CHAPTER 1

UNDERSTANDING AND WORKING WITH THE FEDERAL TAX LAW

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Learning Objective	Topic	Status: Present Edition	Q/P in Prior Edition
1	LO 1	Revenue neutrality	Unchanged	1
2	LO 2	Nonrevenue factors	New	
3	LO 2	Encouraging technological factors	New	
4	LO 2	Special treatment for farmers and natural resources	New	
5	LO 2	Impact of personal savings	New	
6	LO 2	Encouragement of small business	New	
7	LO 2	Equity considerations	Unchanged	8
8	LO 2	Purpose of charitable contributions	New	
9	LO 2	Purpose of child credit	New	
10	LO 2	Political campaign expenses	New	
11	LO 2	Tax credit for tuition	New	
12	LO 2	Credits versus deductions	New	
13	LO 2	Double taxation and effect of a credit versus a deduction	Unchanged	13
14	LO 2	Wherewithal to pay concept: transfer to controlled corporation	Unchanged	14
15	LO 2	Avoiding the corporate income tax	Unchanged	15
16	LO 2	Wherewithal to pay: example	Unchanged	16
17	LO 2	Recognized gain versus realized gain: amount	Unchanged	17
18	LO 2	Like-kind exchange versus involuntary conversion: losses	Unchanged	18
19	LO 2	Settlement time period	Unchanged	19
20	LO 2	Installment method	Unchanged	20
21	LO 2	Keogh Plan: grace period	Unchanged	21
22	LO 2	Bracket creep: indexation	Unchanged	22
23	LO 2	Community property states	Unchanged	23
24	LO 2	Community property states	Unchanged	24
25	LO 2	Deterrence provisions	Unchanged	25
26	LO 3	$14,000 annual gift tax exclusion: audit	Updated	26
27	LO 4	Continuity of interest concept	Unchanged	27
28	LO 3	IRS adjustment to clearly reflect income	Modified	28

Question/ Problem	Learning Objective	Topic	Status: Present Edition	Q/P in Prior Edition
29	LO 5	Structure of the Code	Unchanged	29
30	LO 5	Legislative origin of tax laws	Unchanged	30
31	LO 5	Effect of President's veto	Unchanged	31
32	LO 5	Identifying the Subtitle of Internal Revenue Code	Unchanged	32
33	LO 5	Code section citation	New	
34	LO 5	Code section citation	New	
35	LO 5	Missing code sections	Unchanged	35
36	LO 6	Location of Regulations	Unchanged	36
37	LO 6	Citations	Unchanged	37
38	LO 5	Role of Federal Courts of Appeals	Modified	38
39	LO 5	Failure of U.S. Government to appeal some court decisions	Modified	39
40	LO 5, 8	Identify selected abbreviations	Modified	40
41	LO 6	Tax research	Modified	42
42	LO 7	Starting tax research	New	
43	LO 8	Primary and secondary sources	Modified	43
44	LO 9	Components of tax planning	Unchanged	44
45	LO 10	CPA exam: simulations	New	
46	LO 2	Like-kind exchange: wherewithal to pay concept	Unchanged	46
47	LO 2, 3	Objectives of tax provisions	Unchanged	47
48	LO 2	Community versus common law property	New	
49	LO 4	Arm's length concept	Modified	49
50	LO 5	Letter rulings and TAMs	Unchanged	50
51	LO 5	Administrative citation	Modified	51
52	LO 6	Citations	New	
53	LO 5	U.S. Court of Appeals	New	
54	LO 5	Court system	New	
55	LO 6	Tax services	Unchanged	55
56	LO 5, 8	Authority	Modified	56
57	LO 5	Court Citations	Unchanged	57

Research Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Locate and describe tax law sources	New	
2	Assessing the validity of tax law sources	New	
3	Determining the disposition of court cases	New	
4	Tax implications of a prize	Unchanged	4
5	Internet activity	Unchanged	5
6	Internet activity	Unchanged	6

CHECK FIGURES

46.a. Realized gain $200,000; recognized gain $100,000.

46.b. Realized loss $300,000; recognized loss $0.

DISCUSSION QUESTIONS

1. When enacting tax legislation, Congress often is guided by the concept of revenue neutrality so that any changes neither increase nor decrease the net revenues raised under the prior rules. Revenue neutrality does not mean that any one taxpayer's tax liability remains the same. Since this liability depends upon the circumstances involved, one taxpayer's increased tax liability could be another's tax saving. Revenue-neutral tax reform does not reduce deficits, but at least it does not aggravate the problem. p. 1-2

2. Economic, social, equity, and political factors play a significant role in the formulation of tax laws. Furthermore, the IRS and the courts have had impacts on the evolution of tax laws. For example, control of the economy has been an important economic consideration in passing a number of laws (e.g., rapid depreciation, changes in tax rates). pp. 1-2 and 1-3

3. The tax law encourages technological progress by allowing immediate (or accelerated) deductions and tax credits for research and development expenditures. p. 1-3

4. Farmers are accorded special tax treatment by being permitted to expense rather than capitalize certain soil and water conservation expenditures and fertilizers. Also, the tax law favors the development of natural resources through percentage depletion deductions and favorable treatment of certain intangible drilling costs. p. 1-4

5. Saving leads to capital formation and thus makes funds available to finance home construction and industrial expansion. For example, the tax laws provide incentives to encourage savings by giving private retirement plans preferential treatment. pp. 1-3 and 1-4

6. a. Section 1244 allows ordinary loss treatment on the worthlessness of small business corporation stock. Since such stock normally would be a capital asset, the operation of § 1244 converts a less desirable capital loss into a more attractive ordinary loss. Such tax treatment was designed to aid small businesses in raising needed capital through the issuance of stock. p. 1-4, Footnote 4, and Chapter 4

   b. The corporate income tax rates favor those corporations with taxable income under $75,000. On a relative basis, it is the smaller corporations that will benefit the most from the graduated corporate tax rates. Further, the $11,750 in tax savings that result from the graduated rate structure is phased out for corporations with taxable income in excess of $100,000. pp. 1-4, 1-5, Example 1, and Chapter 2

   c. By allowing corporations to split or combine (i.e., merge or consolidate) without adverse tax consequences, small corporations are in a position to compete more effectively with larger counterparts. p. 1-4 and Chapter 7

7. Reasonable persons can, and often do, disagree about what is fair or unfair. In the tax area, moreover, equity is generally tied to a particular taxpayer's personal situation. For example, the text discusses the difference in tax treatment for taxpayers renting an apartment versus purchasing a house. Another equity difference relates to how a business is organized (i.e., partnership versus corporation). Equity, then, is not what appears fair or unfair to any one taxpayer or group of taxpayers. It is, instead, what the tax law recognizes. p. 1-6

8. This deduction can be explained by social considerations. The deduction shifts some of the financial and administrative burden of socially desirable programs from the public (the government) sector to the private (the citizens) sector. p. 1-5

9. Encouraging taxpayers to provide care for children and disabled dependents while gainfully employed is socially desirable. p. 1-6

10. Allowing a deduction for campaign expenditures in excess of campaign contributions, some believe, would encourage the use of wealth as a means of winning elections. p. 1-6

11. Such a provision might be justified on social considerations because private schools do relieve the public sector of the cost of educating these students. Equity also might serve as a justification since the parents are, in effect, paying twice for the cost of education: first through taxes paid to finance public education and second for the tuition paid to the private school. pp. 1-5 and 1-6

12. A credit allows a dollar-for-dollar reduction in tax liability, whereas a deduction's value depends upon the taxpayer's tax bracket. Thus, a deduction is worth more to a high tax bracket individual than a lower tax bracket individual. p. 1-6 and Footnote 10

13. The deduction allowed for Federal income tax purposes for state and local income taxes is not designed to neutralize the effect of multiple taxation on the same income. At most, this deduction provides only partial relief. Only the allowance of a full tax credit would achieve complete neutrality.

    a. With the standard deduction, a taxpayer is, *indirectly*, obtaining the benefit of a deduction for any state or local income taxes he or she may have paid. This is so because the standard deduction is in lieu of itemized deductions, which include the deductions for state and local income taxes.

    b. If the taxpayer is in the 10% tax bracket, one dollar of a deduction for state or local taxes would save ten cents of Federal income tax liability. In the 33% tax bracket, the saving becomes thirty-three cents. The deduction approach (as opposed to the allowance of a credit) favors high bracket taxpayers.

    p. 1-6 and Footnote 10

14. Under the general rule, a transfer of a partnership's assets to a new corporation could result in a taxable gain. However, if certain conditions are met, § 351 postpones the recognition of any gain (or loss) on the transfer of property by Heather to a controlled corporation.

    The wherewithal to pay concept recognizes the inequity of taxing a transaction when Heather lacks the means with which to pay any tax. Besides, Heather's economic position would not change significantly as a result of such a transfer. Heather owned the assets before the transfer and still would own the assets after a transfer to a controlled corporation.

    Example 5

15. Yes, once incorporated, the business may be subject to the Federal corporate income tax. However, the corporate tax rates *might* be lower than Heather's individual tax rates, especially if dividends are not paid to Heather.

    The corporate income tax could be avoided altogether by electing to be an S corporation. An S corporation is generally not taxed at the corporate level; instead, the income flows through the corporate veil and is taxed at the shareholder level. An S election allows a business to operate as a corporation but be taxed like a partnership.

    p. 1-4, Footnote 5, Example 2, and Chapter 12

16. Examples include like-kind exchanges, involuntary conversions, transfers of property to a controlled corporation, transfers of property to a partnership, and tax-free reorganization. p. 1-7 and Examples 3 to 7

17. Generally, recognized (taxable) gain cannot exceed the realized gain. p. 1-7 and Footnote 18

18. Recognition of gain ultimately occurs when the property is disposed of. p. 1-8

19. One year. p. 1-9

20. The installment method on the sale of property permits the gain to be recognized over the payout period. p. 1-10

21. Requiring a taxpayer to make a contribution to a Keogh retirement plan by the end of the year would force an accurate determination of net self-employment income long before the income tax return must be prepared and filed. Example 11

22. Because of the progressive nature of the income tax, any wage adjustment to compensate for inflation can increase the income tax bracket of the recipient. The overall impact is an erosion of purchasing power. Congress recognized this problem and began to adjust various income tax components (the indexation procedure) in 1985, based upon the rise in the consumer price index over the prior year. pp. 1-10 and 1-11

23. Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho, Nevada, Wisconsin, and (if elected by the spouses) Alaska. pp. 1-11, 1-12, and Footnote 23

24. The difference between common law and community property systems centers around the property rights possessed by married persons. In a common law system, each spouse owns whatever he or she earns. Under a community property system, one-half of the earnings of each spouse is considered owned by the other spouse. Assume, for example, Harold and Ruth are husband and wife, and their only income is the $80,000 annual salary Harold receives. If they live in New York (a common law state), the $80,000 salary belongs to Harold. If, however, they live in Texas (a community property state), the $80,000 salary is divided equally, in terms of ownership, between Harold and Ruth. Footnote 23

25. Deterrence provisions include:

    - Alternative minimum tax.
    - Imputed interest rules.
    - Limitation on the deductibility of interest on investment indebtedness.
    - Unreasonable accumulated earnings tax.
    - Personal holding company tax.

    p. 1-11

26. The exclusion decreases the number of gift tax returns that must be filed (as well as reduces the taxes paid) which reduces audit effort. p. 1-13 and Footnote 28

27. Primarily concerned with business readjustments, the continuity of interest concept permits tax-free treatment only if the taxpayer retains a substantial continuing interest in the property

transferred to the new business. Due to the continuing interest retained, the transfer should not have tax consequences because the position of the taxpayer has not changed. This concept applies to transfers to controlled corporations (Chapter 4), corporate reorganizations (Chapter 7), and transfers to partnerships (Chapter 10). p. 1-15

28. Under § 482 the IRS has the authority to allocate income and deductions among businesses owned or controlled by the same interests when the allocation is necessary to prevent the evasion of taxes or to clearly reflect the income of each business. Pursuant to § 482, therefore, the IRS might allocate interest income to White Corporation even though none was provided for in the loan agreement. Example 12

29. No, Congress merely redesignated the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986. The Tax Reform Act merely amended, deleted, or added provisions to the TRA of 1954. p. 1-17

30. False. Federal tax legislation generally originates in the House of Representatives, where it is first considered by the House Ways and Means Committee. Tax bills can originate in the Senate only when they are attached as riders to other legislative proposals as was the case with the American Taxpayer Relief Act of 2012. p. 1-18

31. A president's veto can be overridden by a two-thirds vote in both the House and Senate. p. 1-18

32. Subtitle A. p. 1-18

33. § 1563 (a) (1) (A)

    - § → Abbreviation of "Section"
    - 1563 → Section number
    - (a) → Subsection number
    - (1) → Paragraph designation
    - (A) → Subparagraph designation

    p. 1-20

34. Yes, some Code Sections omit the subsection designation and use, instead, the paragraph designation as the first subpart [e.g., §§ 212(1) and 1221(1)]. Footnote 34

35. When the 1954 Code was drafted, the omission of some Code section numbers was intentional. This omission provided flexibility to incorporate later changes into the Code without disrupting its organization. This technique is retained in the 1986 code. Footnote 32

36. Proposed, final, and Temporary Regulations are published in the *Federal Register* and are reproduced in major tax services. Final Regulations are issue as Treasury Decisions (TDs). p. 1-22 and Exhibit 1.1

37. a. A Temporary Regulation, with 1 referring to the type of regulation (i.e., income tax), 428 is the related code section number, (7) is the subsection number, T means temporary, b is the paragraph designation, and (4) is the subparagraph designation.

b. Revenue Ruling number 11, appearing on page 174 of Volume 1 of the Cumulative Bulletin issued in 1960.

c. Technical Advice Memorandum number 3 issued during the 37th week of 1988.

pp. 1-21 to 1-24

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

October 12, 2013

Mr. Jennifer Olde
3246 Highland Drive
Clifton, VA 22024

Dear Mr. Olde:

In response to your recent request, the fact-finding determination of a lower trial court is binding on a Federal Court of Appeals. A Federal Court of Appeals is limited to a review of the record of trial compiled by a trial court. Rarely will an appellate court disturb a lower court's fact-finding determination.

Should you need more information, do not hesitate to contact me.

Sincerely,

Marilyn S. Crumbley
Tax Partner

p. 1-27

39. TAX FILE MEMORANDUM

DATE: September 12, 2013

FROM: Sarah Flinn

RE: Telephone conversation with Will Thomas regarding the failure of the IRS to appeal

I explained to Mr. Thomas that there were numerous reasons why the IRS may decide not to appeal a decision it loses in a District Court. For example, the work load may be too heavy. Or the IRS may have decided that this particular case is not a good decision to appeal (e.g., sympathetic taxpayer). Third, the IRS might not wish to appeal this case to the appropriate Court of Appeals. I stressed that the failure to appeal does not necessarily mean that the IRS agrees with the results reached.

p. 1-27

40. a. If the taxpayer decides to choose a District Court as the trial court for litigation, the District Court of Utah would be the forum to hear the case. Unless the prior decision has been reversed on appeal, one would expect the same court to follow its earlier holding.

b. If the taxpayer decides to choose the Court of Federal Claims as the trial court for litigation, the decision previously rendered by this Court should have a direct bearing on the outcome. If the taxpayer selects a different trial court (i.e., the appropriate U.S. District Court or the U.S. Tax Court), the decision rendered by the Court of Federal Claims would be persuasive but not controlling. It is assumed that the results reached by the Court of Federal Claims were not reversed on appeal.

c. The decision of a Court of Appeals will carry more weight than one rendered by a trial court. Since the taxpayer lives in California, however, any appeal from a District Court or the U.S. Tax Court would go to the Ninth Court of Appeals. Although the Ninth Court of Appeals might be influenced by what the Second Court of Appeals has decided, it is not compelled to follow such holding.

d. Since the U.S. Supreme Court is the top appellate court, complete reliance can be placed on its decisions. Nevertheless, one should investigate any decision to see whether or not the Code has been modified to change the results reached. There also exists the rare possibility that the Court may have changed its position in a later decision.

e. When the IRS acquiesces in a decision of the Tax Court, it agrees with the results reached. As long as such acquiescence remains in effect, taxpayers can be assured that this represents the position of the IRS on the issue involved. Keep in mind, however, that the IRS can change its mind and can, at any time, withdraw the acquiescence and substitute a nonacquiescence.

f. The issuance of a nonacquiescence reflects that the IRS does not agree with the results reached by a Tax Court decision. Consequently, taxpayers are placed on notice that the IRS will continue to challenge the issue involved.

pp. 1-24 to 1-28, 1-41, and Figure 1.3

41. Mack Rogers has a number of hardcopy approaches available, depending upon the available library. One approach is to begin with the index volume of a tax service. Since the subject matter "§ 1244 stock" is somewhat self-contained, he may start with the Internal Revenue Code and Treasury Regulations. The textbook on pp. 1-33 and 1-44 lists the major tax services which Mr. Rogers could consult. Another approach for Mr. Rogers is to use CCH's *Federal Tax Articles*. After looking up "§ 1244 stock" in the subject index, Mr. Rogers should be able to find a number of articles written about this subject. In addition, the RIA tax service has a topical ''Index to Tax Articles' section that is organized using the service's paragraph index system. He should check *Tax Management Portfolios* also. Several computer-based tax research tools are also available to Mr. Rogers, which may be the quickest approach. pp. 1-32 to 1-36

42. Most tax researchers begin with the index volume of a hard copy tax service or a keyword search on an online tax service. If the problem is not complex, the researcher may bypass a tax service and turn directly to the Internal Revenue Code and the Treasury Regulations (both are available online; see Exhibit 1.3). For the beginner, this process saves time and will solve many of the basic problems. If the researcher does not have access to the Code or Regulations, the resources of a tax service may be necessary. Several of the major tax services publish paperback editions of the Code and Treasury Regulations that can be purchased at modest prices. p. 1-39

43. a. Primary source.

b. Secondary source.

c. Primary source.

d. Secondary source, but substantial authority for purposes of the accuracy-related penalty in § 6662.

e. Secondary source, but substantial authority for purposes of the accuracy-related penalty in § 6662.

pp. 1-41 and 1-42

44. Key components of effective tax planning are:

- Avoid the recognition of income (usually by resorting to a nontaxable source or nontaxable event).
- Defer recognition of income (or accelerate deductions).
- Convert the classification of income (or deductions) to a more advantageous form (e.g. ordinary income into capital gain).
- Choose the business entity with the desired tax attributes.

p. 1-46

45. Simulations are small case studies designed to test a candidate's tax knowledge and skills using real-life, work-related situations. Simulations include a four-function pop-up calculator, a blank spreadsheet with some elementary functionality, and authoritative literatures appropriate to the subject matter. The taxation database includes authoritative excerpts (e.g., Internal Revenue Code and Regulations, IRS publications, and Federal tax forms) that are necessary to complete the tax case study simulations. p. 1-47

PROBLEMS

46. a. Bart has a realized gain of $200,000 determined as follows:

Amount received on the exchange		
Real estate worth	$900,000	
Cash	100,000	$1,000,000
Amount given up on the exchange		
Basis of real estate		(800,000)
Realized gain		$ 200,000

Bart's recognized gain is limited to the *lesser* of realized gain of $200,000 or the other property (boot) received of $100,000. Thus, the recognized gain is limited to other property (boot) received of $100,000. Thus, the recognized gain is $100,000 [the amount of cash (boot) received by Bart]. § 1031

b. Roland has a realized loss of $300,000, determined as follows:

Amount given up on the exchange	
Real estate with a basis of	$1,200,000
Cash	100,000

Amount received on the exchange	$1,000,000
Basis of property given up	(1,300,000)
Realized loss	($ 300,000)

None of Roland's realized loss can be recognized.

c. Under the wherewithal to pay concept, forcing Bart to recognize a gain of $100,000 makes sense. Because of the $100,000 cash received, not only has Bart's economic position changed, but he now has the means to pay the tax on the portion of the realized gain that is recognized.

The disallowance of Roland's realized loss is consistent with the usual approach of the wherewithal to pay concept. Not only is this the price that must be paid for tax-free treatment, but also a carryover basis and adjustment under § 1031(d) prevents a deterioration of Roland's tax position. Note: After the exchange, Roland has a basis of $1,300,000 in the real estate received from Bart [i.e., $1,200,000 (basis in the real estate given up) + $100,000 (cash given up)].

pp. 1-7 to 1-9, Example 3, and Footnotes 18 and 19

47. a. W. Wherewithal to pay concept. Example 3

b. CE. Control of the economy. p. 1-3

c. ESB. Encouragement of small business. p. 1-4 and Footnote 5

d. SC. Social considerations. p. 1-6

e. EI. Encouragement of certain industries. p. 1-4

f. AF. Administrative feasibility. p. 1-13

g. SC. Social considerations. p. 1-5

48. a. Louisiana, community property.

b. Virginia, common law.

c. Arizona, community property.

d. Rhode Island, common law.

e. Alaska, community property may be elected by spouses.

f. California, community property.

Footnote 23

49. The real question is whether the parties acted in an arm's length manner. In other words, was the $100,000 selling price the true value of the property?

a. Where the parties to a transaction are related to each other, the IRS is quick to apply the arm's length concept. It might, for example, find that the value of the property was less than $100,000. In this event, the difference probably is dividend income to Benny.

b. The same danger exists even if Benny (the seller) is not a shareholder in Jet Corporation (the purchaser) as long as he is related to the one in control. If the value of the property is less than $100,000, the IRS could find a constructive dividend to Benny's father of any difference. Because Benny ended up with the benefit, it follows that the father has made a gift to the son of such difference. Chapter 5

c. Since Benny is neither a shareholder in Jet Corporation nor related to any of its shareholders, it is doubtful that the IRS would question the $100,000 selling price or the substance of the sale.

p. 1-14

50. a. Letter rulings are issued for a fee by the National Office of the IRS upon a taxpayer's request and describe how the IRS will treat a proposed transaction for tax purposes. In general, they apply only to the taxpayer who asks for and obtains the ruling, but post-1984 rulings may be substantial authority for purposes of avoiding the accuracy-related penalties.

b. The National Office of the IRS releases technical advice memoranda (TAMs) weekly. TAMs resemble letter rulings in that they give the IRS's determination of an issue. Letter rulings, however, are responses to requests by taxpayers, whereas TAMs are issued by the National Office of the IRS in response to questions raised by taxpayers or IRS field personnel during audits. TAMs deal with completed rather than proposed transactions and are often requested for questions relating to exempt organizations and employee plans. Although TAMs are not officially published and may not be cited or used as precedent, post-1984 TAMs may be substantial authority for purposes of the accuracy-related penalties.

pp. 1-23 and 1-24

51. a. Revenue Procedure number 10, appearing on page 272 of Volume 1 of the Cumulative Bulletin for 2001.

b. Revenue Ruling number 14 appearing on page 31 of the 27th weekly issue of the *Internal Revenue Bulletin* for 2011.

c. The 30th letter ruling issued during the 25th week of 2011.

p. 1-24

52. a. IRC. p. 1-20

b. FR, IRB, CB. Exhibit 1.1

c. IRB, CB. Exhibit 1.1

d. FR, IRB, CB. Exhibit 1.1

e. IRB, CB. Exhibit 1.1

f. NA, a court decision.

g. NA, a letter ruling. p. 1-24

53. a. Fifth Circuit.

b. Tenth Circuit.

c. Eleventh Circuit.

d. Ninth Circuit.

e. Second Circuit.

Figure 1.4

54. a. A

b. T

c. U

d. T

e. T

f. C

g. N

h. D

pp. 1-24 and 1-28 to 1-31

55. a. *United States Tax Reporter* is published by Research Institute of America (formerly published as *Federal Taxes* by Prentice-Hall, Inc.).

b. *Standard Federal Tax Reporter* is published by Commerce Clearing House, Inc.

c. *Federal Tax Coordinator 2d* is published by Research Institute of America.

d. *Mertens Law of Federal Income Taxation* is published by West Group.

e. *Tax Management Portfolios* is published by The Bureau of National Affairs, Inc.

f. *CCH Tax Research Consultant* is published by Commerce Clearing House, Inc.

p. 1-33

56. a. P.

b. P.

c. P.

d. P.

e. S.

f. P.

g. S.

h. P.

i. B. Primary to the taxpayer to whom issued, but secondary for all other taxpayers.

j. P.

k. S. Cannot be cited as precedent.

l. P.

m. S.

n. S. Courts generally do not recognize proposed regulations.

pp. 1-16, 1-32, 1-41, and 1-42

57. a. For a regular decision of the U.S. Tax Court that was issued in 1970. The decision can be found in Volume 54, page 1514, of the Tax Court of the United States Reports, published by the U.S. Government Printing Office. p. 1-29

b. For a decision of the U.S. Second Circuit Court of Appeals that was rendered in 1969. The decision can be found in Volume 408, page 1117, of the Federal Reporter, Second Series (F. 2d), published by West Publishing Company. p. 1-30

c. For a decision of the U.S. Second Circuit Court of Appeals that was rendered in 1969. The decision can be found in Volume 1 for 1969, paragraph 9319, of the U.S. Tax Cases, published by Commerce Clearing House. p. 1-30

d. For a decision of the U.S. Second Circuit Court of Appeals that was rendered in 1969. The decision can be found in Volume 23, page 1090, of the Second Series of American Federal Tax Reports, now published by RIA (formerly P-H). p. 1-30

[Note that the citations that appear in parts b., c., and d. are for the same case.]

e. For a decision of the U.S. District Court of Mississippi that was rendered in 1967. The decision can be found in Volume 293, page 1129, of the Federal Supplement Series, published by West Publishing Company. p. 1-30

f. For a decision of the U.S. District Court of Mississippi that was rendered in 1967. The decision can be found in Volume 1 for 1967, paragraph 9253, of the U.S. Tax Cases, published by Commerce Clearing House. p. 1-30

g. For a decision of the U.S. District Court of Mississippi that was rendered in 1967. The decision can be found in Volume 19, page 647, of the Second Series of American Federal Tax Reports, now published by RIA (formerly P-H). p. 1-30

[Note that the citations that appear in parts e., f., and g. are for the same case.]

h. For a decision of the U.S. Supreme Court that was rendered in 1935. The decision can be found in Volume 56, page 289, of the Supreme Court Reporter, published by West Publishing Company. p. 1-31 i For a decision of the U.S. Supreme Court that was rendered in 1935. The decision can be found in Volume 1 for 1936, paragraph 9020, of the U.S. Tax Cases, published by Commerce Clearing House. p. 1-31

j. For a decision of the U.S. Supreme Court that was rendered in 1935. The decision can be found in Volume 16, page 1274, of the American Federal Tax Reports, now published by RIA (formerly P-H). p. 1-31

[Note that the citations that appear in parts h., i., and j. are for the same case.]

k. For a decision of the former U.S. Court of Claims that was rendered in 1970. The decision can be found in Volume 422, page 1336, of the Federal Reporter, Second Series, published by West Publishing Company. This court is the Claims Court (renamed the Court of Federal Claims effective October 30, 1992) and current cases are in the Federal Claims Reporter. p. 1-31

Proposed solutions to the **Research Problems** are found in the Instructor's Guide. Previously, these items were a part of the Instructor's Companion Site for the textbook.

CHAPTER 2

CORPORATIONS: INTRODUCTION AND OPERATING RULES

SOLUTIONS TO PROBLEM MATERIALS

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

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

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

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

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

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

CHECK FIGURES

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

DISCUSSION QUESTIONS

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

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

pp. 2-2 to 2-8

2. C corporations are separate taxable entities. Cassowary Corporation will report the operating income and tax-exempt income on its return (Form 1120), resulting in taxable income of \$120,000 for the year. Shareholders are required to report income from a C corporation only to the extent of dividends received; thus, Barbara reports no income from Cassowary for 2013. An S corporation is a tax reporting entity but (generally) not a taxable entity. Instead, its profit (loss) and separately stated items flow through to the shareholders. Emu Corporation will report ordinary business income of \$120,000 and separately stated tax-exempt interest income of \$8,000 on its return (Form 1120S), with 40% of these amounts allocated to Barbara (Schedule K-1). Barbara will report ordinary business income of \$48,000 and tax-exempt interest income of \$3,200 on her individual return (Form 1040). The absence of dividend distributions from Emu Corporation does not affect Barbara's treatment of the income. pp. 2-3 and 2-5

3. Art should consider operating the business as a sole proprietorship (or a single-member LLC) for the first three years. If he works 15 hours per week in the business, he will exceed the minimum number of hours required to be a material participant (52 × 15 = 780) under the passive loss rules. [An individual is treated as materially participating in an activity if he or she participates in the activity for more than 500 hours during the year. Reg. § 1.469-5T(a)(1).] Therefore, he will be able to deduct the losses against his other income. When the business becomes profitable, Art should consider incorporating. If he reinvests the profits in the business, the value of the stock should grow accordingly, and he should be able to sell his stock in the corporation for long-term capital gain. pp. 2-2 to 2-8, 2-38, and 2-39

4. A C corporation is a separate taxable entity (Form 1120), and its taxable income has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Thus, Lava Corporation will have taxable income of \$129,000 (operating income of \$120,000 + STCG of \$9,000). As no dividends were distributed, Abdul has no tax consequences in the current year with respect to Lava Corporation.

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

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

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

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

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

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

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

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

7. Double taxation refers to the fact that (for C corporations) income in subject to Federal taxation once at the corporate level and then again at the shareholder level when distributed as dividends. Because there is no corporate deduction for dividend distributions, amounts distributed are subject to two levels of taxation. The preferential tax rate applicable to qualified dividend income tempers the impact of double taxation. For closely held corporations, a common tax planning tool used to minimize double taxation is to generate corporate payments to shareholders that are deductible by the corporation. These payments often take several forms, including compensation, rent/lease, interest, royalties, etc. Transactions between closely held corporations and their shareholders are subject to greater scrutiny by the IRS, and the related payments must be reasonable and arms-length in amount to avoid recharacterization as nondeductible dividend distributions. p. 2-4

8. Yes, most states allow for single-member LLCs. Under the default rules of the check-the-box Regulations, a single-member LLC is taxed as a sole proprietor. A single-member LLC can elect to be taxed instead as a corporation by filing Form 8832 (Entity Classification Election). pp. 2-7 and 2-8

9. The statement is correct. Because no Form 8832 was filed, the LLC will be taxed as a partnership, the default classification for multi-member LLCs under the check-the-box Regulations. A Form 8832 is required to be filed only if the taxpayer wants to elect to have the entity classified as a corporation for Federal tax purposes. p. 2-8

10. In general, the statement is correct. That is, corporate taxpayers generally may choose a calendar year or a fiscal year for reporting purposes. However, the use of a fiscal year is restricted for personal service corporations and S corporations. For such corporations, the

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

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

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

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

   p. 2-10

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

   a. Jade Corporation has $4.8 million of average gross receipts over the 2010-2012 period. Thus, Jade satisfies the gross receipts exception and may use the cash method of accounting.

   b. Lime Corporation, a PSC, may use the cash method of accounting without regard to its gross receipts.

   pp. 2-10 and 2-11

13. A corporation that uses the accrual method cannot claim a deduction for an expense involving a related party (e.g., a more than 50% shareholder) until the recipient reports that amount as income. Lupe, a cash basis taxpayer, must report the $100,000 bonus in 2014, the year he receives the payment. Jasper Corporation may deduct the $100,000 bonus in 2014, the year Lupe is required to report it as income. p. 2-11 and Example 12

14. Both corporations and individuals include recognized capital gains in their taxable income. For a corporate taxpayer, there is no preferential tax rate applicable to long-term capital gains. Instead, the capital gain is taxed at Parrot's normal tax rate of 25%. The preferential tax rate of 15% would apply to Jeanette's long-term capital gain. p. 2-11

15. John and Eagle Corporation each net the $10,000 LTCG against the $18,000 STCL, resulting in an $8,000 net capital loss. John reports the capital transactions on his individual tax return, deducts $3,000 of the net capital loss in the current year, and carries forward to 2014 a $5,000 STCL for the remainder of the net capital loss. Eagle reports the capital transactions on its the corporate tax return, but none of the $8,000 net capital loss is deductible in the current year. Instead, Eagle carries back a $8,000 STCL three years and, if necessary, forward 5 years, to be offset against capital gains in such years. pp. 2-11 and 2-12

16. For an individual taxpayer, there is no deprecation recapture under § 1250 with respect to realty placed in service after 1986 and depreciated under the straight-line method. However, under § 291, a C corporation must treat a portion of gain recognized on the disposition of § 1250 property as depreciation recapture (ordinary income). The § 291 ordinary income amount is equal to 20% of the excess of the amount of depreciation recapture that would arise if the property was § 1245 property over the amount of depreciation recapture computed under § 1250 (without regard to § 291). As a result, some of the gain recognized by a C corporation on the sale of the warehouse will be ordinary income (and not § 1231 gain). p. 2-12 and Example 15

17. a. If Osprey is a personal service corporation, it cannot deduct any of the passive loss in the current year. A personal service corporation cannot offset a passive loss against either active or portfolio income.

    b. A closely held corporation that is not a personal service corporation can offset passive losses against net active income but not against portfolio income. Therefore, Osprey can deduct $100,000 of the passive loss in the current year. The remaining $20,000 of passive loss is carried forward.

    pp. 2-13 and 2-14

18. A closely held C corporation that is not a personal service corporation can offset a passive loss against net active income, but not against portfolio income. Hummingbird can deduct only $40,000 of the $45,000 passive loss. Thus, Hummingbird's taxable income is $15,000 ($40,000 + $15,000 – $40,000). Example 16

19. In order to be deductible by an accrual basis corporation in the year authorized by its board of directors, a charitable contribution must be paid within 2 1/2 months of the end of the year of authorization (March 15, 2014, in this case). Because payment was not made within the required time period, the charitable contribution is deductible in 2014. p. 2-14

20. The rules for determining the amount of a charitable contribution of property by a C corporation are:

    - Loss property (fair market value less than basis) = fair market value.
    - Ordinary income property (property that, if sold, would *not* result in a long-term capital gain or § 1231 gain) = basis.
        - Certain contributions of *inventory* qualifying for increased contribution amount (e.g., contribution of inventory that is related to organization's exempt function and such use is solely for the care of the ill, needy, or infants) = lesser of (1) the sum of the property's basis plus 50% of the appreciation on the property or (2) twice the property's basis.
    - Capital gain property (property that, if sold, would result in a long-term capital gain or § 1231 gain) = fair market value.
        - Contributions of tangible personal property to charitable organization which does not use the property for purpose related to its exempt function = basis.
        - Contributions to certain private foundations = basis.

    pp. 2-14 and 2-15

21. The following tax issues should be considered.

- Is Orange an accrual method taxpayer and, if so, will the contribution be made by March 15, 2014, so as to obtain a deduction in 2013?
- Will the contribution consist of property or cash?
- If the contribution consists of property, what is the character of the property (capital gain or ordinary income property) and amount of the contribution deduction?
- What is the current year's taxable income limitation on the deductibility of charitable contributions?
- In what tax year did the charitable contribution carryover originate and when does the 5-year period for such carryover expire?
- If the $45,000 sum of the current year's contribution plus the carryover amount exceeds the taxable income limitation, should the current year's gift be deferred to the subsequent tax year?

pp. 2-14 to 2-16, 2-39, and 2-40

22. The domestic productions activities deduction is equal to 9% of the *lesser* of the taxpayer's (1) qualified productions activities income or (2) taxable income. However, the deduction cannot exceed 50% of the corporation's W-2 wages related to qualified productions activities income. pp. 2-16 and 2-17

23. As a general rule, an NOL is carried back 2 years and forward 20 years to offset taxable income in such carryover years. However, a taxpayer can (irrevocably) elect to forgo the carryback period and just carry the NOL forward. In determining whether Gold should make the election, some of the relevant issues are:

- What are Gold's marginal tax rates for the carryback years?
  - What effect, if any, would an NOL carryback have on the prior years' tax computations?
- What is Gold's estimated future marginal tax rate?
  - What is Gold's estimated future taxable income?
  - Are corporate income tax rates anticipated to change in the future?
- Does Gold have immediate cash flow needs that would favor the carryback approach?

pp. 2-17 and 2-40

24. Otter Corporation will be allowed a dividends received deduction equal to 70% of the $15,000 dividend it received from Marmot (subject to taxable income limitation described in Example 27). It will pay tax at the applicable corporate tax rate of 25% on the remaining portion of the dividend. Gerald must include in income the entire $15,000 dividend he received from Marmot, and he will pay tax at the 15% rate applicable to individuals. Examples 3 and 27

25. A corporation that owns stock in another corporation is allowed a dividends received deduction. The deduction percentage is based on the percentage of ownership that the recipient corporation has in the corporation paying the dividend. Currently, with Mustard's 15% ownership interest in Burgundy, the deduction percentage is 70%. If the stock purchase

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

26. In order to claim the dividends received deduction with respect to any stock, the corporation must have held the stock for more than 45 days during the 91-day period beginning on the date that is 45 days before the ex-dividend date (or, in the case of preferred stock, more than 90 days during the 181-day period beginning on the date that is 90 days before the ex-dividend date). p. 2-19 and Footnote 21

27. Cuckoo Corporation's organizational expenditures include legal expenses incurred for drafting of corporate charter and bylaws (option a.), accounting fees incurred in organization (option b.), and expenses of temporary board of directors' organizational meetings (option c.). Startup expenditures include employee salaries incurred during training period before opening for business (option d.). Brokerage fees incurred in stock sales (option e.) are neither organizational expenditures nor startup expenditures. The brokerage fees cannot be deducted but reduce the amount of the capital realized from the sale of stock. pp. 2-20 and 2-21

28. The 35% marginal income tax rate begins at $10 million of taxable income for a C corporation which is not a PSC. Once a non-PSC's taxable income reaches $18,333,333, the average income tax rate is 35%. The rate imposed on PSCs is a flat 35% on all taxable income. p. 2-22 and Exhibit 2.1

29. Plum Corporation and Ivory Corporation are members of a controlled group of corporations (related corporations) and subject to a special income tax liability computation. The special computation limits the amount of a controlled group's taxable income that is taxed at rates lower than 35% to that amount the corporations in the group would have if they were one corporation. As a result, Omar's plan will be ineffective in lowering the overall corporate income tax liability of the two corporations. p. 2-23

30. Estimated tax payments are required if the corporation's tax liability is expected to be $500 or more. The required annual payment (which includes estimated AMT liability) is the *lesser* of (1) 100% of the corporation's tax for the current year or (2) 100% of the corporation's tax for the preceding year. p. 2-24

31. The starting point on Schedule M-1 is net income per books. Additions and subtractions are entered for items that affect net income per books and taxable income differently. An example of an addition is Federal income tax expense, which is deducted in computing net income per books but is disallowed in computing taxable income. An example of a subtraction is a charitable contributions carryover that was deducted for book purposes in a prior year but deducted in the current year for tax purposes.

<u>ADDITIONS</u>

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

<u>SUBTRACTIONS</u>

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

p. 2-25 and Example 35

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

PROBLEMS

33. a. Income, gains, deductions, and losses of a proprietorship are reported on the individual tax return of the sole proprietor (Form 1040). Consequently, Roger reports the $45,000 net operating profit ($220,000 operating income – $175,000 operating expenses) and $10,000 long-term capital loss on his tax return. The LTCL will be subject to the capital loss limitations applicable to individual taxpayers. Riflebird Company, as a proprietorship, files no entity Federal income tax return for the year.

b. A C corporation is a separate taxable entity which files a corporate income tax return. Riflebird Company will report taxable income of $45,000 ($220,000 operating income – $175,000 operating expenses) on its Form 1120. A corporation cannot currently deduct a net capital loss. Instead, the LTCL is subject to the corporate capital loss carryover rules (carried back 3 years and forward 5 years, as STCL). Riflebird Company's taxable income has no effect on the shareholders until such time a dividend is paid. When dividends are paid, shareholders must report dividend income on their tax returns. Therefore, Roger does not report Riflebird's net profit or long-term capital loss on his individual return.

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

34. a. Otter, a partnership, is not a taxpaying entity. Its profit (loss) and separate items flow through to the partners. The partnership's Form 1065 reports net profit of $110,000 ($320,000 income – $210,000 expenses). The partnership also reports the $15,000 long-term capital gain as a separately stated item on Form 1065. Ellie and Linda each receive a Schedule K-1 reflecting net profit of $55,000 and separately stated long-term capital gain of $7,500, which each reports on her own return. The 20/15/0% preferential tax rate applies to the LTCG. The withdrawals do not affect taxable income but decrease their basis in the partnership. Example 2

b. Otter, an S corporation, is not a taxpaying entity. Its profit (loss) and separate items flow through to the shareholders. The S corporation's Form 1120S reports net profit of $110,000 ($320,000 income – $210,000 expenses). The S corporation also shows the $15,000 long-term capital gain as a separately stated item on Form 1120S. Ellie and Linda each receive a Schedule K-1 reporting net profit of $55,000 and separately stated long-term capital gain of $7,500, which each reports on her own return (subject to capital loss limitation). The 20/15/0% preferential tax rate applies to the LTCG. The withdrawals do not affect taxable income but decrease their basis in the S corporation. p. 2-3

c. Otter, a C corporation, is a taxpaying entity. Otter's Form 1120 reports taxable income of $125,000 ($320,000 income – $210,000 expenses + $15,000 LTCG). Corporations do not received a preferential tax rate on LTCG income. Ellie and Linda report dividend income of $25,000 each. The dividend income is subject to the normal preferential rate. pp. 2-3, 2-4, 2-11, and Example 3

35. a. Azure Company, as a C corporation, has taxable income of $350,000 and corporate income tax of $119,000 [$350,000 × 34% (see Exhibit 2.1)]. The exclusion for

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

b. Since dividend distributions are not deductible, the income tax consequences to Azure Company, a C corporation, are the same as in a. above (i.e., corporate income tax of \$119,000). Sasha incurs income tax of \$15,000 (\$75,000 × 20%) with respect to the dividends she received during the year.

c. The salary paid to Sasha is deducible by Azure Company, resulting in taxable income of \$275,000 (\$350,000 net operating income – \$75,000 salary), and corporate income tax of \$90,500 (see Exhibit 2.1). Sasha incurs income tax of \$29,700 (\$75,000 × 39.6%) with respect to the salary she received during the year.

d. There is no Federal income tax applicable to businesses formed as sole proprietorships. Instead, the income and expenses of a proprietorship retain their character and are reported on the individual income tax return of the proprietor. Sasha therefore incurs income tax of \$138,600 (\$350,000 net operating income × 39.6% marginal tax rate) with respect to Azure Company.

e. The result would be the same as in d. above. Sasha must pay tax on the net operating income of Azure Company, regardless of the amount she withdraws.

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

36. a. An S corporation is not a taxable entity. Its profit (loss) and separately stated items flow through to the shareholders. Taupe Corporation's Form 1120S reports ordinary business income of \$420,000 and separately stated long-term capital gain of \$30,000. Torsten receives a Schedule K-1 reporting ordinary business income of \$420,000 and separately stated long-term capital gain of \$30,000. Torsten will report ordinary business income of \$420,000 and long-term capital gain of \$30,000 on his individual income tax return (Form 1040), regardless of how much of the income was withdrawn from Taupe. Torsten's income tax liability with respect to the income from Taupe is \$172,320 [(\$420,000 ordinary business income × 39.6% marginal tax rate) + (\$30,000 LTCG × 20% preferential tax rate)].

b. A C corporation is a taxable entity, and Taupe Corporation's Form 1120 reports taxable income of \$450,000 (\$420,000 ordinary business income + \$30,000 LTCG) and income tax of \$153,000 [\$450,000 × 34% (see Exhibit 2.1)]. C corporations do not receive any preferential tax rate with respect to long-term capital gains. The taxable income of a C corporation has no effect on the shareholders until such time a dividend is paid. Therefore, Torsten has no tax consequences in 2013 with respect to Taupe Corporation.

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

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

a. Kirsten's after-tax income is computed below:

Income from proprietorship	\$200,000

Less deductions ($6,100 standard deduction + $3,900 exemption)	(10,000)
Taxable income	$190,000
Tax on $190,000 (see Appendix A for Tax Rate Schedules)	$ 46,831
After-tax income ($200,000 – $46,831)	$153,169

b. Tax on corporation's net income of $200,000:

Tax on $200,000 (see Exhibit 2.1)	$ 61,250
Corporation's after-tax income ($200,000 – $61,250)	$138,750
Kirsten's taxable income ($138,750 dividend – $6,100 standard deduction – $3,900 exemption)	$128,750
Kirsten's tax on $128,750 at rates applicable to dividends [($36,250 × 0%) + .15($128,750 – $36,250)]	$ 13,875
Kirsten's after-tax income ($138,750 – $13,875)	$124,875

c. The corporation will have taxable income of $61,250 ($200,000 net income before compensation deduction – $138,750 salary). Kirsten will have taxable income of $128,750 ($138,750 – $6,100 standard deduction – $3,900 exemption). Her tax will be $29,343, and her after-tax income will be $109,407 ($138,750 – $29,343).

pp. 2-2 to 2-5

38. a. Wilson can claim an itemized deduction of $17,400 [$90,000 – $50,000 (insurance recovery) – $100 (floor on personal casualty losses) – $22,500 (10% of $225,000 AGI)].

b. Wilson can deduct $40,000 [$90,000 – $50,000 (insurance recovery)]. Corporations are not subject to the $100 floor or the 10%-of-AGI limitation.

p. 2-9

39. a.

Gross income	$395,000	
Ordinary deductions	(245,000)	
Taxable income (to owner of proprietorship)	$150,000	
Tax @ 33%		$49,500

b.

Gross income of corporation	$395,000	
Ordinary deductions	(245,000)	
Salary	(100,000)	
Taxable income	$ 50,000	
Corporate tax @ 15%		$ 7,500
Gross income of shareholder		
Salary	$100,000	
Tax @ 33%		33,000
Total tax		$40,500

c.

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

d.

Gross income of corporation	$395,000	
Ordinary deductions	(245,000)	
Salary	(100,000)	
Taxable income	$ 50,000	
Corporate tax @ 15%		$ 7,500
Tax paid by shareholder		
On salary ($100,000 × 33%)	$ 33,000	
On dividend [($50,000 – $7,500) × 15%]	6,375	39,375
Total tax		$46,875

e.

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

December 3, 2013

Mr. Robert Benton
1121 Monroe Street
Ironton, OH 45638

Dear Mr. Benton:

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

COMPUTATION 1

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

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

COMPUTATION 2

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

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

COMPUTATION 3

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

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

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

Sincerely,

Jon Thomas, CPA

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

40. a. The salary for the deferral period (October 1 through December 31) must be at least proportionate to the employee's salary received for the prior fiscal year. The amount that Carmine Corporation must pay Juan during the period October 1 through December 31, 2013, to permit Carmine to continue to use its fiscal year without negative tax effects, is $84,000 ($336,000 × 3/12). Example 11

    b. Carmine Corporation, a PSC, is subject to a tax rate of 35% on all of its taxable income. The corporation would pay tax of $33,250 ($95,000 × 35%) for the tax year ending September 30, 2013. To illustrate the negative tax impact of classification as a PSC, compare this amount with to the $20,550 (see Exhibit 2.1) that a corporation that is not a PSC would pay on taxable income of $95,000. p. 2-22

41. a. Under the cash method of accounting, the salaries are deducible in the year they are paid by Broadbill. Thus, Broadbill deducts $440,000 ($220,000 × 2), the amount of salaries paid by the corporation in 2013. The $40,000 of salaries paid by Broadbill in 2014 is deductible by the corporation in 2014.

    b. An accrual method corporation cannot claim a deduction for an accrual with respect to a related party (e.g., more-than-50% shareholder). Instead, the deduction is deferred until such time the recipient reports that amount as income. Thus, Broadbill deducts $460,000 [$220,000 (salary paid in 2013 to related party Marcia) + $240,000 (salary paid and accrued to unrelated party Zack). The $20,000 of Marcia's 2013 salary that is accrued by Broadbill on December 31, 2013, is deductible by the corporation in 2014 (the year it is paid to Marcia).

Example 12

42. a. Under the check-the-box Regulations, a single-member LLC is treated as a sole proprietorship unless corporate status is elected by filing a proper Form 8332 (Entity Classification Election). If Lemon Company is a proprietorship, then \$10,500 (\$70,000 × 15%) of individual income tax results in 2013 for Jonathan. The income (or loss) of a proprietorship is reported on the proprietor's individual return (Form 1040). Individuals in the 33% marginal tax bracket receive a preferential tax rate of 15% on LTCGs.

b. If Lemon is a C corporation, then \$12,500 of corporate income tax results in 2013. Corporations do not receive a preferential tax rate for LTCGs, and such income is taxed at the normal corporate rates resulting in a tax of \$12,500 [(\$50,000 × 15%) + (\$20,000 × 25%)].

p. 2-11 and Exhibit 2.1

43. a. \$105,000 taxable income = \$480,000 (operating income) – \$390,000 (operating expenses) + \$55,000 (LTCG) – \$40,000 (STCL). The tax on \$105,000 of taxable income is \$24,200 [(\$50,000 × 15%) + (\$25,000 × 25%) + (\$25,000 × 34%) + (\$5,000 × 39%)]. Corporations include LTCGs in taxable income and do not receive a preferential tax rate with respect to such income.

b. \$90,000 taxable income = \$480,000 (operating income) – \$390,000 (operating expenses) + \$15,000 (LTCG) – \$15,000 (STCL). No deduction is allowed for the \$25,000 net capital loss. Instead, the net capital loss is carried back 3 years and forward 5 years. The tax on \$90,000 of taxable income is \$18,850 [(\$50,000 × 15%) + (\$25,000 × 25%) + (\$15,000 × 34%)].

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

44. a. If Goshawk is a proprietorship, only \$21,000 of the \$40,000 long-term capital loss can be deducted in 2013. The loss will offset the short-term capital gain of \$18,000 first; then, an additional \$3,000 of the loss may be utilized as a deduction against ordinary income. The remaining \$19,000 net capital loss is carried forward to 2014 and years thereafter until completely deducted. The capital loss carryover retains its character as long term. Example 13

b. If Goshawk is a C corporation, only \$18,000 of the long-term capital loss can be deducted in 2013. The loss deduction is limited to the amount of capital gains (\$18,000 STCG). A corporation cannot claim a net capital loss as a deduction against ordinary income. The \$22,000 net capital loss can be carried back to the three preceding years to reduce any net capital gains in those years. (The loss is carried back first to the tax year 2010.) Any loss not offset against net capital gains in the three previous years can be carried forward for five years, to offset capital gains in those years. The long-term capital loss will be treated as a short-term capital loss as it is carried back and forward. Example 14

45. a.

Net short-term capital gain	\$ 15,000
Net long-term capital loss	(105,000)
Net capital loss	(\$ 90,000)

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

b. 2013 net capital loss ($90,000)

Offset against	
2010 (net long-term capital gains)	$18,000
2011 (net short-term capital gains)	25,000
2012 (net long-term capital gains)	20,000
Total carrybacks	$63,000

c. $27,000 ($90,000 – $63,000) STCL carryforward to 2014, 2015, 2016, 2017, and 2018, in that order.

d. These transactions are netted with the taxpayer's other capital transactions for 2013. Assuming these are the only capital transactions in 2013, the taxpayer offsets $15,000 of capital gains against the capital losses and deducts an additional $3,000 in capital losses. The remaining $87,000 ($105,000 – $15,000 – $3,000) is carried forward indefinitely (as long-term capital loss).

Examples 13 and 14

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

First, determine the recognized gain:

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

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

Third, determine the normal § 1250 recapture amount:

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

Fourth, determine the additional § 291 amount:

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

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

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

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

Example 15

47. a. A closely held C corporation that is a personal service corporation is subject to the passive activity loss rules and, as a result, Plum cannot deduct any of the $75,000 passive activity loss in the current year. Therefore, Plum's taxable income is $430,000 ($410,000 net active income + $20,000 portfolio income – $0 passive activity loss).

b. A closely held C corporation that is *not* a personal service corporation is subject to the passive loss rules, but it can deduct a passive activity loss against net active income (but not portfolio income). Thus, Plum's taxable income is $355,000 [$410,000 (net active income) + $20,000 (portfolio income) – $75,000 (passive activity loss)].

Example 16

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

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

December 3, 2013

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

Dear Mr. Thompson:

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

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

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

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

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

Sincerely,

Richard Stinson, CPA

<u>Note to instructor</u>: The land and stock are "unrelated use property" but they are not "tangible personal property."

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

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

<u>Assuming a gift of the land in 2014</u>
2013 taxable income limitation: 10% × $1 million = $100,000.
2013 charitable contribution deduction: $75,000 (carryover from 2008 gift).
2014 taxable income limitation: 10% × 1.2 million = $120,000.
2014 charitable contribution deduction: $120,000 (gift of land; excess contribution of $130,000 is carried forward for up to 5 years).

<u>Assuming a gift of the land in 2013</u>
2013 taxable income limitation: 10% × $1 million = $100,000.
2013 charitable contribution deduction: $100,000 (gift of land; excess contribution of $150,000 is carried forward for up to 5 years). Carryover from 2008 gift ($75,000) disappears, as 2013 is the last year of the carryover period.
2014 taxable income limitation: 10% × 1.2 million = $120,000.
2014 charitable contribution deduction: $120,000 (carryover from 2013 gift; remaining $30,000 of carryover from 2013 gift carries over to 2015).

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

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

December 17, 2013

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

Dear Mr. Simms:

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

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

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

Sincerely,

Alicia Gomez, CPA

pp. 2-14 and 2-16

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

b. Organizational expenditures now total $52,000 ($21,000 + $3,000 + $28,000). Since organizational expenditures exceed $50,000, the $5,000 first-year expensing limit is reduced to $3,000 [$5,000 – ($52,000 – $50,000)]. Thus, the 2013 deduction for organizational expenditures is $3,544 {$3,000 (amount that can be immediately expensed) + [($52,000 – $3,000) ÷ 180 months × 2 months]}.

Examples 29 and 43

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

57. Purple Corporation:

Tax on—$65,000	
Tax on $50,000 × 15%	$ 7,500
Tax on $15,000 × 25%	3,750
Total tax	$ 11,250

Azul Corporation:

Tax on—$290,000	
Tax on $100,000	$ 22,250
Tax on $190,000 × 39%	74,100
Total tax	$ 96,350

Pink Corporation:

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

Turquoise Corporation:

Tax on $19,000,000 × 35%	$6,650,000

Teal Corporation (a personal sevice corporation):

Tax on $130,000 × 35%	$ 45,500

p. 2-22, Exhibit 2.1, and Examples 30 and 31

58. Since Red and White are members of a controlled group of corporations, and since they did not consent to an apportionment plan, the marginal tax brackets are apportioned equally to the two entities. As such, Red Corporation's income tax liability is $42,325 [($25,000 × 15%) + ($12,500 × 25%) + ($12,500 × 34%) + ($80,000 × 39%)], and White Corporation's income tax liability is $69,625 [($25,000 × 15%) + ($12,500 × 25%) + ($12,500 × 34%) + ($150,000 × 39%)]. (Note that the combined tax liability of $111,950 for the two corporations is equal to the tax liability they would have incurred if they were taxed as one corporation with their combined taxable income of $330,000.) pp. 2-21, 2-22, and Exhibit 2.1

59. Grouse, a large corporation, may use the prior year's tax liability exception only for purposes of its first estimated tax payment for 2013. Any shortfall from not using the current year's (2013) tax liability for the first installment must be paid in conjunction with the second installment payment. As such, Grouse's installment payment dates and amounts are as follows:

Payment	Amount
April 15, 2013	$ 59,500*
June 15, 2013	212,500**
September 15, 2013	136,000
December 15, 2013	136,000
Total	$544,000

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

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

Example 34

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

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

Minus:	
Items that increased net income per books but did not affect taxable income:	
– Tax-exempt interest income	(15,000)
– Life insurance proceeds received as a result of the death of the corporate president	(150,000)
Taxable income	$150,000

Example 35

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

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

Example 35

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

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

Example 36

63. Pelican, Inc., reports the meals and entertainment expenditures on line 11, Part III as follows: book expense of $10,000 in column (a), permanent difference of ($5,000) in column (c), and tax return deduction of $5,000 in column (d). This problem illustrates reporting procedures when book expenses are greater than tax return deductions. It also illustrates the reporting of permanent differences. Example 40

64. Pelican, Inc., reports the fines and penalties on line 12, Part III as follows: book expense of $50,000 in column (a), permanent difference of ($50,000) in column (c), and tax return deduction of $0 in column (d). Further, PGW reports the depreciation on line 31, Part III as follows: book expense of $245,000 in column (a), temporary difference of $65,000 in column

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

65. These amounts must be reported on line 32, Part III as follows: $190,000 book bad debt expense in column (a), ($130,000) temporary difference in column (b), and $60,000 tax return bad debt expense in column (d). This problem illustrates reporting procedures when book expenses are greater than tax return deductions. It also illustrates the reporting of temporary differences. Example 40

66. Organizational expenditures and startup expenditures were incurred in January, February, and March. For both types of expenditures, the corporation can elect to expense the first $5,000 of qualifying expenditures and amortize the remaining balance over a period of 180 months. Don and Steve should identify the organizational and startup expenditures that qualify, and decide whether to make the elections. Since the elections are deemed to be made, a decision to forgo either would require a statement to that effect attached to the corporation's return.

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

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

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

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

Proposed solutions to the Tax Return Problems are found at the Instructor Companion Site for the textbook (www.cengage.com/taxation/swft). Proposed solutions to the Research Problems are found in the Instructor's Guide; previously, these items were a part of the Instructor's Companion Site.

Problem 1: Pet Kingdom Corporate Tax Return

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

U.S. Corporation Income Tax Return

For calendar year 2012 or tax year beginning ____________, ending ____________

► Information about Form 1120 and its separate instructions is at *www.irs.gov/form1120*.

OMB No. 1545-0123

2012

A Check if: 1a Consolidated return (attach Form 851) ☐	**TYPE OR PRINT** Name: Pet Kingdom, Inc.	**B** Employer identification number: 11-1111111
b Life/nonlife consolidated return ☐	Number, street, and room or suite no. If a P.O. box, see instructions.: 1010 Northwest Parkway	**C** Date incorporated: 11/1/2006
2 Personal holding co. (attach Sch. PH) ☐	City or town: Dallas; State: TX; ZIP code: 75255	**D** Total assets (see instructions): $ 12,900,445
3 Personal service corp. (see instructions) ☐		
4 Schedule M-3 attached ☒	**E** Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change	

Income	1a	Gross receipts or sales	1a	6,900,000		
	b	Returns and allowance	1b	240,000		
	c	Balance. Subtract line 1b from line 1a			1c	6,660,000
	2	Cost of goods sold (attach Form 1125-A)			2	2,760,000
	3	Gross profit. Subtract line 2 from line 1c			3	3,900,000
	4	Dividends (Schedule C, line 19)			4	52,500
	5	Interest			5	24,000
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	
	10	Other income (see instructions—attach statement)			10	
	11	**Total income.** Add lines 3 through 10 ►			11	3,976,500
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ►			12	630,000
	13	Salaries and wages (less employment credits)			13	870,000
	14	Repairs and maintenance			14	168,000
	15	Bad debts			15	
	16	Rents			16	129,000
	17	Taxes and licenses			17	285,000
	18	Interest			18	261,000
	19	Charitable contributions			19	45,000
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	165,000
	21	Depletion			21	
	22	Advertising			22	69,000
	23	Pension, profit-sharing, etc., plans			23	
	24	Employee benefit programs			24	72,000
	25	Domestic production activities deduction (attach Form 8903)			25	
	26	Other deductions (attach statement)			26	
	27	**Total deductions.** Add lines 12 through 26 ►			27	2,694,000
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	1,282,500
	29a	Net operating loss deduction (see instructions)	29a			
	b	Special deductions (Schedule C, line 20)	29b	36,750		
	c	Add lines 29a and 29b			29c	36,750
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28 (see instructions)			30	1,245,750
	31	Total tax (Schedule J, Part I, line 11)			31	423,555
	32	Total payments and refundable credits (Schedule J, Part II, line 21)			32	428,000
	33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ► ☐			33	
	34	**Amount owed.** If line 32 is smaller than the total of lines 31 and 33, enter amount owed			34	0
	35	**Overpayment.** If line 32 is larger than the total of lines 31 and 33, enter amount overpaid			35	4,445
	36	Enter amount from line 35 you want: **Credited to 2013 estimated tax** ►		**Refunded** ►	36	4,445

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
	SELF-PREPARED RETURN			
Firm's name ►			Firm's EIN ►	
Firm's address ►			Phone no.	
City	State		ZIP code	

For Paperwork Reduction Act Notice, see separate instructions. Form **1120** (2012)

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Form 1120 (2012) Pet Kingdom, Inc. 11-1111111 Page **2**

Schedule C **Dividends and Special Deductions** (see instructions)

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

Form **1120** (2012)

Form 1120 (2012) Pet Kingdom, Inc. 11-1111111 Page 3

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

Part I–Tax Computation

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

Part II–Payments and Refundable Credits

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

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

		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. ▶ 453910		
b	Business activity ▶ Retail Trade		
c	Product or service ▶ Pet and Pet Supplies Store		
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	

Form **1120** (2012)

Form 1120 (2012) Pet Kingdom, Inc. 11-1111111 Page 4

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

		Yes	No
5	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851,** Affiliations Schedule? For rules of constructive ownership, see instructions.		X
	If "Yes," complete (i) through (iv) below.		

(i) Name of Corporation	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Incorporation	**(iv)** Percentage Owned in Voting Stock

		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 . .		X
	If "Yes," complete (i) through (iv) below.		

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

		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. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.		
7	At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of **(a)** the total voting power of all classes of the corporation's stock entitled to vote or **(b)** the total value of all classes of the corporation's stock?		X
	For rules of attribution, see section 318. If "Yes," enter: **(i)** Percentage owned ► ______ and **(ii)** Owner's country ► ______		
	(c) The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ► ______		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount . . . . ► ☐		
	If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
9	Enter the amount of tax-exempt interest received or accrued during the tax year ► $ 18,000		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ► 2		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here . . . . ► ☐		
	If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.		
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ► $ ______		
13	Are the corporation's total receipts (line 1c plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than $250,000?		X
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ► $ ______		
14	Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement (see instructions)?		X
	If "Yes," complete and attach Schedule UTP.		
15a	Did the corporation make any payments in 2012 that would require it to file Form(s) 1099?	X	
b	If "Yes," did or will the corporation file required Forms 1099?	X	
16	During this tax year, did the corporation have an 80% or more change in ownership, including a change due to redemption of its own stock?		X
17	During or subsequent to this tax year, but before the filing of this return, did the corporation dispose of more than 65% (by value) of its assets in a taxable, non-taxable, or tax deferred transaction?		X
18	Did the corporation receive assets in a section 351 transfer in which any of the transferred assets had a fair market basis or fair market value of more than $1 million?		X

Form **1120** (2012)

Form 1120 (2012) Pet Kingdom, Inc. 11-1111111 Page 5

Schedule L Balance Sheets per Books

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

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

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

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

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

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

Form 1120 (2012)

Form **1125-A** (Rev. December 2012) Department of the Treasury Internal Revenue Service

Cost of Goods Sold

▶ Attach to Form 1120, 1120-C, 1120-F, 1120S, 1065, or 1065-B.
▶ Information about Form 1125-A and its instructions is at *www.irs.gov/form1125a.*

OMB No. 1545-2225

Name	Employer identification number
Pet Kingdom, Inc.	11-1111111

1	Inventory at beginning of year	1	3,300,000
2	Purchases	2	3,096,000
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	**Total.** Add lines 1 through 5	6	6,396,000
7	Inventory at end of year	7	3,636,000
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return (see instructions)	8	2,760,000

9 a Check all methods used for valuing closing inventory:

- *(i)* ☐ 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 amount of closing inventory computed under LIFO **9d**

e If property is produced or acquired for resale, do the rules of section 263A apply to the entity (see instructions)? ☐ Yes ☒ No

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

For Paperwork Reduction Act Notice, see instructions. Form **1125-A** (Rev. 12-2012)

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SCHEDULE G (Form 1120)
(Rev. December 2011)
Department of the Treasury
Internal Revenue Service

Information on Certain Persons Owning the Corporation's Voting Stock

▶ Attach to Form 1120.
▶ See instructions on page 2.

OMB No.1545-0123

Name: Pet Kingdom, Inc.

Employer identification number (EIN): 11-1111111

Part I **Certain Entities Owning the Corporation's Voting Stock.** (Form 1120, Schedule K, Question 4a). Complete columns (i) through (v) below for any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization that owns directly 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote (see instructions).

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

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

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

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

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

SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More

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

OMB No. 1545-0123

2012

Name of corporation (common parent, if consolidated return): Pet Kingdom, Inc.

Employer identification number: 11-1111111

Check applicable box(es): (1) [X] Non-consolidated return (2) [ ] Consolidated return (Form 1120 only)

(3) [ ] Mixed 1120/L/PC group (4) [ ] Dormant subsidiaries schedule attached

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

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
[ ] **Yes.** Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
[X] **No.** Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.

b Did the corporation prepare a certified audited non-tax-basis income statement for that period?
[ ] **Yes.** Skip line 1c and complete lines 2a through 11 with respect to that income statement.
[X] **No.** Go to line 1c.

c Did the corporation prepare a non-tax-basis income statement for that period?
[X] **Yes.** Complete lines 2a through 11 with respect to that income statement.
[ ] **No.** Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4a.

2a Enter the income statement period: Beginning 1/1/2012 Ending 12/31/2012

b Has the corporation's income statement been restated for the income statement period on line 2a?
[ ] **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
[X] **No.**

c Has the corporation's income statement been restated for any of the five income statement periods preceding the period on line 2a?
[ ] **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
[X] **No.**

3a Is any of the corporation's voting common stock publicly traded?
[ ] **Yes.**
[X] **No.** If "No," go to line 4a.

b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock . . . . [ ]

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock . . . . [ ]

4a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	**4a**	863,445
b	Indicate accounting standard used for line 4a (see instructions): (1) [ ] GAAP 2) [ ] IFRS 3) [ ] Statutory (4) [ ] Tax-basis (5) [ ] Other (specify) ________		
5a	Net income from nonincludible foreign entities (attach statement)	**5a**	( )
b	Net loss from nonincludible foreign entities (attach statement and enter as a positive amount)	**5b**	
6a	Net income from nonincludible U.S. entities (attach statement)	**6a**	( )
b	Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	**6b**	
7a	Net income (loss) of other includible foreign disregarded entities (attach statement)	**7a**	
b	Net income (loss) of other includible U.S. disregarded entities (attach statement)	**7b**	
c	Net income (loss) of other includible entities (attach statement)	**7c**	
8	Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	**8**	
9	Adjustment to reconcile income statement period to tax year (attach statement)	**9**	
10a	Intercompany dividend adjustments to reconcile to line 11 (attach statement)	**10a**	
b	Other statutory accounting adjustments to reconcile to line 11 (attach statement)	**10b**	
c	Other adjustments to reconcile to amount on line 11 (attach statement)	**10c**	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10 . .	**11**	863,445

Note. Part I, line 11, must equal the amount on Part II, line 30, column (a), and Schedule M-2, line 2.

12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines.

		Total Assets	Total Liabilities
a	Included on Part I, line 4 . . . . ▶	12,900,445	6,343,000
b	Removed on Part I, line 5 . . . . ▶		
c	Removed on Part I, line 6 . . . . ▶		
d	Included on Part I, line 7 . . . . ▶		

For Paperwork Reduction Act Notice, see the Instructions for Form 1120. **Schedule M-3 (Form 1120) 2012**
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Schedule M-3 (Form 1120) 2012 Page **2**

Name of corporation (common parent, if consolidated return)	Employer identification number
Pet Kingdom, Inc.	11-1111111

Check applicable box(es): (1) ☐ Consolidated group (2) ☐ Parent corp (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corp (5) ☐ Mixed 1120/L/PC group

Check if a sub-consolidated: (6) ☐ 1120 group (7) ☐ 1120 eliminations

Name of subsidiary (if consolidated return)	Employer identification number

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

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

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

Schedule M-3 (Form 1120) 2012

Schedule M-3 (Form 1120) 2012 Page 3

Name of corporation (common parent, if consolidated return): Pet Kingdom, Inc.

Employer identification number: 11-1111111

Check applicable box(es): (1) ☐ Consolidated group (2) ☐ Parent corp (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corp (5) ☐ Mixed 1120/L/PC group

Check if a sub-consolidated: (6) ☐ 1120 group (7) ☐ 1120 eliminations

Name of subsidiary (if consolidated return)

Employer identification number

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

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

Schedule M-3 (Form 1120) 2012

Form **1125-E**
(Rev. December 2012)
Department of the Treasury
Internal Revenue Service

Compensation of Officers

▶ Attach to Form 1120, 1120-C, 1120-F, 1120-RIC, or 1120-REIT.
▶ Information about Form 1125-E and its separate instructions is at *www.irs.gov/form1125e.*

OMB No. 1545-2225

Name	Employer identification number
Pet Kingdom, Inc.	11-1111111

Note. Complete Form 1125-E only if total receipts are $500,000 or more. See instructions for definition of total receipts.

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of stock owned (d) Common	Percent of stock owned (e) Preferred	(f) Amount of compensation
1	Janet Morton	123-45-6789	100.00%	50.00%	%	315,000
	Kim Wong	987-65-4321	100.00%	50.00%	%	315,000
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
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			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	

2	Total compensation of officers	2	630,000
3	Compensation of officers claimed on Form 1125-A or elsewhere on return	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1120, page 1, line 12 or the appropriate line of your tax return	4	630,000

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Form **8916-A**

Department of the Treasury
Internal Revenue Service

Supplemental Attachment to Schedule M-3

▶ Attach to Schedule M-3 for Form 1065, 1120, 1120-L, 1120-PC, or 1120S.
▶ Information about Form 8916-A and its instructions is at *www.irs.gov/form1120*.

OMB No. 1545-2061

2012

Name of common parent	Employer identification number
Pet Kingdom, Inc.	11-1111111
Name of subsidiary	Employer identification number

Part I Cost of Goods Sold

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

For Paperwork Reduction Act Notice, see instructions. Form **8916-A** (2012)
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Form 8916-A (2012) Pet Kingdom, Inc. 11-1111111 Page 2

Part II Interest Income

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

Part III Interest Expense

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

Form **8916-A** (2012)

Pet Kingdom, Inc. 11-1111111

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

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

Line 9, Sch L (1120) - Other Investments

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

Line 14, Sch L (1120) - Other Assets

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