

CHAPTER 2

CORPORATIONS: INTRODUCTION AND OPERATING RULES

SOLUTIONS TO PROBLEM MATERIALS

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	LO 1	Choice of entity: tax and nontax factors in entity selection	Unchanged	1
2	LO 1	Corporation versus S corporation: treatment of operating income and tax-exempt income; no distributions	Unchanged	2
3	LO 1, 7	Corporation versus proprietorship: treatment of losses	Unchanged	3
4	LO 1, 2	Corporation versus partnership: treatment of operating income and STCG	New	
5	LO 1, 2	Corporation versus LLC and S corporation	New	
6	LO 1, 2	Closely held corporations: shareholder transactions	New	
7	LO 1	Double taxation	New	
8	LO 1	LLCs: single member	New	
9	LO 1	LLCs: multi-owner default rule	Unchanged	9
10	LO 2	Accounting periods: general rule and fiscal year limitation	Unchanged	10
11	LO 2	Accounting periods: PSC fiscal year limitation	Unchanged	11
12	LO 2	Accounting methods: limitation on cash method	Unchanged	12
13	LO 2	Accounting methods: limitation on accrual of expenses to cash basis related party	New	
14	LO 2	Net capital gain: corporate and individual tax rates contrasted	Unchanged	14
15	LO 2	Net capital loss: corporation and individual contrasted	Modified	15
16	LO 2	Recapture of depreciation: § 291 adjustment	Unchanged	16
17	LO 2	Passive loss rules: closely held C corporations and PSCs contrasted	Modified	17
18	LO 2	Passive loss rules: closely held C corporation	Unchanged	18

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
19	LO 2	Charitable contributions: year of deduction for accrual basis corporation	Modified	19
20	LO 2	Charitable contributions: amount of contributions	Unchanged	20
21	LO 2, 7	Charitable contributions: year-end planning issues with carryover	Unchanged	21
22	LO 2	Domestic production activities deduction: computation	New	
23	LO 2, 3, 7	NOL carryover issues	Unchanged	23
24	LO 1, 3	Dividends received deduction: corporate versus individual treatment	Unchanged	24
25	LO 3	Dividends received deduction: reduced ownership interest	New	
26	LO 3	Dividends received deduction: holding period requirement	Unchanged	26
27	LO 3	Organizational and startup expenditures contrasted	Modified	27
28	LO 4	Corporate income tax rates: highest marginal rate and average tax rates	New	
29	LO 5	Tax liability of related corporations	Unchanged	29
30	LO 6	Estimated tax payments: required annual payment	Unchanged	30
31	LO 6	Schedule M-1: adjustments	Modified	31
32	LO 6	Schedule M-3: reconciliation of expense item	Unchanged	32
33	LO 1, 2	Compare operating income and LTCL treatment for regular corporations and proprietorships	New	
34	LO 1, 2	Tax treatment of income and distributions from partnership, S and C corporations	Modified	34
35	LO 1, 2	Corporation versus proprietorship: salary versus dividends; tax-exempt interest	Unchanged	35
36	LO 1, 2	Corporations versus S corporation: ordinary income and LTCG	Modified	36
*37	LO 1	Corporation versus proprietorship: after-tax comparison	Updated	37
38	LO 2	Comparison of deduction for casualty loss for individual and corporate taxpayers	Unchanged	38
*39	LO 1, 4, 7	Corporation versus proprietorship: total tax liability	Modified	39
40	LO 2, 4	Personal service corporation: salary requirements for use of fiscal year and tax rate	Unchanged	40
41	LO 2	Accounting methods: related party expense; cash versus accrual	Unchanged	41
42	LO 1, 2, 4	Capital gains and losses: tax rate on LTCG for corporation versus single-member LLC	New	

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
43	LO 2, 4	Capital gains and losses: net capital gain and net capital loss; tax computation	New	
44	LO 2	Capital gains and losses: comparison of treatment of net capital losses for individual and corporate taxpayers	New	
45	LO 2	Capital gains and losses: corporate capital loss carryback/carryover rules	Modified	45
46	LO 2	Recapture of depreciation on § 1250 property: corporation versus individual	Unchanged	46
47	LO 2	Passive loss of closely held corporation; PSC	New	
48	LO 2	Corporate charitable contributions: amount of contributions	Unchanged	48
49	LO 2, 7	Corporate charitable contributions: tax planning	Modified	49
50	LO 2, 7	Corporate charitable contributions: carryover; tax planning	Unchanged	50
51	LO 2, 7	Corporate charitable contributions: timing of deduction; taxable income limit	Unchanged	51
52	LO 2	Domestic production activities deduction	Unchanged	52
*53	LO 2, 3	Net operating loss: computed with dividends received deduction	Unchanged	53
*54	LO 3	Dividends received deduction	New	
55	LO 3	Organizational expenditures	Modified	55
*56	LO 3	Startup expenditures	Unchanged	56
*57	LO 4	Determine corporate income tax liability	Modified	57
58	LO 5	Tax liability of related corporations	Unchanged	58
59	LO 6	Estimated tax payments: large corporation	Unchanged	59
*60	LO 6	Schedule M-1, Form 1120	New	
61	LO 6	Schedule M-1, Form 1120	Unchanged	61
62	LO 6	Schedule M-2, Form 1120	New	
63	LO 6	Schedule M-3, Form 1120	Unchanged	63
64	LO 6	Schedule M-3, Form 1120	Unchanged	64
65	LO 6	Schedule M-3, Form 1120	Unchanged	65
66	LO 2, 3, 7	Tax issues involved in starting a new business in the corporate form	Unchanged	66

*The solution to this problem is available on a transparency master.

<u>Tax Return Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	Corporation income tax (Form 1120 with Sch. M-3)	Unchanged	1
2	Corporation income tax (Form 1120)	New	

<u>Research Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	Limitation on fiscal year-end for PSC: business purpose exception	Unchanged	1
2	Startup expenditures	New	
3	Personal service corporation: application to surveying business	Unchanged	3
4	Internet activity	New	
5	Internet activity	Unchanged	5
6	Internet activity	Unchanged	6

CHECK FIGURES

- | | | | |
|-------|--|-------|--|
| 33.a. | Roger will report profit \$45,000 and long-term capital loss \$10,000. | 44.b. | \$18,000 deducted 2013; \$22,000 carried back to 2010, then 2011, etc. |
| 33.b. | Riflebird taxable income \$45,000 and \$10,000 STCL carryback. Roger no consequences. | 45.a. | Offset short-term capital gain of \$15,000 against net long-term capital loss of \$105,000. The \$90,000 net capital loss is carried back 3 years and forward 5 years. |
| 34.a. | Each partner reports \$55,000 net profit and long-term capital gain \$7,500. | 45.b. | Total carryback \$63,000. |
| 34.b. | Same as a. | 45.c. | \$27,000; carry forward to 2014, etc. |
| 34.c. | Corporation reports \$125,000 income. Shareholders each report \$25,000 dividend income. | 45.d. | Deduct \$18,000 in 2013, \$87,000 carried forward indefinitely. |
| 35.a. | Azure tax of \$119,000; Sasha \$0 tax. | 46.a. | Ordinary income of \$57,498 and § 1231 gain of \$429,994. |
| 35.b. | Azure tax of \$119,000; Sasha \$15,000 tax. | 46.b. | Section 1231 gain of \$487,492. |
| 35.c. | Azure tax of \$90,500; Sasha \$29,700 tax. | 47.a. | \$430,000. |
| 35.d. | Azure tax of \$0; Sasha \$138,600 tax. | 47.b. | \$355,000. |
| 35.e. | Azure tax of \$0; Sasha \$138,600 tax. | 48. | \$118,500. |
| 36.a. | Taupe tax of \$0; Torsten tax of \$172,320. | 49. | Sell Brown stock and donate proceeds. |
| 36.b. | Taupe tax of \$153,000; Torsten \$0 tax. | 50. | Gift land in 2014. |
| 37.a. | After-tax income \$153,169. | 51. | 2013. |
| 37.b. | After-tax income \$124,875. | 52.a. | \$81,000. |
| 37.c. | After-tax income \$109,407. | 52.b. | \$75,000. |
| 38.a. | \$17,400 itemized deduction. | 53.a. | \$54,000. |
| 38.b. | \$40,000. | 53.b. | (\$12,000). |
| 39.a. | \$49,500. | 54. | Almond \$70,000; Blond \$70,000; Cherry \$63,000. |
| 39.b. | \$40,500. | 55.a. | \$5,422. |
| 39.c. | \$41,750. | 55.b. | \$3,544. |
| 39.d. | \$46,875. | 56. | \$6,217. |
| 40.a. | \$84,000. | 57. | Purple \$11,250; Azul \$96,350; Pink \$4,222,500; Turquoise \$6,650,000; Teal \$45,500. |
| 40.b. | \$33,250. | 58. | Red \$42,325; White \$69,625. |
| 41.a. | \$440,000. | 59. | April 15, \$59,500; June 15, \$212,500; September 15, \$136,000; December 15, \$136,000. |
| 41.b. | \$460,000. | 60. | Taxable income of \$150,000. |
| 42.a. | \$10,500. | 61. | Taxable income of \$265,000. |
| 42.b. | \$12,500. | 62. | \$1,032,260. |
| 43.a. | \$105,000 taxable income; \$24,200 tax. | | |
| 43.b. | \$90,000 taxable income; \$18,850 tax. | | |
| 44.a. | \$21,000 deducted 2013; \$19,000 carried forward to 2014. | | |

DISCUSSION QUESTIONS

1. You should ask questions that will enable you to assess both tax and nontax factors that will affect the entity choice. Some relevant questions are addressed in the following table, although there are many additional possibilities.

Question	Reason for the question
What type of business are you going to operate?	This question will provide information that may affect the need for limited liability, ability to raise capital, ease of transferring interests in the business, how long the business will continue, and how the business will be managed.
What amount and type of income (loss) do you expect from the business?	Income from a business will eventually be reported on the tax returns of the owners.
What is the amount and type of income (loss) that you expect from other sources?	For example, income (loss) from a partnership, S corporation, or LLC will “flow through” to the owners. Dividends from a C corporation must be reported on the tax returns of the shareholders. Any income (loss) from other sources will also be reported on the returns of the owners. Thus, for planning purposes, it is important to know all sources and types of income (loss) that the owners will have.
Do you expect to have losses in the early years of the business?	Losses of partnerships, S corporations, and LLCs flow through to the owners and represent potential deductions on their individual returns. Losses of a C corporation do not flow through.
Will you withdraw profits from the business or leave them in the business so it can grow?	Profits from a partnership, S corporation, or LLC will “flow through” to the owners, and will be subject to taxation on their individual tax returns. Profits of a C corporation must be reported on the tax returns of the shareholders only if such profits are paid out to shareholders as dividends. Thus, in the case of a partnership, S corporation, or LLC, owners must pay tax on profits before plowing funds back into the business. In the case of a C corporation, the corporation must pay tax on its profits.
In what state(s) will the business be formed?	States assess business taxes (e.g., corporate income tax, franchise tax) on various forms of entities, including some that apply to S corporations, partnerships, and/or LLCs.

pp. 2-2 to 2-8

2. C corporations are separate taxable entities. Cassowary Corporation will report the operating income and tax-exempt income on its return (Form 1120), resulting in taxable income of \$120,000 for the year. Shareholders are required to report income from a C corporation only to the extent of dividends received; thus, Barbara reports no income from Cassowary for 2013. An S corporation is a tax reporting entity but (generally) not a taxable entity. Instead, its profit (loss) and separately stated items flow through to the shareholders. Emu Corporation will report ordinary business income of \$120,000 and separately stated tax-exempt interest income of \$8,000 on its return (Form 1120S), with 40% of these amounts allocated to Barbara (Schedule K-1). Barbara will report ordinary business income of \$48,000 and tax-exempt interest income of \$3,200 on her individual return (Form 1040). The absence of dividend distributions from Emu Corporation does not affect Barbara's treatment of the income. pp. 2-3 and 2-5
3. Art should consider operating the business as a sole proprietorship (or a single-member LLC) for the first three years. If he works 15 hours per week in the business, he will exceed the minimum number of hours required to be a material participant ($52 \times 15 = 780$) under the passive loss rules. [An individual is treated as materially participating in an activity if he or she participates in the activity for more than 500 hours during the year. Reg. § 1.469-5T(a)(1).] Therefore, he will be able to deduct the losses against his other income. When the business becomes profitable, Art should consider incorporating. If he reinvests the profits in the business, the value of the stock should grow accordingly, and he should be able to sell his stock in the corporation for long-term capital gain. pp. 2-2 to 2-8, 2-38, and 2-39
4. A C corporation is a separate taxable entity (Form 1120), and its taxable income has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Thus, Lava Corporation will have taxable income of \$129,000 (operating income of \$120,000 + STCG of \$9,000). As no dividends were distributed, Abdul has no tax consequences in the current year with respect to Lava Corporation.

Partnerships are tax reporting entities (Form 1065), and the income, gains, deductions, and losses of a partnership are passed through to and reported by the partners on their tax returns. Short-term capital gains of a partnership retain their character when reported by the partners. Distributions (or the lack thereof) typically do not affect the tax treatment of partnership activities. Thus, Abdul will report operating income of \$48,000 ($\$120,000 \times 40\%$ partnership interest) and a STCG of \$3,600 ($\$9,000 \times 40\%$ partnership interest) with respect to Drab Partnership.

pp. 2-2, 2-3, and 2-5

5. If Catbird Company is an LLC: A single-member LLC is taxed as a proprietorship. Thus, Janice will report the \$100,000 operating income (Schedule C), \$15,000 long-term capital gain (Schedule D), and if she itemizes, \$5,000 charitable contribution (Schedule A) on her tax return. The \$70,000 withdrawal would have no effect on Janice's individual tax return.

If Catbird Company is an S corporation: An S corporation is a tax reporting entity (Form 1120S), and its income, gains, deductions, and losses are passed through to and reported by the shareholders on their tax returns. Separately stated items (e.g., long-term capital gain and charitable contribution) retain their character at the shareholder level. Consequently, Janice will report the \$100,000 operating income (Schedule E), \$15,000 long-term capital gain (Schedule D), and if she itemizes, \$5,000 charitable contribution (Schedule A) on her tax return. The \$70,000 withdrawal would have no effect on Janice's individual tax return.

If Catbird Company is a C corporation: A C corporation is a separate taxable entity, and its taxable income has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Thus, Catbird Company will report taxable income of \$110,000 (\$100,000 operating income + \$15,000 LTCG – \$5,000 charitable contribution) on its Form 1120. Corporations receive no preferential tax rate on long-term capital gains. Janice will report dividend income of \$70,000 (Schedule B) on her individual tax return.

pp. 2-2 to 2-8, 2-11, and 2-16

6.
 - If Joel buys the warehouse and rents it to the corporation, he can charge the corporation the highest amount of rent that is *reasonable*. The rental operation can help bail some profits out of the corporation and avoid double taxation on corporate income. Joel would have rent income but Manatee would have a deduction for rent expense.
 - The depreciation and other expenses incurred in connection with the warehouse will be deductible by Joel, which should enable him to offset some or all of the rental income. If the rental property produces a loss, Joel can use the loss to offset any passive income he might have.
 - Upon future sale of the warehouse, Joel will not be subject to the § 291 additional depreciation recapture provision that would be applicable to Manatee Corporation.
 - Any § 1231 gain resulting from the sale of the warehouse would qualify for the preferential tax rate on long-term capital gains. C corporations do not receive any preferential tax rate on long-term capital gains.

pp. 2-4, 2-11, and 2-12

7. Double taxation refers to the fact that (for C corporations) income is subject to Federal taxation once at the corporate level and then again at the shareholder level when distributed as dividends. Because there is no corporate deduction for dividend distributions, amounts distributed are subject to two levels of taxation. The preferential tax rate applicable to qualified dividend income tempers the impact of double taxation. For closely held corporations, a common tax planning tool used to minimize double taxation is to generate corporate payments to shareholders that are deductible by the corporation. These payments often take several forms, including compensation, rent/lease, interest, royalties, etc. Transactions between closely held corporations and their shareholders are subject to greater scrutiny by the IRS, and the related payments must be reasonable and arms-length in amount to avoid recharacterization as nondeductible dividend distributions. p. 2-4
8. Yes, most states allow for single-member LLCs. Under the default rules of the check-the-box Regulations, a single-member LLC is taxed as a sole proprietor. A single-member LLC can elect to be taxed instead as a corporation by filing Form 8832 (Entity Classification Election). pp. 2-7 and 2-8
9. The statement is correct. Because no Form 8832 was filed, the LLC will be taxed as a partnership, the default classification for multi-member LLCs under the check-the-box Regulations. A Form 8832 is required to be filed only if the taxpayer wants to elect to have the entity classified as a corporation for Federal tax purposes. p. 2-8
10. In general, the statement is correct. That is, corporate taxpayers generally may choose a calendar year or a fiscal year for reporting purposes. However, the use of a fiscal year is restricted for personal service corporations and S corporations. For such corporations, the

calendar year is the required reporting period, subject to a few limited exceptions (e.g., business purpose for fiscal year can be demonstrated, deferral under a § 444 election). p. 2-10

11. A C corporation is relatively unrestricted as to the choice of accounting periods, and generally may choose either a fiscal year or a calendar year. It is not necessary for a new C corporation to obtain consent of the IRS with regard to its choice of an accounting period. Personal service corporations, however, can elect a fiscal year only under one of the following circumstances:

- A business purpose for the year can be demonstrated.
- The year results in a deferral of not more than three months' income. An election under § 444 is required, and the PSC will be subject to the deduction limitations of § 280H.
- The PSC retained the same year that was used for its fiscal year ending 1987, provided an election was made under § 444 and subject to the deduction limitations of § 280H.

Thus, Salmon Corporation can elect a March 31 fiscal year-end, but Scarlet Corporation would need to satisfy the business purpose exception to qualify for a March 31 fiscal year-end.

p. 2-10

12. In general, a corporation is *not* allowed to use the cash method of accounting for Federal tax purposes. However, S corporations, qualified personal service corporations, and C corporations engaged in the trade or business of farming or timber are exceptions to this rule. Further, a C corporation with \$5 million or less of average gross receipts over the past three years is allowed to use the cash method.

- a. Jade Corporation has \$4.8 million of average gross receipts over the 2010-2012 period. Thus, Jade satisfies the gross receipts exception and may use the cash method of accounting.
- b. Lime Corporation, a PSC, may use the cash method of accounting without regard to its gross receipts.

pp. 2-10 and 2-11

13. A corporation that uses the accrual method cannot claim a deduction for an expense involving a related party (e.g., a more than 50% shareholder) until the recipient reports that amount as income. Lupe, a cash basis taxpayer, must report the \$100,000 bonus in 2014, the year he receives the payment. Jasper Corporation may deduct the \$100,000 bonus in 2014, the year Lupe is required to report it as income. p. 2-11 and Example 12
14. Both corporations and individuals include recognized capital gains in their taxable income. For a corporate taxpayer, there is no preferential tax rate applicable to long-term capital gains. Instead, the capital gain is taxed at Parrot's normal tax rate of 25%. The preferential tax rate of 15% would apply to Jeanette's long-term capital gain. p. 2-11
15. John and Eagle Corporation each net the \$10,000 LTCG against the \$18,000 STCL, resulting in an \$8,000 net capital loss. John reports the capital transactions on his individual tax return, deducts \$3,000 of the net capital loss in the current year, and carries forward to 2014 a \$5,000 STCL for the remainder of the net capital loss. Eagle reports the capital transactions on its corporate tax return, but none of the \$8,000 net capital loss is deductible in the current year. Instead, Eagle carries back a \$8,000 STCL three years and, if necessary, forward 5 years, to be offset against capital gains in such years. pp. 2-11 and 2-12

16. For an individual taxpayer, there is no depreciation recapture under § 1250 with respect to realty placed in service after 1986 and depreciated under the straight-line method. However, under § 291, a C corporation must treat a portion of gain recognized on the disposition of § 1250 property as depreciation recapture (ordinary income). The § 291 ordinary income amount is equal to 20% of the excess of the amount of depreciation recapture that would arise if the property was § 1245 property over the amount of depreciation recapture computed under § 1250 (without regard to § 291). As a result, some of the gain recognized by a C corporation on the sale of the warehouse will be ordinary income (and not § 1231 gain). p. 2-12 and Example 15
17. a. If Osprey is a personal service corporation, it cannot deduct any of the passive loss in the current year. A personal service corporation cannot offset a passive loss against either active or portfolio income.
- b. A closely held corporation that is not a personal service corporation can offset passive losses against net active income but not against portfolio income. Therefore, Osprey can deduct \$100,000 of the passive loss in the current year. The remaining \$20,000 of passive loss is carried forward.
- pp. 2-13 and 2-14
18. A closely held C corporation that is not a personal service corporation can offset a passive loss against net active income, but not against portfolio income. Hummingbird can deduct only \$40,000 of the \$45,000 passive loss. Thus, Hummingbird's taxable income is \$15,000 (\$40,000 + \$15,000 – \$40,000). Example 16
19. In order to be deductible by an accrual basis corporation in the year authorized by its board of directors, a charitable contribution must be paid within 2 1/2 months of the end of the year of authorization (March 15, 2014, in this case). Because payment was not made within the required time period, the charitable contribution is deductible in 2014. p. 2-14
20. The rules for determining the amount of a charitable contribution of property by a C corporation are:
- Loss property (fair market value less than basis) = fair market value.
 - Ordinary income property (property that, if sold, would *not* result in a long-term capital gain or § 1231 gain) = basis.
 - Certain contributions of *inventory* qualifying for increased contribution amount (e.g., contribution of inventory that is related to organization's exempt function and such use is solely for the care of the ill, needy, or infants) = lesser of (1) the sum of the property's basis plus 50% of the appreciation on the property or (2) twice the property's basis.
 - Capital gain property (property that, if sold, would result in a long-term capital gain or § 1231 gain) = fair market value.
 - Contributions of tangible personal property to charitable organization which does not use the property for purpose related to its exempt function = basis.
 - Contributions to certain private foundations = basis.

pp. 2-14 and 2-15

21. The following tax issues should be considered.
- Is Orange an accrual method taxpayer and, if so, will the contribution be made by March 15, 2014, so as to obtain a deduction in 2013?
 - Will the contribution consist of property or cash?
 - If the contribution consists of property, what is the character of the property (capital gain or ordinary income property) and amount of the contribution deduction?
 - What is the current year's taxable income limitation on the deductibility of charitable contributions?
 - In what tax year did the charitable contribution carryover originate and when does the 5-year period for such carryover expire?
 - If the \$45,000 sum of the current year's contribution plus the carryover amount exceeds the taxable income limitation, should the current year's gift be deferred to the subsequent tax year?
- pp. 2-14 to 2-16, 2-39, and 2-40
22. The domestic productions activities deduction is equal to 9% of the *lesser* of the taxpayer's (1) qualified productions activities income or (2) taxable income. However, the deduction cannot exceed 50% of the corporation's W-2 wages related to qualified productions activities income. pp. 2-16 and 2-17
23. As a general rule, an NOL is carried back 2 years and forward 20 years to offset taxable income in such carryover years. However, a taxpayer can (irrevocably) elect to forgo the carryback period and just carry the NOL forward. In determining whether Gold should make the election, some of the relevant issues are:
- What are Gold's marginal tax rates for the carryback years?
 - What effect, if any, would an NOL carryback have on the prior years' tax computations?
 - What is Gold's estimated future marginal tax rate?
 - What is Gold's estimated future taxable income?
 - Are corporate income tax rates anticipated to change in the future?
 - Does Gold have immediate cash flow needs that would favor the carryback approach?
- pp. 2-17 and 2-40
24. Otter Corporation will be allowed a dividends received deduction equal to 70% of the \$15,000 dividend it received from Marmot (subject to taxable income limitation described in Example 27). It will pay tax at the applicable corporate tax rate of 25% on the remaining portion of the dividend. Gerald must include in income the entire \$15,000 dividend he received from Marmot, and he will pay tax at the 15% rate applicable to individuals. Examples 3 and 27
25. A corporation that owns stock in another corporation is allowed a dividends received deduction. The deduction percentage is based on the percentage of ownership that the recipient corporation has in the corporation paying the dividend. Currently, with Mustard's 15% ownership interest in Burgundy, the deduction percentage is 70%. If the stock purchase

increases Mustard's ownership interest in Burgundy to 20% or more, but less than 80%, then the deduction percentage is 80%. If the stock purchase increases Mustard's ownership interest in Burgundy to 80% or more, then the deduction percentage is 100%. p. 2-18

26. In order to claim the dividends received deduction with respect to any stock, the corporation must have held the stock for more than 45 days during the 91-day period beginning on the date that is 45 days before the ex-dividend date (or, in the case of preferred stock, more than 90 days during the 181-day period beginning on the date that is 90 days before the ex-dividend date). p. 2-19 and Footnote 21
27. Cuckoo Corporation's organizational expenditures include legal expenses incurred for drafting of corporate charter and bylaws (option a.), accounting fees incurred in organization (option b.), and expenses of temporary board of directors' organizational meetings (option c.). Startup expenditures include employee salaries incurred during training period before opening for business (option d.). Brokerage fees incurred in stock sales (option e.) are neither organizational expenditures nor startup expenditures. The brokerage fees cannot be deducted but reduce the amount of the capital realized from the sale of stock. pp. 2-20 and 2-21
28. The 35% marginal income tax rate begins at \$10 million of taxable income for a C corporation which is not a PSC. Once a non-PSC's taxable income reaches \$18,333,333, the average income tax rate is 35%. The rate imposed on PSCs is a flat 35% on all taxable income. p. 2-22 and Exhibit 2.1
29. Plum Corporation and Ivory Corporation are members of a controlled group of corporations (related corporations) and subject to a special income tax liability computation. The special computation limits the amount of a controlled group's taxable income that is taxed at rates lower than 35% to that amount the corporations in the group would have if they were one corporation. As a result, Omar's plan will be ineffective in lowering the overall corporate income tax liability of the two corporations. p. 2-23
30. Estimated tax payments are required if the corporation's tax liability is expected to be \$500 or more. The required annual payment (which includes estimated AMT liability) is the *lesser* of (1) 100% of the corporation's tax for the current year or (2) 100% of the corporation's tax for the preceding year. p. 2-24
31. The starting point on Schedule M-1 is net income per books. Additions and subtractions are entered for items that affect net income per books and taxable income differently. An example of an addition is Federal income tax expense, which is deducted in computing net income per books but is disallowed in computing taxable income. An example of a subtraction is a charitable contributions carryover that was deducted for book purposes in a prior year but deducted in the current year for tax purposes.

ADDITIONS

- c. Federal income tax per books
- d. Capital loss in excess of capital gain
- e. Charitable contributions in excess of taxable income limitation
- f. Premiums paid on life insurance policies covering executives (corporation is beneficiary).

SUBTRACTIONS

- a. Life insurance proceeds received upon death of covered executive.
- b. Tax depreciation in excess of book tax depreciation
- g. Domestic production activities deduction

p. 2-25 and Example 35

32. Corporations with total assets of *\$10 million or more* are required to file Schedule M-3; thus, Woodpecker, with \$8.5 million of assets, is not required to file the form. If a Schedule M-3 is filed by Woodpecker, the amortization is reported on line 28, Part III as follows: \$40,000 book amortization in column (a), \$15,000 temporary difference in column (b), and \$55,000 tax return amortization in column (d). p. 2-26 and Example 39

PROBLEMS

33. a. Income, gains, deductions, and losses of a proprietorship are reported on the individual tax return of the sole proprietor (Form 1040). Consequently, Roger reports the \$45,000 net operating profit (\$220,000 operating income – \$175,000 operating expenses) and \$10,000 long-term capital loss on his tax return. The LTCL will be subject to the capital loss limitations applicable to individual taxpayers. Riflebird Company, as a proprietorship, files no entity Federal income tax return for the year.
- b. A C corporation is a separate taxable entity which files a corporate income tax return. Riflebird Company will report taxable income of \$45,000 (\$220,000 operating income – \$175,000 operating expenses) on its Form 1120. A corporation cannot currently deduct a net capital loss. Instead, the LTCL is subject to the corporate capital loss carryover rules (carried back 3 years and forward 5 years, as STCL). Riflebird Company's taxable income has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Therefore, Roger does not report Riflebird's net profit or long-term capital loss on his individual return.

pp. 2-2 to 2-4 and 2-12

34. a. Otter, a partnership, is not a taxpaying entity. Its profit (loss) and separate items flow through to the partners. The partnership's Form 1065 reports net profit of \$110,000 (\$320,000 income – \$210,000 expenses). The partnership also reports the \$15,000 long-term capital gain as a separately stated item on Form 1065. Ellie and Linda each receive a Schedule K-1 reflecting net profit of \$55,000 and separately stated long-term capital gain of \$7,500, which each reports on her own return. The 20/15/0% preferential tax rate applies to the LTCG. The withdrawals do not affect taxable income but decrease their basis in the partnership. Example 2
- b. Otter, an S corporation, is not a taxpaying entity. Its profit (loss) and separate items flow through to the shareholders. The S corporation's Form 1120S reports net profit of \$110,000 (\$320,000 income – \$210,000 expenses). The S corporation also shows the \$15,000 long-term capital gain as a separately stated item on Form 1120S. Ellie and Linda each receive a Schedule K-1 reporting net profit of \$55,000 and separately stated long-term capital gain of \$7,500, which each reports on her own return (subject to capital loss limitation). The 20/15/0% preferential tax rate applies to the LTCG. The withdrawals do not affect taxable income but decrease their basis in the S corporation. p. 2-3
- c. Otter, a C corporation, is a taxpaying entity. Otter's Form 1120 reports taxable income of \$125,000 (\$320,000 income – \$210,000 expenses + \$15,000 LTCG). Corporations do not received a preferential tax rate on LTCG income. Ellie and Linda report dividend income of \$25,000 each. The dividend income is subject to the normal preferential rate. pp. 2-3, 2-4, 2-11, and Example 3
35. a. Azure Company, as a C corporation, has taxable income of \$350,000 and corporate income tax of \$119,000 [$\$350,000 \times 34\%$ (see Exhibit 2.1)]. The exclusion for

municipal bond interest applies to C corporations. Since Sasha received no dividends or salary from Azure during the year, she is not currently taxed on any the corporation's income.

- b. Since dividend distributions are not deductible, the income tax consequences to Azure Company, a C corporation, are the same as in a. above (i.e., corporate income tax of \$119,000). Sasha incurs income tax of \$15,000 ($\$75,000 \times 20\%$) with respect to the dividends she received during the year.
- c. The salary paid to Sasha is deductible by Azure Company, resulting in taxable income of \$275,000 ($\$350,000$ net operating income – $\$75,000$ salary), and corporate income tax of \$90,500 (see Exhibit 2.1). Sasha incurs income tax of \$29,700 ($\$75,000 \times 39.6\%$) with respect to the salary she received during the year.
- d. There is no Federal income tax applicable to businesses formed as sole proprietorships. Instead, the income and expenses of a proprietorship retain their character and are reported on the individual income tax return of the proprietor. Sasha therefore incurs income tax of \$138,600 ($\$350,000$ net operating income $\times 39.6\%$ marginal tax rate) with respect to Azure Company.
- e. The result would be the same as in d. above. Sasha must pay tax on the net operating income of Azure Company, regardless of the amount she withdraws.

pp. 2-2 to 2-5 and 2-8

- 36. a. An S corporation is not a taxable entity. Its profit (loss) and separately stated items flow through to the shareholders. Taupe Corporation's Form 1120S reports ordinary business income of \$420,000 and separately stated long-term capital gain of \$30,000. Torsten receives a Schedule K-1 reporting ordinary business income of \$420,000 and separately stated long-term capital gain of \$30,000. Torsten will report ordinary business income of \$420,000 and long-term capital gain of \$30,000 on his individual income tax return (Form 1040), regardless of how much of the income was withdrawn from Taupe. Torsten's income tax liability with respect to the income from Taupe is \$172,320 [$(\$420,000 \text{ ordinary business income} \times 39.6\% \text{ marginal tax rate}) + (\$30,000 \text{ LTCG} \times 20\% \text{ preferential tax rate})$].
- b. A C corporation is a taxable entity, and Taupe Corporation's Form 1120 reports taxable income of \$450,000 ($\$420,000$ ordinary business income + $\$30,000$ LTCG) and income tax of \$153,000 [$\$450,000 \times 34\%$ (see Exhibit 2.1)]. C corporations do not receive any preferential tax rate with respect to long-term capital gains. The taxable income of a C corporation has no effect on the shareholders until such time a dividend is paid. Therefore, Torsten has no tax consequences in 2013 with respect to Taupe Corporation.

pp. 2-3, 2-4, and 2-11

- 37. If Purple Company is a proprietorship, Kirsten must report net income of \$200,000, regardless of the amount she withdraws. If the company is a C corporation, it must pay corporate tax on its taxable income and Kirsten must report any dividends she receives from the company as income.
 - a. Kirsten's after-tax income is computed below:

Income from proprietorship	\$200,000
----------------------------	-----------

- | | |
|--|------------------|
| Less deductions (\$6,100 standard deduction + \$3,900 exemption) | <u>(10,000)</u> |
| Taxable income | <u>\$190,000</u> |
| Tax on \$190,000 (see Appendix A for Tax Rate Schedules) | <u>\$ 46,831</u> |
| After-tax income (\$200,000 – \$46,831) | <u>\$153,169</u> |
- b. Tax on corporation's net income of \$200,000:
Tax on \$200,000 (see Exhibit 2.1) \$ 61,250
- Corporation's after-tax income (\$200,000 – \$61,250) \$138,750
- Kirsten's taxable income (\$138,750 dividend – \$6,100 standard deduction – \$3,900 exemption) \$128,750
- Kirsten's tax on \$128,750 at rates applicable to dividends $[(\$36,250 \times 0\%) + .15(\$128,750 - \$36,250)]$ \$ 13,875
- Kirsten's after-tax income (\$138,750 – \$13,875) \$124,875
- c. The corporation will have taxable income of \$61,250 (\$200,000 net income before compensation deduction – \$138,750 salary). Kirsten will have taxable income of \$128,750 (\$138,750 – \$6,100 standard deduction – \$3,900 exemption). Her tax will be \$29,343, and her after-tax income will be \$109,407 (\$138,750 – \$29,343).

pp. 2-2 to 2-5

38. a. Wilson can claim an itemized deduction of \$17,400 [\$90,000 – \$50,000 (insurance recovery) – \$100 (floor on personal casualty losses) – \$22,500 (10% of \$225,000 AGI)].
- b. Wilson can deduct \$40,000 [\$90,000 – \$50,000 (insurance recovery)]. Corporations are not subject to the \$100 floor or the 10%-of-AGI limitation.

p. 2-9

39. a.

Gross income	\$395,000	
Ordinary deductions	<u>(245,000)</u>	
Taxable income (to owner of proprietorship)	<u>\$150,000</u>	
Tax @ 33%		<u>\$49,500</u>
- b.

Gross income of corporation	\$395,000	
Ordinary deductions	<u>(245,000)</u>	
Salary	<u>(100,000)</u>	
Taxable income	<u>\$ 50,000</u>	
Corporate tax @ 15%		\$ 7,500
Gross income of shareholder		
Salary	\$100,000	
Tax @ 33%		<u>33,000</u>
Total tax		<u>\$40,500</u>
- c.

Gross income of corporation	\$395,000	
Ordinary deductions	<u>(245,000)</u>	
Taxable income	<u>\$150,000</u>	
Corporate tax [\$22,250 + (39% × \$50,000)]		<u>\$41,750</u>

d.	Gross income of corporation	\$395,000	
	Ordinary deductions	(245,000)	
	Salary	<u>(100,000)</u>	
	Taxable income	<u>\$ 50,000</u>	
	Corporate tax @ 15%		\$ 7,500
	Tax paid by shareholder		
	On salary ($\$100,000 \times 33\%$)	\$ 33,000	
	On dividend [$(\$50,000 - \$7,500) \times 15\%$]	<u>6,375</u>	<u>39,375</u>
	Total tax		<u>\$46,875</u>

e. Hoffman, Raabe, Smith, and Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 3, 2013

Mr. Robert Benton
1121 Monroe Street
Ironton, OH 45638

Dear Mr. Benton:

This letter is in response to your inquiry as to the Federal income tax effects of incorporating your business in 2014. I have analyzed the tax results under both assumptions, proprietorship and corporation. I cannot give you a recommendation until we discuss the matter further and you provide me with some additional information. My analysis based on information you have given me to date is presented below.

COMPUTATION 1

Total tax on \$150,000 taxable income if you continue as a proprietorship (33% tax rate)	<u>\$49,500</u>
Total tax if you incorporate:	
Individual tax on \$100,000 salary @ 33%	\$33,000
Corporate tax on \$50,000 corporate taxable income	<u>7,500</u>
Total	<u>\$40,500</u>

Although this analysis appears to favor incorporating, it is important to consider that there will be additional tax on the \$42,500 of income left in the corporation if you withdraw that amount as a dividend in the future, as calculated below:

COMPUTATION 2

After-tax income left in corporation (\$50,000 taxable income – \$7,500 corporate tax)	<u>\$42,500</u>
Tax on \$42,500 @ 15%	<u>\$6,375</u>
Total tax paid if you incorporate (\$40,500 + \$6,375)	<u>\$46,875</u>

Comparison of computations 1 and 2 appears to support incorporating. If you incorporate and recover the income left in the corporation as long-term capital gain from a sale of stock in the future, the total tax cost of incorporating will be the same, as shown in computation 3 below.

COMPUTATION 3

After-tax income left in corporation (\$50,000 taxable income – \$7,500 corporate tax)	<u>\$42,500</u>
Tax on \$42,500 @ 15% LTCG rate	<u>\$6,375</u>
Total tax paid if you incorporate (\$40,500 + \$6,375)	<u>\$46,875</u>

In summary, incorporating appears to be the most attractive option, whether you recover income left in the corporation as capital gain or as dividend income. Keep in mind, however, that there are important nontax and other tax considerations with respect to this decision. We can discuss those issues at our next meeting.

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

Sincerely,

Jon Thomas, CPA

pp. 2-2 to 2-5, 2-39, and Exhibit 2.1

40.
 - a. The salary for the deferral period (October 1 through December 31) must be at least proportionate to the employee's salary received for the prior fiscal year. The amount that Carmine Corporation must pay Juan during the period October 1 through December 31, 2013, to permit Carmine to continue to use its fiscal year without negative tax effects, is \$84,000 ($\$336,000 \times 3/12$). Example 11
 - b. Carmine Corporation, a PSC, is subject to a tax rate of 35% on all of its taxable income. The corporation would pay tax of \$33,250 ($\$95,000 \times 35\%$) for the tax year ending September 30, 2013. To illustrate the negative tax impact of classification as a PSC, compare this amount with to the \$20,550 (see Exhibit 2.1) that a corporation that is not a PSC would pay on taxable income of \$95,000. p. 2-22
41.
 - a. Under the cash method of accounting, the salaries are deductible in the year they are paid by Broadbill. Thus, Broadbill deducts \$440,000 ($\$220,000 \times 2$), the amount of salaries paid by the corporation in 2013. The \$40,000 of salaries paid by Broadbill in 2014 is deductible by the corporation in 2014.
 - b. An accrual method corporation cannot claim a deduction for an accrual with respect to a related party (e.g., more-than-50% shareholder). Instead, the deduction is deferred until such time the recipient reports that amount as income. Thus, Broadbill deducts \$460,000 [$\$220,000$ (salary paid in 2013 to related party Marcia) + $\$240,000$ (salary paid and accrued to unrelated party Zack)]. The \$20,000 of Marcia's 2013 salary that is accrued by Broadbill on December 31, 2013, is deductible by the corporation in 2014 (the year it is paid to Marcia).

Example 12

42. a. Under the check-the-box Regulations, a single-member LLC is treated as a sole proprietorship unless corporate status is elected by filing a proper Form 8332 (Entity Classification Election). If Lemon Company is a proprietorship, then \$10,500 ($\$70,000 \times 15\%$) of individual income tax results in 2013 for Jonathan. The income (or loss) of a proprietorship is reported on the proprietor's individual return (Form 1040). Individuals in the 33% marginal tax bracket receive a preferential tax rate of 15% on LTCGs.
- b. If Lemon is a C corporation, then \$12,500 of corporate income tax results in 2013. Corporations do not receive a preferential tax rate for LTCGs, and such income is taxed at the normal corporate rates resulting in a tax of \$12,500 [$(\$50,000 \times 15\%) + (\$20,000 \times 25\%)$].

p. 2-11 and Exhibit 2.1

43. a. $\$105,000$ taxable income = $\$480,000$ (operating income) – $\$390,000$ (operating expenses) + $\$55,000$ (LTCG) – $\$40,000$ (STCL). The tax on $\$105,000$ of taxable income is $\$24,200$ [$(\$50,000 \times 15\%) + (\$25,000 \times 25\%) + (\$25,000 \times 34\%) + (\$5,000 \times 39\%)$]. Corporations include LTCGs in taxable income and do not receive a preferential tax rate with respect to such income.
- b. $\$90,000$ taxable income = $\$480,000$ (operating income) – $\$390,000$ (operating expenses) + $\$15,000$ (LTCG) – $\$15,000$ (STCL). No deduction is allowed for the $\$25,000$ net capital loss. Instead, the net capital loss is carried back 3 years and forward 5 years. The tax on $\$90,000$ of taxable income is $\$18,850$ [$(\$50,000 \times 15\%) + (\$25,000 \times 25\%) + (\$15,000 \times 34\%)$].

pp. 2-11, 2-12, and Exhibit 2.1

44. a. If Goshawk is a proprietorship, only $\$21,000$ of the $\$40,000$ long-term capital loss can be deducted in 2013. The loss will offset the short-term capital gain of $\$18,000$ first; then, an additional $\$3,000$ of the loss may be utilized as a deduction against ordinary income. The remaining $\$19,000$ net capital loss is carried forward to 2014 and years thereafter until completely deducted. The capital loss carryover retains its character as long term. Example 13
- b. If Goshawk is a C corporation, only $\$18,000$ of the long-term capital loss can be deducted in 2013. The loss deduction is limited to the amount of capital gains ($\$18,000$ STCG). A corporation cannot claim a net capital loss as a deduction against ordinary income. The $\$22,000$ net capital loss can be carried back to the three preceding years to reduce any net capital gains in those years. (The loss is carried back first to the tax year 2010.) Any loss not offset against net capital gains in the three previous years can be carried forward for five years, to offset capital gains in those years. The long-term capital loss will be treated as a short-term capital loss as it is carried back and forward. Example 14

45. a.
- | | |
|-----------------------------|---------------------------|
| Net short-term capital gain | \$ 15,000 |
| Net long-term capital loss | <u>(105,000)</u> |
| Net capital loss | <u><u>(\$ 90,000)</u></u> |

Gorilla cannot deduct the net capital loss of $\$90,000$ on its 2013 return, but must carry it back to the three preceding years, applying it against net capital gains in 2010, 2011, and 2012, in that order. The net capital loss is carried back or forward as a short-term capital loss.

- b. 2013 net capital loss (\$90,000)
- Offset against
- | | |
|-------------------------------------|-----------------|
| 2010 (net long-term capital gains) | \$18,000 |
| 2011 (net short-term capital gains) | 25,000 |
| 2012 (net long-term capital gains) | <u>20,000</u> |
| Total carrybacks | <u>\$63,000</u> |
- c. \$27,000 (\$90,000 – \$63,000) STCL carryforward to 2014, 2015, 2016, 2017, and 2018, in that order.
- d. These transactions are netted with the taxpayer's other capital transactions for 2013. Assuming these are the only capital transactions in 2013, the taxpayer offsets \$15,000 of capital gains against the capital losses and deducts an additional \$3,000 in capital losses. The remaining \$87,000 (\$105,000 – \$15,000 – \$3,000) is carried forward indefinitely (as long-term capital loss).

Examples 13 and 14

46. a. Under § 291, a corporation will incur an additional amount of depreciation recapture (ordinary income) upon a disposition of § 1250 property for a gain. The § 291 adjustment is equal to 20% of the excess of the amount of depreciation recapture that would arise if the property was § 1245 property over the amount of depreciation recapture computed under § 1250 (without regard to § 291).

First, determine the recognized gain:

Sales price		\$850,000
Less adjusted basis:		
Cost of property	\$650,000	
Less cost recovery	<u>(287,492)</u>	<u>(362,508)</u>
Recognized gain		<u>\$487,492</u>

Second, determine the § 1245 recapture potential. This is the lesser of \$487,492 (recognized gain) or \$287,492 (cost recovery claimed).

Third, determine the normal § 1250 recapture amount:

Cost recovery taken	\$287,492
Less straight-line cost recovery	<u>(287,492)</u>
§ 1250 ordinary income	<u>\$ –0–</u>

Fourth, determine the additional § 291 amount:

§ 1245 recapture potential	\$287,492
Less § 1250 recapture amount	<u>(–0–)</u>
Excess § 1245 recapture potential	\$287,492
Apply § 291 percentage	<u>20%</u>
Additional ordinary income under § 291	<u>\$ 57,498</u>

Heron Corporation's recognized gain of \$487,492 is accounted for as follows:

Ordinary income under § 1250	\$ –0–
Ordinary income under § 291	57,498
§ 1231 gain	<u>429,994</u>
Total recognized gain	<u>\$487,492</u>

- b. Heron Company, as a sole proprietorship, is not subject to § 291; instead, the normal depreciation recapture rules apply with respect to the gain recognized on the sale of the realty. The realty is § 1250 property and there is no recapture of depreciation under that provision when straight-line depreciation is used. As such, the entire gain of \$487,492 is treated as § 1231 gain on the tax return of the proprietor of Heron.

Example 15

47. a. A closely held C corporation that is a personal service corporation is subject to the passive activity loss rules and, as a result, Plum cannot deduct any of the \$75,000 passive activity loss in the current year. Therefore, Plum's taxable income is \$430,000 (\$410,000 net active income + \$20,000 portfolio income – \$0 passive activity loss).
- b. A closely held C corporation that is *not* a personal service corporation is subject to the passive loss rules, but it can deduct a passive activity loss against net active income (but not portfolio income). Thus, Plum's taxable income is \$355,000 [\$410,000 (net active income) + \$20,000 (portfolio income) – \$75,000 (passive activity loss)].

Example 16

48. The total amount of Aquamarine's charitable contributions for the year is \$118,500. The painting is capital gain property, but it is tangible personal property which was not used for a purpose related to the qualified organization's exempt function. Thus, the amount of the contribution is limited to the painting's basis, or \$15,000. The Apple stock is capital gain property and the amount of the contribution is the stock's fair market value, or \$90,000. The canned groceries are ordinary income property but the donation qualifies for the enhanced deduction for corporate contributions of inventory. As such, the amount of the contribution of the inventory is equal to the lesser of (1) the sum of the property's basis plus 50% of the appreciation on the property, or (2) twice the property's basis. Thus, the amount of the contribution of the canned groceries is \$13,500 [\$10,000 (basis) + .5(\$17,000 – \$10,000)]. pp. 2-14, 2-15, and Example 22

49. Hoffman, Raabe, Smith, and Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 3, 2013

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

Dear Mr. Thompson:

I have evaluated the proposed alternatives for your 2013 year-end contribution to the University of Maine. I recommend that you sell the Brown Corporation stock and donate the proceeds to the University. The four alternatives are discussed below.

Donation of cash, the unimproved land, or the Brown Corporation stock each will result in a \$200,000 charitable contribution deduction. Donation of the Maize Corporation stock will result in only a \$140,000 charitable contribution deduction.

Contribution of the stock will result in a less desirable outcome from a tax perspective. However, you will benefit in two ways if you sell the stock and give the \$200,000 in proceeds to the University. Donation of the proceeds will result in a \$200,000 charitable contribution deduction. In addition, sale of the land will result in a \$160,000 long-term capital loss. If Jay Corporation had capital gains of at least \$160,000 and paid corporate income tax in the past three years, the entire loss can be carried back and Jay will receive tax refunds for the carryback years. If Jay Corporation had no capital gains in the carryback years, the capital loss can be carried forward and offset against capital gains of the corporation for up to five years.

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

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

Sincerely,

Richard Stinson, CPA

Note to instructor: The land and stock are “unrelated use property” but they are not “tangible personal property.”

pp. 2-12, 2-14, and 2-15

50. Gray Corporation should defer the gift of the land until 2014. This would allow Gray to fully deduct in 2013 the carryover contribution amount of \$75,000. If, instead, Gray gifted the land in 2013, the corporation would lose any otherwise allowable deduction as to the \$75,000 carryover amount. This occurs because current year gifts are applied against the taxable income limitation before application of any carryover amounts. Thus, the taxable income limitation for 2013 would be completely exhausted by the gift of land in 2013. Since 2013 represents the fifth and last year of the carryover period, a gift of the land in 2013 precludes any deduction for the \$75,000. A gift of appreciated land held for more than one year as an investment results in a charitable deduction equal to the land’s fair market value (subject to the taxable income limitation).

Assuming a gift of the land in 2014

2013 taxable income limitation: $10\% \times \$1 \text{ million} = \$100,000$.

2013 charitable contribution deduction: \$75,000 (carryover from 2008 gift).

2014 taxable income limitation: $10\% \times 1.2 \text{ million} = \$120,000$.

2014 charitable contribution deduction: \$120,000 (gift of land; excess contribution of \$130,000 is carried forward for up to 5 years).

Assuming a gift of the land in 2013

2013 taxable income limitation: $10\% \times \$1 \text{ million} = \$100,000$.

2013 charitable contribution deduction: \$100,000 (gift of land; excess contribution of \$150,000 is carried forward for up to 5 years). Carryover from 2008 gift (\$75,000) disappears, as 2013 is the last year of the carryover period.

2014 taxable income limitation: $10\% \times 1.2 \text{ million} = \$120,000$.

2014 charitable contribution deduction: \$120,000 (carryover from 2013 gift; remaining \$30,000 of carryover from 2013 gift carries over to 2015).

pp. 2-14, 2-15, 2-39, and 2-40

51. Hoffman, Raabe, Smith, and Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 17, 2013

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

Dear Mr. Simms:

On December 13 you asked me to advise you on the timing of a contribution by Simms Corporation to the University of Washington. My calculations show that the corporation will maximize its tax savings by making the contribution in 2013.

If the corporation makes the contribution in 2013, it can deduct \$25,000 as a charitable contribution, which will save \$9,750 (39% tax rate \times \$25,000 deduction) in Federal income tax. However, if the corporation makes the contribution in 2014, the percentage limitations applicable to corporations will limit the 2014 deduction to \$10,000 (\$100,000 projected profit \times 10% limit). The corporation will save \$3,400 (34% tax rate \times \$10,000 deduction) in taxes as a result of this deduction. The corporation may carry the remaining \$15,000 forward for five years or until exhausted. If the corporation continues at the 2014 profit level, it will save an additional \$5,100, for a total tax savings of \$8,500.

This analysis makes it clear that the corporation will save \$1,250 more (\$9,750 – \$8,500) if it makes the contribution in 2013. In addition, all of the savings will occur in 2013. If the corporation makes the contribution in 2014, its tax savings will be split among several years. My advice is that the corporation should make the contribution immediately so ownership of the stock can be transferred by December 31.

Sincerely,

Alicia Gomez, CPA

pp. 2-14 and 2-16

52. a. White's domestic production activities deduction is equal to 9% of the lesser of:

- taxable income (before DPAD) of \$900,000, or
- qualified production activities income of \$1.2 million.

The tentative deduction is \$81,000 (\$900,000 \times 9%). Because W-2 wages attributable to QPAI were \$200,000, the wage limitation (\$200,000 \times 50% = \$100,000) does not apply. Therefore, White's DPAD is \$81,000.

- b. The wage limitation now applies and White's DPAD is \$75,000 (\$150,000 \times 50%).

pp. 2-16, 2-17, and Example 25

53. a. The key to this question is the relationship between the dividends received deduction and the net operating loss deduction. The dividends received deduction is limited to a percentage of taxable income of the corporation *unless* taking the full dividends

received deduction would cause or increase an NOL. In this case the dividends received deduction is limited to 70% of taxable income.

Gross income		
From operations	\$660,000	
Dividends	<u>240,000</u>	\$900,000
Less: Expenses from operations		<u>(720,000)</u>
Income before the dividends received deduction		\$180,000
Dividends received deduction (70% × \$180,000)		<u>(126,000)</u>
Taxable income		<u>\$ 54,000</u>

The dividends received deduction is limited to 70% of taxable income (before the dividends received deduction) because taking 70% of \$240,000 (\$168,000) would not create a net operating loss. Example 27

- b. If Swallow Corporation owns 26% of Brown Corporation's stock, the percentage for calculating the dividends received deduction would be 80%. Under these circumstances, taking the full dividends received deduction would create an NOL.

Gross income		
From operations	\$660,000	
Dividends	<u>240,000</u>	\$900,000
Less: Expenses from operations		<u>(720,000)</u>
Income before the dividends received deduction		\$180,000
Dividends received deduction (80% × \$240,000)		<u>(192,000)</u>
Net operating loss		<u>(\$ 12,000)</u>

The dividends received deduction is not limited to 80% of taxable income (before the dividends received deduction) because taking 80% of \$240,000 (\$192,000) creates a net operating loss. Example 26

54. Following the procedure used in Example 27 in the text, proceed as follows:

	<u>Almond Corporation</u>	<u>Blond Corporation</u>	<u>Cherry Corporation</u>
<u>Step 1</u>			
70% × \$100,000 (dividend received)	\$70,000		
70% × \$100,000 (dividend received)		\$70,000	
70% × \$100,000 (dividend received)	<u> </u>	<u> </u>	<u>\$70,000</u>
<u>Step 2</u>			
70% × \$200,000 (taxable income before DRD)	\$140,000		
70% × \$50,000 (taxable income before DRD)		\$35,000	
70% × \$90,000 (taxable income before DRD)	<u> </u>	<u> </u>	<u>\$63,000</u>
<u>Step 3</u>			
Lesser of Step 1 or Step 2	\$70,000		\$63,000
Generates a net operating loss	<u> </u>	<u>\$70,000</u>	<u> </u>

Consequently, the dividends received deduction for Almond Corporation is \$70,000 under the general rule. Blond Corporation also claims a dividends received deduction of \$70,000 because a net operating loss results when the Step 1 amount (\$70,000) is subtracted from

100% of taxable income before DRD (\$50,000). Cherry Corporation, however, is subject to the taxable income limitation and is allowed only \$63,000 as a dividends received deduction.

pp. 2-18, 2-19, and Example 27

55. a. For 2013, the deduction for organizational expenditures is \$5,422 { \$5,000 (amount that can be immediately expensed) + [(\$43,000 – \$5,000) ÷ 180 months × 2 months] }. Except for the expenses related to the printing and sale of the stock certificates, all other expenses qualify for the § 248 amortization election. Thus, organizational expenditures total \$43,000 (\$21,000 + \$3,000 + \$19,000). To qualify for the election, the expenditure must be *incurred* before the end of the taxable year in which the corporation begins business. Since the legal fees were incurred in 2013, the \$19,000 qualifies as organizational expenditures.
- b. Organizational expenditures now total \$52,000 (\$21,000 + \$3,000 + \$28,000). Since organizational expenditures exceed \$50,000, the \$5,000 first-year expensing limit is reduced to \$3,000 [\$5,000 – (\$52,000 – \$50,000)]. Thus, the 2013 deduction for organizational expenditures is \$3,544 { \$3,000 (amount that can be immediately expensed) + [(\$52,000 – \$3,000) ÷ 180 months × 2 months] }.

Examples 29 and 43

56. All \$41,500 of the expenditures are startup expenditures. Egret can elect under § 195 to currently write off the first \$5,000 and to amortize the remaining amount of such expenditures over a 180-month period beginning with the month in which it begins business (i.e., July 1, 2013). Thus, Egret's deduction in 2013 for startup expenditures is \$6,217 { \$5,000 + \$1,217 [(\$41,500 – \$5,000) ÷ 180 months × 6 months] }. Egret makes the § 195 election simply by claiming the deduction on its 2013 tax return. (If Egret decides to forgo the § 195 election, the \$41,500 must be capitalized and is deductible only when the corporation ceases to do business and liquidates.) p. 2-21

57. Purple Corporation:

Tax on—\$65,000

Tax on \$50,000 × 15%	\$ 7,500
Tax on \$15,000 × 25%	3,750
Total tax	<u>\$ 11,250</u>

Azul Corporation:

Tax on—\$290,000	
Tax on \$100,000	\$ 22,250
Tax on \$190,000 × 39%	74,100
Total tax	<u>\$ 96,350</u>

Pink Corporation:

Tax on—\$12,350,000	
Tax on \$10 million	\$3,400,000
Tax on \$2,350,000 × 35%	822,500
Total tax	<u>\$4,222,500</u>

Turquoise Corporation:

Tax on \$19,000,000 × 35%	<u>\$6,650,000</u>
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Teal Corporation (a personal service corporation):

Tax on \$130,000 × 35%	<u>\$ 45,500</u>
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p. 2-22, Exhibit 2.1, and Examples 30 and 31

58. Since Red and White are members of a controlled group of corporations, and since they did not consent to an apportionment plan, the marginal tax brackets are apportioned equally to the two entities. As such, Red Corporation's income tax liability is \$42,325 [(\$25,000 × 15%) + (\$12,500 × 25%) + (\$12,500 × 34%) + (\$80,000 × 39%)], and White Corporation's income tax liability is \$69,625 [(\$25,000 × 15%) + (\$12,500 × 25%) + (\$12,500 × 34%) + (\$150,000 × 39%)]. (Note that the combined tax liability of \$111,950 for the two corporations is equal to the tax liability they would have incurred if they were taxed as one corporation with their combined taxable income of \$330,000.) pp. 2-21, 2-22, and Exhibit 2.1
59. Grouse, a large corporation, may use the prior year's tax liability exception only for purposes of its first estimated tax payment for 2013. Any shortfall from not using the current year's (2013) tax liability for the first installment must be paid in conjunction with the second installment payment. As such, Grouse's installment payment dates and amounts are as follows:

<u>Payment</u>	<u>Amount</u>
April 15, 2013	\$ 59,500*
June 15, 2013	212,500**
September 15, 2013	136,000
December 15, 2013	<u>136,000</u>
Total	<u>\$544,000</u>

*Based on preceding year's tax, for first installment only: [\$700,000 taxable income × 34% (see Exhibit 2.1)] = \$238,000 ÷ 4 = \$59,500.

**Based on current year's tax, for remaining installments: [\$1.6 million taxable income × 34% (see Exhibit 2.1)] = \$544,000 ÷ 4 = \$136,000. Second installment must include shortfall from first installment: [\$136,000 + (\$136,000 – \$59,500)] = \$212,500.

Example 34

60. Emerald's net income per books is reconciled to taxable income as follows:

Net income per books (after tax)	\$257,950
Plus:	
Items that decreased net income per books but did not affect taxable income:	
+ Federal income tax per books	41,750
+ Excess of capital losses over capital gains	6,000
+ Interest on loan to purchase tax-exempt bonds	1,500
+ Premiums paid on life insurance policy on life of Albatross's president	<u>7,800</u>
Subtotal	<u>\$315,000</u>

Minus:

Items that increased net income per books
but did not affect taxable income:

– Tax-exempt interest income	(15,000)
– Life insurance proceeds received as a result of the death of the corporate president	<u>(150,000)</u>

Taxable income	<u><u>\$150,000</u></u>
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Example 35

61. Sparrow's net income per books is reconciled to taxable income as follows:

Net income per books (after tax)	\$174,100
Plus:	
Items that decreased net income per books but did not affect taxable income:	
+ Federal income tax per books	86,600
+ Excess of capital loss over capital gains	9,400
+ Interest paid on loan incurred to purchase tax-exempt bonds	1,100
+ Nondeductible meals and entertainment	<u>5,500</u>
Subtotal	\$276,700
Minus:	
Items that increased net income per books but did not affect taxable income:	
– Tax-exempt interest income	(4,500)
– Excess of MACRS over book depreciation	<u>(7,200)</u>
Taxable income	<u><u>\$265,000</u></u>

Example 35

62. Dove's unappropriated retained earnings per books, as of December 31, 2013, is determined as follows:

Balance at beginning of year	\$ 796,010
Plus:	
Net income (loss) per books	<u>386,250</u>
Subtotal	\$1,182,260
Minus:	
Cash dividend distributions	<u>(150,000)</u>
Balance at end of year	<u><u>\$1,032,260</u></u>

Example 36

63. Pelican, Inc., reports the meals and entertainment expenditures on line 11, Part III as follows: book expense of \$10,000 in column (a), permanent difference of (\$5,000) in column (c), and tax return deduction of \$5,000 in column (d). This problem illustrates reporting procedures when book expenses are greater than tax return deductions. It also illustrates the reporting of permanent differences. Example 40
64. Pelican, Inc., reports the fines and penalties on line 12, Part III as follows: book expense of \$50,000 in column (a), permanent difference of (\$50,000) in column (c), and tax return deduction of \$0 in column (d). Further, PGW reports the depreciation on line 31, Part III as follows: book expense of \$245,000 in column (a), temporary difference of \$65,000 in column

(b), and tax return deduction of \$310,000 in column (d). This problem illustrates the Schedule M-3 reporting when book expenses are both more than and less than tax return deductions. It also illustrates the reporting of both temporary and permanent differences. Examples 39 and 40

65. These amounts must be reported on line 32, Part III as follows: \$190,000 book bad debt expense in column (a), (\$130,000) temporary difference in column (b), and \$60,000 tax return bad debt expense in column (d). This problem illustrates reporting procedures when book expenses are greater than tax return deductions. It also illustrates the reporting of temporary differences. Example 40
66. Organizational expenditures and startup expenditures were incurred in January, February, and March. For both types of expenditures, the corporation can elect to expense the first \$5,000 of qualifying expenditures and amortize the remaining balance over a period of 180 months. Don and Steve should identify the organizational and startup expenditures that qualify, and decide whether to make the elections. Since the elections are deemed to be made, a decision to forgo either would require a statement to that effect attached to the corporation's return.

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

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

If Don and Steve are family members (e.g., brothers) as defined under § 267 and the corporation selects the accrual method of accounting, the accrued bonuses will not be deductible until the year of payment. If the payment date is not changed, the deduction for bonuses will be disallowed, which could result in underpayment of estimated payments, which would result in a penalty.

pp. 2-10, 2-11, 2-20, 2-21, and 2-42

Problem 1: Pet Kingdom Corporate Tax Return

Form 1120 Department of the Treasury Internal Revenue Service	U.S. Corporation Income Tax Return For calendar year 2012 or tax year beginning _____, ending _____ <small>Information about Form 1120 and its separate instructions is at www.irs.gov/form1120.</small>	OMB No. 1545-0123 <div style="font-size: 2em; font-weight: bold;">2012</div>
A Check if: 1a Consolidated return (attach Form 851) <input type="checkbox"/> b Life/nonlife consolidated return <input type="checkbox"/> 2 Personal holding co. (attach Sch. PH) <input type="checkbox"/> 3 Personal service corp. (see instructions) <input type="checkbox"/> 4 Schedule M-3 attached <input checked="" type="checkbox"/>	NAME OR PRINT Name: Pet Kingdom, Inc. Number, street, and room or suite no. If a P.O. box, see instructions: 1010 Northwest Parkway City or town: Dallas State: TX ZIP code: 75255	B Employer identification number 11-1111111 C Date incorporated 11/1/2006 D Total assets (see instructions) \$ 12,900,445
E Check if: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change		
Income	1a Gross receipts or sales 1a 6,900,000 1b Returns and allowance 1b 240,000 c Balance. Subtract line 1b from line 1a 1c 6,660,000 2 Cost of goods sold (attach Form 1125-A) 2 2,760,000 3 Gross profit. Subtract line 2 from line 1c 3 3,900,000 4 Dividends (Schedule C, line 19) 4 52,500 5 Interest 5 24,000 6 Gross rents 6 7 Gross royalties 7 8 Capital gain net income (attach Schedule D (Form 1120)) 8 9 Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797) 9 10 Other income (see instructions—attach statement) 10 11 Total income. Add lines 3 through 10 11 3,976,500	
Deductions (See instructions for limitations on deductions.)	12 Compensation of officers (see instructions—attach Form 1125-E) 12 630,000 13 Salaries and wages (less employment credits) 13 870,000 14 Repairs and maintenance 14 168,000 15 Bad debts 15 16 Rents 16 129,000 17 Taxes and licenses 17 285,000 18 Interest 18 261,000 19 Charitable contributions 19 45,000 20 Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562) 20 165,000 21 Depletion 21 22 Advertising 22 69,000 23 Pension, profit-sharing, etc., plans 23 24 Employee benefit programs 24 72,000 25 Domestic production activities deduction (attach Form 8903) 25 26 Other deductions (attach statement) 26 27 Total deductions. Add lines 12 through 26 27 2,694,000 28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11 28 1,282,500 29a Net operating loss deduction (see instructions) 29a 29b Special deductions (Schedule C, line 20) 29b 36,750 29c Add lines 29a and 29b 29c 36,750	
Tax, Refundable Credits, and Payments	30 Taxable income. Subtract line 29c from line 28 (see instructions) 30 1,245,750 31 Total tax (Schedule J, Part I, line 11) 31 423,555 32 Total payments and refundable credits (Schedule J, Part II, line 21) 32 428,000 33 Estimated tax penalty (see instructions). Check if Form 2220 is attached <input type="checkbox"/> 33 34 Amount owed. If line 32 is smaller than the total of lines 31 and 33, enter amount owed 34 0 35 Overpayment. If line 32 is larger than the total of lines 31 and 33, enter amount overpaid 35 4,445 36 Enter amount from line 35 you want: Credited to 2013 estimated tax Refunded 36 4,445	
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.		
Sign Here Signature of officer _____ Date _____ Title _____	May the IRS discuss this return with the preparer shown below (see instructions)? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	
Paid Preparer Use Only Print/Type preparer's name _____ Preparer's signature _____ Date _____ Firm's name _____ Firm's EIN _____ Firm's address _____ Phone no. _____ City _____ State _____ ZIP code _____	Check <input type="checkbox"/> if self-employed PTIN _____	

For Paperwork Reduction Act Notice, see separate instructions.

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HTA

Form 1120 (2012) Pet Kingdom, Inc.

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Schedule C Dividends and Special Deductions (see instructions)		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)	52,500	70	36,750
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	0
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructions	0
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	0
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	0
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	0
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	0
8	Dividends from wholly owned foreign subsidiaries		100	0
9	Total. Add lines 1 through 8. See instructions for limitation			36,750
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	0
11	Dividends from affiliated group members		100	0
12	Dividends from certain FSCs		100	0
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	Total dividends. Add lines 1 through 17. Enter here and on page 1, line 4 ▶	52,500		
20	Total special deductions. Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			36,750

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Schedule J Tax Computation and Payment (see instructions)**Part I—Tax Computation**

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120))	<input type="checkbox"/>	
2	Income tax. Check if a qualified personal service corporation (see instructions)	<input type="checkbox"/>	2 423,555
3	Alternative minimum tax (attach Form 4626)		3
4	Add lines 2 and 3		4 423,555
5a	Foreign tax credit (attach Form 1118)	5a	
b	Credit from Form 8834, line 30 (attach Form 8834)	5b	
c	General business credit (attach Form 3800)	5c	
d	Credit for prior year minimum tax (attach Form 8827)	5d	
e	Bond credits from Form 8912	5e	
6	Total credits. Add lines 5a through 5e	6	0
7	Subtract line 6 from line 4	7	423,555
8	Personal holding company tax (attach Schedule PH (Form 1120))	8	
9a	Recapture of investment credit (attach Form 4255)	9a	
b	Recapture of low-income housing credit (attach Form 8611)	9b	
c	Interest due under the look-back method—completed long-term contracts (attach Form 8697)	9c	
d	Interest due under the look-back method—income forecast method (attach Form 8866)	9d	
e	Alternative tax on qualifying shipping activities (attach Form 8902)	9e	
f	Other (see instructions—attach statement)	9f	
10	Total. Add lines 9a through 9f	10	0
11	Total tax. Add lines 7, 8, and 10. Enter here and on page 1, line 31.	11	423,555

Part II—Payments and Refundable Credits

12	2011 overpayment credited to 2012	12	
13	2012 estimated tax payments	13	428,000
14	2012 refund applied for on Form 4466	14	()
15	Combine lines 12, 13, and 14	15	428,000
16	Tax deposited with Form 7004	16	
17	Withholding (see instructions)	17	
18	Total payments. Add lines 15, 16, and 17	18	428,000
19	Refundable credits from:		
a	Form 2439	19a	
b	Form 4136	19b	
c	Form 8827, line 8c	19c	
d	Other (attach statement—see instructions)	19d	
20	Total credits. Add lines 19a through 19d	20	0
21	Total payments and credits. Add lines 18 and 20. Enter here and on page 1, line 32	21	428,000

Schedule K Other Information (see instructions)

1	Check accounting method: a <input type="checkbox"/> Cash b <input checked="" type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) _____	Yes	No
2	See the instructions and enter the:		
a	Business activity code no. <u>453910</u>		
b	Business activity <u>Retail Trade</u>		
c	Product or service <u>Pet and Pet Supplies Store</u>		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidary controlled group? If "Yes," enter name and EIN of the parent corporation _____		X
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		X
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G)	X	

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Schedule K Other Information *continued* (see instructions)

				Yes	No
5 At the end of the tax year, did the corporation:					
a Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on Form 851 , Affiliations Schedule? For rules of constructive ownership, see instructions.					X
If "Yes," complete (i) through (iv) below.					
(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock		
b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions.					X
If "Yes," complete (i) through (iv) below.					
(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Country of Organization	(iv) Maximum Percentage Owned in Profit, Loss, or Capital		
6 During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.)					X
If "Yes," file Form 5452 , Corporate Report of Nondividend Distributions.					
If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.					
7 At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of (a) the total voting power of all classes of the corporation's stock entitled to vote or (b) the total value of all classes of the corporation's stock?					X
For rules of attribution, see section 318. If "Yes," enter:					
(i) Percentage owned ▶ and (ii) Owner's country ▶					
(c) The corporation may have to file Form 5472 , Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ▶					
8 Check this box if the corporation issued publicly offered debt instruments with original issue discount					<input type="checkbox"/>
If checked, the corporation may have to file Form 8281 , Information Return for Publicly Offered Original Issue Discount Instruments.					
9 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ \$				18,000	
10 Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶				2	
11 If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here					<input type="checkbox"/>
If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.					
12 Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ▶ \$					
13 Are the corporation's total receipts (line 1c plus lines 4 through 10 on page 1) for the tax year and its total assets at the end of the tax year less than \$250,000?					X
If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ▶ \$					
14 Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement (see instructions)?					X
If "Yes," complete and attach Schedule UTP.					
15a Did the corporation make any payments in 2012 that would require it to file Form(s) 1099?				X	
b If "Yes," did or will the corporation file required Forms 1099?				X	
16 During this tax year, did the corporation have an 80% or more change in ownership, including a change due to redemption of its own stock?					X
17 During or subsequent to this tax year, but before the filing of this return, did the corporation dispose of more than 65% (by value) of its assets in a taxable, non-taxable, or tax deferred transaction?					X
18 Did the corporation receive assets in a section 351 transfer in which any of the transferred assets had a fair market basis or fair market value of more than \$1 million?					X

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Pet Kingdom, Inc.

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Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
Assets					
1	Cash		1,056,000		748,000
2a	Trade notes and accounts receivable	1,815,000		2,021,000	
b	Less allowance for bad debts	()	1,815,000	()	2,021,000
3	Inventories		3,300,000		3,636,000
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)		330,000		330,000
6	Other current assets (attach statement)		385,000		389,445
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)		990,000		990,000
10a	Buildings and other depreciable assets	4,805,000		4,805,000	
b	Less accumulated depreciation	(727,000)	4,078,000	(847,000)	3,958,000
11a	Depletable assets				
b	Less accumulated depletion	()	0	()	0
12	Land (net of any amortization)		715,000		715,000
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	()	0	()	0
14	Other assets (attach statement)		123,000		113,000
15	Total assets		12,792,000		12,900,445
Liabilities and Shareholders' Equity					
16	Accounts payable		2,035,000		1,837,000
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach statement)		213,000		184,000
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more		4,550,000		4,322,000
21	Other liabilities (attach statement)				
22	Capital stock: a Preferred stock				
	b Common stock	3,000,000	3,000,000	3,000,000	3,000,000
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach statement)				
25	Retained earnings—Unappropriated		2,994,000		3,557,445
26	Adjustments to shareholders' equity (attach statement)				
27	Less cost of treasury stock		()		()
28	Total liabilities and shareholders' equity		12,792,000		12,900,445

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return

Note: Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more—see instructions

1	Net income (loss) per books		7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books			Tax-exempt interest \$	0
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize):	0			
5	Expenses recorded on books this year not deducted on this return (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
a	Depreciation \$		a	Depreciation \$	
b	Charitable contributions \$		b	Charitable contributions \$	
c	Travel and entertainment \$				0
		0			
6	Add lines 1 through 5	0	9	Add lines 7 and 8	0
			10	Income (page 1, line 28)—line 6 less line 9	0

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year	2,994,000	5	Distributions: a Cash	300,000
2	Net income (loss) per books	863,445		b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	
		0			
4	Add lines 1, 2, and 3	3,857,445	7	Add lines 5 and 6	300,000
			8	Balance at end of year (line 4 less line 7)	3,557,445

Form 1120 (2012)

Form 1125-A (Rev. December 2012) Department of the Treasury Internal Revenue Service	Cost of Goods Sold ▶ Attach to Form 1120, 1120-C, 1120-F, 1120S, 1065, or 1065-B. ▶ Information about Form 1125-A and its instructions is at www.irs.gov/form1125a.	OMB No. 1545-2225
Name Pet Kingdom, Inc.		Employer identification number 11-1111111
1 Inventory at beginning of year	1	3,300,000
2 Purchases	2	3,096,000
3 Cost of labor	3	
4 Additional section 263A costs (attach schedule)	4	
5 Other costs (attach schedule)	5	
6 Total. Add lines 1 through 5	6	6,396,000
7 Inventory at end of year	7	3,636,000
8 Cost of goods sold. Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return (see instructions)	8	2,760,000
9 a Check all methods used for valuing closing inventory:		
(i) <input type="checkbox"/> Cost		
(ii) <input checked="" type="checkbox"/> Lower of cost or market		
(iii) <input type="checkbox"/> Other (Specify method used and attach explanation.) ▶ _____		
b Check if there was a writedown of subnormal goods ▶ <input type="checkbox"/>		
c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ <input type="checkbox"/>		
d If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO 9d _____		
e If property is produced or acquired for resale, do the rules of section 263A apply to the entity (see instructions)? . . . <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No		
f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No		

**SCHEDULE G
(Form 1120)**(Rev. December 2011)
Department of the Treasury
Internal Revenue Service**Information on Certain Persons Owning the
Corporation's Voting Stock**▶ Attach to Form 1120.
▶ See instructions on page 2.

OMB No. 1545-0123

Name

Employer identification number (EIN)

Pet Kingdom, Inc.

11-1111111

Part I**Certain Entities Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4a).

Complete columns (i) through (v) below for any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Percentage Owned in Voting Stock

Part II**Certain Individuals and Estates Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4b). Complete columns (i) through (iv) below for any individual or estate that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

(i) Name of Individual or Estate	(ii) Identifying Number (if any)	(iii) Country of Citizenship (see instructions)	(iv) Percentage Owned in Voting Stock
Janet Morton	123-45-6789	United States	50.000%
Kim Wong	987-65-4321	United States	50.000%

For Paperwork Reduction Act Notice,
see the Instructions for Form 1120.
1833

Schedule G (Form 1120) (Rev. 12-2011)

OMB No. 1545-0123

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1120 or 1120-C. ▶ Information about Schedule M-3 (Form 1120) and its separate instructions is available at www.irs.gov/form1120.

2012

Name of corporation (common parent, if consolidated return)

Employer identification number

Pet Kingdom, Inc.

11-11111111

Check applicable box(es): (1) ☒ Non-consolidated return (2) ☐ Consolidated return (Form 1120 only)
(3) ☐ Mixed 1120/L/PC group (4) ☐ Dormant subsidiaries schedule attached

Part I Financial Information and Net Income (Loss) Reconciliation (see instructions)

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year? <input type="checkbox"/> Yes. Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K. <input checked="" type="checkbox"/> No. Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.	
b Did the corporation prepare a certified audited non-tax-basis income statement for that period? <input type="checkbox"/> Yes. Skip line 1c and complete lines 2a through 11 with respect to that income statement. <input checked="" type="checkbox"/> No. Go to line 1c.	
c Did the corporation prepare a non-tax-basis income statement for that period? <input checked="" type="checkbox"/> Yes. Complete lines 2a through 11 with respect to that income statement. <input type="checkbox"/> No. Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4a.	
2a Enter the income statement period: Beginning <u>1/1/2012</u> Ending <u>12/31/2012</u>	
b Has the corporation's income statement been restated for the income statement period on line 2a? <input type="checkbox"/> Yes. (If "Yes," attach an explanation and the amount of each item restated.) <input checked="" type="checkbox"/> No.	
c Has the corporation's income statement been restated for any of the five income statement periods preceding the period on line 2a? <input checked="" type="checkbox"/> Yes. (If "Yes," attach an explanation and the amount of each item restated.) <input type="checkbox"/> No.	
3a Is any of the corporation's voting common stock publicly traded? <input type="checkbox"/> Yes. <input checked="" type="checkbox"/> No. If "No," go to line 4a.	
b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock 	
c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock 	
4a Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4a 863,445
b Indicate accounting standard used for line 4a (see instructions): (1) <input type="checkbox"/> GAAP (2) <input type="checkbox"/> IFRS (3) <input type="checkbox"/> Statutory (4) <input type="checkbox"/> Tax-basis (5) <input type="checkbox"/> Other (specify) _____	
5a Net income from nonincludible foreign entities (attach statement)	5a ()
b Net loss from nonincludible foreign entities (attach statement and enter as a positive amount)	5b
6a Net income from nonincludible U.S. entities (attach statement)	6a ()
b Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	6b
7a Net income (loss) of other includible foreign disregarded entities (attach statement)	7a
b Net income (loss) of other includible U.S. disregarded entities (attach statement)	7b
c Net income (loss) of other includible entities (attach statement)	7c
8 Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	8
9 Adjustment to reconcile income statement period to tax year (attach statement)	9
10a Intercompany dividend adjustments to reconcile to line 11 (attach statement)	10a
b Other statutory accounting adjustments to reconcile to line 11 (attach statement)	10b
c Other adjustments to reconcile to amount on line 11 (attach statement)	10c
11 Net income (loss) per income statement of includible corporations. Combine lines 4 through 10	11 863,445
Note. Part I, line 11, must equal the amount on Part II, line 30, column (a), and Schedule M-2, line 2.	
12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines.	

Schedule M-3 (Form 1120) 2012

Page **2**

Name of corporation (common parent, if consolidated return)

Employer identification number

Pet Kingdom, Inc.

11-1111111

Check applicable box(es): (1) ☐ Consolidated group (2) ☐ Parent corp (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corp (5) ☐ Mixed 1120/LPC groupCheck if a sub-consolidated: (6) ☐ 1120 group (7) ☐ 1120 eliminations

Name of subsidiary (if consolidated return)

Employer identification number

Part II **Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return** (see instructions)

Income (Loss) Items (Attach schedules for lines 1 through 11)		(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1	Income (loss) from equity method foreign corporations				
2	Gross foreign dividends not previously taxed				
3	Subpart F, QEF, and similar income inclusions				
4	Section 78 gross-up				
5	Gross foreign distributions previously taxed				
6	Income (loss) from equity method U.S. corporations				
7	U.S. dividends not eliminated in tax consolidation				
8	Minority interest for includible corporations				
9	Income (loss) from U.S. partnerships				
10	Income (loss) from foreign partnerships				
11	Income (loss) from other pass-through entities				
12	Items relating to reportable transactions (attach statement)				
13	Interest income (attach Form 8916-A)	42,000		(18,000)	24,000
14	Total accrual to cash adjustment				
15	Hedging transactions				
16	Mark-to-market income (loss)				
17	Cost of goods sold (attach Form 8916-A)	(2,760,000)			(2,760,000)
18	Sale versus lease (for sellers and/or lessors)				
19	Section 481(a) adjustments				
20	Unearned/deferred revenue				
21	Income recognition from long-term contracts				
22	Original issue discount and other imputed interest				
23a	Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b	Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c	Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d	Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e	Abandonment losses				
f	Worthless stock losses (attach statement)				
g	Other gain/loss on disposition of assets other than inventory				
24	Capital loss limitation and carryforward used				
25	Other income (loss) items with differences (attach statement)				
26	Total income (loss) items. Combine lines 1 through 25	(2,718,000)	0	(18,000)	(2,736,000)
27	Total expense/deduction items (from Part III, line 38)	(908,055)	(45,000)	482,055	(471,000)
28	Other items with no differences	4,489,500			4,489,500
29a	Mixed groups, see instructions. All others, combine lines 26 through 28	863,445	(45,000)	464,055	1,282,500
b	PC insurance subgroup reconciliation totals				
c	Life insurance subgroup reconciliation totals				
30	Reconciliation totals. Combine lines 29a through 29c	863,445	(45,000)	464,055	1,282,500

Note. Line 30, column (a), must equal the amount on Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

Schedule M-3 (Form 1120) 2012

Schedule M-3 (Form 1120) 2012

Page **3**

Name of corporation (common parent, if consolidated return)

Employer identification number

Pet Kingdom, Inc.

11-1111111

Check applicable box(es): (1) ☐ Consolidated group (2) ☐ Parent corp (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corp (5) ☐ Mixed 1120/LPC groupCheck if a sub-consolidated: (6) ☐ 1120 group (7) ☐ 1120 eliminations

Name of subsidiary (if consolidated return)

Employer identification number

Part III Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items (see instructions)

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense	423,555		(423,555)	
2 U.S. deferred income tax expense				
3 State and local current income tax expense				
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Foreign withholding taxes				
8 Interest expense (attach Form 8916-A)	271,500		(10,500)	261,000
9 Stock option expense				
10 Other equity-based compensation				
11 Meals and entertainment				
12 Fines and penalties				
13 Judgments, damages, awards, and similar costs				
14 Parachute payments				
15 Compensation with section 162(m) limitation				
16 Pension and profit-sharing				
17 Other post-retirement benefits				
18 Deferred compensation				
19 Charitable contribution of cash and tangible property	45,000			45,000
20 Charitable contribution of intangible property				
21 Charitable contribution limitation/carryforward				
22 Domestic production activities deduction				
23 Current year acquisition or reorganization investment banking fees				
24 Current year acquisition or reorganization legal and accounting fees				
25 Current year acquisition/reorganization other costs				
26 Amortization/impairment of goodwill				
27 Amortization of acquisition, reorganization, and start-up costs				
28 Other amortization or impairment write-offs				
29 Section 198 environmental remediation costs				
30 Depletion				
31 Depreciation	120,000	45,000		165,000
32 Bad debt expense				
33 Corporate owned life insurance premiums	48,000		(48,000)	
34 Purchase versus lease (for purchasers and/or lessees)				
35 Research and development costs				
36 Section 118 exclusion (attach statement)				
37 Other expense/deduction items with differences (attach statement)				
38 Total expense/deduction items. Combine lines 1 through 37. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive	908,055	45,000	(482,055)	471,000

Schedule M-3 (Form 1120) 2012

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Form 8916-A Department of the Treasury Internal Revenue Service	Supplemental Attachment to Schedule M-3 ▶ Attach to Schedule M-3 for Form 1065, 1120, 1120-L, 1120-PC, or 1120S. ▶ Information about Form 8916-A and its instructions is at www.irs.gov/form1120 .	OMB No. 1545-2061 <div style="font-size: 2em; font-weight: bold; margin-top: 10px;">2012</div>
Name of common parent Pet Kingdom, Inc.		Employer identification number 11-1111111
Name of subsidiary		Employer identification number

Part I Cost of Goods Sold

Cost of Goods Sold Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 Amounts attributable to cost flow assumptions . . .				
2 Amounts attributable to:				
a Stock option expense				
b Other equity based compensation				
c Meals and entertainment				
d Parachute payments				
e Compensation with section 162(m) limitation				
f Pension and profit sharing				
g Other post-retirement benefits				
h Deferred compensation				
i Section 198 environmental remediation costs				
j Amortization				
k Depletion				
l Depreciation				
m Corporate owned life insurance premiums				
n Other section 263A costs				
3 Inventory shrinkage accruals				
4 Excess inventory and obsolescence reserves				
5 Lower of cost or market write-downs				
6 Other items with differences (attach schedule)				
7 Other items with no differences	2,760,000			2,760,000
8 Total cost of goods sold. Add lines 1 through 7, in columns a, b, c, and d	2,760,000	0	0	2,760,000

For Paperwork Reduction Act Notice, see instructions.

Form **8916-A** (2012)

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Form 8916-A (2012) Pet Kingdom, Inc.

11-1111111 Page **2****Part II Interest Income**

	Interest Income Item	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1	Tax-exempt interest income	18,000		-18,000	
2	Interest income from hybrid securities				
3	Sale/lease interest income				
4a	Intercompany interest income — From outside tax affiliated group				
4b	Intercompany interest income — From tax affiliated group				
5	Other interest income	24,000			24,000
6	Total interest income. Add lines 1 through 5. Enter total on Schedule M-3 (Forms 1120, 1120-PC, and 1120-L), Part II, line 13 or Schedule M-3 (Forms 1065 and 1120S) Part II, line 11.	42,000	0	-18,000	24,000

Part III Interest Expense

	Interest Expense Item	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1	Interest expense from hybrid securities				
2	Lease/purchase interest expense				
3a	Intercompany interest expense — Paid to outside tax affiliated group				
3b	Intercompany interest expense — Paid to tax affiliated group				
4	Other interest expense	271,500		-10,500	261,000
5	Total interest expense. Add lines 1 through 4. Enter total on Schedule M-3 (Form 1120) Part III, line 8; Schedule M-3 (Forms 1120-PC and 1120-L), Part III, line 36; Schedule M-3 (Form 1065) Part III, line 27; or Schedule M-3 (Form 1120S) Part III, line 26.	271,500	0	-10,500	261,000

Form **8916-A** (2012)

Pet Kingdom, Inc.

11-1111111

Line 6, Sch L (1120) - Other Current Assets

		Beginning	End
1	Certificates Of Deposit	385,000	385,000
2	Prepaid Federal Tax		4,445
3	Total other current assets	385,000	389,445

Line 9, Sch L (1120) - Other Investments

		Beginning	End
1	Stock Investment	990,000	990,000
2	Total other investments	990,000	990,000

Line 14, Sch L (1120) - Other Assets

		Beginning	End
1	Other Assets	123,000	113,000
2	Total other assets	123,000	113,000

Problem 2: Kingfisher Corporate Tax Return

Form 1120 Department of the Treasury Internal Revenue Service	U.S. Corporation Income Tax Return For calendar year 2012 or tax year beginning _____, ending _____ <small>Information about Form 1120 and its separate instructions is at www.irs.gov/form1120.</small>	OMB No. 1545-0123 <div style="font-size: 2em; font-weight: bold;">2012</div>
A Check if: 1a Consolidated return (attach Form 851) <input type="checkbox"/> b Life/nonlife consolidated return <input type="checkbox"/> 2 Personal holding co. (attach Sch. PH) <input type="checkbox"/> 3 Personal service corp. (see instructions) <input type="checkbox"/> 4 Schedule M-3 attached <input type="checkbox"/>	TYPE OR PRINT Name Kingfisher Corporation Number, street, and room or suite no. If a P.O. box, see instructions. 1717 Main Street City or town State ZIP code Ely MN 55731	B Employer identification number 11-1111111 C Date incorporated 2/12/2002 D Total assets (see instructions) \$ 1,974,347
E Check if: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change		
Income	1a Gross receipts or sales 1a 1,884,000 b Returns and allowance 1b 64,000 c Balance. Subtract line 1b from line 1a 1c 1,820,000 2 Cost of goods sold (attach Form 1125-A) 2 736,000 3 Gross profit. Subtract line 2 from line 1c 3 1,084,000 4 Dividends (Schedule C, line 19) 4 9,000 5 Interest 5 4,000 6 Gross rents 6 7 Gross royalties 7 8 Capital gain net income (attach Schedule D (Form 1120)) 8 9 Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797) 9 10 Other income (see instructions—attach statement) 10 11 Total income. Add lines 3 through 10 11 1,097,000	
Deductions (See instructions for limitations on deductions.)	12 Compensation of officers (see instructions—attach Form 1125-E) 12 300,000 13 Salaries and wages (less employment credits) 13 232,000 14 Repairs and maintenance 14 45,000 15 Bad debts 15 16 Rents 16 38,000 17 Taxes and licenses 17 68,000 18 Interest 18 10,000 19 Charitable contributions 19 12,000 20 Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562) 20 32,000 21 Depletion 21 22 Advertising 22 5,000 23 Pension, profit-sharing, etc., plans 23 24 Employee benefit programs 24 19,000 25 Domestic production activities deduction (attach Form 8903) 25 26 Other deductions (attach statement) 26 16,000 27 Total deductions. Add lines 12 through 26 27 777,000 28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11 28 320,000 29a Net operating loss deduction (see instructions) 29a b Special deductions (Schedule C, line 20) 29b 6,300 29c 6,300	
Tax, Refundable Credits, and Payments	30 Taxable income. Subtract line 29c from line 28 (see instructions) 30 313,700 31 Total tax (Schedule J, Part I, line 11) 31 105,593 32 Total payments and refundable credits (Schedule J, Part II, line 21) 32 108,000 33 Estimated tax penalty (see instructions). Check if Form 2220 is attached <input type="checkbox"/> 33 34 Amount owed. If line 32 is smaller than the total of lines 31 and 33, enter amount owed 34 0 35 Overpayment. If line 32 is larger than the total of lines 31 and 33, enter amount overpaid 35 2,407 36 Enter amount from line 35 you want: Credited to 2013 estimated tax 36 2,407	
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.		
Sign Here Signature of officer _____ Date _____ Title _____	May the IRS discuss this return with the preparer shown below (see instructions)? <input type="checkbox"/> Yes <input type="checkbox"/> No	
Paid Preparer Use Only Print/Type preparer's name _____ Preparer's signature _____ Date _____ Firm's name _____ Firm's EIN _____ Firm's address _____ Phone no. _____ City _____ State _____ ZIP code _____	Check <input type="checkbox"/> if self-employed PTIN _____	

For Paperwork Reduction Act Notice, see separate instructions.

Form 1120 (2012)

HTA

Form 1120 (2012) Kingfisher Corporation

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Schedule C Dividends and Special Deductions (see instructions)		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)	9,000	70	6,300
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	0
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructions	0
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	0
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	0
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	0
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	0
8	Dividends from wholly owned foreign subsidiaries		100	0
9	Total. Add lines 1 through 8. See instructions for limitation			6,300
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	0
11	Dividends from affiliated group members		100	0
12	Dividends from certain FSCs		100	0
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	Total dividends. Add lines 1 through 17. Enter here and on page 1, line 4 ▶	9,000		
20	Total special deductions. Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			6,300

Form 1120 (2012)

Form 1120 (2012) Kingfisher Corporation

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Schedule J Tax Computation and Payment (see instructions)**Part I—Tax Computation**

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120))	<input type="checkbox"/>	
2	Income tax. Check if a qualified personal service corporation (see instructions)	<input type="checkbox"/>	105,593
3	Alternative minimum tax (attach Form 4626)		
4	Add lines 2 and 3		105,593
5a	Foreign tax credit (attach Form 1118)	5a	
b	Credit from Form 8834, line 30 (attach Form 8834)	5b	
c	General business credit (attach Form 3800)	5c	
d	Credit for prior year minimum tax (attach Form 8827)	5d	
e	Bond credits from Form 8912	5e	
6	Total credits. Add lines 5a through 5e	6	0
7	Subtract line 6 from line 4	7	105,593
8	Personal holding company tax (attach Schedule PH (Form 1120))	8	
9a	Recapture of investment credit (attach Form 4255)	9a	
b	Recapture of low-income housing credit (attach Form 8611)	9b	
c	Interest due under the look-back method—completed long-term contracts (attach Form 8697)	9c	
d	Interest due under the look-back method—income forecast method (attach Form 8866)	9d	
e	Alternative tax on qualifying shipping activities (attach Form 8902)	9e	
f	Other (see instructions—attach statement)	9f	
10	Total. Add lines 9a through 9f	10	0
11	Total tax. Add lines 7, 8, and 10. Enter here and on page 1, line 31.	11	105,593

Part II—Payments and Refundable Credits

12	2011 overpayment credited to 2012	12	
13	2012 estimated tax payments	13	108,000
14	2012 refund applied for on Form 4466	14	()
15	Combine lines 12, 13, and 14	15	108,000
16	Tax deposited with Form 7004	16	
17	Withholding (see instructions)	17	
18	Total payments. Add lines 15, 16, and 17	18	108,000
19	Refundable credits from:		
a	Form 2439	19a	
b	Form 4136	19b	
c	Form 8827, line 8c	19c	
d	Other (attach statement—see instructions)	19d	
20	Total credits. Add lines 19a through 19d	20	0
21	Total payments and credits. Add lines 18 and 20. Enter here and on page 1, line 32	21	108,000

Schedule K Other Information (see instructions)

1	Check accounting method: a <input type="checkbox"/> Cash b <input checked="" type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) _____	Yes	No
2	See the instructions and enter the:		
a	Business activity code no. <u>451110</u>		
b	Business activity <u>Retail Sporting Goods</u>		
c	Product or service <u>Fishing Tackle</u>		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidary controlled group? If "Yes," enter name and EIN of the parent corporation _____		X
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		X
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G)	X	

Form 1120 (2012)

Form 1120 (2012) Kingfisher Corporation

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Schedule K Other Information *continued* (see instructions)

				Yes	No
5 At the end of the tax year, did the corporation:					
a Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on Form 851 , Affiliations Schedule? For rules of constructive ownership, see instructions.					X
If "Yes," complete (i) through (iv) below.					
(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock		
b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions.					X
If "Yes," complete (i) through (iv) below.					
(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Country of Organization	(iv) Maximum Percentage Owned in Profit, Loss, or Capital		
6 During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.)					X
If "Yes," file Form 5452 , Corporate Report of Nondividend Distributions.					
If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.					
7 At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of (a) the total voting power of all classes of the corporation's stock entitled to vote or (b) the total value of all classes of the corporation's stock?					X
For rules of attribution, see section 318. If "Yes," enter:					
(i) Percentage owned ▶ and (ii) Owner's country ▶					
(c) The corporation may have to file Form 5472 , Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ▶					
8 Check this box if the corporation issued publicly offered debt instruments with original issue discount					<input type="checkbox"/>
If checked, the corporation may have to file Form 8281 , Information Return for Publicly Offered Original Issue Discount Instruments.					
9 Enter the amount of tax-exempt interest received or accrued during the tax year				\$	2,500
10 Enter the number of shareholders at the end of the tax year (if 100 or fewer)					2
11 If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here					<input type="checkbox"/>
If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.					
12 Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.)				\$	
13 Are the corporation's total receipts (line 1c plus lines 4 through 10 on page 1) for the tax year and its total assets at the end of the tax year less than \$250,000?					X
If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ▶ \$					
14 Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement (see instructions)?					X
If "Yes," complete and attach Schedule UTP.					
15a Did the corporation make any payments in 2012 that would require it to file Form(s) 1099?				X	
b If "Yes," did or will the corporation file required Forms 1099?				X	
16 During this tax year, did the corporation have an 80% or more change in ownership, including a change due to redemption of its own stock?					X
17 During or subsequent to this tax year, but before the filing of this return, did the corporation dispose of more than 65% (by value) of its assets in a taxable, non-taxable, or tax deferred transaction?					X
18 Did the corporation receive assets in a section 351 transfer in which any of the transferred assets had a fair market basis or fair market value of more than \$1 million?					X

Form **1120** (2012)

Form 1120 (2012) Kingfisher Corporation

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Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
Assets					
1	Cash		384,000		287,780
2a	Trade notes and accounts receivable	547,000		668,000	
b	Less allowance for bad debts	()	547,000	()	668,000
3	Inventories		480,000		569,600
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)		60,000		60,000
6	Other current assets (attach statement)				2,407
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)		180,000		180,000
10a	Buildings and other depreciable assets	192,000		192,000	
b	Less accumulated depreciation	(71,040)	120,960	(103,040)	88,960
11a	Depletable assets				
b	Less accumulated depletion	()	0	()	0
12	Land (net of any amortization)		116,000		116,000
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	()	0	()	0
14	Other assets (attach statement)		2,880		1,600
15	Total assets		1,890,840		1,974,347
Liabilities and Shareholders' Equity					
16	Accounts payable		240,000		220,440
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach statement)		64,240		32,000
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more		168,000		165,000
21	Other liabilities (attach statement)				
22	Capital stock: a Preferred stock				
	b Common stock	400,000	400,000	400,000	400,000
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach statement)				
25	Retained earnings—Unappropriated		1,018,600		1,156,907
26	Adjustments to shareholders' equity (attach statement)				
27	Less cost of treasury stock		()		()
28	Total liabilities and shareholders' equity		1,890,840		1,974,347

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return

Note: Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more—see instructions

1	Net income (loss) per books	202,307	7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books	105,593		Tax-exempt interest \$	2,500
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize):	0			2,500
5	Expenses recorded on books this year not deducted on this return (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
a	Depreciation \$		a	Depreciation \$	
b	Charitable contributions \$		b	Charitable contributions \$	
c	Travel and entertainment \$				0
	State Bond Interest Expense 1,800				
	Life Insurance Premiums 12,800	14,600			
6	Add lines 1 through 5	322,500	9	Add lines 7 and 8	2,500
			10	Income (page 1, line 28)—line 6 less line 9	320,000

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year	1,018,600	5	Distributions: a Cash	64,000
2	Net income (loss) per books	202,307		b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	
		0			
4	Add lines 1, 2, and 3	1,220,907	7	Add lines 5 and 6	64,000
			8	Balance at end of year (line 4 less line 7)	1,156,907

Form 1120 (2012)

Form 1125-A (Rev. December 2012) Department of the Treasury Internal Revenue Service	Cost of Goods Sold ▶ Attach to Form 1120, 1120-C, 1120-F, 1120S, 1065, or 1065-B. ▶ Information about Form 1125-A and its instructions is at www.irs.gov/form1125a.	OMB No. 1545-2225
Name Kingfisher Corporation		Employer identification number 11-1111111
1 Inventory at beginning of year	1	480,000
2 Purchases	2	825,600
3 Cost of labor	3	
4 Additional section 263A costs (attach schedule)	4	
5 Other costs (attach schedule)	5	
6 Total. Add lines 1 through 5	6	1,305,600
7 Inventory at end of year	7	569,600
8 Cost of goods sold. Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return (see instructions)	8	736,000
9 a Check all methods used for valuing closing inventory:		
(i) <input type="checkbox"/> Cost		
(ii) <input checked="" type="checkbox"/> Lower of cost or market		
(iii) <input type="checkbox"/> Other (Specify method used and attach explanation.) ▶ _____		
b Check if there was a writedown of subnormal goods ▶ <input type="checkbox"/>		
c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ <input type="checkbox"/>		
d If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO 9d _____		
e If property is produced or acquired for resale, do the rules of section 263A apply to the entity (see instructions)? . . . <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No		
f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No		

**SCHEDULE G
(Form 1120)**(Rev. December 2011)
Department of the Treasury
Internal Revenue Service**Information on Certain Persons Owning the
Corporation's Voting Stock**▶ Attach to Form 1120.
▶ See instructions on page 2.

OMB No. 1545-0123

Name

Employer identification number (EIN)

Kingfisher Corporation

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Part I **Certain Entities Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4a).

Complete columns (i) through (v) below for any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Percentage Owned in Voting Stock

Part II **Certain Individuals and Estates Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4b). Complete columns (i) through (iv) below for any individual or estate that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

(i) Name of Individual or Estate	(ii) Identifying Number (if any)	(iii) Country of Citizenship (see instructions)	(iv) Percentage Owned in Voting Stock
Nancy Trout	123-45-6789	United States	50.000%
Delores Lake	987-65-4321	United States	50.000%

For Paperwork Reduction Act Notice,
see the Instructions for Form 1120.
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Schedule G (Form 1120) (Rev. 12-2011)

Kingfisher Corporation

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Line 26 (1120) - Other Deductions

1	Legal and professional fees	1	16,000
2	Total other deductions	2	16,000
3	Total deductions less expenses for offsetting credits	3	16,000

Line 6, Sch L (1120) - Other Current Assets

		Beginning	End
1	Prepaid Federal Income Tax	1	2,407
2	Total other current assets	2	0

Line 9, Sch L (1120) - Other Investments

		Beginning	End
1	Certificates Of Deposit	1	80,000
2	Stock Investments	2	100,000
3	Total other investments	3	180,000