

*** CHAPTER ONE ***

INCOME TAXATION OF CORPORATIONS

SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

1-1 Historically, an association that was not treated as a corporation under state or Federal law (e.g., a partnership) could be classified as a corporation for Federal income tax purposes and thus be inadvertently exposed to the disadvantages of the regular (C) corporate form of doing business. The aspects that were addressed in determining whether an association should be classified and taxed as a corporation included: (1) Continuity of life, (2) Centralized management, (3) Limited liability, and (4) Free transferability. If three of these four characteristics were satisfied, an entity would be taxed as a corporation, even if the entity was treated differently under state law. For example, a limited liability partnership (LLP) or a limited liability company (LLC) could be treated as a corporation for tax purposes if it had, along with limited liability, two of the other three characteristics (e.g., centralized management and no restrictions on the transfer of interests).

Naturally, the above classification rules led to a great number of conflicts between the IRS and taxpayers. To simplify this process, the IRS issued regulations effective January 1, 1997 that replace the old rules for classifying entities with a “check-the-box” system. Under the current rules, an entity organized as a corporation under state law, or an entity classified under the Code as a corporation, will be treated as a corporation and will not be allowed to make an election. However, any other business entity (e.g., an LLC) that has at least two members may elect to be treated as a corporation or partnership for tax purposes (an entity with only one member will be treated as a corporation or a sole proprietorship). In general, existing entities will continue to operate as they are as long as there is a reasonable basis for the current classification. (See pp. 1-5 and 1-6.)

1-2 The IRS may try to disregard the corporation if its organization and/or operation is solely to reduce taxes (i.e., a sham). The shareholders may try to ignore the

corporation if they want limited liability without double taxation. (See pp. 1-6 and 1-7.)

- 1-3 a.** Both corporate and individual taxpayers must include as income all dividends-received. However, corporations are entitled to a 70 percent or more dividends-received deduction in arriving at taxable income. [See pp. 1-9 through 1-14 and § 243(a).]
- b.** Corporations do not have the dichotomy of deductions between “for” and “from” A.G.I. All allowable deductions are considered in arriving at taxable income. (See p. 1-8.)
- c.** Corporate casualty losses are not reduced by the \$100 statutory floor and 10 percent of A.G.I. (See p. 1-8.)
- d.** Corporations are limited to a charitable contribution deduction of 10 percent of taxable income without reduction for charitable contributions, the dividends-received deduction, NOL carrybacks, and capital loss carrybacks, instead of 20, 30, or 50 percent of A.G.I. [See pp. 1-17 through 1-19 and § 170(b)(2).]
- e.** Like individual taxpayers, corporations must include the full amount of net long-term capital gains in income. Unlike individuals who have a maximum rate of 15 percent on net long-term capital gains, corporations must compute the tax on such gains at their regular tax rates. (See p. 1-19.)
- f.** Corporate capital losses may only be used to reduce capital gains. (See pp. 1-19 and 1-20.)
- g.** Corporations are limited to a three-year back and five-year forward carryover of capital losses. All carryovers are deemed short-term losses. Individuals are not permitted a capital loss carryback but may carry forward capital losses indefinitely, and such losses retain their identity as short-term or long-term losses. (See pp. 1-19 and 1-20.)
- h.** Corporations generally compute the amount of § 1245 and § 1250 ordinary income recapture on the sales of depreciable assets in the same manner as do individuals. However, for sales of depreciable residential real property, § 291 requires corporate taxpayers to treat as ordinary income 20 percent of any § 1231 gain that would have been ordinary income if Code § 1245 rather than § 1250

had applied to the transaction. (See Example 21, pp. 1-21 and 1-22, and § 291.)

- 1-4** Corporations are permitted a dividends-received deduction to negate the triple taxation caused by the inclusion of dividends in income without an offsetting deduction by the payor corporation. The recipient corporation is allowed an *80 percent* rather than the usual 70 percent dividends-received deduction if it owns at least 20 percent but less than 80 percent of the dividend-paying corporation. If the recipient corporation owns 80 percent or more of the dividend-paying corporation, the dividends-received deduction is 100 percent. [See pp. 1-9 through 1-14 and § 243(a).]
- 1-5** The dividends-received deduction may not exceed 70 percent of the corporation's taxable income computed without the deduction, NOL carryovers and carrybacks, and capital loss carrybacks. This limitation is ignored if the corporation has an NOL for the year. Additionally, the dividends-received deduction is either limited or not allowed on so-called *debt-financed portfolio stock* or for extraordinary dividends. Finally, a corporation must hold the stock of the dividend-paying corporation for more than 45 days before it is sold or any dividends received on such stock will be ineligible for the dividends-received deduction. (See pp. 1-9 through 1-14.)
- 1-6** A corporation must carry forward, for up to five years, its qualified contribution to the extent the contribution exceeds 10 percent of taxable income (computed before the dividends-received deduction, NOL carrybacks, and capital loss carrybacks). Current contributions are deducted before carryforwards. The order was probably imposed to limit the tax benefit of prior years' contributions. See Examples 18 and 19 and pp. 1-17 through 1-19.)
- 1-7** Corporations that are members of a controlled group [as defined in Code § 1563 (a)] must share the tax benefit of the lower graduated corporate tax rates. The three categories of controlled groups are:
- Parent corporations and their 80 percent owned subsidiaries;
 - Two or more corporations where five or fewer noncorporate shareholders collectively own more than 50 percent of the stock of each corporation (i.e., so-called brother-sister corporations); and

- Three or more corporations, each of which is a member of either a parent-subsidiary controlled group *or* a brother-sister controlled group, *and* at least one of the corporations is both the common parent corporation of a parent-subsidiary controlled group and a member of a brother-sister controlled group (i.e., a combined controlled group). (See Examples 27 through 32 and pp. 1-25 through 1-30.)

- 1-8** Corporations (except qualified personal service corporations) with taxable income in excess of \$100,000 are subject to a 5 percent surtax on the excess, up to a maximum surtax of \$11,750 (the tax savings of the lower tax rates). Therefore, a corporation with \$170,000 of taxable income pays tax at a marginal rate of 39 percent. The flat tax rate imposed on the last dollar of income of a corporation with taxable income of \$335,000 or more is *34 percent* (up to \$10 million, at which point the marginal rate increases to 35 percent). (See Exhibit 1-4, Examples 22 through 24, and pp. 1-23 and 1-25.)
- 1-9** The alternative minimum tax is, as the name suggests, a tax liability computed in lieu of the regular computational result. If the taxpayer's tentative alternative minimum tax (AMT) is greater than its regular tax liability, this *excess*, the AMT liability, is an addition to the regular tax liability. Thus, the AMT is not an amount paid in lieu of the regular income tax; it is in addition to this amount. (See Exhibit 1-8 and pp. 1-30 through 1-34.)
- 1-10** There are several tax benefits that have not specifically been made subject to the corporate alternative minimum tax (e.g., tax-exempt interest, proceeds of key-person life insurance, and the dividends-received deduction). The adjustment for adjusted current earnings (ACE) is an attempt to ensure that corporations taking advantage of these tax benefits pay at least a minimal amount of tax. (See Exhibit 1-10 and p. 1-33.)

PROBLEMS

- 1-11 a.** Individual — \$10,000 (the entire amount received)
 Corporation — \$3,000 [$\$10,000 - (\$10,000 \times 70\% = \$7,000 \text{ dividends-received deduction})$] (See Exhibit 1-3 and pp. 1-9 through 1-14.)
- b.** Individual — \$ 1,900 (FMV – \$ 100) Corporation — \$2,700 (basis) (See p. 1-8.)

- c. Individual — \$900 (\$6,000 net capital gain $\times$ 15% assuming asset was held for more than 12 months) Corporation — \$2,340 (\$6,000 $\times$ 39%), assuming corporate income is not in excess of \$335,000 (See pp. 1-19 and 1-20.)
- d. Individual — \$8,000 [\$11,000 (\$8,000 LTCG + \$3,000 STCG) – \$3,000 NSTCL carryover (the carryover from 2009 is \$3,000 because \$3,000 of the loss was allowed to offset ordinary income in 2009)]
Corporation — \$5,000 [\$11,000 (\$8,000 LTCG + \$3,000 STCG) – \$6,000 NSTCL carryover (the carryover from 2009 is \$6,000 because none of the loss was allowed to offset ordinary income in 2009)] Example 20 and pp. 1-19 and 1-20.)
- e. Individual — \$30,000 (50% $\times$ A.G.I.) Corporation — \$5,000 (10% $\times$ taxable income) (See pp. 1-17 through 1-19.)
- f. The amount of the gain recognized and its character can be computed using several steps (See Example 21 and p. 1-22).

Step 1 Compute realized and recognized gain

Gain recognized on the sale is \$130,000 computed as follows:

Amount realized		\$250,000
Adjusted basis		
Cost	\$200,000	
Depreciation (straight-line)	<u>(80,000)</u>	<u>(120,000)</u>
Gain realized and recognized		<u>\$130,000</u>

Individual—The recapture rules for gains on sales of realty for individual taxpayers do not apply in this situation. The recapture rules apply only if an accelerated method was used. Because the building was depreciated using the straight-line method there is no § 1250 depreciation recapture. An individual taxpayer would stop here and report a § 1231 gain (potential long-term capital gain) of \$130,000.

Corporation—A corporation reports the same amount of gain as an individual taxpayer, \$130,000, but its character differs. Under the §291 recapture rules, corporations would report ordinary income of \$16,000 and § 1231 gain of \$124,000 computed as follows:

Step 2 Compute excess depreciation

Actual depreciation	\$80,000
Straight-line depreciation	<u>(80,000)</u>
Excess depreciation	<u>\$ 0</u>

Step 3 Compute § 1250 depreciation

Lesser of

Realized gain \$130,000

Or

Excess depreciation \$ 0

Section 1250 depreciation recapture \$ 0

Step 4 Compute § 1245 depreciation if § 1245 applied

Lesser of

Realized gain \$130,000

Or

Actual depreciation \$ 80,000

Section 1245 depreciation
recapture \$80,000

Step 5 Compute § 291 ordinary income

Depreciation recapture if

§ 1245 applied \$80,000

§ 1250 actual depreciation recapture (0)

Excess recapture potential \$80,000

§ 291 recapture rate × 20%

§ 291 ordinary income \$16,000

Step 6 Compute character of remaining gain realized

Realized and recognized gain \$130,000

Less: Ordinary income under § 291 (16,000)

Section 1231 gain \$124,000

[See Example 21, pp. 1-21 and 1-22 and § 291 and 1245(a)(5).]

1-12 a. Net short-term gain equals \$10,000 (\$20,000 gain – \$10,000 loss). Net long-term loss equals \$23,000 (\$5,000 gain – \$28,000 loss). The combination of the short-term gain and long-term loss yields a net long-term loss of \$13,000.

This loss may not be used on the 2009 Form 1120 but must be carried back three years and then forward five years in search of capital gains. When carried back, the loss is treated as a short-term loss.

- b. The loss must first be carried back three years to 2006 (no loss carryback is available for 2005) to absorb the \$8,000 capital gain. The remaining loss of \$5,000 ($\$13,000 - \$8,000$) is carried to 2008 and is used to absorb the \$1,000 capital gain. Note: The \$3,000 loss reported in 2007 was carried back to 2005 and was absorbed by the \$6,000 capital gain.
- c. The unused loss from 2008 of \$4,000 ($\$5,000 - \$1,000$) may be used in 2009 to offset any net capital gain. As with carrybacks, the loss is treated as a short-term loss even though the 2009 loss was long-term.

(See pp. 1-19 and 1-20.)

- 1-13 a.** \$14,000 ($\$20,000 \times 70\%$), if not debt-financed portfolio stock or an extraordinary dividend. This is not limited by income ($\$100,000 + \$20,000 - \$30,000 - \$40,000 = \$50,000$). b. \$12,600 [$(\$120,000 - \$102,000) \times 70\%$] (See Exhibit 1-3 and pp. 1-9 through 1-14.) The dividends-received deduction is limited to 70 percent of taxable income since the dividends-received are greater than taxable income, but the regular dividends-received deduction will not produce a net operating loss. (See Example 5 and p. 1-11.)

- 1-14 a.** \$22,400 [$(\$170,000 + \$40,000 - \$178,000 = \$32,000) \times 70\%$]. Although the tentative DRD is \$28,000, the DRD is subject to the taxable income limitation. b. \$28,000 ($\$40,000 \times 70\%$). Note that by adding an additional \$5,000 of operating expenses, the corporation's taxable income before the dividends-received deduction is reduced to \$27,000 ($\$32,000 - \$5,000$), and the tentative income is negative. The corporation will not be subject to the limitation as in part (a) above. As a result, the dividends-received deduction is increased by \$5,600 ($\$28,000 - \$22,400$).

(See Exhibit 1-3, Example 6, and pp. 1-10 and 1-12.)

- 1-15 a.** Of the \$41,000 of organization expenses incurred, the corporation may expense up to \$5,000 in the first year and the balance, \$36,000 ($\$41,000 - \$5,000$) may be amortized over 180 months beginning the month the business

begins, September 1. The deductible organizations expenses for the first year would be \$5,800 computed as follows:

Total incurred in first year of business	\$41,000	
Expensed portion	<u>(5,000)</u>	\$5,000
Balance to be amortized over 180 months	\$36,000	
Amortization per month (\$36,000/180 months)	\$200	
Number of months in first year	<u>× 4</u>	
Amortization in first year		<u>800</u>
Total deduction in year 1		<u>\$5,800</u>

- b.** \$2,400 (\$200 amortization per month × 12 months).
- c.** \$2,400 same as in (b) above. Note that in 2024, the final year of amortization, the deduction is only \$1,600 (\$200 per month × 8 months)
- d.** No change. The amount of organization expense eligible to be expensed or amortized is the amount *incurred* during the first year of business regardless of whether the corporation is a cash or accrual basis taxpayer. The fact that the expense was paid is irrelevant since it was incurred in the first year.
- e.** No change. As noted above, the amount of organization expense eligible to be expensed or amortized is the amount *incurred* during the first year of business regardless of whether the corporation is a cash or accrual basis taxpayer. The fact that the expense was paid is irrelevant since it was incurred in the first year.
- f.** Only the amount incurred in the first year of business \$29,000 would be eligible to be deducted under §248. The amount incurred in the second year of business, \$12,000, must be capitalized and is not eligible for deduction or amortization. It could only be recovered if the corporation were to sell its assets or upon liquidation. As a result, the amount deductible in the first year would be \$5,333 computed as follows:

Total incurred in first year of business	\$29,000	
Expensed portion	<u>(5,000)</u>	\$5,000

Balance to be amortized over	\$24,000	
180 months		
Amortization per month		\$133.33
(\$24,000/180 months)		
Number of months in first year	<u>× 4</u>	
Amortization in first year		<u>533</u>
Total deduction in year 1		<u>\$5,333</u>

(See Examples 11 through 13 and pp. 1-14 and 1-15.)

1-16 The correct answers are b, c, d, and f Answer a is not amortizable under § 248 as an organizational expense but may be amortizable under § 195 as a “start-up” expenditure. Answer e is incorrect because the cost of issuing stock is a selling expense, which is treated as a reduction in the proceeds from selling the stock. [See p. 1-14 and Reg. § 1.248-1(b)(3).]

1-17 a. \$70,000 [(\$600,000 + \$100,000 dividends before the dividends-received deduction) = \$700,000 × 10%]. b. \$8,000 (\$70,000 maximum deduction – \$68,000 from 2009 contributions = \$2,000 remaining to deduct; \$10,000 carryover from 2008 – \$2,000 used in 2009).

(See Example 6 and Example 7 and pp. 1-16 and 1-17.)

1-18 Accrual basis corporations may deduct a charitable contribution in the year the contribution is authorized by the board of directors if payment is made by the fifteenth day of the third month following the close of the tax year. In this case, a deduction is allowed in 2010 for the authorized contribution when paid before March 15, 2011. Therefore, the payment made on February 28, 2011 qualifies, whereas the payment made on March 29, 2011 does not qualify. (See p. 1-17.)

1-19

1.

Sales price	\$410,000	
Less: Adjusted basis		
Cost	\$400,000	
S/L depreciation	<u>(87,000)</u>	<u>(313,000)</u>

Realized gain	<u>\$ 97,000</u>
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2. Because the building was depreciated using the straight-line method, there is no § 1250 depreciation recapture.
3. Depreciation recapture if § 1245 applied would be the lesser of the \$97,000 realized gain or the \$87,000 actual depreciation. Thus, if § 1245 applied, the depreciation recapture would be \$87,000.
4. § 291 ordinary income is computed as follows:

Depreciation recapture under § 1245	\$87,000
Less: § 1250 depreciation recapture	(<u>0</u>)
Excess recapture potential	\$87,000
Times the § 291 rate	<u>× 20%</u>
Equals § 291 ordinary income	<u>\$17,400</u>

5. Character of the \$97,000 realized gain:

Realized gain	\$97,000
Less: Ordinary income	<u>(17,400)</u>
§1231 gain	<u>\$79,600</u>

[See Example 21, pp. 1-21 and 1-22, and §§ 291 and 1245.]

- 1-20** \$41,750 [(15% × \$50,000 = \$7,500) + (25% × \$25,000 = \$6,250) + (34% × \$75,000 = \$25,500) + (5% × \$50,000 = \$2,500)]. Note that \$50,000 of L Corporation's taxable income is subject to the 5 percent surtax. (See Example 23 and p. 1-24.)
- 1-21** F Corporation's 2010 income tax liability before credits or prepayments is \$80,750 [(15% × \$50,000 = \$7,500) + (25% × \$25,000 = \$6,250) + (34% × \$175,000 = \$59,500) + (5% surtax × \$150,000 = \$7,500)]. If F is a personal service corporation (PSC), its tax liability before credits or prepayments will be \$87,500 (35% × \$250,000) since a PSC is subject to a flat rate of 35 percent (i.e., it is denied the benefits of the lower tax rates regardless of the amount of its taxable income). (See pp. 1-23 and 1-24.)
- 1-22** A brother-sister controlled group is defined as two or more corporations connected through the stock ownership of noncorporate shareholders. It exists if five or fewer individuals, estates or trusts own more than 50 percent of the total

combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each, taking into account only the *lowest stock ownership* of each shareholder that is identical with respect to each corporation. To determine whether a controlled group exists in this case, all combinations of corporations must be examined:

Four corporations: RUST

Three corporations: RUS, RUT, RST, AND UST

Two corporations: RU, RS, RT, US, UT AND ST

These tests are performed below.

<i>Individuals</i>	<i>Corporation</i>				<i>Lowest Identical Ownership</i>
	<u><i>R</i></u>	<u><i>U</i></u>	<u><i>S</i></u>	<u><i>T</i></u>	
A	30%	5%	40%	50%	5%
B	10	10	10	20	10
C	40	5	10	10	5
D	20	80	0	20	0
					<u>20%</u>

R, U, S and T are not a controlled group because the total lowest identical ownership is only 20% and does not exceed the required threshold of 50%

Tests of combinations of three corporations: RUS, RUT, RST, AND UST

RUS

	Percentage of			Lowest
	<u>Corporation Owned</u>			Identical
<u>Shareholder</u>	<u>R</u>	<u>U</u>	<u>S</u>	<u>Ownership</u>
A	30	5	40	5
B	10	10	10	10
C	40	5	10	5
D	20	80	0	0
				<u>20%</u>

RUT

	Percentage of			Lowest
	<u>Corporation Owned</u>			Identical
<u>Shareholder</u>	<u>R</u>	<u>U</u>	<u>T</u>	<u>Ownership</u>
A	30	5	50	5
B	10	10	20	10
C	40	5	10	5
D	20	80	20	<u>20</u>
				<u>40%</u>

RST

	Percentage of			Lowest
	<u>Corporation Owned</u>			Identical
<u>Shareholder</u>	<u>R</u>	<u>U</u>	<u>S</u>	<u>Ownership</u>
A	30	40	50	30
B	10	10	20	10
C	40	10	10	10
D	20	0	20	0
				<u>50%</u>

UST

	Percentage of			Lowest
	<u>Corporation Owned</u>			Identical
<u>Shareholder</u>	<u>R</u>	<u>U</u>	<u>T</u>	<u>Ownership</u>
A	5	40	50	5
B	10	10	20	10
C	5	10	10	5
D	80	0	20	<u>0</u>
				<u>15%</u>

None of these four combinations-RUS, RUT, RST, UST-are considered a controlled group since the total lowest identical ownership of each group is does not exceed 50 percent. Of the four combinations, RST has the greatest total lowest identical ownership of 50%. However, the test is met only if the total lowest identical ownership exceeds 50 percent.

Tests of two corporations: RU, RS, RT, US, UT AND ST

RU				RS			
<u>Shareholder</u>	Percentage of Corporation Owned		Lowest Identical Ownership	<u>Shareholder</u>	Percentage of Corporation Owned		Lowest Identical Ownership
	<u>R</u>	<u>U</u>			<u>R</u>	<u>S</u>	
A	30	5	5	A	30	40	30
B	10	10	10	B	10	10	10
C	40	5	5	C	40	10	10
D	20	80	20	D	20	0	<u>0</u>
			<u>40%</u>				<u>50%</u>
RT				US			
<u>Shareholder</u>	Percentage of Corporation Owned		Lowest Identical Ownership	<u>Shareholder</u>	Percentage of Corporation Owned		Lowest Identical Ownership
	<u>R</u>	<u>T</u>			<u>U</u>	<u>S</u>	
A	30	50	5	A	30	40	30
B	10	20	10	B	10	10	10
C	40	10	5	C	40	10	10
D	20	20	20	D	20	0	<u>0</u>
			<u>40%</u>				<u>50%</u>
UT				ST			
<u>Shareholder</u>	Percentage of Corporation Owned		Lowest Identical Ownership	<u>Shareholder</u>	Percentage of Corporation Owned		Lowest Identical Ownership
	<u>U</u>	<u>T</u>			<u>S</u>	<u>T</u>	

<u>Shareholder</u>	<u>R</u>	<u>U</u>	<u>Ownership</u>	<u>Shareholder</u>	<u>R</u>	<u>S</u>	<u>Ownership</u>
A	5	50	5	A	40	50	40
B	10	20	10	B	10	20	10
C	5	10	5	C	40	10	10
D	80	20	20	D	0	20	<u>0</u>
			<u>40%</u>				<u>60%</u>

Of these six combinations, RT and ST are considered brother-sister controlled groups since the total lowest identical ownership of the RT group, 70%, and the ST group, 60%, both exceed the 50 percent requirement.

See Examples 28, 29, 30 and pp. 1-27 through 1-28.

1-23 a.

Regular taxable income	\$ 100,000
Plus: AMT adjustments	+ 0
Less: AMT adjustments	<u>- 0</u>
AMT adjusted taxable income	\$ 100,000
Plus: Excess depreciation (\$90,000 – \$60,000)	<u>+ 30,000</u>
AMTI before the adjusted current earnings item	\$ 130,000
Plus: 75% of adjusted current earnings in excess of AMTI without this item	
[75% × (\$210,000 – \$130,000)]*	<u>+ 60,000</u>
Alternative Minimum Taxable Income (AMTI)	<u>\$ 190,000</u>

* Adjusted current earnings equals AMTI of \$130,000 + \$80,000 of nontaxable life insurance proceeds.

b.

AMTI [from part a above]	\$ 190,000
Less: Exemption	
[\$40,000 – 25% of (\$190,000 – \$150,000)	<u>- 30,000</u>
AMTI base	\$ 160,000
Times: AMT rate	<u>× 20%</u>
Gross AMT	\$ 32,000

Less: Allowed credits	<u>— 0</u>
Tentative AMT	\$ 32,000
Less: Regular tax liability	<u>— 22,250</u>
Alternative Minimum Tax (AMT)	<u>\$ 9,750</u>

(See Exhibits 1-8, 1-9, 1-10 and 1-11; Examples 33 and 34; and pp. 1-30 through 1-34.)

1-24

a.

Net income from operations		\$ 150,000
Dividends		<u>+ 10,000</u>
Income before special deductions		\$ 160,000
Less sum of:		
NOL carryover	\$30,000	
Charitable contributions		
[10% × (\$160,000 –	+ 13,000	
\$30,000 NOL)]		
Dividends received deduction		
(70% × \$10,000)]	<u>+7,000</u>	<u>(50,000)</u>
Taxable income		<u>\$110,000</u>

Note: The \$5,000 of 2010 net capital gains are offset by the capital loss carryover from 2009.

$$\$26,150 [(15\% \times \$50,000 = \$7,500) + (25\% \times \$25,000 = \$6,250) + (34\% \times \$25,000 = \$8,500) + (39\% \times \$10,000 = \$3,900)]$$

- b. Charitable contribution carryover from 2009 = \$17,000 (\$30,000 – \$13,000 used in 2010) Capital loss carryover from 2009 = \$4,000 (\$9,000 – \$5,000 used in 2009)

(See pp. 1-7 through 1-21.)

1-25

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return			
Note: Schedule M-3 may be required instead of Schedule M-1—see instructions.			
1	Net income (loss) per books	125,730	
2	Federal income tax per books	10,500	
3	Excess of capital losses over capital gains	3,600	
4	Income subject to tax not recorded on books this year (itemize):		
5	Expenses recorded on books this year not deducted on this return (itemize):		
a	Depreciation \$ 520		
b	Charitable contributions \$ 300		
c	Travel and entertainment \$		
d	Other (itemize):		
	KEY PERSON LIFE INS PROCEEDS = \$1,250	2,070	
6	Add lines 1 through 5	141,900	
7	Income recorded on books this year not included on this return (itemize):		
a	Tax-exempt interest \$ 3,500		
b	Other (itemize):		
	LIFE INSURANCE PROCEEDS = \$75,000		78,500
8	Deductions on this return not charged against book income this year (itemize):		
a	Depreciation \$ 1,400		
b	Charitable contributions \$		
c	Other (itemize):		
			1,400
9	Add lines 7 and 8		79,500
10	Income—line 6 less line 9		62,000

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books			
1	Balance at beginning of year	200,00	
2	Net income (loss) per books	125,730	
3	Other increases (itemize):		
4	Add lines 1, 2, and 3	325,730	
5	Distributions: a Cash		23,500
	b Stock		
	c Property		
6	Other decreases (itemize):		
7	Add lines 5 and 6		23,500
8	Balance at end of year (line 4 less line 7)		302,230

(See Examples 37 and 39 and pp. 1-35 and 1-36.)

1-26 The reconciliation of book income to taxable income is as follows:

Net book income		\$300,000
Add: Actual Federal income tax	\$ 80,000	
Overaccrual of FIT*	10,000	
Insurance premiums	6,000	
Net capital loss	<u>4,000</u>	100,000
Less: Life insurance proceeds	\$120,000	
Excess depreciation	<u>36,000</u>	<u>(156,000)</u>
Taxable income		<u>\$ 244,000</u>

* Assuming actual Federal income tax is entered on Line 2 of Schedule M-1. Because the accrued Federal income tax exceeded the actual tax by \$10,000, this overaccrual must be added back to net book income. (See pp. 1-35 and 1-36).

1-27 The Schedule M-3 is generally a detail reconciliation of book to taxable income. See pp.1-37 through 1-39.

- a. False. The M-3 is a substitute for the M-1. Both require a reconciliation of book income to taxable income. The M-3 is required in some instances.

However, taxpayers that are not required to file the M-3 may do so. In fact, a corporation may want to do to meet their reportable transaction obligation. The M-2 is a reconciliation of retained earnings.

- b.** False. The M-3 must be completed by any corporation that files Form 1120 and has assets of \$10 million or more at the end of the year. If a group of corporations file a consolidated tax return, the \$10 million is measured on a consolidated basis (i.e., the assets of the group are aggregated). While most publicly traded companies will be required to file the M-3, other corporations will also find it necessary to file. In measuring whether its assets meet the \$10 million threshold, a corporation must use the same basis as it prepares its financial statements.
- c.** True. There is no indication in the instructions of the M-1 as to which “book income” is to be used in the reconciliation.
- d.** False. Corporations may be required to file an M-3 even though they are not required to file a SEC Form 10-K. If a corporation has assets of \$10 million or more at the end of the year it must file an M-3. In completing Part I, the starting point is the income shown on an SEC Form 10-K if it is filed. If a 10-K is not filed, the income from a certified audited financial statement is used. Failing these, the corporation uses the number reported on income statements prepared for other purposes (e.g., a utilities commission). If none of these conditions apply, the net income per the corporation’s books and records is entered on line 11, and the remainder of Part I is left blank.
- e.** False. While it is true that the M-3 requires far greater detail (70 or so lines vs. 8 for the M-1), it is not the only difference between the M-1 and M-3. Schedule M-3 requires the corporation to classify any difference as permanent or temporary. Such classification is not required on the M-1. This is significant since permanent differences are far more interesting to the government. On the roadmap of corporate reporting, the sign of a permanent difference to an IRS agent is an attraction worth stopping for.
- f.** True.
- g.** True. Even corporations that are not required to file an M-3 may want to do

so to satisfy the reportable transaction requirement for significant differences (i.e., over \$10 million).

1-28 Normally depreciation results in a timing difference. If it is mistakenly classified as a permanent difference, the IRS may believe the corporation is attempting to claim tax depreciation on an otherwise nondepreciable asset. An audit may result that might not have otherwise occurred. Such an error would be easy to explain during the audit, but obviously corporations do not want that kind of attention. Consequently, it is very important to correctly identify timing differences and permanent differences. Since the form is designed to highlight each type of difference, a misclassified could result in heightened scrutiny. (See pp. 1-37 through 1-39.)

1-29 Under the general rule for estimated tax payments, F must make timely quarterly payments of \$33,750 [$(\$120,000 \text{ regular tax} + \$15,000 \text{ alternative minimum tax}) \div 4 \times 100\%$] to avoid imposition of the penalty. F's quarterly payments were only \$26,000, so F is tentatively subject to the penalty. However, because F is not a "large" corporation, it may qualify under the exception based on last year's tax liability. The quarterly payments based on this exception are only \$25,000 ($\$100,000 \text{ last year's tax} \div 4$). Because actual quarterly payments exceed this amount and all other requirements are met, F does not have an underpayment and is not subject to penalty. (See pp. 1-43 and 1-44.)

1-30 Refer to the solution for *Problem 1-29*. Because F Corporation is now a "large" corporation, it may not rely on the exception based on last year's tax liability (except for the first quarterly installment). The first installment is not underpaid because the \$26,000 actual payment exceeded the \$25,000 required payment based on last year's tax. If this rule were not in effect, the underpayment for the first quarter would be \$7,750 ($\$33,750 \text{ required payment} - \$26,000 \text{ actual payment}$). This amount must be paid with the second installment. Therefore, the second installment is underpaid by \$15,500 ($\$7,750 \text{ from the first installment} + \$7,750 \text{ from the second installment}$). The third and fourth installments are underpaid by \$7,750. (See pp. 1-43 and 1-44.)

1-31 a. G has a realized loss of \$2,000 ($\$2,000 \text{ sales price} - \$4,000 \text{ adjusted basis}$).

However, this loss is not recognized because this is a sale between related parties (§ 267). The \$2,000 disallowed loss is carried over to the ABC Corporation for possible future use. b. ABC has a realized gain of \$3,000 (\$5,000 sales price – \$2,000 adjusted basis), only \$1,000 of which must be recognized (\$3,000 realized gain — \$2,000 loss carryover from G). Note: the carryover loss cannot be used to add to or to create a loss.

(See pp. 1-22 and 1-23.)

1-32 a. H wishes to create long-term capital gain on the sale of the building (which would be taxed at favorable rates) and allow XYZ to depreciate the \$160,000 basis allocated to the building against its ordinary income (34% marginal tax rate). Note: The gain on the sale of the land is § 1231 gain. b. The sale of the building from H to XYZ is treated as the sale of an ordinary income property under § 1239. Therefore, the gain on the sale of the building is taxed at H's 34% marginal tax rate.

(See pp. 1-22 and 1-23.)

TAX RETURN PROBLEMS

The solution to the Tax Return Problems (**1-33 and 1-34**) are contained in the *Instructor's Guide* for 2011.

RESEARCH PROBLEM

The solution to the Research Problem (**1-35**) is contained in the *Instructor's Guide* for 2011.