# 1

## Income Taxation of Corporations

## Solutions to Problem Materials

### DISCUSSION QUESTIONS

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

Naturally, the above classification rules led to a great number of conflicts between the IRS and taxpayers. To simplify this process, the IRS issued regulations effective January 1, 1997 that replace the old rules for classifying entities with a "check-the-box" system. Under the current rules, an entity organized as a corporation under state law, or an entity classified under the Code as a corporation, will be treated as a corporation and will not be allowed to make an election. However, any other business entity (e.g., an LLC) that has at least two members may elect to be treated as a corporation or partnership for tax purposes (an entity with only one member will be treated as a corporation or a sole proprietorship). In general, existing entities will continue to operate as they are as long as there is a reasonable basis for the current classification. (See pp. 1-4 through 1-6.)

1-2 The IRS may try to disregard the corporation if its organization and/or operation is solely to reduce taxes (i.e., a sham). The shareholders may try to ignore the corporation if they want limited liability without double taxation. (See p. 1-6.)

1-3

a. Both corporate and individual taxpayers must include as income all dividends-received. However, corporations are entitled to a 70 percent or more dividends-received deduction in arriving at taxable income. [See pp. 1-8 through 1-13 and § 243(a).]

b. Corporations do not have the dichotomy of deductions between "for" and "from" A.G.I. All allowable deductions are considered in arriving at taxable income. (See p. 1-8.)

c. Corporate casualty losses are not reduced by the $100 statutory floor and 10 percent of A.G.I. (See p. 1-8.)

d. Corporations are limited to a charitable contribution deduction of 10 percent of taxable income without reduction for charitable contributions, the dividends-received deduction, NOL carrybacks, and capital loss carrybacks, instead of 20, 30, or 50 percent of A.G.I. [See pp. 1-16 through 1-18 and § 170(b)(2).]

e. Like individual taxpayers, corporations must include the full amount of net long-term capital gains in income. Unlike individuals who have a maximum rate of 15 percent on net long-term capital gains, corporations must compute the tax on such gains at their regular tax rates. (See p. 1-19.)

f. Corporate capital losses may only be used to reduce capital gains. (See pp. 1-19 and 1-20.)

g. Corporations are limited to a three-year back and five-year forward carryover of capital losses. All carryovers are deemed short-term losses. Individuals are not permitted a capital loss carryback but may carry forward capital losses indefinitely, and such losses retain their identity as short-term or long-term losses. (See pp. 1-19 and 1-20.)

h. Corporations generally compute the amount of § 1245 and § 1250 ordinary income recapture on the sales of depreciable assets in the same manner as do individuals. However, for sales of depreciable residential real property, § 291 requires corporate taxpayers to treat as ordinary income 20 percent of any § 1231 gain that would have been ordinary income if Code § 1245 rather than § 1250 had applied to the transaction. (See Example 21, pp. 1-20 and 1-21, and § 291.)

1-4 Corporations are permitted a dividends-received deduction to negate the triple taxation caused by the inclusion of dividends in income without an offsetting deduction by the payor corporation. The recipient corporation is allowed an *80 percent* rather than the usual 70 percent dividends-received deduction if it owns at least 20 percent but less than 80 percent of the dividend-paying corporation. If the recipient corporation owns 80 percent or more of the dividend-paying corporation, the dividends-received deduction is 100 percent. [See pp. 1-8 through 1-13 and § 243(a).]

1-5 The dividends-received deduction may not exceed 70 percent of the corporation's taxable income computed without the deduction, NOL carryovers and carrybacks, and capital loss carrybacks. This limitation is ignored if the corporation has an NOL for the year. Additionally, the dividends-received deduction is either limited or not allowed on so-called *debt-financed portfolio stock* or for extraordinary dividends. Finally, a corporation must hold the stock of the dividend-paying corporation for more than 45 days before it is sold or any dividends received on such stock will be ineligible for the dividends-received deduction. (See pp. 1-8 through 1-13.)

1-6 A corporation must carry forward, for up to five years, its qualified contribution to the extent the contribution exceeds 10 percent of taxable income (computed before the dividends-received deduction, NOL carrybacks, and capital loss carrybacks). Current contributions are deducted before carryforwards. The order was probably imposed to limit the tax benefit of prior years' contributions. See Examples 18 and 19 and pp. 1-17 and 1-18.)

1-7 Corporations that are members of a controlled group [as defined in Code § 1563 (a)] must share the tax benefit of the lower graduated corporate tax rates. The three categories of controlled groups are:

- Parent corporations and their 80 percent owned subsidiaries;
- Two or more corporations where five or fewer noncorporate shareholders collectively own more than 50 percent of the stock of each corporation (i.e., so-called brother-sister corporations); and
- Three or more corporations, each of which is a member of either a parent-subsidiary controlled group *or* a brother-sister controlled group, *and* at least one of the corporations is both the common parent corporation of a parent-subsidiary controlled group and a member of a brother-sister controlled group (i.e., a combined controlled group). (See Examples 27 through 32 and pp. 1-24 through 1-28.)

1-8 Corporations (except qualified personal service corporations) with taxable income in excess of $100,000 are subject to a 5 percent surtax on the excess, up to a maximum surtax of $11,750 (the tax savings of the lower tax rates). Therefore, a corporation with $170,000 of taxable income pays tax at a marginal rate of 39 percent. The flat tax rate imposed on the last dollar of income of a corporation with taxable income of $335,000 or more is *34 percent* (up to $10 million, at which point the marginal rate increases to 35 percent). (See Exhibit 1-4, Examples 22 through 24, and pp. 1-22 and 1-23.)

1-9 The alternative minimum tax is, as the name suggests, a tax liability computed in lieu of the regular computational result. If the taxpayer's tentative alternative minimum tax (AMT) is greater than its regular tax liability, this *excess,* the AMT liability, is an addition to the regular tax liability. Thus, the AMT is not an amount paid in lieu of the regular income tax; it is in addition to this amount. (See Exhibit 1-8 and pp. 1-28 through 1-33.)

1-10 There are several tax benefits that have not specifically been made subject to the corporate alternative minimum tax (e.g., tax-exempt interest, proceeds of key-person life insurance, and the dividends-received deduction). The adjustment for adjusted current earnings (ACE) is an attempt to ensure that corporations taking advantage of these tax benefits pay at least a minimal amount of tax. (See Exhibit 1-10 and p. 1-31.)

**PROBLEMS**

1-11

a. Individual — $10,000 (the entire amount received)

Corporation — $3,000 [$10,000 – ($10,000 × 70% = $7,000 dividends-received deduction)] (See Exhibit 1-3 and pp. 1-8 through 1-13.)

b. Individual — $ 1,900 (FMV – $ 100)

Corporation — $2,700 (basis) (See p. 1-8.)

c. Individual — $900 ($6,000 net capital gain × 15% assuming asset was held for more than 12 months)

Corporation — $2,340 ($6,000 × 39%), assuming corporate income is not in excess of $335,000 (See pp. 1-19 and 1-20.)

d. Individual — $8,000 [$11,000 ($8,000 LTCG + $3,000 STCG) – $3,000 NSTCL carryover (the carryover from 2010 is $3,000 because $3,000 of the loss was allowed to offset ordinary income in 2010)]

Corporation — $5,000 [$11,000 ($8,000 LTCG + $3,000 STCG) – $6,000 NSTCL carryover (the carryover from 2010 is $6,000 because none of the loss was allowed to offset ordinary income in 2010)] Example 20 and pp. 1-19 and 1-20.)

e. Individual — $30,000 (50% × A.G.I.)

Corporation — $5,000 (10% × taxable income) (See pp. 1-17 through 1-19.)

f. The amount of the gain recognized and its character can be computed using several steps (See Example 21 and pp. 1-20 and 1-21.)

Step 1 Compute realized and recognized gain

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

| | | |
|---|---|---|
| Amount realized | | $250,000 |
| Adjusted basis | | |
| Cost | $200,000 | |
| Depreciation (straight-line) | (80,000) | |

| | |
|---|---|
| | (120,000) |
| Gain realized and recognized | $130,000 |

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

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

Step 2 Compute excess depreciation

| | |
|---|---|
| Actual depreciation | $80,000 |
| Straight-line depreciation | (80,000) |
| Excess depreciation | $___0 |

Step 3 Compute § 1250 depreciation

Lesser of

Realized gain $130,000

Or

Excess depreciation $ 0

Section 1250 depreciation recapture $ 0

Step 4 Compute § 1245 depreciation if § 1245 applied

Lesser of

Realized gain $130,000

Or

Actual depreciation $ 80,000

Section 1245 depreciation recapture $80,000

Step 5 Compute § 291 ordinary income

Depreciation recapture if

§ 1245 applied $80,000

§ 1250 actual depreciation recapture ( 0)

Excess recapture potential $80,000

§291 recapture rate × 20%

§ 291 ordinary income $16,000

Step 6 Compute character of remaining gain realized

Realized and recognized gain $130,000

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

Section 1231 gain $124,000

[See Example 21, pp. 1-20 and 1-21 and § 291 and 1245(a)(5).]

1-12

a. Net short-term gain equals $10,000 ($20,000 gain – $10,000 loss). Net long-term loss equals $23,000 ($5,000 gain — $28,000 loss). The combination of the short-term gain and long-term loss yields a net long-term loss of $13,000. This loss may not be used on the 2010 Form 1120 but must be carried back three years and then forward five years in search of capital gains. When carried back, the loss is treated as a short-term loss.

b. The loss must first be carried back three years to 2007 (no loss carryback is available for 2006) to absorb the $8,000 capital gain. The remaining loss of $5,000 ($13,000 – $8,000) is carried to 2009 and is used to absorb the $1,000 capital gain. Note: The $3,000 loss reported in 2008 was carried back to 2006 and was absorbed by the $6,000 capital gain.

c. The unused loss from 2009 of $4,000 ($5,000 – $1,000) may be used in 2010 to offset any net capital gain. As with carrybacks, the loss is treated as a short-term loss even though the 2010 loss was long-term.

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

1-13

a. $14,000 ($20,000 × 70%), if not debt-financed portfolio stock or an extraordinary dividend. This is not limited by income ($100,000 + $20,000 – $30,000 – $40,000 = $50,000).

b. $12,600 [($120,000 – $102,000) × 70%] (See Exhibit 1-3 and pp. 1-8 through 1-13.) The dividends-received deduction is limited to 70 percent of taxable income since the dividends-received are greater than taxable income, but the regular dividends-received deduction will not produce a net operating loss. (See Example 5 on p. 1-10.)

1-14

a. $22,400 [($170,000 + $40,000 – $178,000 = $32,000) × 70%]. Although the tentative DRD is $28,000, the DRD is subject to the taxable income limitation.

b. $28,000 ($40,000 × 70%). Note that by adding an additional $5,000 of operating expenses, the corporation's taxable income before the dividends-received deduction is reduced to $27,000 ($32,000 — $5,000), and the tentative income is negative. The corporation will not be subject to the limitation as in part (a) above. As a result, the dividends-received deduction is increased by $5,600 ($28,000 – $22,400).

(See Exhibit 1-3, Example 6, and pp. 1-9 through 1-11.)

1-15

a. Of the $41,000 of organization expenses incurred, the corporation may expense up to $5,000 in the first year and the balance, $36,000 ($41,000 – $5,000) may be amortized over 180 months beginning the month the business begins, September 1. The deductible organizations expenses for the first year would be $5,800 computed as follows:

Total incurred in first year of business $41,000

Expensed portion (5,000) $5,000

Balance to be amortized over 180 months $36,000

Amortization per month ($36,000/180 months) $200

Number of months in first year × 4

Amortization in first year 800

Total deduction in year one $5,800

b. $2,400 ($200 amortization per month × 12 months).

c. $2,400 same as in (b) above. Note that in 2025, the final year of amortization, the deduction is only $1,600 ($200 per month × 8 months)

d. No change. The amount of organization expense eligible to be expensed or amortized is the amount *incurred* during the first year of business regardless of whether the corporation is a cash or accrual basis taxpayer. The fact that the expense was paid is irrelevant since it was incurred in the first year.

e. No change. As noted above, the amount of organization expense eligible to be expensed or amortized is the amount *incurred* during the first year of business regardless of whether the corporation is a cash or accrual basis taxpayer. The fact that the expense was paid is irrelevant since it was incurred in the first year.

f. Only the amount incurred in the first year of business $29,000 would be eligible to be deducted under §248. The amount incurred in the second year of business, $12,000, must be capitalized and is not eligible for deduction or amortization. It could only be recovered if the corporation were to sell its assets or upon liquidation. As a result, the amount deductible in the first year would be $5,333 computed as follows:

Total incurred in first year of business $29,000

Expensed portion (5,000) $5,000

Balance to be amortized over 180 months $24,000

Amortization per month ($24,000/180 months) $133.33

Number of months in first year × 4

Amortization in first year 533

Total deduction in year one $5,333

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

1-16 The correct answers are b, c, d, and f. Answer a is not amortizable under § 248 as an organizational expense but may be amortizable under § 195 as a "start-up" expenditure. Answer e is incorrect because the cost of issuing stock is a selling expense, which is treated as a reduction in the proceeds from selling the stock. [See p. 1-13 and Reg. § 1.248-1(b)(3).]

1-17

a. $70,000 [($600,000 + $100,000 dividends before the dividends-received deduction) = $700,000 × 10%].

b. $8,000 ($70,000 maximum deduction – $68,000 from 2011 contributions = $2,000 remaining to deduct; $10,000 carryover from 2010 – $2,000 used in 2011).

(See Examples 18 and 19 and pp. 1-17 and 1-18.)

1-18 Accrual basis corporations may deduct a charitable contribution in the year the contribution is authorized by the board of directors if payment is made by the fifteenth day of the third month following the close of the tax year. In this case, a deduction is allowed in 2011 for the authorized contribution when paid before March 15, 2012. Therefore, the payment made on February 28, 2012 qualifies, whereas the payment made on March 29, 2012 does not qualify. (See Example 15 on p. 1-16.)

1-19

| | | | |
|---|---|---|---|
| 1. Sales price | | | $410,000 |
| Less: Adjusted basis | | | |
| Cost | | $400,000 | |
| S/L depreciation | (87,000) | (313,000) | |
| Realized gain | | | $ 97,000 |

2. Because the building was depreciated using the straight-line method, there is no § 1250 depreciation recapture.

3. Depreciation recapture if § 1245 applied would be the lesser of the $97,000 realized gain or the $87,000 actual depreciation. Thus, if § 1245 applied, the depreciation recapture would be $87,000.

4. § 291 ordinary income is computed as follows:

| | |
|---|---|
| Depreciation recapture under § 1245 | $87,000 |
| Less: § 1250 depreciation recapture | (0) |
| Excess recapture potential | $87,000 |
| Times the § 291 rate | x 20% |
| Equals § 291 ordinary income | $17,400 |

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

| | |
|---|---|
| Realized gain | $97,000 |
| Less: Ordinary income | (17,400) |
| § 1231 gain | $79,600 |

[See Example 21, pp. 1-20 and 1-21, and §§ 291 and 1245.]

1-20 $41,750 [(15% × $50,000 = $7,500) + (25% × $25,000 = $6,250) + (34% × $75,000 = $25,500) + (5% × $50,000 = $2,500)]. Note that $50,000 of L Corporation's taxable income is subject to the 5 percent surtax. (See Example 23 and p. 1-22.)

1-21 F Corporation's 2011 income tax liability before credits or prepayments is $80,750 [(15% × $50,000 = $7,500) + (25% × $25,000 = $6,250) + (34% × $175,000 = $59,500) + (5% surtax × $150,000 = $7,500)]. If F is a personal service corporation (PSC), its tax liability before credits or prepayments will be $87,500 (35% × $250,000) since a PSC is subject to a flat rate of 35 percent (i.e., it is denied the benefits of the lower tax rates regardless of the amount of its taxable income). (See pp. 1-23 and 1-24.)

1-22 A brother-sister controlled group is defined as two or more corporations connected through the stock ownership of noncorporate shareholders. It exists if five or fewer individuals, estates or trusts own more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each, taking into account only the *lowest stock ownership* of each shareholder that is identical with respect to each corporation. To determine whether a controlled group exists in this case, all combinations of corporations must be examined:

Four corporations: RUST

Three corporations: RUS, RUT, RST, AND UST

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

These tests are performed below.

| | | | | | | |
|---|---|---|---|---|---|---|
| | | *Corporations* | | | *Lowest Identical* | |
| *Individuals* | | *R* | *U* | *S* | *T* | *Ownership* |
| A | 30% | 5% | 40% | 50% | 5% | |
| B | 10 | 10 | 10 | 20 | 10 | |
| C | 40 | 5 | 10 | 10 | 5 | |
| D | 20 | 80 | 0 | 20 | 0 | |
| | | | | | 20% | |

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

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

**RUS** **RUT**

| | *Percentage of Corporation Owned* | | | | | *Percentage of Corporation Owned* | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Shareholder* | *R* | *U* | *S* | *Lowest Identical Ownership* | *Shareholder* | *R* | *T* | *U* | *Lowest Identical Ownership* |
| A | 30 | 5 | 40 | 5 | A | 30 | 5 | 50 | 5 |
| B | 10 | 10 | 10 | 10 | B | 10 | 10 | 20 | 10 |
| C | 40 | 5 | 10 | 5 | C | 40 | 5 | 10 | 5 |
| D | 20 | 80 | 0 | 0 | D | 20 | 80 | 20 | 20 |
| | | | | 20% | | | | | 40% |

**RST** **UST**

| | *Percentage of Corporation Owned* | | | | | *Percentage of Corporation Owned* | | | |
|---|---|---|---|---|---|---|---|---|---|
| *Shareholder* | *R* | *S* | *T* | *Lowest Identical Ownership* | *Shareholder* | *U* | *S* | *T* | *Lowest Identical Ownership* |
| A | 30 | 40 | 50 | 30 | A | 5 | 40 | 50 | 5 |
| B | 10 | 10 | 20 | 10 | B | 10 | 10 | 20 | 10 |
| C | 40 | 10 | 10 | 10 | C | 5 | 10 | 10 | 5 |
| D | 20 | 0 | 20 | 0 | D | 80 | 0 | 20 | 20 |
| | | | | 50% | | | | | 15% |

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

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

**RU** **RS**

| | *Percentage of Corporation Owned* | | | | *Percentage of Corporation Owned* | | |
|---|---|---|---|---|---|---|---|
| *Shareholder* | *R* | *U* | *Lowest Identical Ownership* | *Shareholder* | *R* | *S* | *Lowest Identical Ownership* |
| A | 30 | *5* | 5 | A | 30 | 40 | 30 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| B | 10 | 10 | 10 | B | 10 | 10 | 10 |
| C | 40 | 5 | 5 | C | 40 | 10 | 10 |
| D | 20 | 80 | 20 | D | 20 | 0 | 0 |
| | | | 40% | | | | 50% |

**RT** **US**

*Percentage of Corporation Owned* *Percentage of Corporation Owned*

| *Shareholder* | *R* | *T* | *Lowest Identical Ownership* | *Shareholder* | *U* | *S* | *Lowest Identical Ownership* |
|---|---|---|---|---|---|---|---|
| A | 30 | 50 | 30 | A | 5 | 40 | 5 |
| B | 10 | 20 | 10 | B | 10 | 10 | 10 |
| C | 40 | 10 | 10 | C | 5 | 10 | 5 |
| D | 20 | 20 | 20 | D | 80 | 0 | 0 |
| | | | 70% | | | | 20% |

**UT** **ST**

*Percentage of Corporation Owned* *Percentage of Corporation Owned*

| *Shareholder* | *U* | *T* | *Lowest Identical Ownership* | *Shareholder* | *S* | *T* | *Lowest Identical Ownership* |
|---|---|---|---|---|---|---|---|
| A | 5 | 50 | 5 | A | 40 | 50 | 40 |
| B | 10 | 20 | 10 | B | 10 | 20 | 10 |
| C | 5 | 10 | 5 | C | 10 | 10 | 10 |
| D | 80 | 20 | 20 | D | 0 | 20 | 0 |
| | | | 40% | | | | 60% |

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

(See Examples 28, 29, 30 and pp. 1-26 and 1-27.)

1-23

a. Regular taxable income $ 100,000

Plus: AMT adjustments + 0

Less: AMT adjustments – 0

AMT adjusted taxable income $ 100,000

Plus: Excess depreciation ($90,000 – $60,000) + 30,000

AMTI before the adjusted current earnings item $ 130,000

Plus: 75% of adjusted current earnings in excess of AMTI without this item [75% × ($210,000 – $130,000)]* Alternative Minimum Taxable Income (AMTI) + 60,000

$ 190,000

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

b.

| | |
|---|---|
| AMTI [from part a above] | $ 190,000 |
| Less: Exemption | |
| [$40,000 – 25% of ($190,000 – $150,000)] | – 30,000 |
| AMTI base | $160,000 |
| Times: AMT rate | × 20% |
| Gross AMT | $ 32,000 |
| Less: Allowed credits | – 0 |
| Tentative AMT | $ 32,000 |
| Less: Regular tax liability | – 22,250 |
| Alternative Minimum Tax (AMT) | $ 9,750 |

(See Exhibits 1-8, 1-9, 1-10 and 1-11; Examples 33 and 34; and pp. 1-29 through 1-33.)

1-24

a. Net income from operations $ 150,000

| | | |
|---|---|---|
| Dividends | | +10,000 |
| Income before special deductions | | $ 160,000 |
| Less sum of: | | |
| NOL carryover | $ 30,000 | |
| Charitable contributions [10% × ($160,000-$30,000 NOL)] | + 13,000 | |
| Dividends received deduction (70% × $10,000)] | + 7,000 | |
| | | (50,000) |
| Taxable income | | $110,000 |

Note: The $5,000 of 2011 net capital gains are offset by the capital loss carryover from 2010.

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

b. Charitable contribution carryover from 2011 = $17,000 ($30,000 – $13,000 used in 2011) Capital loss carryover from 2010 = $4,000 ($9,000 – $5,000 used in 2011)

(See pp. 1-6 through 1-20.)

1-25

[Insert UNF here]

(See Examples 37 and 39 and pp. 1-34 and 1-35.)

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

| | | |
|---|---|---|
| Net book income | | $300,000 |
| Add: Actual Federal income tax | $ 80,000 | |
| Overaccrual of FIT* | 10,000 | |
| Insurance premiums | 6,000 | |
| Net capital loss | 4,000 | |
| | | 100,000 |
| Less: Life insurance proceeds | $120,000 | |

| | | |
|---|---|---|
| Excess depreciation | 36,000 | |
| | | (156,000) |
| Taxable income | | $ 244,000 |

*Assuming actual Federal income tax is entered on Line 2 of Schedule M-1. Because the accrued Federal income tax exceeded the actual tax by $10,000, this overaccrual must be added back to net book income. (See pp. 1-33 and 1-34).

1-27 The Schedule M-3 is generally a detail reconciliation of book to taxable income. See pp. 1-38 through 1-40.

a. False. The M-3 is a substitute for the M-1. Both require a reconciliation of book income to taxable income. The M-3 is required in some instances. However, taxpayers that are not required to file the M-3 may do so. In fact, a corporation may want to do to meet their reportable transaction obligation. The M-2 is a reconciliation of retained earnings.

b. False. The M-3 must be completed by any corporation that files From 1120 and has assets of $10 million or more at the end of the year. If a group of corporations file a consolidated tax return, the $10 million is measured on a consolidated basis (i.e., the assets of the group are aggregated). While most publicly traded companies will be required to file the M-3, other corporations will also find it necessary to file. In measuring whether its assets meet the $10 million threshold, a corporation must use the same basis as it prepares its financial statements.

c. True. There is no indication in the instructions of the M-1 as to which "book income" is to be used in the reconciliation.

d. False. Corporations may be required to file an M-3 even though they are not required to file a SEC Form 10-K. If a corporation and has assets of $10 million or more at the end of the year it must file an M-3. In completing Part I, the starting point is the income shown on an SEC Form 10-K if it is filed. If a 10-K is not filed, the income from a certified audited financial statement is used. Failing these, the corporation uses the number reported on income statements prepared for other purposes (e.g., a utilities commission). If none of these conditions apply, the net income per the corporation's books and records is entered on line 11, and the remainder of Part I is left blank.

e. False. While it is true that the M-3 requires far greater detail (70 or so lines vs. 8 for the M-1), it is not the only difference between the M-1 and M-3. Schedule M-3 requires the corporation to classify any difference as permanent or temporary. Such classification is not required on the M-1. This is significant since permanent differences are far more interesting to the government. On the roadmap of corporate reporting, the sign of a permanent difference to an IRS agent is an attraction worth stopping for.

f. True.

g. True. Even corporations that are not required to file an M-3 may want to do so to satisfy the reportable transaction requirement for significant differences (i.e., over $10 million).

1-28 Normally depreciation results in a timing difference. If it is mistakenly classified as a permanent difference, the IRS may believe the corporation is attempting to claim tax depreciation on an otherwise nondepreciable asset. An audit may result that might not have otherwise occurred. Such an error would be easy to explain during the audit, but obviously corporations do not want that kind of attention. Consequently, it is very important to correctly identify timing differences and permanent differences. Since the form is designed to highlight each type of difference, a misclassified could result in heightened scrutiny. (See pp. 1-38 through 1-40.)

1-29 Under the general rule for estimated tax payments, F must make timely quarterly payments of $33,750 [($120,000 regular tax + $15,000 alternative minimum tax) ÷ 4 × 100%] to avoid imposition of the penalty. F's quarterly payments were only $26,000, so F is tentatively subject to the penalty. However, because F is not a "large" corporation, it may qualify under the exception based on last year's tax liability. The quarterly payments based on this exception are only $25,000 ($100,000 last year's tax ÷ 4). Because actual quarterly payments exceed this amount and all other requirements are met, F does not have an underpayment and is not subject to penalty. (See pp. 1-41 and 1-42.)

1-30 Refer to the solution for *Problem 1-29.* Because F Corporation is now a "large" corporation, it may not rely on the exception based on last year's tax liability (except for the first quarterly installment). The first installment is not underpaid because the $26,000 actual payment exceeded the $25,000 required payment based on last year's tax. If this rule were not in effect, the underpayment for the first quarter would be $7,750 ($33,750 required payment – $26,000 actual payment). This amount must be paid with the second installment. Therefore, the second installment is underpaid by $15,500 ($7,750 from the first installment + $7,750 from the second installment). The third and fourth installments are underpaid by $7,750. (See pp. 1-41 and 1-42.)

1-31

a. G has a realized loss of $2,000 ($2,000 sales price — $4,000 adjusted basis). However, this loss is not recognized because this is a sale between related parties (§ 267). The $2,000 disallowed loss is carried over to the ABC Corporation for possible future use.

b. ABC has a realized gain of $3,000 ($5,000 sales price – $2,000 adjusted basis), only $1,000 of which must be recognized ($3,000 realized gain — $2,000 loss carryover from G). Note: the carryover loss cannot be used to add to or to create a loss.

(See pp. 1-21 and 1-22.)

1-32

a. H wishes to create long-term capital gain on the sale of the building (which would be taxed at favorable rates) and allow XYZ to depreciate the $160,000 basis allocated to the building against its ordinary income (34% marginal tax rate). Note: The gain on the sale of the land is § 1231 gain.

b. The sale of the building from H to XYZ is treated as the sale of an ordinary income property under § 1239. Therefore, the gain on the sale of the building is taxed at H's 34% marginal tax rate.

(See pp. 1-21 and 1-22.)

## TAX RETURN PROBLEMS

Solutions to the Tax Return Problems (1-33–1-34) are contained in the *Instructor's Resource Guide and Test Bank* for 2012.

## TAX RESEARCH PROBLEMS

Solutions to the Tax Research Problems (1-35) are contained in the *Instructor's Resource Guide and Test Bank* for 2012.

# 1

# Income Taxation of Corporations

## Solutions to Tax Research Problems

### TAX RESEARCH PROBLEMS

**1-35** Linda is correct in her assessment that the regular corporate form will not be a suitable vehicle for holding her investment property. This option is not viable because losses will remain within the corporation for possible future use against corporate income. Because she can qualify for the $25,000 exception to the passive activity loss rules for actively managed rental realty, she will want the losses passed through to her for use on her individual return.

Linda is also correct with respect to using an S corporation as a vehicle for holding her investment. Although use of an S corporation would appear ideal because losses flow through to the shareholders, the total amount of deductible losses allowed to her would be limited to the basis in her capital account ($40,000). Given the high rate of interest on her loan and the riskiness of her investment, her basis could be reduced to zero within several years.

Linda's third option is interesting and, according to the Supreme Court case of *Bollinger,* viable. If the corporation can be formed as a regular corporation and be treated for Federal income purposes as Linda's agent, all losses will pass through to her and may be used against her total basis in the investment of $240,000. Her basis in her investment includes the nonrecourse note because the investment in realty was acquired with a nonrecourse loan from a qualified lender [see § 465 (b)(6)].

There are, however, a number of precautions for ensuring acceptability of this third option by the IRS. According to the Supreme Court in *Bollinger,* the corporate-agent relationship is established if (1) the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, (2) the corporation functions as the agent and not the principal with respect to the asset for all purposes, and (3) the corporation is held out as the agent and not the principal in all dealings with third parties relating to the asset.

If Linda follows the Supreme Court guidelines, it is very likely she will obtain her objectives. What specifically can she do? The *Bollinger* case provides a model of specific steps to take to establish an agency relationship. Bollinger formed an agency relationship with his corporation and stipulated that the corporation was formed solely to obtain financing, that the corporation was not liable for maintenance of the property or for repayment of any promissory notes, and that Bollinger would indemnify and hold the corporation harmless from any liability it might sustain as his agent.

**Note: Solutions to tax return problems 1-33 and 1-34 are located after the test bank and answers.**

# 1

# Income Taxation of Corporations

## Test Bank

**True or False**

______ **1.** The proprietorship uses gross ordinary income as the basis for calculating any self-employment tax due.

______ **2.** In contrast to a regular corporation, an S corporation's pass-through of income and deductions to its shareholders allows it to avoid double taxation of the same source of income.

______ **3.** In transactions between the partners and the partnership, the parties are generally treated like unrelated parties.

______ **4.** Section 11 of the Code imposes a tax on all corporations, including nonprofit organizations.

______ **5.** A corporation is an artificial "person" created by Federal law.

______ **6.** If an individual taxpayer creates a legal corporation under state law, the government (i.e., the IRS) cannot disregard the entity and tax the individual taxpayer on the income.

______ **7.** Although recognized as partnerships under state law, certain partnerships are treated and taxed as corporations for Federal income tax purposes.

______ **8.** All bad debts of a corporation are treated as business rather than nonbusiness bad debts.

______ **9.** A corporation is allowed a dividends-received deduction only if the corporation is a member of an affiliated group and the dividends are received from another member of the same group.

______ **10.** In computing a corporation's limitation on the dividends-received deduction, its taxable income is determined without the deductions for dividends received, net operating loss carryovers, and capital loss carrybacks.

______ **11.** Where a dividends-received deduction adds to or creates a net operating loss, the taxable income limitation decreases from 70 percent to 34 percent.

_______ **12.** At its election, a corporation can *either* deduct all organizational costs paid during the current year *or* amortize the expenditures over a period not less than 180 months.

_______ **13.** Because organizational costs are assets with indefinite lives (i.e., they have value for the life of the corporation), they may not be expensed or amortized.

_______ **14.** Organizational expenses incurred by an accrual basis corporation in its first year of existence but paid in a later year will not qualify for amortization.

_______ **15.** If an accrual basis corporation incurs an additional expense in setting up its accounting system after the close of its first tax year but before the due date of its initial return, the expense qualifies as an organizational expense and may be amortized.

_______ **16.** A corporation is not allowed a dividends-received deduction in computing its net operating loss for any given year.

_______ **17.** A corporation's annual charitable contribution deduction is limited to 10 percent of its taxable income without reduction for charitable contributions, the dividends-received deduction, net operating loss carrybacks, and capital loss carrybacks.

_______ **18.** In planning for its annual charitable contributions, a corporation should take into account any net operating loss or capital loss *carryforwards* since such items reduce the corporation's taxable income base for purposes of the annual deduction limitation.

_______ **19.** Unlike individuals, corporations with excess capital losses in the current year are allowed to carry these losses back five years and forward three years to offset capital gains in the carryback or carryforward years.

_______ **20.** A corporation may be required to recapture (as ordinary income) a greater portion of its gain on the sale of depreciable real property than would an individual taxpayer.

_______ **21.** An accrual basis corporation must use the cash method in claiming deductions for amounts paid to its cash basis sole shareholder.

_______ **22.** The 2011 Federal income tax rate for a calendar year corporation with taxable income of $335,000 up to $10 million is 34 percent.

_______ **23.** Corporation A is equally owned by 10 unrelated individual shareholders. Corporation B is 100 percent owned by *one* of the shareholders that owns stock of Corporation A. As a result of this common stock ownership, Corporations A and B are members of a brother-sister controlled group.

_______ **24.** A personal service corporation with taxable income of $10,000 for its 2011 calendar year will have a regular Federal income tax liability of $3,500 before credits or prepayments.

_______ **25.** A corporation with alternative minimum taxable income of $20,000 will be subject to an alternative minimum tax of $4,000.

## Multiple Choice

_______ **26.** Which of the following is *not* true?

- **a.** Because all activities of a corporation are considered to be business activities, a corporation cannot have a nonbusiness bad debt.
- **b.** The proprietorship, partnership, and S corporation pass through to individuals, partners, and shareholders all items of income, deduction, gain, loss, or credit for Federal income tax purposes.
- **c.** Unlike individuals, a corporation's charitable deduction is limited to 10 percent of taxable income figured before certain deductions.
- **d.** A corporation is allowed to deduct 70 percent of dividends paid to shareholders provided that it is a taxable domestic corporation.
- **e.** By making a proper election on its tax return for the year of the loss, a corporation may forgo the two-year carryback and, instead, carry its net operating loss forward up to 20 years.

_______ **27.** Which of the following is *not* a corporate characteristic?

- **a.** Free transferability
- **b.** Ability to sue and be sued
- **c.** Continuity of life
- **d.** Centralized management
- **e.** Limited liability

_______ **28.** Which of the following is treated the same for individuals and corporations?

- **a.** Depreciation recapture
- **b.** Charitable contributions
- **c.** Capital losses
- **d.** Depreciation
- **e.** Bad debts

_______ **29.** R Corporation had 2011 gross income of $200,000, including $100,000 of dividends received from a less than 20 percent owned taxable domestic corporation. R had deductible business expenses of $110,000 before considering its dividends-received deduction. What is R Corporation's dividends-received deduction for 2011, assuming no restrictions other than the taxable income limitation may apply?

- **a.** $63,000
- **b.** $68,000
- **c.** $70,000
- **d.** $80,000
- **e.** $100,000

_______ **30.** For its taxable year ending December 31, 2011, T Corporation has the following taxable income and deductible expenses:

| | |
|---|---|
| Gross income from operations | $205,000 |
| Deductible expenses of operations | 218,000 |
| Dividends received | 35,000 |

The dividends were received from a taxable domestic corporation in which T owns 15 percent of the stock (not debt-financed). What is T Corporation's dividends-received deduction for 2011?

- **a.** $0
- **b.** $15,400
- **c.** $21,000
- **d.** $24,500
- **e.** $35,000

______ **31.** Corporations A, B, and C are *taxable domestic corporations*. All are members of an affiliated group. Corporation A pays a $50,000 dividend to B and a $50,000 dividend to C. Corporations B and C are each entitled to a dividends-received deduction of

**a.** $35,000
**b.** $40,000, subject to the taxable income limitation
**c.** $50,000
**d.** $0
**e.** None of the above

______ **32.** New Corporation was organized and began active business on January 7, 2011. New incurred the following expenses in connection with opening the business:

| | |
|---|---|
| Legal fees for drafting the charter and bylaws | $ 750 |
| Legal fees for the transfer of the ownership titles of assets from shareholders to the corporation 100 | |
| State incorporation fees | 250 |
| Printing cost for stock certificates | 175 |
| Fees paid to temporary directors for first two organization meetings | 300 |
| Accounting fees to set up initial recordkeeping system | 400 |
| Total | $1,975 |

Assuming New Corporation adopts a calendar year for tax purposes, what is the maximum amount of organizational expenses that may be deducted on the corporation's initial tax return?

**a.** $0
**b.** $
**c.** $1,800
**d.** $1,975

______ **33.** A newly formed corporation elected to use a fiscal year ending June 30. On July 17, 2011, the corporation began business and incurred $8,000 of qualified organizational expenses. Assuming that the corporation properly elected to deduct/amortize these costs, what is the amount of organization expenses that it should deduct on its tax return for the fiscal year ending June 30, 2012.

**a.** $0
**b.** $533
**c.** $5,000
**d.** $5,200

______ **34.** X Corporation, which files its tax return on a cash basis, incurred organizational costs (not to a related party) of $5,000 during its first year. $1,875 of these expenses were *paid* in the fourth month after the close of its taxable year. What is the maximum deduction the corporation is entitled to claim on its first tax return if that tax return is for a period of $11\frac{1}{2}$ months and a proper election is made?

**a.** $0, because organizational costs have an indefinite life
**b.** $200
**c.** $3,125
**d.** $5,000

______ **35.** The charitable deduction for a corporation is limited both by type of property contributed and an annual maximum amount. Which of the following is a *false* statement?

**a.** An accrual basis corporation may deduct contributions authorized during the tax year but actually paid within two and one-half months after the close of the tax year.
**b.** The annual maximum amount of charitable deduction for a corporation is 10 percent of taxable income calculated before certain deductions.
**c.** Generally, a corporation is allowed a deduction for the fair market value of capital gain and ordinary income property.
**d.** In certain cases where a corporation donates capital gain property, the allowable deduction is limited to the fair market value, reduced by the amount of unrealized appreciation (i.e., the deduction is limited to the property's adjusted basis).

______ **36.** Which *one* of the following statements is *true* for a regular corporation?

**a.** Charitable contributions in excess of the 10 percent limitation may be carried over to subsequent years indefinitely.
**b.** A contribution carryover is allowed as a deduction even if it increases a net operating loss.
**c.** Charitable contributions in excess of the 10 percent limitation may, subject to limitations, be carried back to each of the preceding three years.
**d.** Charitable contributions in excess of the 10 percent limitation may, subject to limitations, be carried over to each of the following five years.
**e.** Subject to the 10 percent limitation, a carryover of excess contributions is used before the contributions made in the carryover year.

______ **37.** T Corporation's taxable income for 2011 was $100,000, computed by erroneously deducting the corporation's total charitable contributions of $12,000. The *correct* contribution deduction for T Corporation is

**a.** $6,000
**b.** $8,800
**c.** $10,000
**d.** $11,200
**e.** $12,000

______ **38.** During its first year of operation, K Corporation had a gross profit from operations of $180,000 and deductions of $250,000 before considering its dividend income or dividends-received deduction. K received dividends of $50,000 from a taxable domestic corporation in which K owned 4.5 percent of the stock. Assuming its ownership of the dividend-paying corporation's stock is not debt financed, what is K Corporation's net operating loss for the year?

**a.** $20,000
**b.** $49,000
**c.** $55,000
**d.** $65,000
**e.** $70,000

______ **39.** Z Corporation had 2011 taxable income of $600,000 before considering the following:

| | |
|---|---|
| Gain on the sale of equipment | $15,000 |
| Loss on the sale of equipment | (29,000) |
| Gain on the sale of land used in the business | 70,000 |
| Loss on the sale of investment held five months | (5,000) |
| Loss on the sale of investment held two years | (18,000) |

The equipment sold at a gain originally cost $150,000, and $90,000 of depreciation had been claimed. What is Z Corporation's taxable income for 2011?

**a.** $618,000
**b.** $633,000
**c.** $647,000
**d.** $671,000
**e.** $685,000

______ **40.** Which of the following is different for corporations than it is for individuals?

**a.** The definition of capital asset
**b.** The determination of holding period for capital assets
**c.** The capital gain and loss netting process
**d.** The treatment of capital loss carryovers

______ **41.** T Corporation sold a commercial building for $200,000 on January 2, 2011 (purchased for $150,000 on December 16, 2006). The building was depreciated using the straight-line method, and depreciation in the amount of $20,000 has been taken. The amount and nature of the gain upon sale is

**a.** $70,000 § 1231 gain
**b.** $50,000 § 1231 gain and $20,000 ordinary income
**c.** $66,000 § 1231 gain and $4,000 ordinary income
**d.** $70,000 ordinary income
**e.** None of the above

______ **42.** J is a 60 percent shareholder in the JS Corporation. In 2008, he sold property to the corporation for $60,000 (basis in his hands of $70,000). In 2011, the corporation sold the property for $65,000 to an unrelated party. The amount of gain or loss the JS Corporation must recognize in 2011 is

**a.** $(5,000)
**b.** $0
**c.** $5,000
**d.** $10,000

______ **43.** Which of the following is a *false* statement regarding transactions between corporations and their shareholders?

**a.** Corporations are not allowed to deduct a loss incurred in a transaction between related parties.
**b.** A shareholder owning 50 percent of a corporation's outstanding stock is a related party according to the general rule.
**c.** In the case of a personal service corporation, any employer-owner that owns any of the corporation's stock is a related party under certain conditions.
**d.** The sale of property at a gain between a corporation and its controlling shareholders is not affected by the related parties rules.

______ **44.** Z Corporation's 2011 calendar year taxable income is $2,000,000. The corporation's 2011 Federal income tax liability before credits and prepayments is

**a.** $680,000
**b.** $769,460
**c.** $899,740
**d.** $920,000
**e.** $1,020,000

______ **45.** A regular corporation and a personal service corporation each have taxable income of $20,000 for the 2011 calendar year. Ignoring the alternative minimum tax provisions, which *one* of the following statements is true regarding the Federal income tax liabilities of these two corporations?

**a.** Both corporations will have the same tax liability before credits or prepayments.
**b.** The regular corporation will have a slightly lower tax liability before credits or prepayments.
**c.** The personal service corporation will have a slightly lower tax liability before credits or prepayments.
**d.** The regular corporation's tax liability will be exactly $2,000 less than the tax liability of the personal service corporation.
**e.** The regular corporation's tax liability will be less than half that of the personal service corporation.

______ **46.** The principal activity of several corporations is shown below. Which of the following could *not* be classified as a personal service corporation?

**a.** Engineering
**b.** Actuarial science
**c.** Performing arts
**d.** Manufacture of personal computers
**e.** Veterinary medicine

______ **47.** Two personal service corporations (PSCs) are properly determined to be a brother-sister controlled group. Corporation A has taxable income of $75,000, and Corporation B has a loss of $50,000. Which of the following is a *true* statement?

**a.** Corporation A may owe $13,750 in Federal income taxes before credits, depending on lower tax rate bracket allocation.
**b.** Corporations A and B are permitted to allocate the use of the lower tax rates in any manner they so elect, provided that both A and B agree to the allocation.
**c.** The corporations will pay a combined tax on the first $25,000 of taxable income at 15 percent, or $3,750.
**d.** Corporation A will owe $26,250 in taxes before credits.
**e.** Both a. and b.

______ **48.** A brother-sister controlled group consists of two or more corporations connected through the stock ownership of certain types of shareholders, including

**a.** Regular corporations, but not S corporations
**b.** S corporations, but not regular corporations
**c.** Individuals and estates, but not trusts
**d.** Individuals, estates, or trusts
**e.** Regular or S personal service corporations

______ **49.** Two or more corporations owned by five or fewer noncorporate shareholders, who collectively own more than 50 percent of the stock of each corporation, would best describe

**a.** Brother-sister controlled group
**b.** Association
**c.** S corporation pending proper election
**d.** Parent-subsidiary controlled group
**e.** Controlled group

______ **50.** Which of the following statements about the corporate alternative minimum tax is *false*?

**a.** Generally, the tax is computed at a 20 percent rate on alternative minimum taxable income (AMTI) in excess of $40,000.
**b.** Alternative minimum tax (AMT) liability exists only if the corporation's tentative AMT (reduced by allowable credits) exceeds its regular tax liability for the year. The difference is called the AMT.
**c.** AMT adjustments simply reflect timing differences between allowed deductions and gain recognition reporting methods for regular tax purposes and for AMT purposes.
**d.** AMT preference items act only to increase tentative AMTI.
**e.** The $40,000 exemption is reduced by 25 percent of the amount of AMTI in excess of $150,000 and is completely phased out for AMT in excess of $250,000.

______ **51.** B Corporation reported taxable income in 2011 of $1 million. Additional information concerning B's 2011 tax return is as follows:

| | |
|---|---|
| Alternative minimum taxable income (without regard to the ACE adjustment item) | $1.2 million |
| Adjusted current earnings (ACE) | 2.0 million |

B Corporation's alternative minimum tax for 2011 is

**a.** $20,000
**b.** $240,000
**c.** $320,000
**d.** None of the above

______ **52.** Which of the corporations below are required to use the accrual method of accounting for tax purposes?

**a.** Corporations with average annual gross receipts of $5 million or less in all prior taxable years.
**b.** Corporations with average annual gross receipts of $5 million or more in all prior taxable years.
**c.** S corporations.
**d.** Personal service corporations.
**e.** Choices a., c., and d. above, but not b.

______ **53.** Which of the following statements is *not* true?

**a.** A corporation is generally allowed to choose either a calendar year or fiscal year for its reporting period.
**b.** A personal service corporation must use a fiscal year unless it can satisfy IRS requirements that there is a business purpose for a calendar year.
**c.** S corporations must generally use a calendar year.
**d.** Because corporations are "persons" only in the legal sense of the word, they are not entitled to the earned income credit.
**e.** None; all are true.

_______ **54.** Which of the following is a positive adjustment to income per books on Schedule M-1 of Form 1120?

- **a.** Proceeds of key person life insurance
- **b.** Excess of capital losses over capital gains
- **c.** Excess of tax depreciation over book depreciation
- **d.** Tax-exempt interest

_______ **55.** Which of the following is *not* true of Schedule M-2 of the corporate tax return (Form 1120)?

- **a.** This schedule reconciles opening and closing retained earnings.
- **b.** This schedule uses tax rather than accounting data.
- **c.** Retained earnings will be increased by net book income and decreased by dividends.
- **d.** Both a. and b. are not true.
- **e.** None of the above; all are true.

_______ **56.** A calendar year corporation is required to file its Federal tax return by

- **a.** March 15
- **b.** April 15
- **c.** May 15
- **d.** June 15
- **e.** none of the above

_______ **57.** Which of the following is *not* true concerning the obligation of a corporation to make estimated tax payments?

- **a.** The estimates are due the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.
- **b.** One-fourth of the estimated tax due is to be paid on each payment date.
- **c.** Generally, unless each payment is for 25 percent or more of the tax (after credits) shown on Form 1120, an underpayment penalty will be imposed.
- **d.** A corporation whose tax liability for the year is less than $500 is not subject to the underpayment penalty.
- **e.** None; all are true.

_______ **58.** Which of the following is *not* true for purposes of the corporate estimated tax payments?

- **a.** A "large" corporation is one with taxable income of $1 million or more in any of the three preceding taxable years.
- **b.** All timely paid estimated tax installments for a "large" corporation will avoid a penalty if they are for 25 percent of the tax shown on the prior year's return if it was for a period of 12 months and showed a tax liability.
- **c.** Both "small" and "large" corporations can use the annualized income exception.
- **d.** None; all are true.

_______ **59.** Large Corporation, with over $1 million in taxable income for each of the last several years, paid estimated tax payments of $30,000 each quarter for the current year. The actual tax liability for the current year is $160,000; last year's tax liability was $145,000. Income is earned evenly throughout the year. What is the quarterly amount that may be subject to the underestimation penalty?

- **a.** There is no underpayment amount subject to penalty.
- **b.** $6,250
- **c.** $10,000
- **d.** $40,000

_______ **60.** X Corporation determines it cannot meet the filing deadline for Form 1120 (U.S. Corporation Income Tax Return) and files an extension on Form 7004. Which of the following is *not* true?

- **a.** The corporation claims an automatic six-month extension of time to file the tax return and to pay the tax due.
- **b.** With permission of the IRS, corporations may be granted an additional three-month extension to submit Form 1120.
- **c.** The corporation extension (Form 7004) must be filed on or before the 15th day of the 3rd month following the close of the taxable year.
- **d.** None; all are true.

1

# Income Taxation of Corporations

## Solutions to Test Bank

### True or False

1. False. *Net* ordinary income is the basis for calculating any self-employment tax due for a proprietorship (See p. 1-2.)

2. True. The tax return of the S corporation is generally a reporting vehicle that details the distribution of the income and expenses to the shareholders. Tax liability is determined at the shareholder level. (See pp. 1-3 and 1-4.)

3. True. The partners and the partnership are generally treated as unrelated. Remember that tax liability is determined at the partner level. (See p. 1-3.)

4. True. Although § 11 requires all corporations to pay tax, other provisions in the law specifically exempt certain types of corporations from taxation. [See p. 1-4 and § 882(a).]

5. False. Corporations are formed under state law. (See p. 1-4.)

6. False. It is the Internal Revenue Code that will be applied in determining the status of an entity for tax purposes. (See p. 1-6 and Reg. § 301.7701-2.)

7. True. Unless specifically exempted from the rule, a publicly traded partnership organized after December 17, 1987 will be treated *and* taxed as a corporation. (See pp. 1-5 and 1-6.)

8. True. Because all activities of a corporation are considered business activities, all bad debts are considered to be business bad debts. (See p. 1-8 and § 166.)

9. False. A corporation is allowed a dividends-received deduction whether or not it is a member of an affiliated group, provided it receives the dividends from a qualifying domestic corporation. (See p. 1-8.)

10. True. The 70 percent dividends-received deduction may not exceed 70 percent of the corporation's taxable income as defined in § 246(b). (See Exhibit 1-3, Examples 4 through 6, and pp. 1-8 through 1-13.)

11. False. There is *no* taxable income limitation where a dividends-received deduction adds to or creates a net operating loss. [See Exhibit 1-3, Examples 6 and 14, pp. 1-11 and 1-15, and § 246(b)(2).]

**12.** False. In general, organizational expenses of a corporation may not be deducted in full in the corporation's first tax year. However, a corporation may elect to deduct organizational costs in a special way—$5,000 during the first tax year with the remainder amortized over 180 months. Thus, only those corporations with expenses of $5,000 or less can expense the full amount in the current tax year. Note that the $5,000 amount is subject to a phase-out when organizational expenses exceed $50,000. (See pp. 1-13 and 1-14.)

**13.** False. In general, organizational expenses of a corporation may not be deducted in full in the corporation's first tax year. However, a corporation may elect to deduct organizational costs in a special way—$5,000 during the first tax year with the remainder amortized over 180 months. Thus, only those corporations with expenses of $5,000 or less can expense the full amount in the current tax year. Note that the $5,000 amount is subject to a phase-out when organizational expenses exceed $50,000. (See p. 1-13 and § 248.)

**14.** False. Neither the taxable year of actual payment nor the corporation's method of accounting (i.e., cash or accrual) affect the qualification of organizational expenses. As long as the expenses are *incurred* during the corporation's first tax year, they qualify for amortization. (See p. 1-13 and § 248.)

**15.** False. Whether the corporation is a cash basis or accrual basis taxpayer is irrelevant. Only those organizational expenses *incurred* by the corporation before the end of its first taxable year will qualify for § 248. (See p. 1-13 and § 248.)

**16.** False. In computing a corporation's net operating loss for any given year, the dividends-received deduction is not limited to taxable income. Thus, the dividends-received deduction can create or increase a corporation's net operating loss for any given year. [See Exhibit 1-3, Examples 6 and 14, pp. 1-11 and 1-15, and § 246(b)(2).]

**17.** True. The annual limitation is 10 percent of taxable income determined without reduction for charitable contributions, the dividends-received deduction, net operating loss carrybacks, and capital loss carrybacks. [See pp. 1-16 through 1-18 and § 170(b)(2).]

**18.** True. Only net operating loss and capital loss *carrybacks* are ignored in computing a corporation's taxable income base for purposes of the annual limitation. (See p. 1-17.)

**19.** False. The carryback period is *three* years and the carryforward period is *five* years. (See Example 20 and pp. 1-19 and 1-20.)

**20.** True. A corporation must treat as ordinary income 20 percent of any § 1231 gain that would have been ordinary income if § 1245 rather than § 1250 applied to the sale of certain depreciable realty. (See Example 21, pp. 1-20 and 1-21, and § 291.)

**21.** True. [See p. 1-21 and § 267(a)(2).]

**22.** True. A regular corporation is subject to a 5 percent surtax on all income in excess of $100,000 until the benefit of the graduated corporate income tax rate structure is eliminated. The elimination of the benefits of the lower corporate tax rates occurs when taxable income exceeds $335,000 (up to $10 million, at which point the marginal rate increases to 35 percent). (See Example 24 and pp. 1-22 and 1-23.)

**23.** False. Because only one of the shareholders of Corporation A owns stock in *both* corporations, the total lowest identical ownership is only 10%. Therefore, a brother-sister controlled group does not exist. (See Examples 28 and 29 and pp. 1-25 through 1-27.)

**24.** True. A personal service corporation (PSC) is not allowed to use the graduated corporate tax rates. Instead, a PSC is subject to a flat tax rate of 35 percent, and its tax liability before credits or prepayments would be $3,500 ($10,000 taxable income × 35%). (See p. 1-23.)

**25.** False. A corporation is subject to the AMT only to the extent it *exceeds* the corporation's regular tax. More importantly here, because a corporation is entitled to a $40,000 exemption, this corporation would not be subject to the AMT. (See Exhibit 1-8 and pp. 1-28 and 1-29.)

**Multiple Choice**

**26.** **d.** While a corporation is allowed to deduct a portion of qualifying dividends received from taxable domestic corporations, there currently is *no* deduction for dividends *paid* to shareholders. (See p. 1-8.)

**27.** **b.** The ability to sue or be sued is not one of the corporate characteristics. (See p. 1-5.)

**28.** **d.** Corporations and individuals are subject to the same rules regarding depreciation deductions. Corporations are subject to the possibility of additional depreciation recapture (i.e., § 291), while individuals are not. Corporations are more limited in their charitable contribution deductions than individuals, and corporations are not allowed to deduct capital losses against ordinary income (i.e., a capital loss deduction). Finally, all bad debts of a corporation are considered to be business bad debts. [See Examples 15 through 21, pp. 1-16 through 1-21, and §§ 291 and 170(b)(2).]

**29.** **a.** The corporation's dividends received deduction is computed as follows:

| | |
|---|---|
| Gross income | $200,000 |
| Business expenses | (110,000) |
| Taxable income before dividends received deduction | $90,000 |
| Lower of this taxable income, or $100,000 qualifying dividends | $90,000 |
| | × 70% |
| Dividends-received deduction | $63,000 |

(See Exhibit 1-3, Example 4, and pp. 1-8 through 1-13.)

**30.** **d.** The 70 percent dividends-received deduction under § 243(a) results in a deduction of $24,500 ($35,000 qualifying dividends × 70%), but § 246(b)(1) limits the deduction to 70 percent of taxable income computed without the dividends-received deduction [i.e., $15,400 (70% × $22,000)] *unless* the taxpayer has a net operating loss before the deduction, or will have a net operating loss as a result of the regular § 243(a) deduction. This is the case here ($205,000 + $35,000 − $218,000 = $22,000 net income − $24,500 § 243(a) deduction = $2,500 NOL). (See Exhibit 1-3, Example 6, and pp. 1-8 through 1-13.)

**31.** **c.** Members of an affiliated group are allowed to deduct 100 percent of the dividends that are received from another member of the same group. A group of organizations is considered affiliated when at least 80 percent of the stock of each corporation is owned by other members of the group. [See p. 1-8 and §§ 243(a)(3), 243(b)(5), and 1504.]

**32.** **c.** All of the expenses except the printing cost for stock certificates qualify as organizational expenses ($750 + $100 + $250 + $300 + $400 = $1,800 total). If New Corporation makes the election on a timely filed return (plus extensions), it will be allowed to deduct the full amount in 2011. (See Example 11 and pp. 1-13 and 1-14.)

**33.** **d.** Because the fiscal year ending June 30, 2012 has 12 full months, the allowed deduction is $5,200 [$5,000 + $200 ($3,000/180 = $16.67 per month × 12 months)]. (See Example 12 and pp. 1-13 and 1-14.)

**34.** **d.** Neither the taxable year of the actual payment nor the corporation's method of accounting affect the calculation. (See Example 11, and pp. 1-13 and 1-14.)

**35.** **c.** The charitable deductions for ordinary income property generally may not exceed the corporation's basis in the property. (See pp. 1-16 and 1-17.)

**36.** **d.** Excess charitable contributions may be carried over to each of the succeeding five years, subject to certain limitations. Since (1) the carryover period is limited to five years, (2) a charitable contribution deduction is allowed only if the corporation has taxable income, (3) excess contributions cannot be carried back, and (4) contributions made in the carryover year must be deducted before considering any carryovers, only answer d is true. (See Examples 18 and 19 and pp. 1-17 and 1-18.)

**37.** **d.** Because the charitable contributions were erroneously deducted in full to arrive at an incorrect taxable income number of $100,000, the first thing that must be done is to add back the $12,000 of deductions. Thus, taxable income before the charitable contribution deduction is correctly $112,000. T Corporation's correct contribution deduction, therefore, is limited to $11,200 [($100,000 + $12,000 = $112,000 correct taxable income before deduction) × 10%]. The remaining $800 of charitable contributions must be carried forward. (See Examples 18 and 19 and pp. 1-17 and 1-18.)

**38.** **c.** K Corporation's net operating loss is $55,000, computed as follows:

| | |
|---|---|
| Gross profit from operations | $180,000 |
| Dividends received | + 50,000 |
| Gross income | $230,000 |
| Less: Ordinary deductions | (250,000) |
| Dividends received deduction ($50,000 × 70%) | (35,000)* |
| Net operating loss | $(55,000) |

*Recall that a corporation's dividends-received deduction is not subject to the taxable income limitation if it adds to, or creates, a net operating loss for the year.

(See Exhibit 1-3, Example 14, and p. 1-15.)

**39.** **b.** Z Corporation's taxable income is $633,000, computed as follows:

| | | |
|---|---|---|
| Taxable income before capital and § 1231 gains and losses | | $600,000 |
| § 1245 depreciation recapture from gain on sale of equipment treated as ordinary income | | + 15,000 |
| § 1231 gains and losses: | | |
| Gain on sale of land | $70,000 | |
| Less: Loss on sale of equipment | (29,000) | |
| Net § 1231 gain treated as long-term capital gain | $41,000 | |
| Long-term capital loss | (18,000) | |
| Net long-term capital gain | $23,000 | |
| Less: Short-term capital loss | (5,000) | |
| Net capital gain | | + 18,000 |
| Taxable income | | $633,000 |

(See pp. 1-18 and 1-19.)

**40.** **d.** Unlike individuals, corporations must treat all capital loss carryovers as short-term losses. (See p. 1-19.)

**41.** **c.** Gain upon sale is calculated as follows:

| | | |
|---|---|---|
| Sales price | | $200,000 |
| Less: Cost | $150,000 | |
| (Depreciation taken) | (20,000) | |
| Adjusted basis | | (130,000) |
| Gain | | $ 70,000 |

Under § 1250, there is no depreciation recapture. If § 1245 depreciation recapture applied to this sale, gain would be ordinary income to the extent of depreciation taken ($20,000), and the remainder would be taxed as § 1231 gain ($50,000). The § 291 depreciation recapture calculation is

| | |
|---|---|
| Amount that would be treated as ordinary income under § 1245 | $20,000 |
| Less: Amount that would be treated as ordinary income under § 1250 | ( 0) |
| Equals: Difference between recapture amounts | $20,000 |
| Times: Rate specified in § 291 | × 20% |
| Equals: Amount treated as ordinary income | $ 4,000 |

Therefore, of the $70,000 total gain, $4,000 is ordinary and the remainder ($66,000) is § 1231 gain. (See Example 21 and pp. 1-20 and 1-21.)

**42.** **b.** Under § 267, J was not allowed to recognize his loss of $10,000 in 2008 (J was a greater than 50% shareholder in the JS Corporation). This loss may be carried over and used to offset gain when the related party sells the property in a taxable transaction to an unrelated party. Therefore, the corporation's realized gain of $5,000 ($65,000 sales price less its $60,000 basis) is not recognized. Note, however, that the suspended loss may not be used to create a recognized loss in the hands of the corporation. As a result, $5,000 of the loss disappears. (See p. 1-21.)

**43.** **b.** With respect to the matching of income and deduction, a related party is any person owning directly or indirectly *more than* 50 percent of the corporation's outstanding stock. (See pp. 1-21 and 1-22.)

**44.** **a.** The correct amount is $680,000 ($2,000,000 × 34%). Because Z Corporation's taxable income exceeds $335,000, it is taxed at the flat rate of 34 percent. (See Example 24 and pp. 1-22 and 1-23.)

**45.** **e.** A regular corporation's tax on $20,000 of taxable income will be $3,000 ($20,000 × 15%). A personal service corporation (PSC) is not allowed to use the lower corporate tax rates. Instead, a PSC is subject to a flat rate of 35 percent. Consequently, the PSC's tax on $20,000 of income will be $7,000 ($20,000 × 35%). (See p. 1-23.)

**46.** **d.** The manufacture of personal computers is not specifically included in the definition of a personal service corporation. [See p. 1-23 and § 448(d)(2).]

**47.** **d.** Congress denied the benefits of the *lower* tax rates to personal service corporations for taxable years after 1987 (Revenue Act of 1987). As a result, the taxable income of a PSC is subject to a flat rate of 35 percent. [See p. 1-23 and § 11(b)(2).]

**48.** **d.** A brother-sister controlled group consists of two or more corporations connected through the stock ownership of certain *noncorporate* shareholders—individuals, estates, or trusts. (See p. 1-25.)

**49.** **a.** This is a description of the brother-sister type of controlled group. [See p. 1-25 and § 1563(a).]

**50.** **e.** The phaseout of the $40,000 exemption occurs at $310,000, *not* at $250,000. $40,000 ÷ 25% = $160,000; $160,000 + $150,000 = $310,000. [See pp. 1-28 through 1-33 and § 55(d)(3)(A).]

**51.** **a.** First, calculate the adjusted current earnings (ACE) adjustment. This is $600,000 [($2 million ACE less $1.2 million AMTI) × 75%]. This results in AMTI of $1.8 million ($1.2 million tentative AMTI + $600,000). Then calculate the tentative AMT. This equals $360,000 ($1.8 million × 20% AMT rate). Note that the exemption is fully phased out when AMTI exceeds $310,000. Finally, calculate the regular tax of $340,000 ($1 million taxable income × 34% rate). Because the tentative AMT exceeds the regular tax, the AMT is $20,000 ($360,000 – $340,000). (See Example 35 and p. 1-32.)

**52.** **b.** Answers a, c, and d are the three basic *exceptions* to the general rule that denies the use of the cash method of accounting for tax purposes to most corporations. (See p. 1-33.)

**53.** **b.** A personal service corporation must use a *calendar* year unless it can satisfy IRS requirements that there is a business purpose for a *fiscal* year. [See p. 1-33, and § 441(I).]

**54.** **b.** Net capital losses are not currently deductible for Federal income tax purposes. The other items are all subtractions from income per books. (See Example 37 and pp. 1-34 and 1-35.)

**55.** **b.** Schedule M-2 reconciles *book* opening and closing retained earnings—using accounting rather than tax data. (See Example 39, and p. 1-37.)

**56.** **a.** The corporate taxpayer is required to file its tax return by March 15. [See p. 1-41 and § 6072(b).]

**57.** **e.** All are true statements concerning the obligation of a corporation to make estimated tax payments. (See pp. 1-41 and 1-42.)

**58.** **b.** A "large" corporation is not allowed to use this exception except for its first installment of the taxable year. (See p. 1-42.)

**59.** **c.** Large Corporation was required to pay $40,000 each quarter ($160,000/4 quarters × 100%). Because Large paid only $30,000 each quarter, the quarterly underpayment is $10,000. Large may not, except for its first quarterly installment, base its payments on last year's tax liability (it is a "large" corporation) and may not use the annualization method (income is earned evenly). (See Example 41 on p. 1-42.)

**60.** **a.** Form 7004 allows a corporation a six-month extension of time to file—not of time to pay the tax. Any tax balance due must be paid with the extension. (See p. 1-41.)

# 1

# Income Taxation of Corporations

## Comprehensive Problems

### Facts for Comprehensive Problems

X Corporation had the following items of income, expense, gain, loss, credit and prepayment for its 2011 calendar year. X Corporation files Form 1120 using a calendar year. The figures shown below were prepared by X Corporation's controller using the accrual method of accounting.

| | | |
|---|---|---|
| Net income from operations (calculated without regard to the following items) | | $520,000 |
| Dividends received (from less than 20% owned corporation; held for 30 days and then sold) | | 10,000 |
| Dividends received (from Y Corporation; X owns 90% of Y and Y owns 80% of X) | | 15,000 |
| Capital gains: long-term | | 5,000 |
| short-term | | 7,500 |
| Capital losses: long-term | | 3,000 |
| short-term | | 8,500 |
| Capital loss carryover from 2010 (short-term) | | 10,000 |
| Charitable contributions (declared by Board of Directors, but paid before $2\frac{1}{2}$ months of year close) | | 75,000 |
| Charitable contribution carryover from 2010 | | 20,000 |
| Net operating loss carryovers: | 2010 | 12,000 |
| | 2009 | 8,000 |
| | 2008 | 22,000 |
| Dividends paid (to Y Corporation) | | 50,000 |
| General business credit carryover from 2010 | | 6,500 |
| Estimated tax payments (timely paid in four equal amounts of $36,000 each) | | 144,000 |

## Comprehensive Problems

**1.** Calculate the following, showing your work.

- **a.** Taxable income for the charitable deduction limit
- **b.** 2011 charitable deduction for taxes
- **c.** Carryover amount of 2010 charitable contributions to 2012, if any
- **d.** Carryover amount of 2009 charitable contributions to 2012, if any

**2.** Calculate the following, showing your work.

- **a.** Net long-term capital gain/loss
- **b.** Net short-term capital gain/loss
- **c.** Net capital gain/loss
- **d.** Amount and year of any capital loss carryover to 2012

**3.** Calculate the following, showing your work.

- **a.** Deduction for dividends received from less than 20% owned corporation, if any
- **b.** Deduction for dividends received from Y corporation, if any
- **c.** Deduction for dividends paid to Y corporation, if any

**4.** Calculate the following, showing your work.

- **a.** Taxable income for 2011
- **b.** Income tax liability before credits and prepayments
- **c.** Net tax due with tax return, if any
- ***d.** Estimated tax underpayment, if any
- ***e.** Estimated tax overpayment, if any

*Relative to amount needed to meet minimum requirement

## Solutions to Comprehensive Problems

**1.** **a.**

| | |
|---|---|
| Net income from operations | $520,000 |
| Add in all dividends received | 25,000 |
| Subtract NOL carryovers | (42,000) |
| Taxable income for the charitable deduction limit | $503,000 |

*Note:* Taxable income for the charitable deduction is figured without reduction for charitable contributions, the dividends-received deduction, net operating loss carrybacks, or capital loss carrybacks.

**b.**

| | |
|---|---|
| Taxable income for the charitable deduction limit | $503,000 |
| Apply limit | × 10% |
| Dollar maximum for charitable deduction for 2011 | $ 50,300 |

Because the $75,000 of actual contributions exceed this limit, the 2011 contribution deduction allowed for taxes is $50,300.

**c.** The 2011 carryover to 2012 is $75,000 − $50,300 = $24,700.

**d.** Because current year contributions are used first for deduction purposes, the contribution carryover from 2010 to 2012 remains the same, $20,000.

**2.** **a.**

| | |
|---|---|
| Long-term capital gain | $ 5,000 |
| Long-term capital loss | – 3,000 |
| Net long-term capital gain | $ 2,000 |

**b.**

| | |
|---|---|
| Short-term capital gain | $ 7,500 |
| Short-term capital loss | – 8,500 |
| Net short-term capital loss | $ 1,000 |

**c.**

| | |
|---|---|
| Net long-term capital gain | $ 2,000 |
| Net short-term capital loss | – 1,000 |
| Net long-term capital gain | $ 1,000 |

**d.**

| | |
|---|---|
| Capital loss carryover from 2010 to 2012 | $10,000 |
| Amount used in 2011 | – 1,000 |
| Capital loss carryover from 2010 to 2012 | $ 9,000 |

*Note:* There is no effect on taxable income for 2011 from capital gains.

**3.** **a.** Because this stock was held for less than 46 days, there is *no* dividends-received deduction.

**b.** X and Y Corporations qualify as affiliated corporations since each owns 80% or more of the stock of the other. A 100% dividends-received deduction is allowed = $15,000.

**c.** There is *no* deduction for dividends paid.

**4.** **a.**

| | |
|---|---|
| Net income from operations | $520,000 |
| Plus: All dividends received | 25,000 |
| Less: Allowable charitable contributions | (50,300) |
| NOL carryovers | (42,000) |
| Dividends-received deduction | (15,000) |
| Taxable income for 2011 | $437,700 |

**b.**

| | |
|---|---|
| Taxable income for 2011 | $437,700 |
| Applicable tax rate | × 34% |
| Income tax liability before credits and prepayments | $148,818 |

**c.**

| | |
|---|---|
| Income tax liability before credits and prepayments | $ 148,818 |
| Less general business credit | (6,500) |
| Income tax liability before prepayments | $ 142,318 |
| Less estimated tax payments | (134,000) |
| Income tax due with return | $ 8,318 |

**d.**

| | |
|---|---|
| Income tax liability before prepayments | $142,318 |
| Apply 100% rate | × 100% |
| Minimum requirement | $142,318 |

Because all four estimated tax payments ($36,000 each) were made timely and in equal amounts, it is evident at this point that *no* estimated tax underpayment exists.

$$\$142{,}318 \div 4 = \$35{,}580$$

Each of the four estimated tax payments exceeded the amount due.

**e.**

| | |
|---|---|
| Estimated tax payments made | $ 144,000 |
| Less: Minimum requirement | (142,318) |
| Amount in excess of minimum requirement | $ 1,682 |

1

# Income Taxation of Corporations

## Solutions to Tax Return Problems

**1-33** Form 1120 is shown on the following pages. Note that the underpayment tax penalty rate used in this solution is assumed to be 6 percent. The actual penalty rate may be different.

Form **1120** Department of the Treasury Internal Revenue Service

# U.S. Corporation Income Tax Return

**For calendar year 2010 or tax year beginning ______, 2010, ending ______, 20 __**

▶ **See separate instructions.**

OMB No. 1545-0123 **2010**

**A Check if:**
1a Consolidated return (attach Form 851) ☐
b Life/nonlife consolidated return ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 attached ☐

**Print or type**
Name: *The Bike Shop*
Number, street, and room or suite no. If a P.O. box, see instructions: *1234 Wheeling Drive*
City or town, state, and ZIP code: *Cincinnati OH 45202*

**B Employer identification number:** *75 4476243*
**C** Date incorporated: *05/01/1994*
**D** Total assets (see instructions): $ *1,984,000.*

**E** Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

| | | | | |
|---|---|---|---|---|
| Income | 1a | Gross receipts or sales *2,100,000.* b Less returns and allowances c Bal ▶ | 1c | *2,100,000.* |
| | 2 | Cost of goods sold (Schedule A, line 8) | 2 | *715,000.* |
| | 3 | Gross profit. Subtract line 2 from line 1c | 3 | *1,385,000.* |
| | 4 | Dividends (Schedule C, line 19) | 4 | *5,000.* |
| | 5 | Interest | 5 | *10,000.* |
| | 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 schedule) | 10 | |
| | 11 | **Total income.** Add lines 3 through 10 ▶ | 11 | *1,400,000.* |
| Deductions (See instructions for limitations on deductions.) | 12 | Compensation of officers (Schedule E, line 4) ▶ | 12 | *210,000.* |
| | 13 | Salaries and wages (less employment credits) | 13 | *265,000.* |
| | 14 | Repairs and maintenance | 14 | *20,000.* |
| | 15 | Bad debts | 15 | *1,000.* |
| | 16 | Rents | 16 | |
| | 17 | Taxes and licenses | 17 | *50,000.* |
| | 18 | Interest | 18 | *14,000.* |
| | 19 | Charitable contributions | 19 | *60,000.* |
| | 20 | Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562) | 20 | *50,000.* |
| | 21 | Depletion | 21 | |
| | 22 | Advertising | 22 | *14,000.* |
| | 23 | Pension, profit-sharing, etc., plans | 23 | |
| | 24 | Employee benefit programs | 24 | |
| | 25 | Domestic production activities deduction (attach Form 8903) | 25 | |
| | 26 | Other deductions (attach schedule) *Meals and entertainment (50%)* | 26 | *5,000.* |
| | 27 | **Total deductions.** Add lines 12 through 26 ▶ | 27 | *689,000.* |
| | 28 | Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11 | 28 | *711,000.* |
| | 29 | **Less: a** Net operating loss deduction (see instructions) — 29a | | |
| | | **b** Special deductions (Schedule C, line 20) — 29b *3,500.* | 29c | *3,500.* |
| Tax, Refundable Credits, and Payments | 30 | **Taxable income.** Subtract line 29c from line 28 (see instructions) | 30 | *707,500.* |
| | 31 | **Total tax** (Schedule J, line 10) | 31 | *240,550.* |
| | 32a | 2009 overpayment credited to 2010 — 32a | | |
| | b | 2010 estimated tax payments — 32b *150,000.* | | |
| | c | 2010 refund applied for on Form 4466 — 32c ( ) d Bal ▶ 32d *150,000.* | | |
| | e | Tax deposited with Form 7004 — 32e | | |
| | f | Credits: (1) Form 2439 (2) Form 4136 — 32f | | |
| | g | Refundable credits from Form 3800, line 19c, and Form 8827, line 8c — 32g | 32h | *150,000.* |
| | 33 | Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☒ | 33 | *3,268.* |
| | 34 | **Amount owed.** If line 32h is smaller than the total of lines 31 and 33, enter amount owed | 34 | *93,818.* |
| | 35 | **Overpayment.** If line 32h is larger than the total of lines 31 and 33, enter amount overpaid | 35 | |
| | 36 | Enter amount from line 35 you want: **Credited to 2011 estimated tax** ▶ **Refunded** ▶ | 36 | |

**Sign Here**

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.

Signature of officer | Date | Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ **Yes** ☐ **No**

**Paid Preparer Use Only**

| Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN |
|---|---|---|---|---|
| | | | | |

Firm's name ▶ | Firm's EIN ▶
Firm's address ▶ | Phone no.

**For Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 11450Q Form **1120** (2010)

Form 1120 (2010) The Bike Shop 75-4476243 Page **2**

**Schedule A** **Cost of Goods Sold** (see instructions)

| | | | |
|---|---|---|---|
| 1 | Inventory at beginning of year | 1 | 375,000. |
| 2 | Purchases | 2 | 700,000. |
| 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 | 1,075,000. |
| 7 | Inventory at end of year | 7 | 360,000. |
| 8 | **Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2 | 8 | 715,000. |

9a Check all methods used for valuing closing inventory:

(i) ☐ Cost

(ii) ☒ Lower of cost or market

(iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) 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 corporation? ☐ Yes ☒ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☒ No

**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) | 5,000. | 70 | 3,500. |
| 2 | Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock) | | 80 | |
| 3 | Dividends on debt-financed stock of domestic and foreign corporations | | see instructions | |
| 4 | Dividends on certain preferred stock of less-than-20%-owned public utilities | | 42 | |
| 5 | Dividends on certain preferred stock of 20%-or-more-owned public utilities | | 48 | |
| 6 | Dividends from less-than-20%-owned foreign corporations and certain FSCs | | 70 | |
| 7 | Dividends from 20%-or-more-owned foreign corporations and certain FSCs | | 80 | |
| 8 | Dividends from wholly owned foreign subsidiaries | | 100 | |
| 9 | **Total.** Add lines 1 through 8. See instructions for limitation | | | 3,500. |
| 10 | Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958 | | 100 | |
| 11 | Dividends from affiliated group members | | 100 | |
| 12 | Dividends from certain FSCs | | 100 | |
| 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 ▶ | 5,000. | | |
| 20 | **Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶ | | | 3,500. |

**Schedule E** **Compensation of Officers** (see instructions for page 1, line 12)

**Note:** *Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1) are $500,000 or more.*

| | (a) Name of officer | (b) Social security number | (c) Percent of time devoted to business | Percent of corporation stock owned (d) Common | (e) Preferred | (f) Amount of compensation |
|---|---|---|---|---|---|---|
| 1 | Sam Smith | 446-46-4646 | 100.0 % | 70.0 % | % | 150,000. |
| | Jane Jones | 313-12-1212 | 100.0 % | 30.0 % | % | 60,000. |
| | | | % | % | % | |
| | | | % | % | % | |
| | | | % | % | % | |

| | | |
|---|---|---|
| 2 | Total compensation of officers | 210,000. |
| 3 | Compensation of officers claimed on Schedule A and elsewhere on return | |
| 4 | Subtract line 3 from line 2. Enter the result here and on page 1, line 12 | 210,000. |

Form **1120** (2010)

Form 1120 (2010) The Bike Shop 75-4476243 Page **3**

**Schedule J** **Tax Computation** (see instructions)

| | | | | | |
|---|---|---|---|---|---|
| 1 | Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)) ▶ ☐ | | | | |
| 2 | Income tax. Check if a qualified personal service corporation (see instructions) ▶ ☐ | | | 2 | |
| 3 | Alternative minimum tax (attach Form 4626) | | | 3 | 240,550. |
| 4 | Add lines 2 and 3 | | | 4 | |
| 5a | Foreign tax credit (attach Form 1118) | 5a | | | |
| b | Credit from Form 8834, line 29 | 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 | |
| 7 | Subtract line 6 from line 4 | | | 7 | |
| 8 | Personal holding company tax (attach Schedule PH (Form 1120)) | | | 8 | 240,550. |
| 9 | Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Form 8902 ☐ Other (attach schedule) | | | 9 | |
| 10 | **Total tax.** Add lines 7 through 9. Enter here and on page 1, line 31 | | | 10 | 240,550. |

**Schedule K** **Other Information** (see instructions)

| | | Yes | No |
|---|---|---|---|
| 1 | Check accounting method: **a** ☐ Cash **b** ☐ Accrual **c** ☐ Other (specify) ▶ | | |
| 2 | See the instructions and enter the: | | |
| a | Business activity code no. ▶ 451110 | | |
| b | Business activity ▶ Bicycle Sales | | |
| c | Product or service ▶ Bicycles | | |
| 3 | Is the corporation a subsidiary in an affiliated group or a parent-subsidiary 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 | |
| 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 If "Yes," complete (i) through (iv). | | |

| **(i)** Name of Corporation | **(ii)** Employer Identification Number (if any) | **(iii)** Country of Incorporation | **(iv)** Percentage Owned in Voting Stock |
|---|---|---|---|
| Sam Smith | 446-46-4646 | United States | 70.0 |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

Form **1120** (2010)

Form 1120 (2010) The Bike Shop 75-4476243 Page **4**

**Schedule K** *Continued*

| | | Yes | No |
|---|---|---|---|
| **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<br>If "Yes," complete (i) through (iv). | | |

| **(i)** Name of Entity | **(ii)** Employer Identification Number (if any) | **(iii)** Country of Organization | **(iv)** Maximum Percentage Owned in Profit, Loss, or Capital |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

| | | Yes | No |
|---|---|---|---|
| 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.<br>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:<br>**(i)** Percentage owned ▶ ______ and **(ii)** Owner's country ▶ ______<br>**(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 ▶ ☐<br>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 ▶ $ ______ | | |
| 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 ▶ ☐<br>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 1a 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)?<br>If "Yes," complete and attach Schedule UTP. | | |

Form **1120** (2010)

Form 1120 (2010) The Bike Shop 75-4476243 Page **5**

**Schedule L** **Balance Sheets per Books**

| | Assets | Beginning of tax year (a) | (b) | End of tax year (c) | (d) |
|---|---|---|---|---|---|
| 1 | Cash | | 110,000. | | 691,000. |
| 2a | Trade notes and accounts receivable | 14,000. | | 31,000. | |
| b | Less allowance for bad debts | ( 2,000. ) | 12,000. | ( 6,000. ) | 25,000. |
| 3 | Inventories | | 375,000. | | 360,000. |
| 4 | U.S. government obligations | | 20,000. | | 20,000. |
| 5 | Tax-exempt securities (see instructions) | | | | |
| 6 | Other current assets (attach schedule) | | 50,000. | | 70,000. |
| 7 | Loans to shareholders | | | | |
| 8 | Mortgage and real estate loans | | | | |
| 9 | Other investments (attach schedule) | | | | |
| 10a | Buildings and other depreciable assets | 795,000. | | 905,000. | |
| b | Less accumulated depreciation | ( 211,000. ) | 584,000. | ( 251,000. ) | 654,000. |
| 11a | Depletable assets | | | | |
| b | Less accumulated depletion | ( ) | | ( ) | |
| 12 | Land (net of any amortization) | | 164,000. | | 164,000. |
| 13a | Intangible assets (amortizable only) | | | | |
| b | Less accumulated amortization | ( ) | | ( ) | |
| 14 | Other assets (attach schedule) | | | | |
| 15 | Total assets | | 1,315,000. | | 1,984,000. |
| | **Liabilities and Shareholders' Equity** | | | | |
| 16 | Accounts payable | | 65,000. | | 350,000. |
| 17 | Mortgages, notes, bonds payable in less than 1 year | | 500,000. | | 400,000. |
| 18 | Other current liabilities (attach schedule) | | | | 93,818. |
| 19 | Loans from shareholders | | | | |
| 20 | Mortgages, notes, bonds payable in 1 year or more | | | | |
| 21 | Other liabilities (attach schedule) | | | | |
| 22 | Capital stock: **a** Preferred stock | | | | |
| | **b** Common stock | 150,000. | | 150,000. | 150,000. |
| 23 | Additional paid-in capital | | | | |
| 24 | Retained earnings—Appropriated (attach schedule) | | | | |
| 25 | Retained earnings—Unappropriated | | 600,000. | | 990,182. |
| 26 | Adjustments to shareholders' equity (attach schedule) | | | | |
| 27 | Less cost of treasury stock | | ( ) | | ( ) |
| 28 | Total liabilities and shareholders' equity | | 1,315,000. | | 1,984,000. |

**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 | 450,182. | 7 | Income recorded on books this year not included on this return (itemize): Tax-exempt interest $ | |
| 2 | Federal income tax per books | 240,550. | | | |
| 3 | Excess of capital losses over capital gains | 2,000. | | | |
| 4 | Income subject to tax not recorded on books this year (itemize): | | | | |
| | | | 8 | Deductions on this return not charged against book income this year (itemize): | |
| 5 | Expenses recorded on books this year not deducted on this return (itemize): | | a | Depreciation $ 10,000. | |
| a | Depreciation $ | | b | Charitable contributions $ | |
| b | Charitable contributions $ | | | | |
| c | Travel and entertainment $ 5,000. | | | | 10,000. |
| | See Ln 5 Stmt 23,268. | 23,268. | 9 | Add lines 7 and 8 | 10,000. |
| 6 | Add lines 1 through 5 | 721,000. | 10 | Income (page 1, line 28)—line 6 less line 9 | 711,000. |

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

| | | | | | |
|---|---|---|---|---|---|
| 1 | Balance at beginning of year | 600,000. | 5 | Distributions: **a** Cash | 60,000. |
| 2 | Net income (loss) per books | 450,182. | | **b** Stock | |
| 3 | Other increases (itemize): | | | **c** Property | |
| | | | 6 | Other decreases (itemize): | |
| | | | 7 | Add lines 5 and 6 | 60,000. |
| 4 | Add lines 1, 2, and 3 | 1,050,182. | 8 | Balance at end of year (line 4 less line 7) | 990,182. |

Form **1120** (2010)

Form **4626** | **Alternative Minimum Tax—Corporations** | OMB No. 1545-0175

Department of the Treasury
Internal Revenue Service

▶ See separate instructions.
▶ Attach to the corporation's tax return.

**2010**

Name: The Bike Shop | **Employer identification number**: 75 4476243

**Note:** *See the instructions to find out if the corporation is a small corporation exempt from the alternative minimum tax (AMT) under section 55(e).*

| | | | | | |
|---|---|---|---|---|---|
| 1 | Taxable income or (loss) before net operating loss deduction | | | 1 | 707,500. |
| 2 | **Adjustments and preferences:** | | | | |
| a | Depreciation of post-1986 property | | | 2a | |
| b | Amortization of certified pollution control facilities | | | 2b | |
| c | Amortization of mining exploration and development costs | | | 2c | |
| d | Amortization of circulation expenditures (personal holding companies only) | | | 2d | |
| e | Adjusted gain or loss | | | 2e | |
| f | Long-term contracts | | | 2f | |
| g | Merchant marine capital construction funds | | | 2g | |
| h | Section 833(b) deduction (Blue Cross, Blue Shield, and similar type organizations only) | | | 2h | |
| i | Tax shelter farm activities (personal service corporations only) | | | 2i | |
| j | Passive activities (closely held corporations and personal service corporations only) | | | 2j | |
| k | Loss limitations | | | 2k | |
| l | Depletion | | | 2l | |
| m | Tax-exempt interest income from specified private activity bonds | | | 2m | |
| n | Intangible drilling costs | | | 2n | |
| o | Other adjustments and preferences | | | 2o | |
| 3 | Pre-adjustment alternative minimum taxable income (AMTI). Combine lines 1 through 2o | | | 3 | 707,500. |
| 4 | **Adjusted current earnings (ACE) adjustment:** | | | | |
| a | ACE from line 10 of the ACE worksheet in the instructions | 4a | 707,500. | | |
| b | Subtract line 3 from line 4a. If line 3 exceeds line 4a, enter the difference as a negative amount (see instructions) | 4b | 0. | | |
| c | Multiply line 4b by 75% (.75). Enter the result as a positive amount | 4c | 0. | | |
| d | Enter the excess, if any, of the corporation's total increases in AMTI from prior year ACE adjustments over its total reductions in AMTI from prior year ACE adjustments (see instructions). **Note:** *You **must** enter an amount on line 4d (even if line 4b is positive)* | 4d | | | |
| e | ACE adjustment.<br>• If line 4b is zero or more, enter the amount from line 4c<br>• If line 4b is less than zero, enter the **smaller** of line 4c or line 4d as a negative amount | | | 4e | 0. |
| 5 | Combine lines 3 and 4e. If zero or less, stop here; the corporation does not owe any AMT | | | 5 | 707,500. |
| 6 | Alternative tax net operating loss deduction (see instructions) | | | 6 | |
| 7 | **Alternative minimum taxable income.** Subtract line 6 from line 5. If the corporation held a residual interest in a REMIC, see instructions | | | 7 | 707,500. |
| 8 | **Exemption phase-out** (if line 7 is $310,000 or more, skip lines 8a and 8b and enter -0- on line 8c): | | | | |
| a | Subtract $150,000 from line 7 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0- | 8a | | | |
| b | Multiply line 8a by 25% (.25) | 8b | | | |
| c | Exemption. Subtract line 8b from $40,000 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0- | | | 8c | 0. |
| 9 | Subtract line 8c from line 7. If zero or less, enter -0- | | | 9 | 707,500. |
| 10 | Multiply line 9 by 20% (.20) | | | 10 | 141,500. |
| 11 | Alternative minimum tax foreign tax credit (AMTFTC) (see instructions) | | | 11 | |
| 12 | Tentative minimum tax. Subtract line 11 from line 10 | | | 12 | 141,500. |
| 13 | Regular tax liability before applying all credits except the foreign tax credit | | | 13 | 240,550. |
| 14 | **Alternative minimum tax.** Subtract line 13 from line 12. If zero or less, enter -0-. Enter here and on Form 1120, Schedule J, line 3, or the appropriate line of the corporation's income tax return | | | 14 | 0. |

**For Paperwork Reduction Act Notice, see the instructions.** Cat. No. 12955I Form **4626** (2010)

**SCHEDULE D (Form 1120)**

Department of the Treasury
Internal Revenue Service

# Capital Gains and Losses

▶ Attach to Form 1120, 1120-C, 1120-F, 1120-FSC, 1120-H, 1120-IC-DISC, 1120-L, 1120-ND, 1120-PC, 1120-POL, 1120-REIT, 1120-RIC, 1120-SF, or certain Forms 990-T.
▶ See separate instructions.

OMB No. 1545-0123

2010

Name: The Bike Shop

Employer identification number: 75-4476243

## Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

| | (a) Description of property (Example: 100 shares of Z Co.) | (b) Date acquired (mo., day, yr.) | (c) Date sold (mo., day, yr.) | (d) Sales price (see instructions) | (e) Cost or other basis (see instructions) | (f) Gain or (loss) (Subtract (e) from (d)) |
|---|---|---|---|---|---|---|
| 1 | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

| | | | |
|---|---|---|---|
| 2 | Short-term capital gain from installment sales from Form 6252, line 26 or 37 . . . . . . . . . . . | 2 | |
| 3 | Short-term gain or (loss) from like-kind exchanges from Form 8824 . . . . . . . . . . . . | 3 | |
| 4 | Unused capital loss carryover (attach computation) . . . . . . . . . . . . . . . . . . | 4 | ( ) |
| 5 | Net short-term capital gain or (loss). Combine lines 1 through 4 . . . . . . . . . . . . . . | 5 | |

## Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

| | (a) Description of property | (b) Date acquired | (c) Date sold | (d) Sales price | (e) Cost or other basis | (f) Gain or (loss) |
|---|---|---|---|---|---|---|
| 6 | Long term capital gain | 01/02/04 | 01/02/10 | 7,000. | 0. | 7,000. |
| | Long term capital losss | 01/02/04 | 01/02/10 | 0. | 9,000. | -9,000. |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

| | | | |
|---|---|---|---|
| 7 | Enter gain from Form 4797, line 7 or 9 . . . . . . . . . . . . . . . . . . . . . . . | 7 | |
| 8 | Long-term capital gain from installment sales from Form 6252, line 26 or 37 . . . . . . . . . . . | 8 | |
| 9 | Long-term gain or (loss) from like-kind exchanges from Form 8824 . . . . . . . . . . . . | 9 | |
| 10 | Capital gain distributions (see instructions) . . . . . . . . . . . . . . . . . . . . | 10 | |
| 11 | Net long-term capital gain or (loss). Combine lines 6 through 10 . . . . . . . . . . . . . | 11 | -2,000. |

## Part III Summary of Parts I and II

| | | | |
|---|---|---|---|
| 12 | Enter excess of net short-term capital gain (line 5) over net long-term capital loss (line 11) . . . . | 12 | |
| 13 | Net capital gain. Enter excess of net long-term capital gain (line 11) over net short-term capital loss (line 5) . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | 13 | |
| 14 | Add lines 12 and 13. Enter here and on Form 1120, page 1, line 8, or the proper line on other returns . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | 14 | |

**Note.** *If losses exceed gains, see* ***Capital losses*** *in the instructions.*

**For Paperwork Reduction Act Notice, see the Instructions for Form 1120.** Cat. No. 11460M **Schedule D (Form 1120) (2010)**

Form **2220**

Department of the Treasury
Internal Revenue Service

# Underpayment of Estimated Tax by Corporations

▶ See separate instructions.
▶ Attach to the corporation's tax return.

OMB No. 1545-0142

2010

| Name | Employer identification number |
|---|---|
| The Bike Shop | 75 4476243 |

**Note:** *Generally, the corporation is not required to file Form 2220 (see Part II below for exceptions) because the IRS will figure any penalty owed and bill the corporation. However, the corporation may still use Form 2220 to figure the penalty. If so, enter the amount from page 2, line 38 on the estimated tax penalty line of the corporation's income tax return, but* **do not** *attach Form 2220.*

## Part I Required Annual Payment

| | | | | | |
|---|---|---|---|---|---|
| 1 | Total tax (see instructions) | | | 1 | 240,550. |
| 2a | Personal holding company tax (Schedule PH (Form 1120), line 26) included on line 1 | 2a | | | |
| b | Look-back interest included on line 1 under section 460(b)(2) for completed long-term contracts or section 167(g) for depreciation under the income forecast method | 2b | | | |
| c | Credit for federal tax paid on fuels (see instructions) | 2c | | | |
| d | **Total.** Add lines 2a through 2c | | | 2d | |
| 3 | Subtract line 2d from line 1. If the result is less than $500, **do not** complete or file this form. The corporation does not owe the penalty | | | 3 | 240,550. |
| 4 | Enter the tax shown on the corporation's 2009 income tax return (see instructions). **Caution:** ***If the tax is zero or the tax year was for less than 12 months, skip this line and enter the amount from line 3 on line 5*** | | | 4 | |
| 5 | **Required annual payment.** Enter the **smaller** of line 3 or line 4. If the corporation is required to skip line 4, enter the amount from line 3 | | | 5 | 240,550. |

## Part II Reasons for Filing—Check the boxes below that apply. If any boxes are checked, the corporation **must** file Form 2220 even if it does not owe a penalty (see instructions).

6 ☐ The corporation is using the adjusted seasonal installment method.

7 ☐ The corporation is using the annualized income installment method.

8 ☐ The corporation is a "large corporation" figuring its first required installment based on the prior year's tax.

## Part III Figuring the Underpayment

| | | | (a) | (b) | (c) | (d) |
|---|---|---|---|---|---|---|
| 9 | **Installment due dates.** Enter in columns (a) through (d) the 15th day of the 4th (***Form 990-PF filers:*** Use 5th month), 6th, 9th, and 12th months of the corporation's tax year | 9 | 04/15/10 | 06/15/10 | 09/15/10 | 12/15/10 |
| 10 | **Required installments.** If the box on line 6 and/or line 7 above is checked, enter the amounts from Schedule A, line 38. If the box on line 8 (but not 6 or 7) is checked, see instructions for the amounts to enter. If none of these boxes are checked, enter 25% of line 5 above in each column | 10 | 60,136. | 60,138. | 60,138. | 60,138. |
| 11 | Estimated tax paid or credited for each period (see instructions). For column (a) only, enter the amount from line 11 on line 15 | 11 | 37,500. | 37,500. | 37,500. | 37,500. |
| | ***Complete lines 12 through 18 of one column before going to the next column.*** | | | | | |
| 12 | Enter amount, if any, from line 18 of the preceding column | 12 | | | | |
| 13 | Add lines 11 and 12 | 13 | | 37,500. | 37,500. | 37,500. |
| 14 | Add amounts on lines 16 and 17 of the preceding column | 14 | | 22,636. | 45,274. | 67,912. |
| 15 | Subtract line 14 from line 13. If zero or less, enter -0- | 15 | 37,500. | 14,864. | 0. | 0. |
| 16 | If the amount on line 15 is zero, subtract line 13 from line 14. Otherwise, enter -0- | 16 | | | | |
| 17 | **Underpayment.** If line 15 is less than or equal to line 10, subtract line 15 from line 10. Then go to line 12 of the next column. Otherwise, go to line 18 | 17 | 22,636. | 45,274. | 60,138. | 60,138. |
| 18 | **Overpayment.** If line 10 is less than line 15, subtract line 10 from line 15. Then go to line 12 of the next column | 18 | | | | |

***Go to Part IV on page 2 to figure the penalty. Do not go to Part IV if there are no entries on line 17—no penalty is owed.***

Form 2220 (2010) The Bike Shop 75-4476243 Page **2**

## Part IV Figuring the Penalty

| | | | (a) | (b) | (c) | (d) |
|---|---|---|---|---|---|---|
| 19 | Enter the date of payment or the 15th day of the 3rd month after the close of the tax year, whichever is earlier (see instructions). ***(Form 990-PF and Form 990-T filers:*** Use 5th month instead of 3rd month.) | 19 | | | | |
| 20 | Number of days from due date of installment on line 9 to the date shown on line 19 | 20 | | | | |
| 21 | Number of days on line 20 after 4/15/2010 and before 7/1/2010 | 21 | | | | |
| 22 | Underpayment on line 17 × $\frac{\text{Number of days on line 21}}{365}$ × 4% | 22 | $ | $ | $ | $ |
| 23 | Number of days on line 20 after 6/30/2010 and before 10/1/2010 | 23 | | | | |
| 24 | Underpayment on line 17 × $\frac{\text{Number of days on line 23}}{365}$ × 4% | 24 | $ | $ | $ | $ |
| 25 | Number of days on line 20 after 9/30/2010 and before 1/1/2011 | 25 | | | | |
| 26 | Underpayment on line 17 × $\frac{\text{Number of days on line 25}}{365}$ × 4% | 26 | $ | $ | $ | $ |
| 27 | Number of days on line 20 after 12/31/2010 and before 4/1/2011 | 27 | | | | |
| 28 | Underpayment on line 17 × $\frac{\text{Number of days on line 27}}{365}$ × 3% | 28 | $ | $ | $ | $ |
| 29 | Number of days on line 20 after 3/31/2011 and before 7/1/2011 | 29 | | | | |
| 30 | Underpayment on line 17 × $\frac{\text{Number of days on line 29}}{365}$ × *% | 30 | $ | $ | $ | $ |
| 31 | Number of days on line 20 after 6/30/2011 and before 10/1/2011 | 31 | | | | |
| 32 | Underpayment on line 17 × $\frac{\text{Number of days on line 31}}{365}$ × *% | 32 | $ | $ | $ | $ |
| 33 | Number of days on line 20 after 9/30/2011 and before 1/1/2012 | 33 | | | | |
| 34 | Underpayment on line 17 × $\frac{\text{Number of days on line 33}}{365}$ × *% | 34 | $ | $ | $ | $ |
| 35 | Number of days on line 20 after 12/31/2011 and before 2/16/2012 | 35 | | | | |
| 36 | Underpayment on line 17 × $\frac{\text{Number of days on line 35}}{366}$ × *% | 36 | $ | $ | $ | $ |
| 37 | Add lines 22, 24, 26, 28, 30, 32, 34, and 36 | 37 | $ | $ | $ | $ |

**38** **Penalty.** Add columns (a) through (d) of line 37. Enter the total here and on Form 1120, line 33; or the comparable line for other income tax returns . . . . 38 $

*Use the penalty interest rate for each calendar quarter, which the IRS will determine during the first month in the preceding quarter. These rates are published quarterly in an IRS News Release and in a revenue ruling in the Internal Revenue Bulletin. To obtain this information on the Internet, access the IRS website at **www.irs.gov.** You can also call 1-800-829-4933 to get interest rate information.

Form **2220** (2010)

## Underpayment Penalty Statement 2010

► Attach to return

Name: The Bike Shop

Employer Identification No.: 75-4476243

| 'Event' | Date | Amount Due | Amount Paid | Balance Due (Overpayment) | Percent | # of Days | Penalty |
|---|---|---|---|---|---|---|---|
| Amount Due | 04/15/10 | 60,136. | | 60,136. | 6.00 | 0 | |
| Payment | 04/15/10 | | 37,500. | 22,636. | 6.00 | 61 | 227. |
| Amount Due | 06/15/10 | 60,138. | | 82,774. | 6.00 | 0 | |
| Payment | 06/15/10 | | 37,500. | 45,274. | 6.00 | 92 | 685. |
| Amount Due | 09/15/10 | 60,138. | | 105,412. | 6.00 | 0 | |
| Payment | 09/15/10 | | 37,500. | 67,912. | 6.00 | 15 | 1,016. |
| Amount Due | 12/15/10 | 60,138. | | 128,050. | 6.00 | 0 | |
| Payment | 12/15/10 | | 37,500. | 90,550. | 6.00 | 90 | 1,340. |
| Date Filed | 03/15/11 | | | 90,550. | | | |

**Total Penalty** ........ 3,268.

CPCV1401.SCR 12/01/05

| *The Bike Shop 75-4476243* | 1 |
|---|---|

Form 1120, Sch K, Corporation Ownership Information
**Ques 5 Stmt**

| Name | ID No. |
|---|---|
| *Sam Smith* | *446-46-4646* |

Form 1120, Page 4, Schedule M-1, Line 5
**Ln 5 Stmt**

| | |
|---|---|
| *Officers'/keyman life insurance premiums* | *10,000.* |
| *Bad debts* | *4,000.* |
| *Skybox rental* | *6,000.* |
| *Tax underpayment penalty* | *3,268.* |
| Total | *23,268.* |

**1-34** Although the calculations in this problem are relatively simple and straightforward, many students may overlook the importance of the AMT credit in answering the question regarding the choice of depreciation methods.

If Paul Schroeder chooses to depreciate the personalty acquired by ABC using MACRS, the corporation will pay an AMT tax of $11,750 and a total tax of $92,500, and will have an AMT credit carry forward of $11,750.

| | |
|---|---|
| Net income (before depreciation) | $300,000 |
| Less: MACRS depreciation | (50,000) |
| Regular taxable income | $250,000 |
| Tax on regular taxable income | $ 80,750 |
| | |
| Regular taxable income | $250,000 |
| Plus: Depreciation adjustment ($50,000 – $37,500) | 12,500 |
| Other AMT adjustments | 200,000 |
| AMTI | $ 462,500 |
| Less: AMT exemption | (0) |
| AMTI subject to tax | $462,500 |
| | |
| Tax on AMTI (20% rate) | $ 92,500 |

The AMT is $11,750 ($92,500 – $80,750); the total tax paid is $92,500; and the AMT credit carryforward is $11,750.

If Paul Schroeder chooses to depreciate the personalty acquired by ABC using AMT ADS, the corporation will pay an AMT tax of $6,875 ($92,500 – $85,625) and a total tax of $92,500, and will have an AMT credit carryforward of $6,875.

| | |
|---|---|
| Net income (before depreciation) | $300,000 |
| Less: AMT ADS depreciation | (37,500) |
| Regular taxable income | $262,500 |
| Tax on regular taxable income | $ 85,625 |
| | |
| Regular taxable income | $262,500 |
| Plus: Other AMT adjustments | 200,000 |
| AMTI | $462,500 |
| Less: AMT exemption | (0) |
| AMTI subject to tax | $462,500 |
| | |
| Tax on AMTI (20% rate) | $ 92,500 |

ABC Corporation pays the same total tax either way. So which method of depreciation should be selected? If MACRS is selected, the AMT credit carryover is $4,875 greater than the credit generated if AMT ADS is selected ($11,750 – $6,875). If this credit can be used in the near future to reduce the regular tax, this is a real advantage for choosing MACRS. However, if the corporation stays in an AMT situation indefinitely, the method of depreciation will not matter.

Form **4626**

Department of the Treasury
Internal Revenue Service

# Alternative Minimum Tax—Corporations

▶ **See separate instructions.**
▶ **Attach to the corporation's tax return.**

OMB No. 1545-0175

**2010**

Name: ABC MANUFACTURING CORP

**Employer identification number**

**Note:** *See the instructions to find out if the corporation is a small corporation exempt from the alternative minimum tax (AMT) under section 55(e).*

| | | | |
|---|---|---|---|
| 1 | Taxable income or (loss) before net operating loss deduction | 1 | 250,000 |
| 2 | **Adjustments and preferences:** | | |
| a | Depreciation of post-1986 property | 2a | 12,500 |
| b | Amortization of certified pollution control facilities | 2b | |
| c | Amortization of mining exploration and development costs | 2c | |
| d | Amortization of circulation expenditures (personal holding companies only) | 2d | |
| e | Adjusted gain or loss | 2e | |
| f | Long-term contracts | 2f | |
| g | Merchant marine capital construction funds | 2g | |
| h | Section 833(b) deduction (Blue Cross, Blue Shield, and similar type organizations only) | 2h | |
| i | Tax shelter farm activities (personal service corporations only) | 2i | |
| j | Passive activities (closely held corporations and personal service corporations only) | 2j | |
| k | Loss limitations | 2k | |
| l | Depletion | 2l | |
| m | Tax-exempt interest income from specified private activity bonds | 2m | |
| n | Intangible drilling costs | 2n | |
| o | Other adjustments and preferences | 2o | 200,000 |
| 3 | Pre-adjustment alternative minimum taxable income (AMTI). Combine lines 1 through 2o | 3 | 462,500 |
| 4 | **Adjusted current earnings (ACE) adjustment:** | | |
| a | ACE from line 10 of the ACE worksheet in the instructions — 4a | | |
| b | Subtract line 3 from line 4a. If line 3 exceeds line 4a, enter the difference as a negative amount (see instructions) — 4b | | |
| c | Multiply line 4b by 75% (.75). Enter the result as a positive amount — 4c | | |
| d | Enter the excess, if any, of the corporation's total increases in AMTI from prior year ACE adjustments over its total reductions in AMTI from prior year ACE adjustments (see instructions). **Note:** *You **must** enter an amount on line 4d (even if line 4b is positive)* — 4d | | |
| e | ACE adjustment.<br>• If line 4b is zero or more, enter the amount from line 4c<br>• If line 4b is less than zero, enter the **smaller** of line 4c or line 4d as a negative amount | 4e | |
| 5 | Combine lines 3 and 4e. If zero or less, stop here; the corporation does not owe any AMT | 5 | 462,500 |
| 6 | Alternative tax net operating loss deduction (see instructions) | 6 | |
| 7 | **Alternative minimum taxable income.** Subtract line 6 from line 5. If the corporation held a residual interest in a REMIC, see instructions | 7 | 462,500 |
| 8 | **Exemption phase-out** (if line 7 is $310,000 or more, skip lines 8a and 8b and enter -0- on line 8c): | | |
| a | Subtract $150,000 from line 7 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0- — 8a | | |
| b | Multiply line 8a by 25% (.25) — 8b | | |
| c | Exemption. Subtract line 8b from $40,000 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0- | 8c | -0- |
| 9 | Subtract line 8c from line 7. If zero or less, enter -0- | 9 | 462,500 |
| 10 | Multiply line 9 by 20% (.20) | 10 | 92,500 |
| 11 | Alternative minimum tax foreign tax credit (AMTFTC) (see instructions) | 11 | |
| 12 | Tentative minimum tax. Subtract line 11 from line 10 | 12 | 92,500 |
| 13 | Regular tax liability before applying all credits except the foreign tax credit | 13 | 80,750 |
| 14 | **Alternative minimum tax.** Subtract line 13 from line 12. If zero or less, enter -0-. Enter here and on Form 1120, Schedule J, line 3, or the appropriate line of the corporation's income tax return | 14 | 11,750 |

**For Paperwork Reduction Act Notice, see the instructions.** Cat. No. 12955I Form **4626** (2010)

Form **4626** | **Alternative Minimum Tax—Corporations** | OMB No. 1545-0175

Department of the Treasury
Internal Revenue Service

▶ See separate instructions.
▶ Attach to the corporation's tax return.

2010

Name: ABC MANUFACTURING CORP | Employer identification number

**Note:** *See the instructions to find out if the corporation is a small corporation exempt from the alternative minimum tax (AMT) under section 55(e).*

| | | | |
|---|---|---|---|
| 1 | Taxable income or (loss) before net operating loss deduction | 1 | 262,500 |
| 2 | **Adjustments and preferences:** | | |
| a | Depreciation of post-1986 property | 2a | |
| b | Amortization of certified pollution control facilities | 2b | |
| c | Amortization of mining exploration and development costs | 2c | |
| d | Amortization of circulation expenditures (personal holding companies only) | 2d | |
| e | Adjusted gain or loss | 2e | |
| f | Long-term contracts | 2f | |
| g | Merchant marine capital construction funds | 2g | |
| h | Section 833(b) deduction (Blue Cross, Blue Shield, and similar type organizations only) | 2h | |
| i | Tax shelter farm activities (personal service corporations only) | 2i | |
| j | Passive activities (closely held corporations and personal service corporations only) | 2j | |
| k | Loss limitations | 2k | |
| l | Depletion | 2l | |
| m | Tax-exempt interest income from specified private activity bonds | 2m | |
| n | Intangible drilling costs | 2n | |
| o | Other adjustments and preferences | 2o | 200,000 |
| 3 | Pre-adjustment alternative minimum taxable income (AMTI). Combine lines 1 through 2o | 3 | 462,500 |
| 4 | **Adjusted current earnings (ACE) adjustment:** | | |
| a | ACE from line 10 of the ACE worksheet in the instructions — 4a | | |
| b | Subtract line 3 from line 4a. If line 3 exceeds line 4a, enter the difference as a negative amount (see instructions) — 4b | | |
| c | Multiply line 4b by 75% (.75). Enter the result as a positive amount — 4c | | |
| d | Enter the excess, if any, of the corporation's total increases in AMTI from prior year ACE adjustments over its total reductions in AMTI from prior year ACE adjustments (see instructions). **Note:** *You **must** enter an amount on line 4d (even if line 4b is positive)* — 4d | | |
| e | ACE adjustment.<br>• If line 4b is zero or more, enter the amount from line 4c<br>• If line 4b is less than zero, enter the **smaller** of line 4c or line 4d as a negative amount | 4e | |
| 5 | Combine lines 3 and 4e. If zero or less, stop here; the corporation does not owe any AMT | 5 | 462,500 |
| 6 | Alternative tax net operating loss deduction (see instructions) | 6 | |
| 7 | **Alternative minimum taxable income.** Subtract line 6 from line 5. If the corporation held a residual interest in a REMIC, see instructions | 7 | 462,500 |
| 8 | **Exemption phase-out** (if line 7 is $310,000 or more, skip lines 8a and 8b and enter -0- on line 8c): | | |
| a | Subtract $150,000 from line 7 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0- — 8a | | |
| b | Multiply line 8a by 25% (.25) — 8b | | |
| c | Exemption. Subtract line 8b from $40,000 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0- | 8c | -0- |
| 9 | Subtract line 8c from line 7. If zero or less, enter -0- | 9 | 462,500 |
| 10 | Multiply line 9 by 20% (.20) | 10 | 92,500 |
| 11 | Alternative minimum tax foreign tax credit (AMTFTC) (see instructions) | 11 | |
| 12 | Tentative minimum tax. Subtract line 11 from line 10 | 12 | 92,500 |
| 13 | Regular tax liability before applying all credits except the foreign tax credit | 13 | 85,625 |
| 14 | **Alternative minimum tax.** Subtract line 13 from line 12. If zero or less, enter -0-. Enter here and on Form 1120, Schedule J, line 3, or the appropriate line of the corporation's income tax return | 14 | 6,875 |

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