CHAPTER 16

CORPORATIONS: INTRODUCTION, OPERATING RULES, AND RELATED CORPORATIONS

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Proprietorship capital gain tax and withdrawal	Unchanged	1
2	Partnership capital gain and withdrawals	New	
3	Corporation versus proprietorship	Unchanged	3
4	Corporate tax versus partnership tax	New	
5	Issue ID	New	
6	Expenses to avoid double taxation	Unchanged	6
7	Unreasonable compensation in closely held corporation	Modified	7
8	Check-the-box rules	Unchanged	8
9	Accrual method required	Unchanged	9
10	Capital loss treatment of corporation and individual	Modified	10
11	Capital gain treatment for corporations and individuals	Modified	11
12	LTCL of individuals and corporations	Modified	12
13	Passive loss rules: closely held C corporations and PSCs contrasted	New	
14	Tax treatment of charitable contributions for corporate and noncorporate taxpayers	New	
15	Corporate dividends received deduction between related corporations	New	
16	Dividends received deduction	Unchanged	16
17	Tax liability of related corporations	Unchanged	17
18	Members of combined group	Unchanged	18
19	Differences between taxable income and accounting income	Unchanged	19

Status: Q/P

Question/ Problem	Topic	Present Edition	in Prior Edition
20	Start-up expenditures	Modified	20
21	Compare LTCL treatment for corporations and for proprietorships	New	
22	Tax effect of NOL: corporation versus proprietorship	Unchanged	22
23	Tax treatment of distributions from proprietorship and corporation	Unchanged	23
24	Corporation net income taxation, cash distribution to owner versus proprietorship with cash distribution	New	
25	Comparison of deduction for casualty loss for individual and corporate taxpayers	New	
26	Tax liability determination as proprietorship or corporation	Unchanged	26
27	Capital loss of corporation	Unchanged	27
28	Comparison of treatment of capital losses for individual and corporate taxpayers	Unchanged	28
29	Capital gains and losses of a corporation; carryback/carryover	Unchanged	29
30	Passive loss of closely held corporation; PSC	Unchanged	30
31	Corporate charitable contribution	Unchanged	31
32	Charitable contributions of corporation; carryover	Modified	32
33	Timing of charitable contributions deduction of accrual basis corporation	Unchanged	33
34	Dividends received deduction	New	
35	Dividends received deduction	Unchanged	35
36	Organizational expenses	Unchanged	36
37	Organizational expenses	New	
38	Determine corporate income tax liability	Unchanged	38
39	Related corporations	Unchanged	39
40	Related corporations	Unchanged	40
41	Brother-sister controlled group	Unchanged	41
42	Schedule M-1, Form 1120	New	
43	Issue ID	Unchanged	43

CHECK FIGURES

21.a.	Andrew will report profit $20,000 and capital loss $5,000.
21.b.	Andrew's income is not increased.
22.	If corporation, Lena's taxable income not affected; if proprietorship, Lena deducts $50,000 loss.
23.a.	$130,223 tax.
23.b.	$128,792 tax.
23.c.	$204,403 tax.
23.d.	$130,223 tax.
24.a.	Joan's tax $54,228.
24.b.	Joan's tax $51,542.
24.c.	Total tax $84,191.
24.d.	Joan's tax $54,228.
25.a.	$33,900.
25.b.	$45,000.
26.a.	$42,460.
26.b.	$31,970.
26.c.	$23,420
26.d.	$42,797.
27.a.	$50,000.
27.b.	$62,000.
	$65,000 for Hugh, $60,000 for Sam.
28.a.	$8,000 deducted 2002; $7,000 carried forward to 2003.
28.b.	$5,000 deducted 2002; $10,000 carried back.
29.a.	Offset short-term capital gain of $30,000 against net long-term capital loss of $190,000. The $160,000 net long-term loss is carried back 3 years and forward 5 years.
29.b.	Total carryback $140,000.
29.c.	$20,000; carry forward 2004.
30.	Offset $45,000 of passive loss against active income. No offset if a PSC.
32.a.	$17,000.
33.	2003.
34.a.	$27,000.
34.b.	($6,000).
35.	Red $70,000; White $140,000; Blue $112,000.
36.a.	$300.
36.b.	$4,320.
36.c.	$300.
36.d.	$4,320.
37.	$830.
38.	Violet $6,900; Indigo $84,650; Blue $550,800; Green $8,400,000.
39.a.	Yes.
39.b.	No.
40.	Wren, Robin, and Finch.
41.a.	Yes.
41.b.	No.
42.	$150,000.

DISCUSSION QUESTIONS

1. Zachary reports the income and expenses of the business on Schedule C of Form 1040, resulting in net profit (ordinary income) of $55,000 ($180,000 – $125,000). He reflects the $55,000 net profit from the business on Form 1040, where he computes taxable income for the year. The $40,000 that Zachary withdrew from the business has no impact on his taxable income. If he has capital gains during the year, these can be offset by the capital loss. If capital losses exceed capital gains, he can use up to $3,000 of the capital loss to offset ordinary income and can carry any unused capital loss forward. Example 1

2. George must report $75,000 income on his tax return, and Mike is not required to report income from the corporation on his tax return. Proprietorship profits flow through to the owner and are reported on the owner's individual income tax return. Shareholders are required to report income from a corporation only to the extent of dividends received. Mike did not receive a dividend. pp. 16-2 and 16-4

3. Art should consider operating the business as a sole proprietorship for the first three years. If he works 15 hours per week in the business, he will exceed the minimum number of hours required to be a material participant. Therefore, he will be able to deduct the losses against his other income. When the business becomes profitable, Art should consider incorporating. If he reinvests the profits in the business, the value of the stock should grow accordingly, and he should be able to sell his stock in the corporation for long-term capital gain. pp. 16-2 to 16-7

4. Losses of sole proprietorships are passed through to their owners, but losses (operating or capital) of regular corporations are not. Capital losses of sole proprietorships retain their character when reported by the proprietor.

   The capital loss of the sole proprietorship is passed through to Lucille, and she is allowed to report it on her tax return as a capital loss. She can offset the loss against capital gains or deduct it against ordinary income (up to $3,000) if she has no capital gains for the year. The capital loss of Mabel's corporation is reported on the tax return of the corporation, which is a separate taxable entity. It has no effect on her taxable income.

   The operating loss is passed through to Lucille, and she is allowed to deduct it on her tax return (subject to at-risk and passive loss limitations). The operating loss of the corporation has no effect on Mabel's tax return.

   pp. 16-2 to 16-4, 16-6, 16-12, and 16-16

5. Harry must report $60,000 of Purple Corporation income and may deduct $3,000 of the $8,000 loss on his Federal income tax return. He may carry forward the $5,000 unused LTCL and treat it as LCTL in the future. S corporations are *similar* to partnerships in that net profit or loss flows through to the shareholders to be reported on their separate returns. The $30,000 withdrawal has no impact on Harry's taxable income. p. 16-4

6. If Tanesha buys the warehouse and rents it to the corporation, she can charge the corporation the highest amount of rent that is *reasonable*. The rental operation can help her to bail some profits out of the corporation and avoid double taxation on corporate income. The depreciation and other expenses incurred in connection with the warehouse will be deductible by Tanesha, which should enable her to offset some or all of the rental

income. If the rental property produces a loss, Tanesha can use the loss to offset any passive income she might have. p. 16-31

7. Section 162 provides that compensation is deductible only to the extent that it is reasonable in amount. If the shareholders accept the IRS agent's finding, $150,000 of the corporation's compensation deduction will be disallowed and treated as a constructive dividend to the shareholders. Trace has taxable income of $150,000. Each shareholder would report salary of $125,000 and a constructive dividend of $75,000. The net effect is that $150,000 is subject to double taxation. p. 16-5 and Example 6

8. The check-the-box rules permit an entity to elect to be taxed either as a partnership or as a corporation. The election is made by filing Form 8832. If Ed and Barbara do not file Form 8832, the entity will be treated as a partnership by default. pp. 16-8 and 16-9

9. Businesses that maintain inventory for sale to customers are required to use the accrual method of accounting for determining sales and cost of goods sold. Therefore, Rose corporation would be required to use the accrual method, at least for transactions involving inventory. p. 16-11

10. Kathy may use the $25,000 to offset any capital gains she has during the year. If she has losses in excess of gains, she may deduct up to $3,000 of the losses as a deduction for AGI, and any remaining losses may be carried forward indefinitely.

    Eagle Corporation may use the capital loss to offset any capital gains incurred during the year. Any excess losses may be carried back three years and forward five years. When carried back or forward, a long-term capital loss is treated as a short-term loss. pp. 16-11 and 16-12

11. Judy reports the long-term capital gain on her individual tax return, and it is subject to a maximum tax rate of 20 percent. Link does not receive special tax treatment for its long-term capital gain. Therefore, the corporation's gain will be taxed at 35 percent. p. 16-12

12. John may deduct $3,000 of his capital loss in computing taxable income for the current year and may carry the remaining $4,000 forward for an indefinite period. He can use it to offset capital gains in the carryforward years, or he can deduct up to $3,000 per year from ordinary income if he has no capital gains. Fox Corporation cannot deduct any of the loss in the year incurred. However, Fox can carry the loss back 3 years and forward five years until the entire loss is offset against capital gains in the carryback or carryforward years. Examples 10 and 11

13. Falcon can deduct none of the passive loss. A personal service corporation cannot offset a passive loss against either active or portfolio income. p. 16-13

14. In order to be deductible by an accrual basis corporation in the year authorized by its board of directors, a charitable contribution must be paid within 2 1/2 months of the end of the year of authorization (March 15 in this case). Because payment was not made by March 15, the contribution is not deductible in 2003. Example 13

15. A corporation that owns stock in another corporation is allowed a dividends received deduction. The deduction percentage is based on the percentage of ownership that the recipient corporation has in the dividend-paying corporation. While Taupe owns 90% of Mocha, the deduction percentage is 100%. After the sale, Taupe will own 45% of Mocha, and the deduction percentage will be 80%. p. 16-16

16. The dividends received deduction depends upon the percentage ownership by the corporate shareholder. If Amber Corporation owns 75% (20% or more, but less than 80%) of Mauve Corporation, Amber would qualify for an 80% deduction ($80,000). If Amber Corporation owns 85% (80% or more) and files a consolidated return with Mauve Corporation, Amber would qualify for a 100% deduction ($100,000). pp. 16-16 and 16-17

17. George's plan will not reduce corporate income taxes. Palmetto, Poplar, and Spruce would be related corporations and would be subject to special rules for computing the corporate income tax. Therefore, the total corporate tax liability would remain unchanged. Examples 25 and 26 and related discussion

18. Yes. They are members of a combined group. Example 33

19. The starting point on Schedule M-1 is net income per books. Additions and subtractions are entered for items that affect net income per books and taxable income differently. An example of an addition is Federal income tax expense, which is deducted in computing net income per books but is disallowed in computing taxable income. An example of a subtraction is a charitable contributions carryover that was deducted for book purposes in a prior year but deducted in the current year for tax purposes. pp. 16-28 to 16-30

20. Martin Corporation should elect to forgo the NOL carryback if profits in the two preceding years were small and if higher profits are expected in the future. Carrying an NOL back to low profit years will generate a smaller tax savings than carrying the loss forward to high profit years. Before electing to forgo an NOL carryback, a corporation should be able to predict with confidence that future profits will be higher. p. 16-32

PROBLEMS

21. a. Revenues, expenses, gains, and losses of a proprietorship flow through to the proprietor. Consequently, Andrew reports the $20,000 net profit and $5,000 capital loss on his individual tax return.

    b. Shareholders are required to report income from a corporation only to the extent of dividends received. Therefore, Andrew does not report the net profit or capital loss on his individual return.

    pp. 16-2 and 16-4

22. If Bunting were a corporation, Lena's taxable income for 2003 would not be affected, because the corporation did not pay a dividend. The corporation's loss would not pass through to Lena.

    If Bunting were a proprietorship, Lena (who qualifies as a material participant) could deduct the $50,000 loss. This would result in a tax savings of $19,300 ($50,000 deduction X 38.6% marginal rate). pp. 16-5 to 16-7

23. Using the 2003 income tax rate schedule (tax rounded to nearest dollar):

a.	Carla's tax on $400,000 at single rates	$130,223
b.	Carla's tax on $50,000 at single rates	$ 9,792

	Cardinal's tax on $350,000 at corporate rates		119,000
	Total tax		$128,792
c.	Corporate taxable income	$350,000	
	Tax on $350,000 at corporate rates	(119,000)	$119,000
	Distributed to Carla	$231,000	
	Salary to Carla	50,000	
	Taxable income to Carla	$281,000	
	Tax on $281,000 at single rates		85,403
	Total tax		$204,403
d.	Carla's tax on $400,000 at single rates		$130,223

pp. 16-2 to 16-6

24. Using the 2003 income tax rate schedule (tax rounded to nearest dollar):

a.	Joan's tax on $200,000 at single rates		$54,228
b.	Joan's tax on $50,000 at single rates		$ 9,792
	Aqua's tax on $150,000 at corporate rates		41,750
	Total tax		$51,542
c.	Corporate taxable income	$150,000	
	Tax on $150,000 at corporate rates	(41,750)	$41,750
	Distributed to Joan	$108,250	
	Salary to Joan	50,000	
	Taxable income to Joan	$158,250	
	Tax on $158,250 at single rates (rounded)		42,441
	Total tax		$84,191
d.	Joan's tax on $200,000 at single rates		$54,228

pp. 16-2 to 16-6 and Examples 3 and 4

25. a. Dakota can deduct $33,900 [$75,000 – $30,000 (insurance recovery) – $100 (floor on personal casualty losses) – $11,000 (10% of AGI)] if she itemizes deductions. If Dakota does not itemize, she would not have a deduction.

b. Dakota can deduct $45,000 [$75,000 – $30,000 (insurance recovery)]. Corporations are not subject to the $100 floor or the 10% limitation.

p. 16-10

26.

a.	Gross income	$200,000	
	Ordinary deductions	(90,000)	
	Taxable income (to owner of proprietorship)	$110,000	
	Tax @ 38.6%		$42,460
b.	Gross income of corporation	$200,000	
	Ordinary deductions	(90,000)	
	Salary	(70,000)	
	Accident and health insurance	(7,000)	

	Taxable income	$ 33,000	
	Corporate tax		$ 4,950
	Gross income of shareholder		
	Salary	$ 70,000	
	Tax @ 38.6%		27,020
	Total tax		$31,970
c.	Gross income of corporation	$200,000	
	Ordinary deductions	(90,000)	
	Accident and health insurance	(7,000)	
	Taxable income	$103,000	
	Corporate tax		$23,420
d.	Gross income of corporation	$200,000	
	Ordinary deductions	(90,000)	
	Salary	(70,000)	
	Accident and health insurance	(7,000)	
	Taxable income	$ 33,000	
	Corporate tax		$ 4,950
	Gross income of shareholder		
	Salary	$ 70,000	
	Dividend ($33,000 – $4,950)	28,050	
	Total	$ 98,050	
	Tax @ 38.6%		37,847
	Total tax		$42,797

e.

Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 2, 2003

Mr. Robert Benton
1121 Monroe Street
Ironton, OH 45638

Dear Mr. Benton:

This letter is in response to your inquiry as to the tax effects of incorporating your business in 2004. I have analyzed the tax results under both assumptions, proprietorship and corporation. I cannot give you a recommendation until we discuss the matter further and you provide me with some additional information. My analysis based on information you have given me to date is presented below.

Computation 1

Total tax on $110,000 taxable income if you continue as a proprietorship	$42,460
Total tax if you incorporate:	
Individual tax on $70,000 salary @ 38.6%	$27,020

Corporate tax on $33,000 corporate taxable income	4,950
Total	$31,970

Although this analysis appears to favor incorporating, it is important to consider that there will be additional tax on the $28,050 of income left in the corporation if you withdraw that amount as a dividend in the future, as calculated below:

Computation 2

Income left in corporation ($33,000 taxable income – $4,950 corporate tax)	$28,050
Tax on $28,050 @ 38.6%	$10,827
Total tax paid if you incorporate ($31,970 + $10,827)	$42,797

Comparison of computations 1 and 2 appears to support continuing as a proprietorship rather than incorporating. However, if you incorporate and recover the income left in the corporation as long-term capital gain in the future, the total tax cost of incorporating will be less, as shown in computation 3 below.

Computation 3

Income left in corporation ($33,000 taxable income – $4,950 corporate tax)	$28,050
Tax on $28,050 @ 20% LTCG rate	$ 5,610
Total tax paid if you incorporate ($31,970 + $5,610)	$37,580

In summary, incorporation appears to be the most attractive option if you recover income left in the corporation as capital gain, but not if you recover it as dividend income. Because of this, it will be necessary for us to discuss your plans for the business, particularly when you plan to withdraw income from the corporation or sell it. After you have conveyed this information to me, I can do additional analyses to isolate the tax impact of your decision. Keep in mind, however, that there are important nontax considerations with respect to this decision. We also can discuss those issues at our next meeting.

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

Sincerely,

Jon Thomas, CPA

pp. 16-2 to 16-6

27. A corporation cannot deduct a net capital loss in the year incurred. The net loss can be carried back for three years and offset against capital gain in the carryback years. If the capital loss is not used in the carryback years, it can be carried forward for five years. Capital gains of corporations are included in taxable income and are not subject to the 20% maximum rate that applies to individuals.

a. $400,000 (operating income) – $350,000 (operating expenses) = $50,000 taxable income. No capital loss deduction is allowed.

b. $400,000 (operating income) – $350,000 (operating expenses) + $12,000 (net capital gain) = $62,000 taxable income.

p. 16-12

28. a. Of the $15,000 long-term capital loss, $8,000 can be deducted in 2002. The loss will offset the capital gains of $5,000 first; then, an additional $3,000 of the loss may be utilized as a deduction against ordinary income. The remaining $7,000 of loss is carried forward to 2004 and years thereafter until completely deducted.

b. Only $5,000 of the loss may be deducted in 2003. The loss deduction is limited to the amount of capital gains ($3,000 STCG + $2,000 LTCG). A corporation may not claim any capital losses as a deduction against ordinary income. The remaining $10,000 in loss can be carried back to the three preceding years to reduce any capital gains in those years. [The loss is carried back first to the tax year 2000.] Any remaining loss not offset against capital gains in the three previous years can be carried forward for five years only, to offset capital gains in those years. The long-term capital loss will be treated as a short-term capital loss as it is carried back and forward.

Examples 10 and 11

29. a.

Net short-term capital gain	$ 30,000
Net long-term capital loss	(190,000)
Excess net long-term loss	($160,000)

The excess capital losses of $160,000 are not deductible on the 2003 return, but must be carried back to the three preceding years, applying them to 2000, 2001, and 2002, in that order. Such long-term capital losses are carried back or forward as short-term capital losses.

b.

2003 excess loss	($160,000)
Offset against	
2000 (net short-term capital gains)	$ 40,000
2001 (net long-term capital gains)	30,000
2002 (net long-term capital gains)	70,000
Total carrybacks	($140,000)

c. $20,000 ($160,000 – $140,000) STCL carryover to 2004, 2005, 2006, 2007, and 2008, in that order.

d. Sylvia would net these transactions with all other capital transactions for 2003. Assuming these were her only capital transactions in 2003, she would offset $30,000 of capital losses against the capital gains and deduct an additional $3,000 in capital losses on her return. The remaining $157,000 ($190,000 – $30,000 – $3,000) would be carried forward indefinitely.

pp. 16-10 and 16-11

30. If Condor is a closely held corporation and not a PSC, it may offset $45,000 of the $80,000 passive loss against the $45,000 of active business income. However, it may not offset the remaining $35,000 against portfolio income. Example 12

    If Condor were a PSC, it could not offset the passive loss against either active or portfolio income. p. 16-13

31. Willis, Hoffman, Maloney, and Raabe, CPAs
    5191 Natorp Boulevard
    Mason, OH 45040

    December 5, 2003

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

    Dear Mr. Thompson:

    I have evaluated the proposed alternatives for your 2003 year-end contribution to the University of Maine. I recommend that you sell the Brown Corporation stock and donate the proceeds to the University. The four alternatives are discussed below.

    Donation of cash, the unimproved land, or the Brown stock each will result in a $120,000 charitable contribution deduction. Donation of the Maize Corporation stock will result in only a $20,000 charitable contribution deduction.

    Contribution of the Brown Corporation stock will result in a less desirable outcome from a tax perspective. However, you will benefit in two ways if you sell the Brown stock and give the $120,000 in proceeds to the University. Donation of the proceeds will result in a $120,000 charitable contribution deduction. In addition, sale of the stock will result in a $50,000 long-term capital loss. If Jay had capital gains of at least $50,000 and paid corporate income tax in the past three years, the entire loss can be carried back and Jay will receive tax refunds for the carryback years. If Jay had no capital gains in the carryback years, the capital loss can be carried forward and offset against capital gains of the corporation for up to five years.

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

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

    Sincerely,

    Richard Stinson, CPA

    pp. 16-13 and 16-14

32. a. Taxable income for purposes of applying the 10% limitation does not include the dividends received deduction. For purposes of the 10% limitation, Bobwhite's

taxable income is $170,000 ($250,000 – $100,000 + $20,000). The maximum charitable contribution allowed for the year, therefore, is $17,000 (10% X $170,000).

b. The excess $3,000 not allowed ($20,000 contribution – $17,000 allowed) can be carried over to the following year.

p. 16-15 and Example 18

33. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 6, 2003

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

Dear Mr. Simms:

On December 5 you asked me to advise you on the timing of a contribution by Simms Corporation to the University of Washington. My calculations show that the corporation will maximize its tax savings by making the contribution in 2003.

If the corporation makes the contribution in 2003, it can deduct $20,000 as a charitable contribution, which will save $7,800 (39% tax rate X $20,000 deduction) in Federal income tax. However, if the corporation makes the contribution in 2004, the percentage limitations applicable to corporations will limit its 2004 deduction to $10,000 ($100,000 projected profit X 10% limit). The corporation will save $3,400 (34% tax rate X $10,000 deduction) in taxes as a result of this deduction. The corporation may carry the remaining $10,000 forward and deduct the amount in 2005. If the corporation continues at the 2004 profit level, it will save an additional $3,400 in tax in 2005, for a total tax savings of $6,800.

This analysis makes it clear that the corporation will save $1,000 more ($7,800 – $6,800) if it makes the contribution in 2003. In addition, all of the savings will occur in 2003. If the corporation makes the contribution in 2004, its tax savings will be split between 2004 and 2005. My advice is that the corporation should make the contribution immediately so ownership of the stock can be transferred by December 31.

Sincerely,

Alicia Gomez, CPA

p. 16-15

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

Gross income:		
From operations	$330,000	
Dividends	120,000	$450,000
Less:		
Expenses from operations		(360,000)
Income before the dividends received deduction		$ 90,000
Dividends received deduction (70% X $90,000)		(63,000)
Taxable income		$ 27,000

The dividends received deduction is limited to 70% of taxable income because taking 70% of $120,000 ($84,000) would not create a net operating loss.

b. If Roadrunner Corporation owns 30% of Crow Corporation's stock, the percentage for calculating the dividends received deduction is 80%. Under these circumstances taking the full dividends received deduction would create an NOL:

Gross income:		
From operations	$330,000	
Dividends	120,000	$450,000
Less:		
Expenses from operations		(360,000)
Income before the dividends received deduction		$ 90,000
Dividends received deduction (80% X $120,000)		(96,000)
Net operating loss		($ 6,000)

Example 21

35. Following the procedure used in Example 21 in the text, proceed as follows:

	Red Corporation	White Corporation	Blue Corporation
Step 1			
(70% X $100,000)	$ 70,000		
(70% X $200,000)		$140,000	$140,000
Step 2			
70% X $200,000 (taxable income)	$140,000		
70% X $100,000 (taxable income)		$ 70,000	
70% X $160,000 (taxable income)			$112,000
Step 3			
Lesser of Step 1 or Step 2	$ 70,000		$112,000
Generates a net operating loss		$140,000	

Consequently, the dividends received deduction for Red Corporation is $70,000 under the general rule. White Corporation claims a dividends received deduction of $140,000 because a net operating loss results when the Step 1 amount ($140,000) is subtracted from 100% of taxable income ($100,000). Blue Corporation, however, is subject to the taxable income limitation and is allowed only $112,000 as a dividends received deduction.

pp. 16-17, 16-18, and Example 21

36. a. $18,000 ÷ 60 months = $300. To qualify for the election, the expenditure must be *incurred* before the end of the taxable year in which the corporation begins business. Amortization does not apply to the $3,600 of expenses that were incurred after the end of the taxable year.

b. ($21,600 ÷ 60 months) X 12 = $4,320.

c. $300 [same as a.]. The corporation's method of accounting is of no consequence in determining organizational expenditures that qualify for the election to amortize.

d. $4,320. [same as b.]

pp. 16-16, 16-17, and Examples 22 and 42

37. Qualifying organizational expenditures include these items:

Expenses of temporary directors and of organizational meetings	$3,500
Fee paid to the state of incorporation	1,000
Accounting services incident to organization	1,500
Legal services for drafting the corporate charter and bylaws	2,300
Total	$8,300

Since an appropriate and timely election under § 248(c) was made, the amount that Topaz Corporation may write off for the tax year 2003 is determined as follows:

($8,300 ÷ 60 months) X 6 (months in tax year) = $830

p. 16-18

38. Violet Corporation:

Tax on $46,000 is $6,900 ($46,000 X 15%).

Indigo Corporation:

Tax on—$260,000

Tax on $100,000	$22,250
Tax on $160,000 X 39%	62,400
Total tax	$84,650

Blue Corporation:

Tax on—$1,620,000

Tax on $335,000	$113,900
Tax on $1,285,000 X 34%	436,900
Total tax	$550,800

Green Corporation:

Tax on—$24,000,000

Tax on $24,000,000 X 35%	$8,400,000

p. 16-6 and Examples 23 and 24

39. a. Yes. A brother-sister controlled group exists. The common ownership is 51%; thus, the 80% and the 50% tests are met.

	Corporations		Common
Shareholders	Black	White	Ownership
Ahmad	20	16	16
Luis	5	54	5
Sara	75	30	30
Total	100	100	51

Example 30

b. No. Black and White Corporations would not be a controlled group if Luis owns no stock in Black Corporation. The common ownership would then be only 46%. In addition, Ahmad and Sara would own only 46% of White Corporation; thus, the 80% test also would not be met.

	Corporations		Common
Shareholders	Black	White	Ownership
Ahmad	20	16	16
Luis	0	54	0
Sara	80	30	30
Total	100	100	46

Example 31

40. Wren, Robin, and Finch Corporations are part of a *combined group*. p. 16-24 and Example 33

41. A brother-sister group exists if both the 80% total ownership test and the 50% common ownership tests are met. See Example 30 for an illustration of these tests.

a. A brother-sister group does exist. Both the 80% and 50% tests are met, as shown below:

Shareholders	Eagle shares	Cardinal shares	Common Ownership
George	30	15	15
Sam	5	50	5
Tom	65	35	35
Total	100	100	55

b. A brother-sister group will not exist if Tom sells 10 of his shares in Cardinal Corporation to Sam. While the 80% total ownership test will continue to be met, the 50% common ownership test will not be met, as show below:

Shareholders	Eagle shares	Cardinal shares	Common Ownership
George	30	15	15
Sam	5	60	5
Tom	65	25	25
Total	100	100	45

c. Several tax advantages will be gained if Tom sells 10 of his shares in Cardinal Corporation to Sam. The special rules that apply to computation of the income tax liability will no longer apply, so each corporation will be able to start at the bottom of the corporate rate schedule. In addition, the limitations that apply to the accumulated earnings credit and the AMT exemption will no longer apply. p. 16-20

d. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 16, 2003

Mr. Tom Roland
3435 Grand Avenue
South Point, OH 45680

Dear Mr.Roland:

I have considered the tax and nontax consequences that will result if you sell 10 shares of your Cardinal Corporation stock to Sam. There are several negative provisions that apply to affiliated corporations. If you sell 10 shares of your Cardinal Corporation stock to Sam, Eagle and Cardinal Corporations will no longer be affiliated corporations. As a result, the special rules that apply to computation of the corporate income tax liability will no longer apply, so each corporation will be able to start at the bottom of the corporate rate schedule. This can result in a substantial tax savings. In addition, the limitations that apply to the accumulated earnings credit and the AMT exemption will no longer apply.

There are two additional factors that you should consider. First, you will realize a $3,000 gain on the sale of your Cardinal Corporation stock. Under current laws, if you held the 10 shares for one year or less, the gain would be taxed at your current marginal rate of 30%. If your holding period is more than one year, the tax rate on the gain is 20%.

The second factor you should consider is that a sale of 10 of your shares to Sam will give him 60% ownership of Cardinal and will give him voting control of the corporation.

As indicated above, there are both tax and nontax factors that you should consider before making your decision.

Sincerely,

Anna Kerr, CPA

pp. 16-21 and 16-35

42. Net income per books is reconciled to taxable income as follows:

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

pp. 16-28 to 16-30, and Example 40

43. Organizational expenditures and start-up expenditures were incurred in January and February. The corporation can elect to amortize qualifying expenditures over a period of 60 months or more. Don and Steve should identify the organizational expenditures that qualify for this election, and decide whether to make the election.

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

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

The accrued bonuses will not be deductible if not paid by the close of the tax year. If the payment date is not changed, the deduction for bonuses will be disallowed, which could result in underpayment of estimated payments, which would result in a penalty.

pp. 16-10, 16-11 and 16-32

NOTES