**Solutions to Research Problems**

**Research Problem 1.**

A PSC [as defined under § 441(i)(2)] must use the calendar year for reporting purposes, unless the PSC can establish, to the satisfaction of the IRS, a business purpose for a fiscal year-end. [§ 441(i)(1)] (A fiscal year can also be elected under the provisions of § 444.) Approval of the IRS to adopt (or change to) a fiscal year under the business purpose exception is obtained by filing Form 1128, “Application to Adopt, Change, or Retain a Tax Year.” [Reg. §§ 1.441-1(c)(2)(i), 1.441-3(b)(1), and 1.442-1(b)(1)] In determining whether a PSC has established a business purpose for a fiscal year, consideration will be given to all of the facts and circumstances relating to the adoption of the fiscal year, including the tax consequences resulting from such adoption. [Reg. § 1.442-1(b)(2)]

Reasons sufficient to satisfy the business purpose standard:

* Fiscal year coincides with the entity’s natural business year. [Reg. § 1.442-1(b)(2)] In general, a natural business year exists if, for each of the 3 most recent 12-month periods that end with the last month of the requested fiscal year, 25% or more of the entity’s gross receipts were derived in the last two months of such requested fiscal year. (In addition to the 25% gross receipts test, a natural business year can also be established under the annual business cycle test and the seasonal business test.) [Rev.Proc. 2002-39, 2002-1 C.B. 1046] In some cases, a PSC satisfying the 25% gross receipts test will be deemed to have established a business purpose and obtain automatic IRS consent. [See Rev.Proc. 2006-46, 2006-2 C.B. 859.]

Reasons *insufficient* to satisfy the business purpose standard:

* Deferral of income to shareholders. [§ 441(i); Reg. § 1.442-1(b)(2)]
* The use of a particular year for regulatory or financial accounting purposes;
* The hiring patterns of a particular business;
* The use of a particular year for administrative purposes;
* The fact that a particular business involves the use of price lists, model years, or other items that change on an annual basis;
* The use of a particular year by related entities; and
* The use of a particular year by competitors. [Rev. Proc. 2002-39, 2002-1 C.B. 1046]

# Research Problem 2

In general, a contribution of inventory to a qualified charitable organization is deductible only the extent of the inventory’s basis. However, certain contributions of inventory to charitable organizations will result in an increased deduction amount. When this enhanced deduction rule applies, the deduction is equal to the lesser of (1) basis plus one-half of the inventory’s appreciation (excess of fair market value over basis) or (2) two times basis. [§ 170(e)(3)(B)] A local or regional food bank is an example of an organization that Southwest Grocer could target to obtain the enhanced deduction for contributions of its inventory. In order to qualify for the enhanced deduction amount, the following rules apply:

* The recipient organization is a § 501(c)(3) tax exempt organization (other than a private nonoperating foundation). [§ 170(e)(3)(A)]
* The use of the inventory by the recipient organization is related to the entity’s exempt purpose or function. [§ 170(e)(3)(A)(i)]
* The inventory may not be used to generate unrelated trade or business income for the exempt organization. [Reg. § 1.170A-4A(b)(2)(i)]
* The inventory will be used by the recipient organization solely for the care of the ill, the needy, or infants. [§ 170(e)(3)(A)(i)]
* The inventory may not be used by any other person except as incidental to primary use in the care of the ill, needy, or infants. [Reg. § 1.170A-4A(b)(2)(ii)(A)]
* The recipient organization may transfer the inventory to another exempt U.S. organization to meet this requirement, as long as the recipient organization obtains a written statement from the other exempt entity that the inventory will be used for appropriate purposes. [Reg. § 1.170A-4A(b)(2)(ii)(A)]
* The inventory is not transferred by the recipient organization in exchange for money, property, or services. [§ 170(e)(3)(A)(ii)]
* There is an exception for nominal costs incurred by the recipient organization for administrative, warehousing, or other similar costs. However, any fee charged should not be based on the value of the inventory (a fee based on weight is acceptable). [Reg. § 1.170A-4A(b)(3)]
* Southwest Grocers receives from the recipient organization a written statement provides that the use and disposition of the inventory will be in accordance with the aforementioned requirements. [§ 170(e)(3)(A)(iii)]
* The statement from the recipient organization should include a description of the contributed inventory, the date of receipt, an attestation that the organization qualifies as a § 501(c)(3) exempt entity, and an attestation that adequate books and records will be maintained and made available to the IRS upon request. [Reg. § 1.170A-4A(b)(4)(i)]
* The statement must be received by Southwest Grocers no later than the due date (including extensions) of the income tax return for the year in which the contribution is made. [Reg. § 1.170A-4A(b)(4)(i)]
* The inventory must satisfy any applicable requirements of the Federal Food, Drug, and Cosmetic Act. [§ 170(e)(3)(A)(iv)]
* Southwest Grocers must decrease its cost of goods sold by the lesser of the inventory’s fair market value or its basis. [Reg. § 1.170A-4A(c)(3)] The basis of inventory is determined under Southwest Grocers’ method of inventory accounting. [Reg. § 1.170A-4A(c)(2)]
* It is necessary to determine the fair market value of the donated inventory and, in the case of some of the food products contemplated for gifting purposes (e.g., dented cans and fungible food items nearing their freshness expiration dates), the fair market value may be subject to dispute. In such cases, the fair market value may not be the usual retail sales price but rather the amount for which such inventory could have been sold at the time of the contribution (including consideration for the quantity involved). [Reg. § 1.170A-1(c)(3)]
* The IRS likely would assert a reduction in fair market value for contributions of dented canned goods and fungible goods nearing their freshness expiration dates. See Rev.Rul. 85-8, 1985-1 C.B. 59 (donated pharmaceutical inventory shortly before their expiration date valued at less than full retail price).
* See, however, *Lucky Stores, Inc.*, 105 T.C. 420 (1995) (donated 4-day-old bread and other “aged” baked goods valued at full retail price, not half retail price as asserted by IRS).
* Form 8283 (Noncash Charitable Contributions) must be filed when the value of the donated inventory exceeds $5,000. For purposes of the $5,000 threshold, only the excess of the charitable deduction over the basis of the inventory is counted. A qualified appraisal generally is required of inventory contributions in excess of $5,000. [Reg. § 1.170A-13(c)]

# Research Problem 3

TAX FILE MEMORANDUM

Date: May 2, 2012

From: Jonathan Smith

Subject: Tern Corporation

**Facts:** Tern Corporation, a calendar year C Corporation, is solely owned by Jessica Ramirez. Tern’s only business since its incorporation in 2009 has been land surveying services. In Tern’s state of incorporation, land surveying can be performed only by a licensed surveyor. Jessica, Tern’s only employee, is a licensed surveyor. Jessica is not a licensed engineer. Upon audit of Tern’s 2009 and 2010 tax returns, the IRS asserted tax deficiencies stemming from its conclusion that the corporation was a personal service corporation subject to the flat tax rate of 35%. Jessica believes that the IRS’s determination is incorrect and she has requested advice on how to proceed.

**At issue:** Is Tern Corporation a personal service corporation under § 448(d)(2) and therefore subject to the flat tax rate of 35?

**Conclusion:** Section 11(b)(2) provides that the taxable income of a qualified personal service corporation, as defined in § 448(d)(2), is subject to a flat tax rate of 35%. Under § 448(d)(2), a “qualified personal service corporation” means any corporation that satisfies both a function test and an ownership test. The function test requires that “substantially all of the activities” of the corporation involve the performance of services in one of eight specified fields, including engineering. [§ 448(d)(2)(A).] The ownership test requires, in general, that substantially all of the stock of the corporation is owned by employees (or retired employees) performing services for the corporation. [§ 448(d)(2)(B).] Since Jessica owns 100% of Tern Corporation and is the corporation’s only employee, the ownership test is not in question.

Temp. Reg. § 1.448-1T(e)(4)(i) provides that the field of engineering includes surveying. Further, the provision notes that the “substantially all of the activities” requirement is satisfied if 95% or more of the time spent by employees of the corporation is devoted to the performance services in a designated field (e.g., engineering). Thus, Tern is a personal service corporation as defined under Temp. Reg. § 1.448-1T(e)(4)(i). In a recent case directly on point with our facts, a corporate taxpayer in the business of land surveying was held to be a personal service corporation as defined by § 448(d)(2). In *Kraatz & Craig Surveying Inc.* [134 T.C. 167 (2010)], the taxpayer argued that Temp. Reg. § 1.448-1T(e)(4)(i) was invalid in that it included surveying in the engineering field. The Tax Court rejected that argument, however, by noting, in part, that the underlying legislative language supported the regulation’s interpretation. [See, e.g., H. Rep. No. 99-841, 99th Cong., 2d Sess., 1986, p. 285.] [The Tax Court also rejected the taxpayer’s argument that state law is determinative of what is included in the field of engineering for purposes of § 448(d)(2).] Thus, the IRS’s determination that Tern Corporation is a personal service corporation subject to the flat tax of 35% is correct and the tax deficiency should be paid. In the future, an attempt should be made to reduce or eliminate Tern’s taxable income through increased compensation payments to Jessica.

**Research Problems 4 through 6**

These problems require that the student access various sites on the Internet. Thus, each student’s solution likely will vary from that of the others.

You should determine the skill and experience levels of the students before making the assignment, coaching them where necessary so as to broaden the scope of the exercise to the entire available electronic world.

Make certain that you encourage students to explore all parts of the Web in this process, including the key tax sites, but also information found through the home pages of newspapers, magazines, businesses, tax professionals, government agencies, political outlets, and so on. They should work with Internet resources other than the Web as well, including newsgroups and other interest-oriented lists.

Build interaction into exercises wherever possible, asking the student to send and receive e-mail in a professional and responsible manner.