Chapter C:3

The Corporate Income Tax

Discussion Questions

C:3-1 Fiscal year or calendar year. Unless High Corporation is an S corporation or a personal service corporation, High can select a tax year ending on the last day of any month (i.e., a fiscal year or a calendar year). pp. C:3-2 through C:3-4.

C:3-2 Yes. Port Corporation may change its annual accounting period without prior approval of the IRS if it satisfies the requirements of Rev. Proc. 2006-46, 2006-2 C.B. 859, as listed on page C:3-4 of the text. If Port does not satisfy these requirements, it can request approval of a change in accounting period by filing a Form 1128 on or before the fifteenth day of the third month following the close of the short period resulting from the change. p. C:3-4.

C:3-3 Stan and Susan need to choose an accounting period. They generally can select either a calendar year or a fiscal year. A fiscal year can permit an income deferral. However, if they elect S corporation status, they generally are required to use a calendar year. Stan and Susan need to select an accounting method. They are required to use the accrual method for sales-related items because inventories are a material income producing factor but may want to use the cash method for other items (i.e., the hybrid method) as long as they are eligible.

Stan and Susan need to select an accounting method for valuation of their inventory, i.e., LIFO, FIFO, etc. They may want to investigate which method is best for their particular type of inventory. Because the price of digital circuits has declined in recent years, the LIFO method does not appear to be a logical choice.

Stan and Susan need to determine whether they will make an election to deduct up to $5,000 each and amortize the balance of organizational expenditures and/or start-up expenditures. An election is advisable because the election cannot be made retroactively if, upon audit, the IRS reclassifies deducted expenses as organizational expenditures. These elections are deemed made automatically under Reg. Secs. 1.248-1 and 1.195-1.

Stan and Susan need to decide what method they will use to write off their research and development expenses, i.e., expense in year incurred or defer and amortize over 60 months or more. They also need to be aware that R&D expenditures made after 2021 will not be deductible at all and will have to be amortized over 60 months.

Stan and Susan need to determine whether they want to make an S election to pass through start-up losses. Stan and Susan need to determine whether they want to capitalize the corporation with debt as well as equity, and, if so, how much debt and how much equity they will use. pp. C:3-2 through C:3-5.

C:3-4 Corporations and individuals compute capital gains and losses the same way. However, corporations cannot deduct capital losses from ordinary income. A corporation can carry a capital loss back three years and forward five years to offset capital gains. Individuals only can carry such losses forward, although the carryforward period is indefinite. Corporations also do not have a preferential tax rate for net capital gains that is lower than the top ordinary income rate as individuals do. pp. C:3-6 and C:3-7.

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C:3-5 Organizational expenditures include outlays incident to the creation of a corporation, chargeable to the corporation's capital account, and of a character that would be amortizable if the corporation had a limited life. The corporation can elect under Sec. 248 to deduct the first $5,000 of the expenditures incurred in the corporation's first tax year and to amortize the remainder over a period of 180 months starting with the month in which the corporation begins business operations. pp. This election is deemed made automatically under Reg. Sec 1.248-1. pp. C:3-8 and C:3-9.

C:3-6 Start-up expenditures are ordinary and necessary business expenses paid or incurred to investigate the creation or acquisition of an active trade or business, to create an active trade or business, or to conduct an activity engaged in for profit or the production of income before the time the activity becomes an active trade or business. A corporation can elect under Sec. 195 to deduct the first $5,000 of the expenditures and to amortize the remainder over a period of 180 months starting with the month in which an active trade or business begins. This election is deemed made automatically under Reg. Sec 1.195-1. pp. C3:9 and C:3-10.

C:3-7 For tax years beginning after December 31, 2017, the deductibility of business interest in a given year is limited to the sum of the following amounts: business interest income, 30% of adjusted taxable income, and floor plan financing interest for motor vehicles. Any amount disallowed because of the above limitation carries over indefinitely. However, small corporations (those meeting the $25 million gross receipts test for small businesses) are exempt from this limitation. Business interest does not include investment interest, and business income does not include investment income. For C corporations, adjusted taxable income means taxable income computed without regard to: (1) income, gain, deduction, or loss not allocable to a trade or business; (2) business interest or business interest income; or the NOL deduction. pp. C:3-10 and C:3-11.

C:3-8 Under Sec. 170, charitable contributions for corporations differ from those allowed to individuals in three ways: (1) the timing of the deduction, (2) the amount of the deduction permitted for the contribution of certain nonmoney property, and (3) the maximum deduction permitted in any given year. Accrual method corporations can deduct certain contributions that remain unpaid at year-end. Such an election is not available to individuals. A corporate taxpayer can deduct a larger amount for health-related and scientific-research property donated from inventory than is permitted an individual taxpayer. A corporation's charitable contribution is limited to 10% of adjusted taxable income, which differs from the series of limits that apply to individuals. pp. C:3-11 through C:3-14.

C:3-9 Year 1 if paid on March 9; Year 2 if paid on April 20. Carver Corporation can deduct the contribution in Year 1 if it pays it on March 9 of Year 2. However, if Carver pays it on April 20 of Year 2 (after the March 15 of Year 2 deadline for a calendar year taxpayer), it cannot deduct the contribution in Year 1 but must deduct it in Year 2. pp. C:3-11 and C:3-12.

C:3-10 If the property qualifies as scientific research property under Sec. 170(e)(4), Zero Corporation's deduction is $2,012 {$1,225 + [0.50 x ($2,800 - $1,225)]} because the tentative deduction amount is less than twice the property's adjusted basis ($2,450 = $1,225 x 2). Otherwise, the contribution deduction is $1,225. pp. C:3-12 and C:3-13.

C:3-11 Under Sec. 243, corporations are allowed a dividends-received deduction to partially or fully mitigate the effects of multiple taxation of corporate earnings. Dividends received by a domestic corporation from another domestic corporation (other than S corporations) qualify for the special

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50%, 65% or 100% deduction. Dividends from a greater than 10%-owned foreign subsidiary also are eligible for a 100% Sec. 245A dividends-received deduction. Ineligible for the dividends-received deduction are distributions that receive capital gain treatment (e.g., liquidating distributions), dividends on stock held 45 days or less, and dividends on debt-financed stock. pp. C:3-14 through C:3-18.

C:3-12 The dividends-received deduction on debt-financed stock is disallowed to prevent a corporation from deducting interest paid on money borrowed to purchase the stock, while paying little or no tax on the dividends received on the stock. Otherwise, the corporation could gain an arbitrage advantage by acquiring debt-financed stock. p. C:3-18.

C:3-13 Carry over to future years indefinitely. In carryover years, the NOL deduction might be limited to 80% of taxable income before the NOL deduction if the NOL carryover exceeds that limit. p. C:3-18.

C:3-14 Various loss limitations. Section 267(a)(1) denies a deduction for losses realized on the sale or exchange of property between a corporation and a shareholder who owns more than 50% (in value) of the corporation's stock (i.e., a controlling shareholder). The purchasing party can use the loss later to reduce his or her recognized gain on a subsequent sale or exchange of the property. Section 267(a)(2) denies a deduction for accrued expenses and interest on certain transactions involving a corporation and a controlling shareholder that use different accounting methods when the payee will include the item in gross income at a date that is later than when it is accrued by the payor. The payor deducts the expense at the time the payee includes it in gross income. p. C:3-20.

C:3-15 $42,000 tax liability. In tax years beginning after 2017, the corporation is subject to flat 21% tax rate. p. C:3-5.

C:3-16 $15,750 = 75,000 × 0.21. Personal service corporations are taxed at a flat 21% rate in tax years beginning after 2017. p. C:3-5.

C:3-17 Brother-sister controlled groups, parent-subsidiary controlled groups, and combined controlled groups. A group of two or more corporations is a <u>brother-sister controlled group</u>, under the 50%-80% definition, if five or fewer individuals, trusts, or estates own (1) at least 80% of the voting power of all classes of voting stock (or at least 80% of the total value of the outstanding stock) of each corporation, and (2) more than 50% of the voting power of all classes of stock (or more than 50% of the total value of the outstanding stock) of each corporation, taking into account only the stock ownership that each person has that is identical with respect to each corporation. A shareholder's identical ownership is the percentage of stock the shareholder owns in common in each of the corporations. For some situations, the corporations are a brother-sister controlled group if the five or fewer shareholders meet the 50%-only definition. A <u>parent-subsidiary controlled group</u> is a group of two or more corporations where one corporation (the parent corporation) owns directly at least 80% of the voting power of all classes of voting stock, or 80% of the total value of all classes of stock, of a second corporation (the subsidiary corporation). The group can contain more than one subsidiary corporation. If the parent corporation, the subsidiary corporation, or any other members of the controlled group together own at least 80% of the voting power of all classes of voting stock, or 80% of the total value of all classes of stock of another corporation, that other corporation is included in the parent-subsidiary controlled group. For purposes of the Sec. 179 expense dollar

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limitation, however, a parent subsidiary group is considered a controlled group if the ownership is more than 50%, rather than at least 80% (see Sec. 179(d)(6) and (7)). A combined controlled group is a group of three or more corporations where the following criteria are met: (1) each corporation is a member of a parent-subsidiary controlled group or a brother-sister controlled group and (2) at least one of the corporations is (a) the parent corporation of a parent-subsidiary controlled group and (b) a member of a brother-sister controlled group. pp. C:3-21 through C:3-24.

C:3-18 Minimum accumulated earnings credit, Sec. 179 expense limitation, and the general business credit. Controlled groups must apportion these tax benefits among its members to prevent them from avoiding limitations through the use of multiple related corporations. Items requiring apportionment include the $250,000 minimum accumulated earnings credit, the amount of depreciable assets that can be expensed under Sec. 179, and the $25,000 general business credit limitation. For brother-sister corporations, the 50%-only definition applies to the minimum accumulated earnings credit while the Sec. 179 expense and the $25,000 general business credit limitations are subject to the 50%-80% definition. p. C: 3-25.

C:3-19 The advantages of a consolidated tax return are: income of a profitable member can be offset by losses of another member; capital gains of one member can be offset by capital losses of another member; and profits or gains reported on intercompany transactions are deferred. The disadvantages are: the election is binding, losses on intercompany transactions are deferred, Sec. 1231 losses of one member offset Sec. 1231 gains of another member, losses of an unprofitable member may limit deductions or credits of a profitable member, and additional administrative expenses are incurred in preparing and filing the consolidated return. pp. C:3-30 and C:3-31.

C:3-20 The substitution of fringe benefits for salary permits the owner-employee to exclude these amounts from personal taxation while the corporation obtains a deduction for the expenditure. Thus, the owner-employee can make certain expenditures out of pre-tax dollars that otherwise might be nondeductible personal expenditures payable out of after-tax dollars (e.g., group term life insurance premiums). pp. C:3-26 and C:3-27.

C:3-21 A determination that part of the compensation paid to an owner-employee is unreasonable in amount for purposes of Sec. 162(a)(1) means that the corporation loses its tax deduction for that portion of the payment. Generally, the unreasonable compensation is taxed as compensation income to the owner-employee despite the disallowance to the corporation. (See also hedge agreements in Chapter C:4.) pp. C:3-28 and C:3-29.

C:3-22 A corporation must pay estimated taxes if it expects its tax liability to exceed $500. The payments are due April 15, June 15, September 15, and December 15 for a calendar year corporation unless the fifteenth falls on a weekend or holiday, in which case amounts paid on the next business day are considered as paid on the due date. Regarding an April 15 due date, the filer also must consider Emancipation Day, which is an observed holiday in Washington, D.C. on April 16. If April 16 falls on Saturday, the observed holiday is the preceding Friday. If it falls on Sunday, the observed holiday is the succeeding Monday. For a fiscal year corporation, the due dates are the fifteenth day of the fourth, sixth, ninth, and twelfth months of the tax year. pp. C:3-29 and C:3-30.

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C:3-23 Underpayment and late filling penalties. A large corporation is one whose taxable income was $1 million or more in any of its three immediately preceding tax years. A large corporation cannot base its estimated payment on last year's liability. It must base its estimated payments on the current year's liability. However, a large corporation can use the prior year's liability for its first estimated tax installment, but it must repay the benefit of the reduced payment with its second installment. pp. C:3-30 and C:3-31.

C:3-24 Underpayment and late filing penalties. A nondeductible penalty applies if a corporation does not deposit its required estimated tax installment on or before the due date for that installment. The IRS assesses interest if any remaining tax due is not paid by the original due date for the corporate tax return. In addition to interest, a late payment penalty (failure-to-pay penalty) applies if the corporation fails to pay the tax on time (see Chapter C:15). If the corporation requests an extension of time to file its tax return, the amount of tax shown on the request for extension (Form 7004) or the amount of tax paid by the original due date must be at least 90% of the tax shown on its Form 1120 to avoid a late payment penalty. pp. C:3-30 through C:3-33.

C:3-25 A corporation must file a tax return each year whether it has any taxable income or not. If the corporation is no longer in existence, it does not have to file a tax return. If it was in existence for only a portion of the year, it must file a short-period return for the portion of the year it was in existence. p. C:3-33.

C:3-26 April 15 or March 15 depending on the tax year involved. The due date for a calendar year corporate tax return is the fifteenth day of the fourth month after the end of the corporation's tax year, or April 15. If the due date falls on a weekend or holiday, the return is due on the next business day. Regarding an April 15 due date, the filer also must consider Emancipation Day, which is an observed holiday in Washington, D.C. on April 16. If April 16 falls on Saturday, the observed holiday is the preceding Friday. If it falls on Sunday, the observed holiday is the succeeding Monday.

The corporation can obtain a six-month extension for filing the tax return if the corporation files Form 7004 (Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns). [Note: For June 30 year-end corporations after 2015 and before 2026, the extension period is seven months.] p. C:3-33.

C:3-27 1. Some book income is not taxable.
2. Some gross income is not included in book income for the current period.
3. Some financial accounting expenses are not deductible for tax purposes.
4. Some deductions allowed for tax purposes are not expenses in determining book income for the current period. pp. C:3-34 and C:3-35.

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Issue Identification Questions

C:3-28
- Is the property received cash or a noncash asset? If a noncash asset, are any liabilities assumed or acquired by the shareholder?
- Does the distribution come from the distributing corporation's E&P?
- What is X-Ray's gross income?
- Is either X-Ray or Yancey a foreign corporation?
- What is the appropriate dividends-received deduction percentage?
  - Does the overall dividends-received deduction limitation restrict the availability of the deduction?
  - Does one of the other special limitations on the dividends-received deduction apply (e.g., 45-day rule or debt-financed stock)?
- If X-Ray receives noncash property, what is the basis of the property to X-Ray?

Because X-Ray owns 10% of Yancey Corporation, it normally is entitled to a $50,000 (0.50 x $100,000) dividends-received deduction under Sec. 243. However, several limitations may apply. If X-Ray's taxable income before the dividends-received deduction is less than $100,000, but at least $70,000, the deduction is limited, under Sec. 246, to 50% of its taxable income before the dividends-received deduction. If X-Ray's taxable income after the dividends-received deduction is negative (i.e., an NOL), the dividends-received deduction limitation does not apply. In addition, if (1) X-Ray has held the Yancey stock for 45 days or less, (2) the Yancey stock is debt-financed, or (3) Yancey is a foreign corporation, X-Ray will receive either a reduced or no dividends-received deduction. See Secs. 245, 246, and 246A. pp. C:3-14 through C:3-18.

C:3-29
- What is Williams Corporation's realized loss?
- What is Williams's recognized loss?
  - Does the sale of property to a shareholder at a loss trigger the application of the Sec. 267 related party rules?
  - Is Barbara related to any other Williams' shareholders (e.g., spouses, siblings, or other entities) whose attribution of stock ownership causes her stock ownership to exceed 50% of Williams' outstanding stock?
  - If a loss is disallowed, can the transaction be restructured to permit recognition of the loss?
- What is Barbara's basis for the truck? Does it reflect an adjustment for the disallowed loss?

The primary issue is whether Barbara is a related party to Williams Corporation under the Sec. 267 rules. If so, the loss on the sale of the truck is disallowed. In this case, because Barbara does not own more than 50% of the Williams stock, she is not a related party, and Williams may deduct a $20,000 ($25,000 - $5,000) loss. The loss is a Sec. 1231 loss if Williams used the truck in the conduct of its trade or business. However, if Barbara's spouse, siblings, or other parties or entities related to her own more than 25% of the stock, Barbara constructively owns more than 50% of Williams, and the loss will be disallowed under Sec. 267. pp. C:3-19 and C:3-20.

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C:3-30 • What is the tax liability for Pencil Corporation? For Eraser Corporation?
  - Are Pencil and Eraser C corporations? S corporations?
  - Are Pencil and Eraser members of a controlled group?
  - Are Mary and Don related parties for purposes of the controlled group stock ownership tests?
  - Are Pencil and Eraser personal service corporations?
- What amounts (if any) are Pencil and Eraser paying to Don and Mary?
  - Have the taxpayers divided up the payments among the three entities (Pencil, Eraser, and the joint return) to minimize their tax liabilities?
  - Can the taxpayers adjust their salaries and/or fringe benefits to reduce their total tax costs?
- If Pencil and/or Eraser are C corporations, would an S election be advisable?

The primary issue is the appropriate corporation classification for Pencil and Eraser Corporations. If both corporations are C corporations, they constitute a controlled group under Sec. 1563 and must apportion the benefit of certain items. Two other important issues are: (1) can either one of the corporations benefit from an S election and (2) what amount of salaries and fringe benefits should Don and Mary withdraw from each of the two corporations to maximize the corporate and shareholder benefits. The last two points are too complicated to arrive at a definitive answer with the limited facts given here. pp. C:3-21 through C:3-25 and C:3-27 through C:3-29.

C:3-31 • How much will future interest deductions be limited by the 30% limitation on net business interest?
- How much will future NOL deductions be limited by the 80% limitations on NOL deductions?
- How are the limitations calculated?
- How will the business interest limitation interact with the NOL deduction limitation?
- What kind if carryovers will arise as a result of these limitations?

The business interest deduction is limited to 30% of adjusted taxable income before the NOL deduction, so that limitation will apply first. Any excess interest carries over to the next year and future years indefinitely. The NOL deduction limitation applies after the business interest deduction limitation, so any reduction of taxable income from that limitation will, in turn, reduce the amount of taxable income to which the 80% limitation applies and hence will reduce the amount of the NOL deduction. Any remaining NOL carries over indefinitely. Thus, Epsilon faces some serious limitations on the deductibility of its interest expense and NOL carryovers. pp. C:3-10 and C:3-11.

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Problems

C:3-32

Asset	Sec. 1231	Ordinary	Total
	Type of Gain		
Land	$35,000		$35,000
Building	49,000	$ 6,000	55,000
Total	$84,000	$ 6,000	$90,000

These amounts are calculated as follows:

Land:		
Sales price		$ 60,000
Minus: Basis (original cost)		(25,000)
Sec. 1231 gain on land		$ 35,000
Building:		
Sales price		$225,000
Minus: Basis (original cost)	$200,000	
Minus: Depreciation	(30,000)	(170,000)
Recognized gain		$ 55,000
Recapture amount on building as if Sec. 1245 property:		
Lesser of:		
$30,000 (depreciation claimed)		
or		
$55,000 (recognized gain)		$ 30,000
Times: Sec. 291 percentage		x 0.20
Ordinary income under Sec. 291		$ 6,000
Sec. 1231 gain on building:		
Recognized gain		$ 55,000
Minus: Ordinary income on building		(6,000)
Sec. 1231 gain on building		$ 49,000

p. C:3-7.

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C:3-33 Taxable income is $910,000. The character of income and losses is determined as follows:

Sec. 1245 depreciation recapture on equipment	$125,000[a]
Sec. 291 depreciation recapture on building	21,000[b]
Total depreciation recapture (ordinary income)	$146,000
Sec. 1231 gain on equipment ($135,000 - $125,000)	$ 10,000
Sec. 1231 gain on building ($105,000 - $21,000)	84,000
Sec. 1231 loss on land	(15,000)
Net Sec. 1231 gain	$ 79,000
Sec. 1231 lookback recapture (ordinary income)	(24,000)
Remaining net Sec. 1231 gain (treated as long-term capital gain)	$ 55,000

[a]Lesser of $125,000 accumulated depreciation or $135,000 gain.
[b]Hypothetical Sec. 1245 recapture is $105,000 (lesser of $120,000 accumulated depreciation or $105,000 gain). Thus, Sec. 291 recapture is $105,000 x 0.20 = $21,000.

Taxable income is calculated as follows:

Ordinary income from operations		$720,000
Total ordinary income from recapture ($146,000 + $24,000)		170,000
Net Sec. 1231 gain (treated as long-term capital gain)	$55,000	
Long-term capital loss on securities	(35,000)	20,000
Taxable income		$910,000

Because the net Sec. 1231 gain is treated as long-term capital gain, the corporation has sufficient gains to offset the long-term capital loss on the securities. p. C:3-7.

C:3-34 a. Delta Corporation can elect to deduct $5,000 of organizational expenditures under Sec. 248 and amortize the remainder over 180 months. Delta also can elect to deduct $5,000 of start-up expenditures under Sec. 195 and amortize the remainder over 180 months. These elections are deemed automatic under temporary Treasury Regulations.

Date	**Expense**	**Amount**	**Treatment**
1/30	Travel expense	$2,000	Start-up expense
5/15	Legal expense	2,500	Organizational expense
5/30	Commission to stockbroker	4,000	Reduction of capital
5/30	Director's fees	2,500	Organizational expense
6/1	Expense of transferring building to Delta	3,000	Capitalized as part of building cost
6/5	Accounting fees	1,500	Organizational expense
6/10	Training expense	5,000	Start-up expense
6/15	Rent expense	1,000	Start-up expense
7/15	Rent expense	1,000	Sec. 162 expense

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b. Organizational expenditures total $6,500, and Delta can deduct $5,033 [$5,000 + ($1,500/180 months x 4 months)] in the first year.

c. Start-up expenditures total $8,000, and Delta can deduct $5,067 [$5,000 + ($3,000/180 months x 4 months)] in the first year. pp. C:3-8 through C:3-10.

C:3-35 a. $30,000 charitable contribution deduction (limited), determined as follows:

Property	Basis	FMV	Deduction Amount
ABC stock (capital gain property)	$18,000	$25,000	$25,000
Inventory (scientific research property) {$17,000 + [0.50 x ($22,000 - $17,000)]}	17,000	22,000	19,500
Antique vase (capital gain property--tangible personal property put to unrelated use)	10,000	18,000	10,000
Total before limitation			$54,500
Deduction limited to $300,000 x 0.10 = $30,000			

b. $24,500 contribution carryover, determined as follows:

Total contribution allowable before limitation	$54,500
Minus: Amount deducted in current year	(30,000)
Contribution carryover to next five years	$24,500

pp. C:3-11 through C:3-14.

C:3-36 a. $40,000 charitable contribution deduction (limited), determined as follows:

Property	Basis	FMV	Deduction
XYZ stock (capital gain property)	$25,000	$19,000	$19,000
ABC stock (capital gain property)	2,000	16,000	16,000
PQR Stock (short-term capital gain)	12,000	18,000	12,000
Total contribution amount			$47,000

The charitable contribution deduction is limited to $40,000 ($400,000 x 0.10).

b. $7,000 contribution carryover, determined as follows:

Total contribution allowable before limitation	$47,000
Minus: Amount deducted in current year	(40,000)
Contribution carryover to next five years	$ 7,000

c. Blue would have been better off selling the XYZ stock first, recognizing the $6,000 ($19,000 - $25,000) loss, and then donating the sales proceeds to the school. Under the original plan, Blue forfeited the loss recognition.

pp. C:3-11 through C:3-14.

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C:3-37 a. Year 1: Contribution limitation: = $180,000 x 0.10 = $18,000
Carryover to Year 2: $20,000 - $18,000 = $2,000
Year 2: Contribution limitation: $125,000 x 0.10 = $12,500
Year 2 contribution consists of $12,000 (Year 2 contribution) and $500 (part of carryover from Year 1)

b. $1,500 carryover to Year 3, determined as follows:

Year 1 contribution	$ 20,000
Amount used in Year 1	(18,000)
Carryover used in Year 2	(500)
Carryover to Year 3	$ 1,500

The entire carryover is from Year 1. pp. C:3-13 and C:3-14.

C:3-38 a. $6,000 charitable contribution deduction; $5,000 carryover, determined as follows:

Gross profit on sales	$120,000
Dividends from less-than-20%-owned corporations	40,000
Gross income	$160,000
Minus: Operating expenses	(100,000)
Adjusted taxable income	$ 60,000
Contribution deduction limitation ($60,000 x 0.10) =	$ 6,000
Contribution carryover ($11,000 - $6,000) =	$ 5,000

b. $34,000 taxable income, calculated as follows:

Adjusted taxable income	$ 60,000
Minus: Charitable contribution deduction	(6,000)
Dividends-received deduction ($40,000 x 0.50)	(20,000)
Taxable income	$ 34,000

The dividends-received deduction limitation ($54,000 x 0.50 = $27,000) does not apply because $20,000 is less than the $27,000 limitation. pp. C:3-13 through C:3-15 and C:3-19.

C:3-39

	Part a	**Part b**	**Part c**
Gross profit on sales	$220,000	$220,000	$220,000
Dividends	100,000	100,000	100,000
Gross income	$320,000	$320,000	$320,000
Minus: Operating expenses	(218,000)	(234,000)	(272,000)
Taxable income before dividends-received deduction	$102,000	$ 86,000	$ 48,000
Dividends-received deduction[a]	(50,000)	(43,000)	(50,000)
Taxable income (NOL)	$ 52,000	$ 43,000	$(2,000)[b]

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[a]Dividends-received deduction equals the lesser of:			
(1) 50% of dividends or	$ 50,000	$ 50,000	$ 50,000
(2) 50% of taxable income before dividends-received deduction	51,000	43,000	N/A

[b]Income limitation does not apply because the dividend-received deduction creates an NOL.

d. Revised answers:

	Part a	**Part b**	**Part c**
Taxable income before the dividends-received deduction	$102,000	$86,000	$ 48,000
Dividends-received deduction from 20%-owned corporation[c]	(45,500)	(45,500)	(45,500)
Dividends-received deduction from less-than-20%-owned corporation[d]	(15,000)	(8,000)	(15,000)
Taxable income (NOL)	$ 41,500	$32,500	$(12,500)

[c]Dividends-received deduction from the 20%-owned corporation equals the lesser of:			
(1) 65% of the dividend or	$ 45,500	$45,500	$45,500
(2) 65% of taxable income before the 65% dividends-received deduction	66,300	$55,900	N/A

[d]Dividends-received deduction from the less-than-20%-owned corporation equals the lesser of:			
(1) 50% of the dividend or	$ 15,000	$15,000	$15,000
(2) 50% of taxable income reduced by the entire dividend from the 20%-owned corporation	16,000	8,000	N/A

pp. C:3-14 through C:3-16.

C:3-40 Beta has dividend income of $10,000 but, under Sec. 246, gets no dividends-received deduction because it held the stock 45 days or less. Beta also has a short-term capital loss of $10,000 ($190,000 - $200,000). pp. C:3-17 and C:3-18.

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C:3-41 a. Cheers may deduct all the interest paid on the loan. Corporations are not subject to the Sec. 163(d) investment interest deduction limitation rules. Also, Cheers has enough taxable income to avoid the 30% limitation on any business interest deduction under Sec. 163(j), although the interest in this situation is investment interest not subject to the business interest limitation in any case.

b. Cheers must include all $40,000 of dividends received from Beer in its income. Under Sec. 246, its regular dividends-received deduction is $20,000 ($40,000 x 0.50). However, under Sec. 246A, the dividends-received deduction percentage is reduced by 80% to 10% [50% x (1.00 - 0.80)] because Cheers debt-financed 80% of the stock purchase. The allowed dividends-received deduction is $4,000 ($40,000 x 0.10). p. C:3-18.

C:3-42 a. $55,000 NOL, calculated as follows:

Gross income from operations	$150,000
Dividends	50,000
Gross income	$200,000
Minus: Operating expenses	(230,000)
NOL before dividends-received deduction	$(30,000)
Minus: Dividends-received deduction ($50,000 x 0.50)	(25,000)
NOL for 2018	$(55,000)

b. $16,000 in 2019 and $39,000 in 2020. In 2019, Ace's NOL deduction is limited to 80% of taxable income, or $16,000 ($20,000 x 0.80), leaving $39,000 to carry over to 2020. In 2020, 80% of Ace's taxable income is $80,000, so Ace can deduct the entire $39,000 remaining NOL carryover in 2020 without limitation. pp. C:3-18 and C:3-19.

C:3-43 a. $11,200. Delta's taxable income for 2019 is calculated as follows:

Operating gross profit	$200,000
Minus: Operating expenses	(120,000)
Taxable income before business interest deduction	$ 80,000
Minus: Business interest deduction (limited to $80,000 x 0.30)	(24,000)
Taxable income before NOL deduction	$ 56,000
Minus: NOL deduction (limited to $56,000 x 0.80)	(44,800)
Taxable income	$ 11,200

b. $6,000 interest; $55,200 NOL. Delta has a $6,000 ($30,000 - $24,000) business interest carryover to 2020 and a $55,200 ($100,000 - $44,800 NOL carryover to 2020. pp. C:3-10, C:3-11, and C:3-18.

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C:3-44 a. $58,000 taxable income, calculated as follows:

Gross income from operations	$180,000
Dividends from less than 20%-owned corporations	100,000
Gross income	$280,000
Minus: Operating expenses	(150,000)
Taxable income before NOL, dividends-received, or charitable contribution deduction	$130,000
Minus: Charitable contribution deduction	(12,000)[a]
Dividends-received deduction	(50,000)[b]
Taxable income before NOL deduction	$ 68,000
NOL deduction	(10,000)[c]
Taxable income	$ 58,000

[a]Charitable contribution deduction limitation: [($130,000 - $10,000) x 0.10]. Deduction is lesser of $20,000 contribution or $12,000 limit.

[b]Dividends-received deduction: $100,000 x 0.50 = $50,000 tentative deduction. Limitation 0.50 x ($130,000 - $12,000) = $59,000. Deduction is lesser of $50,000 or $59,000 limitation.

[c]NOL deduction is not limited because 80% of taxable income before the NOL deduction is $54,400 ($68,000 x 0.80), which is greater than the NOL carryover.

b. Beta has an $8,000 ($20,000 - $12,000) charitable contribution deduction carryover to the next five years. p. C:3-19.

C:3-45 a. Union's realized loss: $6,000 = $18,000 - $24,000. Union does not recognize the loss because Jane is the controlling shareholder of the corporation.

b. Jane's realized gain: $15,000 = $28,000 - ($18,000 - $5,000). Jane's recognized gain: $9,000 = $15,000 - $6,000 disallowed loss from Part a.

c. Jane's realized and recognized loss is: $3,000 = $10,000 - ($18,000 - $5,000). The $6,000 loss disallowed in Part a is permanently lost. p. C:3-20.

C:3-46 Next year. Value cannot deduct the payment until the year it pays it (and Brett includes it in gross income) because Brett is a cash basis taxpayer and a controlling shareholder [Sec. 267(a)(2)]. Thus, the payment is deductible next year. pp. C:3-20.

C:3-47 a. $90,000 taxable income; $18,900 tax, calculated as follows:

Gross profit from operations	$150,000
Plus: Net capital gain	1,000*
Total income	$151,000
Minus: Operating expenses	(61,000)
Taxable income	$ 90,000
Tax liability ($90,000 x 0.21)	$ 18,900

*($8,000 - $15,000) + ($10,000 - $2,000) = $1,000.

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b. $89,000 taxable income; $18,690 tax, calculated as follows:*

Gross profit from operations	$150,000
Minus: Operating expenses	(61,000)
Taxable income	$ 89,000
Tax liability ($89,000 x 0.21)	$ 18,690

*Western has a net capital loss of $2,000 [($8,000 - $15,000) + ($10,000 - $5,000)]. Western may carry this loss back three years and forward five years.

pp. C:3-5 through C:3-7.

C:3-48 Year 1: Taxable income, $140,000; tax liability, $29,400.
Year 2: Taxable income, $441,000; tax liability, $92,610.
These amounts are calculated as follows:

Year 1:	
Gross profit on sales	$240,000
Minus: Operating expenses	(100,000)
Net operating income	$140,000
Long-term capital gain	8,000
Short-term capital loss allowed ($4,000 carries over)	(8,000)
Taxable income	$140,000
Tax liability ($140,000 x 0.21)	$ 29,400

Year 2:	
Gross profit on sales	$600,000
Minus: Operating expenses	(165,000)
Net operating income	$435,000
Long-term capital gain	10,000
Short-term capital loss carryover	(4,000)
Taxable income	$441,000
Tax liability ($441,000 x 0.21)	$ 92,610

pp. C:3-5 through C:3-7 and C:3-18.

C:3-49 If a regular corporation:

(a) $10,500 = $50,000 x 0.21
(b) $105,000 = $500,000 x 0.21
(c) $10,500,000 = $50,000,000 x 0.21

If a personal service corporation, same above.

p. C:3-5.

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C:3-50 a. $57,000 taxable income; $11,970 tax, calculated as follows:

Gross profits	$120,000
Dividends (more than 20%-owned corporations)	30,000
Gross income	$150,000
Minus: Operating expenses	(65,000)
Adjusted taxable income	$ 85,000
Minus: Charitable contribution deduction ($85,000 x 0.10)	(8,500)
Taxable income before the dividends-received deduction	$ 76,500
Minus: Dividends-received deduction ($30,000 x 0.65)	(19,500)
Taxable income	$ 57,000
Tax liability ($57,000 x 0.21)	$ 11,970

b. $1,500 and $15,000 carryovers. Pace has a $1,500 ($10,000 - $8,500) charitable contribution carryover to the next five years. Pace also has a $15,000 ($10,000 + $5,000) capital loss that it can carry back three years and forward five years as a short-term capital loss. pp. C:3-5 and C:3-13 through C:3-16.

C:3-51 $96,250 taxable income; $20,213 tax, calculated as follows:

Gross profits on sales	$ 80,000
Capital gain net income ($40,000 + $25,000)	65,000
Dividends from more-than-20%-owned corporation	15,000
Gross income	$160,000
Minus: Operating expenses	(45,000)
Dividends-received deduction ($15,000 x 0.65)	(9,750)
NOL carryover from the preceding year (not limited)	(9,000)
Taxable income	$ 96,250
Tax liability ($96,250 x 0.21)	$ 20,213

pp. C:3-5 through C:3-7 and C:3-13 through C:3-16.

C:3-52 a. A brother-sister group under either the 50%-80% definition or the 50%-only definition.

b. Jones and Kane are a brother-sister group under the 50%-only definition but not a controlled group under the 50%-80% definition. The 80% test is failed because Mary owns no stock in Kane Corporation. Tom owns more than 50% of both Jones and Kane stock.

c. A parent-subsidiary group. Link Corporation is the 80% parent of Model; Link and Model together own 90% of Name.

d. A combined-controlled group. Oat and Peach Corporations are brother-sister corporations under either definition. Oat Corporation is the parent of Rye Corporation. Seed Corporation is a group member because Oat and Rye together own 90% of Seed. Therefore, the Oat-Rye-Seed group is a parent-subsidiary group. Because Oat belongs to both groups, all four corporations are a combined controlled group. pp. C:3-21 through C:3-24.

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C:3-53 Option 3 results in the lowest overall tax at $74,319.
In all three options, individual taxable income is $226,000 ($250,000 - $24,000 standard deduction). In Option 1, $77,200 of taxable income is subject to the 0% preferential tax rate, and the remaining $148,800 is subject to the 15% preferential tax rate. In Option 2, $125,000 is subject to the 15% preferential tax rate, and the remaining $101,000 is subject to ordinary tax rates. In Option 3, all $226,000 of taxable income is subject to ordinary tax rates.

Corporate taxable income is $400,000 in Option 1, $275,000 ($400,000 - $125,000 salary) in Option 2, and $150,000 ($400,000 - $250,000 salary) in Option 3.

Tax liabilities are calculated as follows:

Option 1:	
Corporation ($400,000 x 0.21)	$ 84,000
Individual [($77,200 x 0.0) + ($148,800) x 0.15)]	22,320
Total tax	$106,320

Option 2:	
Corporation ($275,000 x 0.21)	$ 57,750
Individual [($125,000 x 0.15) + ($8,907 + 0.22 x ($101,000 - $77,400)]	32,849
Total tax	$ 90,599

Option 3:	
Corporation ($150,000 x 0.21)	$ 31,500
Individual [$28,179 + 0.24 x ($226,000 - $165,000)]	42,819
Total tax	$ 74,319

Thus, Option 2 results in the lowest overall tax liability. pp. C:3-27 and C:3-28.

C:3-54 The savings associated with the $3,000 of nontaxable fringe benefits equals $3,000 times Elizabeth's marginal tax rate. The disadvantage of paying fringe benefits is that they generally cannot be restricted to key personnel or shareholder-employees but must cover virtually all employees. Because Elizabeth is the sole shareholder of Omega Corporation it may be less expensive for her to pay the cost of the fringe benefit personally. p. C:3-32.

C:3-55 a. $105,000, except for the first quarter. Using the current year tax, the minimum estimated tax payment for each quarter of 2018 will be $105,000 ($420,000 ÷ 4). Because Zeta Corporation is a large corporation, its estimated tax payments other than its first payment for the year cannot be based on the prior year's tax liability. If Zeta uses the prior year's tax for the first payment, only $93,500 ($374,000 ÷ 4) will be due for that payment. The second payment must be $116,500 [$105,000 + ($105,000 - $93,500)] to make up the shortfall in the first payment. A smaller estimated tax payment might be possible if the annualized income or seasonal exception applies.

b. Zeta's 2018 tax return is due on April 15, 2019.

c. Generally, remaining taxes would be due on April 15, 2019, but Zeta should owe no additional taxes when it files the tax return because its estimated tax payments of $420,000 should exactly equal the $420,000 tax liability. However, if the estimated tax payments turn out to be less than the actual tax liability, Zeta must pay the additional taxes no later than April 15, 2019.

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d. Zeta may obtain an automatic six-month extension of time to file until October 15, 2019. This extension to file does not extend the time for the payment of the tax (if any), which still is due by April 15, 2019. However, the corporation will not be penalized if it pays at least 90% of its total tax liability by the unextended due date, although it will be charged interest on any unpaid balance. pp. C:3-29 through C:3-32.

C:3-56 a. $5,562,50. Because Wright is not a large corporation, its minimum estimated tax payments are the lesser of:

1. $22,250 (2017 tax) ÷ 4 = $5,562.50 each quarter.

   or

2. $126,000 (2018 tax) ÷ 4 = $31,500 each quarter.

Thus, quarterly payments of $5,562.50 on April 15, June 15, September 15, and December 15 of 2018 are sufficient to avoid under payment penalties. If any of these dates fall on a weekend or holiday, a payment made on the next business day is considered to have been made on the due date.

b. Wright's 2018 tax return is due on April 15, 2019. However, Wright may obtain an automatic six-month extension of time to file until October 15, 2019.

c. All remaining taxes are due on April 15, 2019. The additional taxes owed will be $103,750 ($126,000 - $22,250). However, the corporation will not be penalized if it pays at least 90% of its total tax liability by the unextended due date, although it will be charged interest on any unpaid balance.

d. $31,500. Now, 25% of 2017's tax becomes $50,000 ($200,000 x 0.25). Therefore, Wright will pay estimated tax payments, based on its estimated 2018 tax, of $31,500 on each quarterly payment date. If the forecast is accurate, Wright will owe no additional taxes when it files the return. pp. C:3-29 through C:3-32.

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C:3-57 a.

Rocket Corporation, Inc. Worksheet to Convert Book Income to Taxable Income For the Year ended December 31						
	Book Income		**Adjustments**		**Taxable Income (before special deductions)**	
Account Title	**Dr.**	**Cr.**	**Dr.**	**Cr.**	**Dr.**	**Cr.**
Sales		3,230,000				3,230,000
Dividends		10,000				10,000
Interest (a)		18,000	3,000			15,000
Gain on stock sale		9,000				9,000
Life ins. proc. (b)		100,000	100,000			0
Cost of sales	2,000,000				2,000,000	
Salaries and wages	500,000				500,000	
Bad debts	13,000				13,000	
Payroll taxes	62,000				62,000	
Interest (c)	12,000			1,000	11,000	
Contributions (d)	50,000			4,200	45,800	
Depreciation	70,000		25,000		95,000	
Other expenses (e)	40,000			5,000	35,000	
Fed. inc. taxes (f)	108,465			108,465		0
NI/TI before spec. ded. (h)	511,535			9,335	502,200	0
Totals	3,367,000	3,367,000	128,000	128,000	3,264,000	3,264,000

(a) Municipal bond interest is excluded from taxable income under Sec. 103.

(b) Life-insurance proceeds are excluded from taxable income under Sec. 101 if paid as a result of the insured's death.

(c) Interest on debt incurred to carry tax-exempt obligations is not deductible.

(d) Allowable contribution deduction:

Gross income	$3,264,000
Minus: Deductions (other than NOL)	(2,716,000)
NOL deduction	(90,000)
Base for calculation of charitable contributions limitation)	$ 458,000
Times: 10% allowable deduction	0.10
Charitable contributions deduction limitation	$ 45,800

Rocket has a $4,200 ($50,000 - $45,800) charitable contribution carryover.

(e) Life insurance premiums are not deductible if the corporation is the beneficiary.

(f) Federal income taxes are not deductible when determining taxable income.

(g)

Taxable income before char. contr. and NOL ded. ($458,000 + $90,000)	$548,000
Minus: Charitable contributions deduction	(45,800)
Taxable income before spec. ded. (Form 1120, Line 28)	$502,200
Minus: Special deductions:	
Dividends-received deduction ($10,000 x 0.65)	(6,500)
NOL deduction	(90,000)
Taxable income	$405,700

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b. Tax provision reconciliation.

Net income before federal income taxes	$620,000
Permanent differences:	
Nondeductible interest	1,000
Nondeductible insurance premiums	5,000
Municipal interest	(3,000)
Life insurance proceeds	(100,000)
Dividends-received deduction	(6,500)
Net income after permanent differences	$516,500
Temporary differences:	
Disallowed charitable contributions	4,200
Depreciation	(25,000)
NOL carryover	(90,000)
Taxable income	$405,700
Federal income tax expense ($516,500 x 0.21)	$108,465
Federal income taxes payable ($405,700 x 0.21)	$ 85,197

pp. C:3-33 through C:3-35 and C:3-44.

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C:3-58 a. Schedule M-1 of Form 1120 (numbers refer to lines of schedule):

1.	Net income per books		$581,760
2.	Federal income tax expense per books		156,240
3.	Excess capital losses		8,000
4.	Income subject to tax not recorded on books		-0-
5.	Expenses recorded on books not deducted in this return:		
	a. Depreciation	$ -0-	
	b. Excess charitable contributions	4,000	
	c. Interest on loan to purchase tax-exempt bonds	7,000	
	d. Insurance premium	9,000	20,000
6.	Total of lines 1 through 5		$766,000
7.	Income on books not in this return:		
	a. Tax-exempt interest	$10,000	
8.	Deductions in this return not on books:		
	a. Depreciation	40,000	
9.	Total of lines 7 and 8		(50,000)
10.	Income (line 28, page 1) [Line 6 less line 9]		$716,000

b. Tax provision reconciliation:

Net income before federal income taxes	$738,000
Permanent differences:	
Nondeductible interest on loan	7,000
Nondeductible insurance premium	9,000
Tax-exempt interest income	(10,000)
Net income after permanent differences	$744,000[a]
Temporary differences:	
Excess capital loss	8,000
Excess charitable contributions	4,000
Depreciation	(40,000)
Taxable income	$716,000[b]

[a]Federal income tax expense = $744,000 x 0.21 = $156,240.
[b]Same as line 10 in Schedule M-1 because of no special deductions (i.e., no dividends-received or NOL deductions).

pp. C:3-33 through C:3-35 and C:3-44.

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C:3-59 Schedule M-2 of Form 1120 (numbers refer to lines of schedule):

1.	Balance at beginning of year		$246,500
2.	Net income per books		259,574
3.	Other increases		-0-
4.	Total of lines 1, 2, and 3		$506,074
5.	Distributions: a. Cash	$23,000	
	b. Stock	-0-	
	c. Property	-0-	
6.	Other decreases: Contingency reserve	60,000	
7.	Total of lines 5 and 6		(83,000)
8.	Balance at end of year (line 4 less line 7)		$423,074

pp. C:3-37.

C:3-60

Step 1: Identify temporary differences.

Beginning of Year:	**Book**	**Tax**	**Difference**
Net basis of:			
Installment note receivable	$ -0-	$ -0-	$ -0-
Fixed assets	360,000	320,000	40,000
Liability for warranties	-0-	-0-	-0-
Carryovers:			
Net operating loss carryover			$15,000
Capital loss carryover			-0-

End of Year:	**Book**	**Tax**	**Difference**
Net basis of:			
Installment note receivable	$ 30,000	$ 21,000	$ 9,000
Fixed assets	280,000	192,000	88,000
Liability for warranties	12,000	-0-	12,000
Carryovers:			
Net operating loss carryover			$ -0-
Capital loss carryover			20,000

Steps 2 - 3: Prepare roll forward schedules and apply tax rates.

DTAs:	**Beg. of Year**	**End of Year**	**Change**
NOL carryover	$15,000	$ -0-	$(15,000)
Capital loss carryover	-0-	20,000	20,000
Liab. For warranties	-0-	12,000	12,000
Total	$15,000	$32,000	$ 17,000
Times: Tax rate	0.21	0.21	
DTA	$ 3,150	$ 6,720	$ 3,570

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DTLs:	Beg. of Year	End of Year	Change
Installment note	$ -0-	$ 9,000	$ 9,000
Fixed assets	40,000	88,000	48,000
Total	$40,000	$97,000	$ 57,000
Times: Tax rate	0.21	0.21	
DTL	$ 8,400	$20,370	$ 11,970

Steps 4 - 5: No valuation allowance or uncertain tax position adjustment needed.

Step 6: Federal income taxes payable.

Gross profit		$800,000
Minus: Tax depreciation	$128,000	
Interest expense ($18,000 - $2,000)	16,000	
Other business expenses	220,000	
State income taxes	27,000	(391,000)
Taxable income before NOL		$409,000
Minus: NOL deduction		(15,000)
Taxable income		$394,000
Federal income taxes payable ($394,000 x 0.21)		$ 82,740*

*Given the facts of this problem, this amount also is the current federal income tax expense for book purposes.

Step 7: Total federal income tax expense.

Current federal income tax expense (from Step 6)	$82,740
Deferred income tax expense	8,400*
Total federal income tax expense	$91,140

*$11,970 - $3,570 from Steps 2 - 3

Step 8: Journal entry.

Current federal income tax expense	82,740	
Deferred income tax expense	8,400	
Deferred tax asset	3,570	
Deferred tax liability		11,970
Federal income taxes payable		82,740

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Step 9: Tax provision reconciliation.

Net income before income taxes	$450,000
Minus: State income taxes	(27,000)
Net income before federal income taxes	$423,000
Permanent differences:	
Nondeductible interest	2,000
Penalties and fines	10,000
Municipal interest	(1,000)
Net income after permanent differences	$434,000
Temporary differences:	
Warranty expense	12,000
Capital loss	20,000
Depreciation	(48,000)
Installment sale	(9,000)
NOL carryover	(15,000)
Taxable income	$394,000
Federal income tax expense ($434,000 x 0.21)	$ 91,140
State effective tax rate ($27,000/$450,000)	6.00%
Federal effective tax rate ($91,140/$450,000)	20.25%
Total effective tax rate ($118,140/$450,000)	26.25%
Federal income taxes payable ($394,000 x 0.21)	$ 82,740

Step 10: Effective tax rate reconciliation.

Statutory tax rate	21.00%
State income tax (net) [6% x (1 – 0.21)]	4.74%
Nondeductible interest ($2,000/$450,000 x 21%)	0.09%
Penalties and fines ($10,000/$450,000 x 21%)	0.47%
Municipal interest [($1,000)/$450,000 x 21%]	(0.05)%
Total effective tax rate	26.25%

Step 11: Partial financial statement presentation.

Net deferred tax liability ($20,370 DTL - $6,720 DTA)	$ 13,650
Net income before federal income taxes	$450,000
Minus: State income tax expense	(27,000)
Federal income tax expense	(91,140)
Net income	$331.860

pp. C:3-37 through C:3-49.

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C:3-61 a. Deferred tax asset = $20,000 x 0.21 = $4,200.
Valuation allowance = $8,000 x 0.21 = $1,680.

b. Current federal income tax expense = $500,000 x 0.21 = $105,000.
Deferred federal income tax expense (benefit) = $4,200 - $1,680 = ($2,520).
Total federal income tax expense = $105,000 - $2,520 = $102,480.
Federal income taxes payable = $500,000 x 0.21 = $105,000.

c. Journal entry:

Current federal income tax expense	105,000	
Deferred tax asset	4,200	
Deferred federal income tax expense (benefit)		2,520
Valuation allowance		1,680
Federal income taxes payable		105,000

d. Tax provision reconciliation:

Operating income	$500,000
Capital loss	(20,000)
Net income before federal income taxes	480,000
Permanent differences:	
Capital loss carryover > 50% likely to be unrealized	8,000
Net income after permanent differences	488,000[a]
Temporary differences:	
Capital loss carryover ≥ 50% likely to be realized	12,000
Taxable income	$500,000[b]

[a]Total federal income tax expense = $488,000 x 0.21 = $102,480.
Effective tax rate = $102,480/$480,000 = 21.35%.
[b]Federal income taxes payable = $500,000 x 0.21 = $105,000.

e. Effective tax reconciliation:

Federal statutory rate	21.00%
Increase due to valuation allowance ($8,000/$480,000 x 21%)	0.35%
Effective tax rate	21.35%

Note that the valuation allowance increases the effective tax rate.

pp. C:3-39 and C:3-40.

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C:3-62 a. Liability for unrecognized tax benefits = $30,000 x 0.21 = $6,300.
Total federal income tax expense = ($1,000,000 + $30,000) x 0.21 = $216,300.
Deferred federal income tax expense = $25,000 x. 0.21 = $5,250.
Current federal income tax expense = $216,300 - $5,250 = $211,050.
Increase in deferred tax liability = $25,000 x. 0.21 = $5,250.
Federal income taxes payable = $975,000 x 0.21 = $204,750.

b. Journal entry:

	Debit	Credit
Current federal income tax expense	211,050	
Deferred federal income tax expense	5,250	
Deferred tax liability		5,250
Liability for unrecognized tax benefits		6,300
Federal income taxes payable		204,750

Although not required for the problem, the tax provision reconciliation is as follows:

Net income before federal income taxes	$1,000,000
Permanent differences:	
Unrecognized expense	30,000
Net income after permanent differences	$1,030,000[a]
Temporary differences	(25,000)
Base for current federal income expense	$1,005,000[b]
Unrecognized expense deducted for tax	(30,000)
Taxable income	$ 975,000[c]

[a]Total federal income tax expense = $1,030,000 x 0.21 = $216,300.
[b]Current federal income tax expense = $1,005,000 x 0.21 = $211,050.
[c]Federal income taxes payable = $975,000 x 0.21 = $204,750.

pp. C:3-40 and C:3-41.

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Comprehensive Problem

C:3-63 a. Equipment 1:

Sales Price			$ 80,000
Cost		$180,000	
Minus: Depreciation for 2016 (0.1429 x $180,000)	$25,722		
Depreciation for 2017 (0.2449 x $180,000)	44,082		
Depreciation for 2018 (0.1749 x $180,000 x 0.5)	15,741		
Total depreciation		(85,545)	
Adjusted basis at time of sale			(94,455)
Sec. 1231 ordinary tax loss on sale of Equipment 1			$ (14,455)

Equipment 2:

Cost	$624,000
Minus: Sec. 179 expense in 2017	(510,000)
MACRS basis	$114,000
Depreciation for 2017 (0.1429 x $114,000)	$ 16,291
Depreciation for 2018 (0.2449 x $114,000)	$ 27,919

b.

Sales		$950,000
Minus: Cost of goods sold		(450,000)
Gross profit		$500,000
Plus: Dividends received on Invest Corporation stock		3,000
LTCG on sale of Invest Corporation stock	$ 30,000	
Minus: Capital loss carryover	(6,000)	
Net capital gain		24,000
Minus: Depreciation ($15,741 + $27,919)	$43,660	
Bad debt deduction	15,000	
Other operating expenses:	105,500	
Loss on sale of Equipment 1	14,455	
Total expenses and loss		(178,615)
Taxable income before special deductions (Form 1120, Line 28)		$348,385
Minus: Dividends-received deduction ($3,000 x 0.50)	$ 1,500	
Net operating loss deduction (carryover)	40,000	
Total special deductions		(41,500)
Taxable income		$306,885
Tax liability ($306,885 x 0.21)		$ 64,446

c.

Net income per books	$186,000
Plus: Federal income taxes per books	90,000
Excess book over tax bad debt expense ($22,000 - $15,000)	7,000
Excess book over tax loss ($70,000 - $14,455)	55,545
Excess book over tax depreciation ($59,500 - $43,660)	15,840
Minus: Capital loss carryover	(6,000)
Taxable income before special deductions (Form 1120, Line 28)	$348,385

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Tax Strategy Problem

C:3-64 a. Barton Corporation's tax on $800,000 is $168,000 ($800,000 x 0.21). Mike and Elaine's tax in 2018 is $30,819 calculated as follows:

Salary	$200,000
Minus: Standard deduction	(24,000)
Taxable income	$176,000

Tax calculated at 2018 married filing jointly rates is as follows: $30,819 = $28,179 + 0.24 x ($176,000 - $165,000).

Mike and Elaine are in the 24% marginal tax rate bracket, and Barton Corporation is in the 21% marginal tax bracket. Therefore, they apparently would incur an additional 3% (24% - 21%) cost by Mike's taking additional salary. Moreover, both Mike and Barton Corporation would have to pay incremental payroll taxes of 1.45% each on any additional salary, for a total percentage of 2.6% [1.45% + 1.45% x (1 - 0.21)], thereby causing a 5.6% (3% + 2.6%) additional tax cost.

b. The Bartons would not save net taxes by having Barton Corporation pay a salary to Elaine Barton. Any payments to her would be taxed at 24% instead of 21%, for an additional cost of 3%, and, moreover, would result in substantial payroll taxes for the corporation and for Mrs. Barton. Specifically, the total payroll tax burden would be 13.7% [7.65% + 7.65% x (1 - 0.21)] per year, for a total increased cost of 16.7% (3% + 13.7%). Thus, paying Elaine a salary instead of increasing Mike's salary results in a significantly higher tax cost.

Tax Form/Return Preparation Problems

C:3-65 (See Instructor's Resource Manual)

C:3-66 (See Instructor's Resource Manual)

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Case Study Problems

C:3-67 The points listed below are the major ones the memorandum to the Chief Financial Officer should cover. The student should prepare the memorandum using proper form with good grammar and punctuation.

1. Marquette Corporation is subject to the estimated tax requirements of Sec. 6655. Quarterly estimated tax payments are due on April 15, June 15, September 15, and December 15 of the current year.

2. Marquette is a large corporation under Sec. 6655(d)(2) because it had greater than $1 million of taxable income in the prior three-year testing period. Thus, Marquette cannot use 100% of its prior year tax liability to satisfy the minimum estimated tax requirements except for the first payment.

3. The current year estimated tax liability is $1.05 million ($5,000,000 x 0.21). Quarterly estimated tax payments based on the current year liability equal $262,500 ($1,050,000 x 0.25). Thus, the first payment, based on the prior year liability (at the then tax rate of 34%), is $212,500 ($2,500,000 x 0.34 x 0.25); the second payment is $312,500 [$262,500 + ($262,500 - $212,500)]; and the last two payments are $262,500 each. The balance of the current year taxes (i.e., excess of taxes shown on the return over the estimated tax payments) is due when Marquette Corporation files its tax return on April 15 of next year.

4. The Chief Financial Officer should be advised to investigate the possibility of using the annualized income or adjusted seasonal installment exceptions permitted under Sec. 6655(e). Acquisition of a tax software package to make these calculations should be considered.

5. The Chief Financial Officer also should be made aware of the penalties and interest that may apply if the corporation fails to make timely estimated tax payments. Interest and penalties also may apply to the final payment if not made timely.

C:3-68 a. According to Statements on Standards for Tax Services (SSTS) No. 6 (see Appendix E in the text), Susan should inform Winter Park Corporation's management that an error has been found and should recommend that Winter Park file an amended return. She may give this recommendation orally. She may not inform the IRS of the error without permission from Winter Park's management.

b. According to SSTS No. 6 (see Appendix E in the text), if Susan represents Winter Park and discovers the error with regard to the NOL, she should inform the client promptly and recommend that the client disclose the error. However, she may not disclose the error to the IRS agents unless the client agrees.

c. Susan should recommend that Winter Park file an amended return. If Winter Park does not agree to file an amended tax return, Susan should not prepare or sign the current year's tax return. According to SSTS No. 1 (see Appendix E in the text), a CPA should not prepare or sign a return if the CPA knows that the return takes a position the CPA could not recommend. As with the earlier returns, Susan should not disclose the error to the IRS.

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C:3-69 The memorandum to Phil Nickelson should address the following points at a minimum:

1. The firm should determine whether the Center for Restoration of Waters is on the IRS's list of qualified charitable organizations. If not, the IRS will disallow the charitable contributions deduction should it audit the return.

2. Charitable contributions in any tax year are deductible up to 10% of the corporation's adjusted taxable income. Excess contributions are deductible over a five-year carryover period.

3. The possibility of accruing charitable contributions to obtain a larger contribution deduction limitation should be considered if the corporation is an accrual method of accounting taxpayer.

4. The automobiles, boats, and real estate are all possible ordinary income properties because they are depreciable assets, and the depreciation recapture would trigger ordinary income if sold. In the case of depreciated property, the deduction probably is limited to the remaining adjusted basis of the property. The deduction available, for example, when an automobile or computer that has been fully depreciated is donated will be zero. If the ordinary income property's adjusted basis exceeds its FMV, however, the deduction is limited to the FMV. Moreover, if the donee sells the vehicle for less than its FMV, the deduction is further limited to the amount of sales proceeds. The ordinary income possibility for buildings under the MACRS rule is quite small since buildings generally are depreciated using the straight-line method.

5. Property that has declined in value should not be donated. Instead, the corporation should consider selling the property, collecting the cash, deducting the loss, and donating the cash.

6. When drafting the gift agreement, the corporation should obtain some assurance that the donated property will be used pursuant to the Center's tax-exempt purpose. If not, the amount of the corporation's contribution deduction will be reduced for the amount of capital gain income that would have been recognized had the property been sold. In addition, some protection against the asset being sold to obtain cash also should be included in the gift agreement.

7. The cost of obtaining an appraisal of donated property is not considered to be a charitable contribution. Instead, the appraisal cost is deductible under Sec. 162. The corporation must file Form 8283 in the case of noncash contributions exceeding $500.

8. The memo should contain an invitation such as the following: Perhaps we should meet and discuss any contributions you plan to make beforehand to determine exactly how much you will be allowed to deduct for tax purposes.

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Tax Research Problems

C:3-70 Under Sec. 6655(d)(1), a corporation can avoid a penalty for failure to pay required estimated tax installments if the total amount of all estimated tax payments made on or before the last day prescribed for the payment of an installment equals or exceeds the lesser of the amount that would have been required if the estimated tax were (1) 100% of the tax shown on the return for the current tax year (Year 2) or (2) 100% of the tax shown on the corporation's return for the preceding tax year (Year 1).

According to Rev. Ruls. 86-58, 1986-1 C.B. 365, and 78-256, 1978-1 C.B. 438, additions to tax for underpayment of estimated tax for the year are computed by reference to the corporation's original return unless the corporation files an amended return on or before the due date of the original return (including extensions). In the situation at hand, additions to tax for underpayment of Wicker's Year 2 estimated taxes are computed by reference to the corporation's original Year 1 return showing a $20,000 liability because Wicker did not file the amended tax return until April 20 of Year 2 (one month after the due date for the return with no extension requested).

If Wicker relies on Sec. 6655(d)(1) to avoid additions to tax for Year 2, it must make estimated tax payments based on the tax liability shown on the original return filed for Year 1, or an amended return filed by the due date for the original return (including extensions). Consequently, Wicker must base its estimated tax payments for Year 2 on the $20,000 tax liability reported on the original Year 1 return if it is going to use the prior year exception. Alternatively, it could rely on having paid 100% of the current tax year liability (Year 2).

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C:3-71 IRC Sec. 53(a) allows a credit against a corporation's regular tax liability equal to the minimum tax credit for the year. The minimum tax credit is a carryover into the year equal to the net minimum tax imposed in all prior years minus amounts allowed as a credit in prior years [Sec. 53(b)]. In other words, the minimum tax credit carryover is the amount of unused minimum tax credits from prior years. However, in the carryover year, the credit allowed is limited to the excess of the corporation's regular tax reduced by other credits over the tentative minimum tax for the carryover year [Sec. 53(c)]. But Sec. 53(d)(2) goes on to say that for corporations, the tentative minimum tax is deemed to be zero. These two subsections together mean the limitation is equal to the corporation's regular tax reduced by other credits. Going even further, Sec. 53(d) allows a refundable credit in addition to the regular tax limitation, that is, in addition to the amount of credit offsetting the regular tax. For tax years beginning in 2018 through 2020, the refundable amount equals 50% the excess of the minimum tax credit carryover over the corporation's regular tax (reduced by other credits). For a tax year beginning in 2021, the refundable portion is 100% of the excess instead of 50%. In effect, for 2021, the IRC imposes no limitation on the amount of allowable credit. Therefore, any minimum tax credit remaining in 2021 can be claimed that year.

If Minimis Corporation expects $100,000 of regular tax for the next four years, it can claim the minimum tax credit (MTC) as follows:

	2018	**2019**	**2020**	**2021**
MTC carryover into the year	$2,000,000	$950,000	$425,000	$162,500
Minus: Regular tax	(100,000)	(100,000)	(100,000)	(100,000)
Excess over regular tax	$1,900,000	$850,000	$325,000	$ 62,500
Times: 50% (100% in 2021)	0.50	0.50	0.50	1.0
Refundable MTC	$ 950,000	$425,000	$162,500	$ 62,500
Total MTC (regular tax plus refundable MTC)	$1,050,000	$525,000	$262,500	$162,500

C:3-72 The points listed below are the major ones the memorandum to the tax manager should cover. The student should prepare the memorandum using proper form with good grammar and punctuation.

1. Under Sec. 170(e), the amount of Bowen's charitable contribution is as follows:

Property Donated	**Deduction Allowed**	
Bates stock	$100,000 FMV	[Sec. 170(e)(1)]
Cash to Red Cross	5,000	
Pledge to Girl Scouts	25,000	[Sec. 170(a)(2)]
Total	$130,000	

However, under Sec. 170(b)(2), Bowen is limited to a deduction of $60,000 (0.10 x $600,000 taxable income) in the current year. The remaining $70,000 ($130,000 - $60,000) carries over to the succeeding five years.

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2. Under ASC 720-25, contributions of noncash property are recorded at their FMV. Therefore, the Bates stock is recorded as a $110,000 contribution. For book purposes, the difference between FMV and book value of $62,700 ($110,000 - $47,300) is recorded as a gain on the disposal of the stock. The pledge to the Girl Scouts is recorded immediately if the pledge is unconditional and depends only on the passage of time. Therefore, Bowen should record, for book purposes, a total contribution of $130,000.

3. The $70,000 difference between the contribution allowed for book purposes ($130,000) and for tax purposes ($60,000) will be an adjustment item on Schedule M-1 or M-3 of Bowen's current year corporate tax return. The Schedule M-1 or M-3 will show the $62,700 as income recognized for book purposes but not for tax purposes.

4. Because of the charitable contributions deduction limitation, Bowen should consider not making the election to deduct for tax purposes the pledge made to the Girl Scouts. If Bowen does not make the election, the contribution will reduce taxable income when paid in next year. If Bowen makes the election to deduct it in the current year, the charitable contribution deduction will create a $70,000 carryover for tax purposes that Bowen can use in the succeeding five years.

Deferring the deduction until next year will reduce the current year carryover to $45,000, and permit any carryover that might occur next year as a result of paying the pledge to be used in the five years following next year.

"What Would You Do In This Situation?" Solution

Ch. C:3, p. C:3-8. Kickbacks to Retain Your Contracts.

The electrical contractor made a number of payments of a questionable nature in the tax year. These payments include $400,000 of kickbacks paid to people working for general contractors who award electrical subcontracts and $100,000 of payments made to individuals in the electrician's union. Section 162(a) permits a deduction for a trade or business expense that is reasonable, ordinary, and necessary. Section 162(c)(1), however, disallows a deduction for any payment made, directly or indirectly, to an official or employee of any government. Section 162(c)(2) disallows a deduction for any payment made, directly or indirectly, to any person if the payment is an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a state (but only if such law is generally enforced), which subjects the payor to a criminal penalty or to a loss of license or privilege to engage in a trade or business.

One would need to look at whether these payments are illegal under federal, state, and local law because both private and government electrical work was involved. Such payments are likely to result in a loss of one's electrical contracting license or privilege to engage in his or her trade or business. According to the facts in the case, these payments are illegal. Because they are illegal, one would need to look further at whether the laws concerning the making of these payments are "generally enforced." If such rules are not enforced, then one might make a case that these payments are "necessary and customary" payments in our client's line of business.

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Additional research should be undertaken with respect to the enforcement of the applicable laws. Substantial authority needs to be obtained that these payments are, in fact, common among the electrical contractors in the client's general area of operation to avoid the Sec. 6662 substantial underpayment penalty. Alternatively, the CPA might consider recommending a disclosure, either on the tax return or in a statement attached to the return, the relevant facts affecting the tax treatment for the transaction and that a reasonable basis exists for such treatment.

Because of the dollar amounts involved, the CPA needs to be careful about other taxpayer and tax return preparer penalties that might be levied in addition to the additional taxes, interest, and substantial understatement penalty that otherwise are imposed.

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