

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 \$150,000 (\$400,000 income – \$250,000 expenses). The partnership also reports the \$20,000 tax-exempt interest as a separately stated item on Form 1065. Ellie and Linda each receive a Schedule K-1 reflecting net profit of \$75,000 and separately stated tax-exempt interest of \$10,000, which each reports on her own return. 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 \$150,000 (\$400,000 income – \$250,000 expenses). The S corporation also shows the \$20,000 tax-exempt interest as a separately stated item on Form 1120S. Ellie and Linda each receive a Schedule K-1 reporting net profit of \$75,000 and separately stated tax-exempt interest of \$10,000, which each reports on her own return. 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 \$150,000 (\$400,000 income – \$250,000 expenses). The \$20,000 of tax-exempt interest is excluded from Otter's gross income. Ellie and Linda report dividend income of \$50,000 each. The dividend income is subject to a maximum tax rate of 15%. pp. 2-3, 2-4, and Example 3
35. a. Azure Company, as a C corporation, has taxable income of \$550,000 (\$500,000 net operating income + \$50,000 LTCG), and corporate income tax of \$187,000 [$\$550,000 \times 34\%$ (see Exhibit 2.1)]. C corporations do not receive a preferential tax rate with respect to LTCGs. 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 \$187,000). Sasha incurs income tax of \$15,000 ($\$100,000 \times 15\%$) 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 \$450,000 (\$400,000 net operating income + \$50,000 LTCG), and corporate income tax of \$153,000 [$\$450,000 \times 34\%$ (see Exhibit 2.1)]. Sasha incurs income tax of \$35,000 ($\$100,000 \times 35\%$) 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 \$182,500 [$\$175,000$ ($\$500,000$ net operating income \times 35% marginal tax rate) + \$7,500 (LTCG \times 15% preferential tax rate)] with respect to Azure Company.
- e. The result would be the same as in d. above. Sasha must pay tax on the income of Azure Company, regardless of the amount she withdraws.

36. Losses of a C corporation are not passed through to the shareholders. The corporation may carry net operating losses to other years (back two years, forward 20). Net capital losses of corporations are not deductible in the year incurred, but can be carried back three years or forward five years.

Under the “check-the-box” Regulations, a single-member LLC is treated as a disregarded entity (unless an election is made to be treated as a corporation). In such cases, the LLC is taxed as a proprietorship and its income (loss) is reported on the individual return of the sole member. Operating losses of a proprietorship are deductible if the proprietor is a material participant. Net capital losses are passed through to and reported by the proprietor (subject to capital loss limitation).

- a. The corporation’s losses are subject to the NOL and capital loss carryback provisions. The losses are not passed through to the shareholder.
- b. Chris is a material participant in Orange Company. Chris has enough other income to be in the 35% bracket, so he will not be in a net operating loss situation after deducting the operating loss from Orange Company. In 2010, he can deduct \$223,000 (\$220,000 operating loss + \$3,000 capital loss). In addition, Chris will have a \$32,000 long-term capital loss carryover to 2011.

pp. 2-6, 2-8, and 2-12

38.
 - a. Wilson can claim an itemized deduction of \$4,900 [\$60,000 – \$40,000 (insurance recovery) – \$100 (floor on personal casualty losses) – \$15,000 (10% of \$150,000 AGI)].
 - b. Wilson can deduct \$20,000 [\$60,000 – \$40,000 (insurance recovery)]. Corporations are not subject to the \$100 floor or the 10%-of-AGI limitation.

p. 2-10

41.
 - a. Under the cash method of accounting, the bonuses are deductible in the year they are paid by Pelican, or 2011. Thus, none of the \$165,000 of bonuses is deductible in 2010.
 - b. Under the accrual method of accounting, Pelican deducts in 2010 the \$75,000 bonus paid to Charles but not the \$90,000 bonus paid to Lucinda. An accrual method corporation cannot deduct an accrued obligation outstanding at the end of the year if it relates to a cash method, related party (e.g., more than 50% shareholder). In such cases, the corporation deducts the payment in the year it is included in the related party recipient’s income. Thus, the \$90,000 bonus paid to Lucinda is deductible by Pelican in 2011.

Example 12

43. A corporation cannot deduct a net capital loss in the year incurred. The net capital loss can be carried back for three years and offset against capital gain in the carryback years. If the capital loss is not used up in the carryback years, the excess can be carried forward for five years. Capital gains of corporations are included in taxable income and are not subject to the preferential rate applicable to individuals. Municipal bond interest is excluded from a corporation’s gross income.
- a. $\$400,000$ (operating income) – $\$355,000$ (operating expenses) + $\$60,000$ (LT CG) – $\$60,000$ (STCL) = $\$45,000$ taxable income. No deduction is allowed for the net capital loss.
 - b. $\$400,000$ (operating income) – $\$355,000$ (operating expenses) + $\$100,000$ (LT CG) – $\$95,000$ (STCL) = $\$50,000$ taxable income.

pp. 2-9 and 2-12

47. Condor, a closely held corporation that is not a PSC, may offset \$125,000 of the \$160,000 passive loss against the \$125,000 of active business income. However, it may not offset the remaining \$35,000 of loss against portfolio income.

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

Example 16

48. The deduction for a charitable contribution of ordinary income property, such as inventory, is limited to the basis of the property. However, for certain contributions of inventory by a corporation, the amount of the deduction 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.
- a. A contribution of computers to a church that will sell the computers does *not* qualify for the increased deduction amount. As such, the charitable deduction is limited to Robin's basis in the computers, or \$45,000.
 - b. A contribution to a university that will use the computers in its student computer lab qualifies for the increased deduction amount. Thus, Robin's charitable deduction is equal to \$80,000 [$\$45,000$ (basis) + $.5(\$115,000 - \$45,000)$].
 - c. In this case, the ceiling on the increased deduction amount applies, and Robin's charitable deduction is equal to twice the property's basis, or \$90,000 { $\$90,000$ is less than $\$100,000$ [$\$45,000$ (basis) + $.5(\$155,000 - \$45,000)$ }].

p. 2-15 and Example 21

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

December 1, 2010

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

Dear Mr. Thompson:

I have evaluated the proposed alternatives for your 2010 year-end contribution to the University of Maine. I recommend that you sell the Brown Corporation stock and donate the proceeds to the University. The four alternatives are discussed below.

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

Contribution of the Brown Corporation stock will result in a less desirable outcome from a tax perspective. However, you will benefit in two ways if you sell the Brown stock and give the \$120,000 in proceeds to the University. Donation of the proceeds will result in a \$120,000 charitable contribution deduction. In addition, sale of the stock will result in a \$50,000 long-term capital loss. If Jay Corporation had capital gains of at least \$50,000 and paid corporate income tax in the past three years, the entire loss can be carried back and Jay will receive tax refunds for the carryback years. If Jay 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

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

50. Gray Corporation should defer the gift of the land until 2011. This would allow Gray to fully deduct in 2010 the carryover contribution amount of \$75,000. If, instead, Gray gifted the land in 2010, 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 2010 would be completely exhausted by the gift of land in 2010. Since 2010 represents the fifth and last year of the carryover period, a gift of the land in 2010 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 2011

2010 taxable income limitation: $10\% \times \$1 \text{ million} = \$100,000$.

2010 charitable contribution deduction: \$75,000 (carryover from 2005 gift).

2011 taxable income limitation: $10\% \times 1.2 \text{ million} = \$120,000$.

2011 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 2010

2010 taxable income limitation: $10\% \times \$1 \text{ million} = \$100,000$.

2010 charitable contribution deduction: \$100,000 (gift of land; excess contribution of \$150,000 is carried forward for up to 5 years). Carryover from 2005 gift (\$75,000) disappears, as 2010 is the last year of the carryover period.

2011 taxable income limitation: $10\% \times 1.2 \text{ million} = \$120,000$.

2011 charitable contribution deduction: \$120,000 (carryover from 2010 gift; remaining \$30,000 of carryover from 2010 gift carries over to 2012).

pp. 2-15, 2-16, and 2-37

52. a. Flamingo's domestic production activities deduction for 2010 is equal to 9% of the lesser of:
- taxable income (before DPAD) of \$850,000, or
 - qualified production activities income of \$740,000.
- The tentative deduction is \$66,600 ($\$740,000 \times 9\%$). Because W-2 wages attributable to QPAI were \$150,000, the wage limitation ($\$150,000 \times 50\% = \$75,000$) does not apply. Therefore, Flamingo's DPAD for 2010 is \$66,600.
- b. The wage limitation now applies and Flamingo's DPAD for 2010 is \$60,000 ($\$120,000 \times 50\%$).

pp. 2-16 , 2-17, and Example 24

53. a. The net operating loss is computed as follows.

Gross income		
From operations	\$300,000	
Dividends	<u>150,000</u>	\$450,000
Less:		
Expenses from operations	\$375,000	
Dividends received deduction	<u>105,000</u>	<u>(480,000)</u>
Net operating loss		<u>(\$ 30,000)</u>

The dividends received deduction is not limited to 70% of taxable income because it creates a net operating loss. Example 25

- b. The NOL is carried back two years and forward 20 years to offset taxable income in such years. However, Ruby can elect to forgo the carryback and only carry forward the NOL. Example 41
54. Following the procedure used in Example 27 in the text, proceed as follows:

	<u>Green Corporation</u>	<u>Orange Corporation</u>	<u>Yellow 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% × \$150,000 (taxable income before DRD)	\$105,000		
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 Green Corporation is \$70,000 under the general rule. Orange Corporation 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). Yellow 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

56. All \$36,500 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., September 1, 2010). Thus, Egret's deduction in 2010 for startup expenditures is \$5,700 { $\$5,000 + \$700 [(\$36,500 - \$5,000) \div 180 \text{ months} \times 4 \text{ months}]$ }. Egret makes the § 195 election simply by claiming the deduction on its 2010 tax return. (If Egret decides to forgo the § 195 election, the \$36,500 must be capitalized and is deductible only when the corporation ceases to do business and liquidates.) p. 2-21

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 \$22,825 [(\$25,000 × 15%) + (\$12,500 × 25%) + (\$12,500 × 34%) + (\$30,000 × 39%)], and White Corporation's income tax liability is \$50,125 [(\$25,000 × 15%) + (\$12,500 × 25%) + (\$12,500 × 34%) + (\$100,000 × 39%)]. (Note that the combined tax liability of \$72,950 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 \$230,000.) p. 2-23 and Exhibit 2.1

60. 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	4,000
+ Nondeductible penalties	2,000
+ 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	\$315,000
Minus:	
Items that increased net income per books but did not affect taxable income:	
– Tax-exempt interest income	(8,000)
– Life insurance proceeds received as a result of the death of the corporate president	(150,000)
– Excess of tax depreciation over book depreciation	(2,200)
– Domestic production activities deduction	<u>(4,800)</u>
Taxable income	<u>\$150,000</u>

Example 35

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

Net income per books (after tax)	\$119,738
Plus:	
Items that decreased net income per books but did not affect taxable income:	
+ Federal income tax per books	49,862
+ Excess charitable contributions	8,750
+ Interest paid on loan incurred to purchase tax-exempt bonds	3,700
+ Premiums paid on policy on life of president of the corporation	<u>6,250</u>
Subtotal	\$188,300
Minus:	
Items that increased net income per books but did not affect taxable income:	
– Tax-exempt interest income	(7,500)
– Excess of MACRS over book depreciation	<u>(10,000)</u>
Taxable income	<u>\$170,800</u>

Example 35