ownership. Redeeming 10% also gives him the needed \$100,000 cash. His basis in the stock is \$40,000 ($10/25 \times \$100,000$); he will have a \$60,000 capital gain. He will need to have more than 10% redeemed to offset the potential \$9,000 ($\$60,000 \times 15\%$) tax. Approximately 11% of his stock redeemed will cover the \$100,000 for medical expenses and the taxes on the gain.

64. *Financing Alternatives*

Solution: The preferred stock is the best alternative.

- a. Loan: $\$2,000,000 \times [9\% (1 - .30)] = \$126,000$ net after-tax interest payments. The cost of the loan, which is the present value of the interest payments (an annuity of 10 years at 6%), is $\$126,000 \times 7.360 = \$927,360$. (In each of the alternatives, \$2,000,000 will have to be paid out at the end of the 10 year period; thus, it is unnecessary to determine the present value for this \$2,000,000 outflow at the end of the 10 year period for any of them under the principle of incremental analysis.)
- b. Bonds: $\$2,000,000 \times [7.5\% (1 - .30)] = \$105,000$ net after-tax interest payments. The present value of the interest payments is $\$105,000 \times 7.360 = \$772,800$. The cost of the loan, however, includes both the total present value of the interest payments and the \$200,000 underwriting fee, a total of \$972,800.
- c. Preferred stock: $\$2,000,000 \times 5\% = \$100,000$. The present value of the dividend payments is $\$100,000 \times 7.360 = \$736,000$. The total cost of the preferred stock,

however, must include the present value of the \$40,000 ($\$2,000,000 \times 2\%$) redemption premium of \$22,320 ($\$40,000 \times .558$). Thus, the total present value cost of the preferred stock is \$808,320 ($\$50,000 + \$736,000 + \$22,320$). The preferred stock is the best alternative.

65. *Foreign Income*

Solution: The corporation is better off with the credit.

Deduction: $\$250,000 - \$75,000 = \$175,000$; tax is $[\$22,250 + (39\% \times \$75,000)] = \$51,500$.

Credit: Tax on $\$250,000 = \$22,250 + (39\% \times \$150,000) = \$80,750$. The corporation can offset \$75,000 of the tax with its foreign tax credit and pay only \$5,750 in taxes. Thus, the corporation is better off with the credit. The corporation is permitted the entire \$75,000 tax credit because the rate of tax on the foreign income of 25 percent ($\$75,000/\$300,000$) is less than the rate of tax on the U.S. income of 32.3% ($\$80,750/\$250,000$).

Appendix 9A—Check Your Understanding

1. *Exempt Status*

Solution: An exempt organization can lose its exempt status if it fails to meet the requirements as an exempt organization under Section 501(c) of the Code on a continuing basis. Among other things, this section requires the exempt organization to be operated for the general public as a whole and receive a majority of its funds from the public or governmental units.

2. *Prohibited Transactions*

Solution: The federal government can levy excises taxes on or end the exempt status of an exempt organization that engages in prohibited transactions.

3. *Unrelated Business Income*

Solution: If an exempt organization is not taxed on its unrelated business income, it would have an unfair advantage when competing with taxable organizations conducting a similar type of business.

4. *Unrelated Business*

Solution: An unrelated business is one that does not have a proximate relationship to the exempt purpose of the organization. A related business has this relationship and supports the exempt status of the organization. For example, hospitals have flower and gift shops and colleges have bookstores and dining facilities; these are related to their exempt purpose. A golf course open to the public owned by a college or a clothing store owned by a hospital would be unrelated businesses.

5. *Prohibited Transactions*

Solution: 1. Paying the personal expenses of an employee or manager. 2. An employee or manager taking for personal use property donated to the organization that was to be sold in a thrift shop. 3. Providing free services to an employee or manager that normally would have a cost if provided to the public.

6. *Private Foundation*

Solution: A private foundation is one that is not supported or operated for the general public as a whole but has a more narrow focus. It receives less than one-third of its annual support from the general public, governments, or other exempt organizations.

7. *Prohibited Transaction*

Solution: A private foundation reduces its excise tax on prohibited transactions by correcting the prohibited transaction.

Appendix 9B—Check Your Understanding

1. *SALT*

Solution: SALT stands for state and local taxation; thus, the practice focuses on tax at these levels rather than federal taxation.

2. *Tax Changes*

Solution: Although most states base income for state income tax purposes on income as determined for federal tax purposes, the states generally specify that this determination of income is based on the Code in effect on a specific date. Thus, unless the state changed the effective date of the Code after additional bonus depreciation went into effect for federal purposes, state income determination would not include this provision. This allows the states time to evaluate any changes in the Code before making them effective for state income tax purposes. Many states decided not to adopt this additional depreciation provision.

3. *Nexus*

Solution: Nexus is the connection between a state and a business that the state is seeking to tax. Without this connection, the state cannot levy taxes on the business. The connection includes, but is not limited to, employees or property located within the state.

4. *Nexus*

Solution: Arizona cannot levy an income tax on Internet sales by Suntan Corporation because it is wholly located in Florida and the company has no nexus with Arizona.

5. *Multi-State Businesses*

Solution: No. Income of a corporation with operations in more than one state must be apportioned between the states. Although more than 100 percent may be taxed by all the states combined because of differences in apportionment formulas, no one state can tax 100 percent of the income.

6. *Use Tax*

Solution: A use tax is levied on property purchased in one state for use by a resident of another state when the selling state levies no sales tax. The rate is normally the same as the state's sales tax and is to be self-imposed.

<h1 style="margin: 0;">1120</h1> <p style="margin: 0; font-size: small;">Form Department of the Treasury Internal Revenue Service</p>		<h2 style="margin: 0;">U.S. Corporation Income Tax Return</h2> <p style="margin: 0; font-size: small;">For calendar year 2012 or tax year beginning _____, 2012, ending _____, 20 ► Information about Form 1120 and its separate instructions is at www.irs.gov/form1120.</p>		<p style="margin: 0; font-size: x-small;">OMB No. 1545-0123</p> <h1 style="margin: 0;">2012</h1>	
<p>A Check if:</p> <p>1a Consolidated return (attach Form 851) <input type="checkbox"/></p> <p>b Life/nonlife consolidated return <input type="checkbox"/></p> <p>2 Personal holding co. (attach Sch. PH) <input type="checkbox"/></p> <p>3 Personal service corp. (see instructions) <input type="checkbox"/></p> <p>4 Schedule M-3 attached <input type="checkbox"/></p>		<p>TYPE OR PRINT</p> <p>Name <u>Chelsea Corporation</u></p> <p>Number, street, and room or suite no. If a P.O. box, see instructions. <u>34 Chelsea Drive</u></p> <p>City or town, state, and ZIP code <u>Sarasota, FL 33456</u></p>		<p>B Employer identification number <u>78-9999999</u></p> <p>C Date incorporated <u>6-15-2002</u></p> <p>D Total assets (see instructions) \$ _____</p>	
<p>E Check if: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change</p>					
Income	1a Gross receipts or sales	1a	<u>1,450,000</u>		
	b Returns and allowances	1b	<u>0</u>		
	c Balance. Subtract line 1b from line 1a	1c		<u>1,450,000</u>	
	2 Cost of goods sold (attach Form 1125-A)	2		<u>625,000</u>	
	3 Gross profit. Subtract line 2 from line 1c	3		<u>825,000</u>	
	4 Dividends (Schedule C, line 19)	4			
	5 Interest	5			
	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		<u>825,000</u>		
Deductions (See instructions for limitations on deductions.)	12 Compensation of officers (see instructions—attach Form 1125-E)	12		<u>187,000</u>	
	13 Salaries and wages (less employment credits)	13		<u>266,000</u>	
	14 Repairs and maintenance	14		<u>14,000</u>	
	15 Bad debts	15			
	16 Rents	16		<u>48,000</u>	
	17 Taxes and licenses	17		<u>87,000</u>	
	18 Interest	18			
	19 Charitable contributions	19			
	20 Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)	20		<u>34,000</u>	
	21 Depletion	21			
	22 Advertising	22			
	23 Pension, profit-sharing, etc., plans	23		<u>28,000</u>	
	24 Employee benefit programs	24		<u>17,000</u>	
	25 Domestic production activities deduction (attach Form 8903)	25			
26 Other deductions (attach statement)	26		<u>91,000</u>		
27 Total deductions. Add lines 12 through 26	27		<u>772,000</u>		
28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11.	28		<u>53,000</u>		
29a Net operating loss deduction (see instructions)	29a				
b Special deductions (Schedule C, line 20)	29b				
c Add lines 29a and 29b	29c		<u>0</u>		
Tax, Refundable Credits, and Payments	30 Taxable income. Subtract line 29c from line 28 (see instructions)	30		<u>53,000</u>	
	31 Total tax (Schedule J, Part I, line 11)	31		<u>8,250</u>	
	32 Total payments and refundable credits (Schedule J, Part II, line 21)	32		<u>15,000</u>	
	33 Estimated tax penalty (see instructions). Check if Form 2220 is attached <input type="checkbox"/>	33			
	34 Amount owed. If line 32 is smaller than the total of lines 31 and 33, enter amount owed	34			
	35 Overpayment. If line 32 is larger than the total of lines 31 and 33, enter amount overpaid	35		<u>6,750</u>	
	36 Enter amount from line 35 you want: Credited to 2013 estimated tax <input type="checkbox"/> Refunded <input type="checkbox"/>	36		<u>6,750</u>	
<p>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.</p>					
<p>Sign Here</p> <p>Signature of officer _____ Date _____ Title _____</p>		<p>May the IRS discuss this return with the preparer shown below (see instructions)? <input type="checkbox"/> Yes <input type="checkbox"/> No</p>			
<p>Paid Preparer Use Only</p> <p>Print/Type preparer's name _____ Preparer's signature _____ Date _____</p> <p>Firm's name _____ Firm's EIN _____</p> <p>Firm's address _____ Phone no. _____</p>		<p>Check <input type="checkbox"/> if self-employed PTIN _____</p>			