

CHAPTER

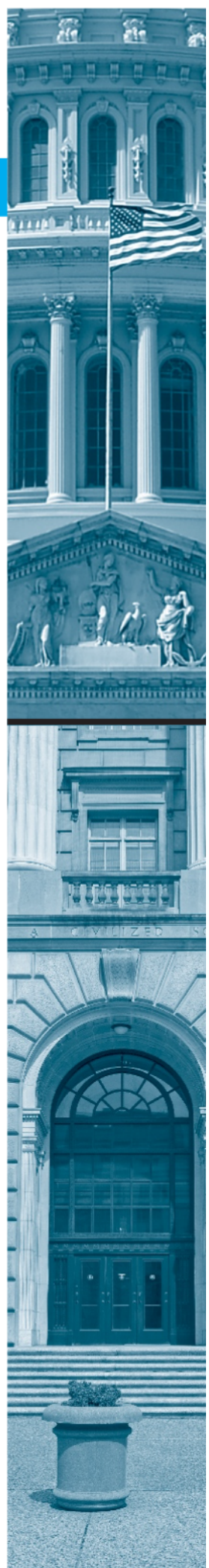
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THE CORPORATE INCOME TAX

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- 1 Select tax years and accounting methods for C corporations
- 2 Calculate deductions particular to corporations and arrive at corporate taxable income and tax liability
- 3 Recognize what a controlled group is and determine the tax consequences of being a controlled group
- 4 Identify planning strategies to reduce taxes for corporations and their shareholders
- 5 Comply with corporate tax filing requirements
- 6 Determine the financial statement implications of corporate federal income taxes



CHAPTER OUTLINE

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A corporation is a separate taxpaying entity that pays tax at a flat 21% rate and that must file an annual tax return even if it has no income or loss for the year. This chapter covers the tax rules for domestic corporations (i.e., corporations incorporated in one of the 50 states or under federal law) and other entities taxed as domestic corporations under the check-the-box regulations.¹ It explains the rules for determining a corporation's taxable income, loss, and tax liability and for filing corporate tax returns. See Table C:3-1 for the general formula for determining the corporate tax liability. It also discusses the financial implications of federal income taxes. Some of these implications appear briefly in the Book-to-Tax Accounting Comparisons, and a more detailed discussion appears at the end of this chapter.

The corporations discussed in this chapter are sometimes referred to as regular or C corporations because Subchapter C of the Internal Revenue Code (IRC) dictates much of their tax treatment. Corporations that have a special tax status include S corporations (see Chapter C:11) and affiliated groups of corporations that file consolidated returns (see Chapter C:8). A comparison of the tax treatments of C corporations, partnerships, and S corporations appears in Appendix F.

CORPORATE ELECTIONS

OBJECTIVE 1

Select tax years and accounting methods for C corporations

Once formed, a corporation must make certain elections, such as selecting its tax year and its accounting methods. The corporation makes these elections on its first tax return. They are important and should be considered carefully because, once made, they generally can be changed only with permission from the Internal Revenue Service (IRS).

CHOOSING A CALENDAR OR FISCAL YEAR

A new corporation may elect to use either a calendar year or a fiscal year as its accounting period. The corporation's tax year must be the same as the annual accounting period used for financial accounting purposes. The corporation makes the election by filing its first tax return for the selected period. A calendar year is a 12-month period ending on December 31. A fiscal year is a 12-month period ending on the last day of any month other than December. Examples of acceptable fiscal years are February 1, 2019, through January 31, 2020, and October 1, 2019, through September 30, 2020. A fiscal year that runs from September 16, 2019, through September 15, 2020, however, is not an acceptable tax year because it does not end on the last day of the month. The IRS requires that a corporation using an unacceptable tax year change to a calendar year.²

KEY POINT

Whereas partnerships and S corporations generally must adopt a calendar year, C corporations (other than personal service corporations) have the flexibility of adopting a fiscal year. The fiscal year must end on the last day of the month.

Short Tax Period. A corporation's first tax year might not cover a full 12-month period. If, for example, a corporation begins business on March 10, 2019, and elects a fiscal year ending on September 30, its first tax year covers the period from March 10, 2019, through September 30, 2019. Its second tax year covers the period from October 1, 2019, through September 30, 2020. The corporation must file a **short-period tax return** for its first tax year.³ From then on, its tax returns will cover a full 12-month period. The last year of a corporation's life, however, also may be a short period covering the period from the beginning of the last tax year through the date the corporation ceases to exist.

Restrictions on Adopting a Tax Year. A corporation may be subject to restrictions in its choice of a tax year. For example, an S corporation generally must use a calendar year (see Chapter C:11), and members of an affiliated group filing a consolidated return must use the same tax year as the group's parent corporation (see Chapter C:8).

A **personal service corporation (PSC)** generally must use a calendar year as its tax year. This restriction prevents a personal service corporation with, for example, a January 31 year-end from distributing a large portion of its income earned during the February through December portion of 2019 to its calendar year shareholder-employees in January

¹ Sec. 7701(a)(4). Corporations that are not classified as domestic are foreign corporations. Foreign corporations are taxed like domestic corporations if they conduct a trade or business in the United States.

² Sec. 441. Section 441 also permits accounting periods of either 52 or 53 weeks that always end on the same day of the week (such as Friday).

³ Sec. 443(a)(2).

▼ **TABLE C:3-1****General Rules for Determining the Corporate Tax Liability**

Gross income	
Minus: Deductions and losses	
Taxable income before special deductions	
Minus: Special deductions	
Taxable income	
Times: Corporate tax rate (21%)	
Tax before credits and other taxes	
Minus: Applicable tax credits	
Plus:	Personal holding company tax (if applicable)
	Accumulated earnings tax (if applicable)
	Other special taxes (if applicable)
Total tax liability	
Minus: Estimated tax payments	
Net tax due (or refund)	

2020, thereby deferring income largely earned in 2019 to 2020. For this purpose, the IRC defines a PSC as a corporation whose principal activity is the performance of personal services by its employee-owners who own more than 10% of the stock (by value) on any day of the year.⁴

A PSC, however, may adopt a fiscal tax year if it can establish a business purpose for such a year. For example, it may be able to establish a natural business year and use that year as its tax year.⁵ Deferral of income by shareholders is not an acceptable business purpose. Even when no business purpose exists, a new PSC may elect to use a September 30, October 31, or November 30 year-end if it meets minimum distribution requirements to employee-owners during the deferral period.⁶ If it fails to meet these distribution requirements, the PSC may have to defer to its next fiscal year the deduction for amounts paid to employee-owners.⁷

EXAMPLE C:3-1

▶ Alice and Bob form Cole Corporation with each shareholder owning 50% of its stock. Alice and Bob use the calendar year as their tax year. Alice and Bob are both active in the business and are the corporation's primary employees. The new corporation performs engineering services for the automotive industry. Cole must use a calendar year as its tax year unless it qualifies for a fiscal year based on a business purpose exception. Alternatively, it may adopt a fiscal year ending on September 30, October 31, or November 30, provided it complies with certain minimum distribution requirements. ◀

Changing the Annual Accounting Period. A corporation that desires to change its annual accounting period must obtain the prior approval of the IRS unless Treasury Regulations specifically authorized the change or IRS procedures allow an automatic change. A change in accounting period usually results in a short period running from the end of the old annual accounting period to the beginning of the new accounting period. A corporation must request approval of an accounting period change by filing Form 1128 (Application for Change in Annual Accounting Period) by the due date of the short period tax return

⁴ Sec. 441(i).

⁵ The natural business year rule requires that the year-end used for tax purposes coincide with the end of the taxpayer's peak business period. (See the partnership and S corporation chapters and Rev. Proc. 2006-46, 2006-2 C.B. 859, for a further explanation of this exception.)

⁶ Sec. 444.

⁷ Sec. 280H.

(including extensions). The IRS usually will approve a request for change if a substantial business purpose exists for the change and if the taxpayer agrees to the IRS's prescribed terms, conditions, and adjustments necessary to prevent any substantial distortion of income. A substantial distortion of income includes, for example, a change that causes the "deferral of a substantial portion of the taxpayer's income, or shifting of a substantial portion of deductions, from one taxable year to another."⁸

Under IRS administrative procedures, a corporation may change its annual accounting period without prior IRS approval if it meets the following conditions:

- The corporation files a short-period tax return for the year of change and annualizes its income when computing its tax for the short period.
- The corporation files full 12-month returns for subsequent years ending on the new year-end.
- The corporation closes its books as of the last day of the short-period and subsequently computes its income and keeps its books using the new tax year.
- If the corporation generates an NOL or capital loss in the short period, it may not carry back the losses but must carry them over to future years.
- The corporation must not have changed its accounting period within the previous 48 months (with some exceptions).
- The corporation must not have an interest in a pass-through entity as of the end of the short period (with some exceptions).
- The corporation is not an S corporation, personal service corporation, tax-exempt organization, or other specialized corporation.⁹

ADDITIONAL COMMENT

Special NOL carryback rules apply to farming losses and insurance companies.

BOOK-TO-TAX ACCOUNTING COMPARISON

Treasury Regulations require taxpayers to use the same overall accounting method for book and tax purposes. However, the courts have allowed different methods if the taxpayer maintains adequate reconciling workpapers. The IRS has adopted the courts' position on this issue.

ADDITIONAL COMMENT

For tax years beginning after December 31, 2018, the gross receipts amount will be adjusted for inflation.

ACCOUNTING METHODS

A new corporation must select the overall accounting method it will use for tax purposes. The method chosen must be indicated on the corporation's initial return. The three possible accounting methods are: accrual, cash, and hybrid.¹⁰

Accrual Method. Under the accrual method, a corporation reports income in the year it earns the income and reports expenses in the year it incurs the expenses. A corporation must use the accrual method unless it qualifies under one of the following exceptions:

- It qualifies as a farming business.¹¹
- It qualifies as a personal service corporation, which is a corporation substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; and substantially all of whose stock is held by current (or retired) employees performing the services listed above, their estates, or (for two years only) persons who inherited their stock from such employees.¹²
- It meets a \$26 million (in 2019) gross receipts test. A corporation meets this test for the current tax year if its average gross receipts for the immediately preceding three years do not exceed \$26 million. If the corporation was not in existence for the entire three-year period, the period during which the corporation *was* in existence may be used.
- It has elected S corporation status.

If a corporation meets one of the exceptions listed above, it may use either the accrual method or one of the following two methods.

⁸ Reg. Sec. 1.442-1(b)(3). Also see Rev. Proc. 2002-39, 2002-1 C.B. 1046.

⁹ Rev. Proc. 2006-45, 2006-2 C.B. 851. For automatic change procedures for S corporations and personal service corporations, see Rev. Proc. 2006-46, 2006-2 C.B. 859.

¹⁰ Sec. 446.

¹¹ Sec. 448(b)(1).

¹² The personal service corporation definition for the tax year election [Sec. 441(i)] is different from the personal service corporation definition for the cash accounting method election [Sec. 448].

ADDITIONAL COMMENT

For tax years beginning after December 31, 2017, a taxpayer meeting the \$26 million (in 2019) gross receipts test described above may treat inventory (1) as non-incidental materials and supplies or (2) in a manner that conforms to the taxpayer's method of accounting used for financial statement purposes.

Cash Method. Under the cash method, a corporation reports income when it actually or constructively receives the income and reports expenses when it pays them. Corporations in service industries such as engineering, medicine, law, and accounting generally use this method because they prefer to defer recognition until they actually receive the income. This method may not be used if the taxpayer does not meet the \$26 million (in 2019) gross receipts test and inventories are a material income-producing factor. In such case, the corporation must use either the *accrual* method or the *hybrid* method of accounting.

Hybrid Method. Under the hybrid method, a corporation uses the accrual method of accounting for sales, cost of goods sold, inventories, accounts receivable, and accounts payable, and uses the cash method of accounting for all other income and expense items. Small businesses with inventories (e.g., retail stores) often use this method. Although they must use the accrual method of accounting for sales-related income and expense items, they often find the cash method less burdensome to use for other income and expense items, such as utilities, rents, salaries, and taxes.

DETERMINING A CORPORATION'S TAXABLE INCOME AND TAX LIABILITY

OBJECTIVE 2

Calculate deductions particular to corporations and arrive at corporate taxable income and tax liability

Each year, C corporations must determine their corporate income (or regular) tax liability. In addition to the income tax, a C corporation may be subject to either the personal holding company tax or the accumulated earnings tax. A corporation's total tax liability equals the sum of its regular income tax liability plus any additional taxes that it owes.

This chapter explains how to compute a corporation's income (or regular) tax liability. Chapter C:5 explains the computation of the personal holding company tax and accumulated earnings tax.

Like an individual, a corporation is a taxpaying entity with gross income and deductions. However, a number of differences arise between individual and corporate taxation as summarized in Figure C:3-1. This section of the text expands on some of these items and discusses other tax aspects particular to corporations.

CORPORATE TAX RATE

Prior to the enactment of the Tax Cuts and Jobs Act of 2017, corporations faced a graduated tax rate schedule ranging from 15% to 35% with two “bubble” rates at 39% and 38%. However, prior to 2018, a corporation having more than \$335,000 of taxable income would have had a 34% tax rate, or if fairly large, a 35% tax rate. Most public companies reported a 35% tax rate before adjusting this number to arrive at their financial accounting effective tax rate. The pre-2018 rate schedule is reproduced in the Quick Reference section of the text. For tax years beginning after 2017, corporations, including personal service corporations, are subject to a flat 21% tax rate. Thus, calculating the corporate tax liability now is much simpler than under the previous system. This tax rate applies to all corporate taxable income regardless of the character of that income. Congress reduced the corporate tax rate to make corporation more competitive in the global marketplace and to induce corporations to use their increased after-tax income to foster growth.

SALES AND EXCHANGES OF PROPERTY

Sales and exchanges of property generally are treated the same way for corporations as for an individual. However, special rules apply to capital gains and losses. Also, corporations are not subject to the 25% tax rate on unrecaptured Sec. 1250 gains, but corporations *are* subject to an additional 20% depreciation recapture rule under Sec. 291 on sales of Sec. 1250 property.

1. **Gross income:** Generally, the same gross income definition applies to individuals and corporations. Certain exclusions are available to individuals but not to corporations (e.g., fringe benefits); other exclusions are available to corporations but not to individuals (e.g., some capital contributions).
2. **Deductions:** Individuals have above-the-line deductions (for AGI) and either itemized deductions (from AGI) or the standard deduction. Corporations do not compute AGI, and their deductions are presumed to be ordinary and necessary business expenses.
3. **Charitable contributions:** Individuals are limited to 60% of AGI (30% for capital gain property). Corporations are limited to 10% of taxable income computed without regard to the dividends-received deductions, capital loss carrybacks, and the contribution deduction itself. Individuals deduct a contribution only in the year they pay it. Accrual basis corporations may deduct contributions in the year of accrual if the board of directors authorizes the contribution by year-end, and the corporation pays it by the fifteenth day of the fourth month of the next year (third month if the corporation has a June 30 year-end).
4. **Depreciation on Sec. 1250 property:** Individuals generally do not recapture depreciation under the MACRS rules because straight-line depreciation applies to real property. Corporations must recapture 20% of the amount that would be recaptured under Sec. 1245. Individuals are subject to a 25% (and possibly an incremental 3.8%) tax rate on unrecaptured Sec. 1250 gains. Corporations are not subject to this rate.
5. **Net capital gains:** The applicable capital gains tax rate for net capital gains and qualified dividends of noncorporate taxpayers is 0%, 15%, or 20%, depending on the taxpayer's filing status and taxable income level. Also, 25% and 28% rates apply for gains on certain types of property. In addition, an incremental 3.8% rate applies to net investment income for taxpayers whose modified AGI exceeds \$200,000 (\$250,000 for married filing jointly). Net investment income includes, among other things, interest, dividends, annuities, royalties, rents, and net gains from the disposition of property not used in a trade or business, all reduced by deductions allocable to such income or gains. Corporate capital gains are taxed at the regular corporate tax rates.
6. **Capital losses:** Individuals can deduct up to \$3,000 of net capital losses to offset ordinary income. Individual capital losses carry over indefinitely. Corporations cannot offset any ordinary income with capital losses. However, capital losses carry back three years and forward five years and offset capital gains in those years.
7. **Dividends-received deduction:** This deduction is not available to individuals. Corporations receive a 50%, 65%, or 100% special deduction depending on the percentage of stock ownership.
8. **NOLs:** Individuals must make many adjustments to arrive at the NOL they are allowed to carry over to subsequent years. A corporation's NOL is the excess of its deductions over its income for the year. NOLs carry over indefinitely if incurred in tax years beginning after 2017. Also, NOLs incurred after this date are subject to an 80% of taxable income limitation. NOLs incurred before this date retain the 20-year carryover period and are not subject to the 80% limitation.
9. For tax years beginning after 2017, a limitation on excess business losses applies to noncorporate taxpayers but not to C corporations.
10. **Tax rates:** Individual's ordinary tax rates range from 10% to 37% (in 2019). The corporate tax rate is a flat 21% for tax years beginning after 2017.
11. **AMT:** Individual AMT rates are 26% or 28%. The corporate AMT is repealed for tax years beginning after 2017.
12. **Passive losses:** Passive loss rules apply to individuals, partners, S corporation shareholders, closely held C corporations, and personal service corporations. They do not apply to widely held C corporations.
13. **Casualty losses:** Casualty losses are deductible in full by a corporation because all corporate casualty losses are considered to be business related. For years beginning after 2017 and before 2026, personal casualty losses are deductible only if attributable to a federally declared disaster. An exception exists for casualty losses to the extent of casualty gains.

FIGURE C-3-1 ► DIFFERENCES BETWEEN INDIVIDUAL AND CORPORATE TAXATION

Capital Gains and Losses. A corporation has a capital gain or loss if it sells or exchanges a capital asset. As with individuals, a corporation must net all its capital gains and losses to obtain its net capital gain or loss position.

Net Capital Gain. A corporation includes all its net capital gains (net long-term capital gains in excess of net short-term capital losses) for the tax year in income. Unlike with individuals, a corporation's capital gains receive no special tax treatment and are taxed in the same manner as any other ordinary income item.

EXAMPLE C-3-2 ► Beta Corporation has a net capital gain of \$40,000, gross profits on sales of \$110,000, and deductible expenses of \$28,000. Beta's taxable income is \$122,000 (\$40,000 + \$110,000 – \$28,000). The \$40,000 of net capital gain receives no special treatment and is taxed at 21% along with the rest of the corporation's taxable income. Thus, the corporation's tax is \$25,620 (\$122,000 × 0.21).

Net Capital Losses. If a corporation incurs a net capital loss, it cannot deduct the net loss in the current year. A corporation's capital losses can offset only capital gains. They never can offset the corporation's ordinary income.

A corporation must carry back a net capital loss as a short-term capital loss to the three previous tax years and offset capital gains in the earliest year possible (i.e., the losses carry back to the third previous year first). If the loss is not totally absorbed as a carryback, the remainder carries over as a short-term capital loss for five years. Any unused capital losses remaining at the end of the carryover period expire.

EXAMPLE C:3-3 ▶

In 2019, East Corporation reports gross profit of \$150,000, deductible expenses of \$28,000, and a net capital loss of \$10,000. East reported the following capital gain net income (excess of gains from sales or exchanges of capital assets over losses from such sales or exchanges) during 2016 through 2018:

Year	Capital Gain Net Income
2016	\$6,000
2017	—0—
2018	3,000

ADDITIONAL COMMENT

A corporation accomplishes the net capital loss carryback by filing either Form 1139, Corporation Application for Tentative Refund, or Form 1120X, Amended U.S. Corporation Income Tax Return. Form 1139 usually results in a quicker refund than does Form 1120X but must be filed within one year after the end of the year in which the net capital loss occurred.

East has taxable income of \$122,000 (\$150,000 – \$28,000) for 2019. East also has a \$10,000 net capital loss that carries back to 2016 first and offsets the \$6,000 capital gain net income reported in that year. East receives a refund for the taxes paid in 2016 on the \$6,000 of capital gains. The \$4,000 (\$10,000 – \$6,000) remainder of the loss carryback carries to 2018 and offsets East's \$3,000 capital gain net income reported in that year. East still has a \$1,000 net capital loss carryover to 2020. ▶

ADDITIONAL COMMENT

Under the modified accelerated cost recovery system (MACRS), Sec. 1250 depreciation recapture seldom, if ever, occurs for individuals because MACRS requires straight-line depreciation for Sec. 1250 property. Nevertheless, individuals would be subject to the 25% tax rate on unrecaptured Sec. 1250 gains.

Sec. 291: Tax Benefit Recapture Rule. If a taxpayer sells Sec. 1250 property at a gain, Sec. 1250 requires that the taxpayer report the recognized gain as ordinary income to the extent the depreciation taken exceeds the depreciation that would have been allowed had the taxpayer used the straight-line method. This ordinary income is known as Sec. 1250 depreciation recapture. For individuals, any remaining gain is characterized as a combination of unrecaptured Sec. 1250 gain and Sec. 1231 gain. Corporations, however, must recapture as ordinary income an amount equal to 20% of the ordinary income that would have been recognized had the property been Sec. 1245 property instead of Sec. 1250 property.

EXAMPLE C:3-4 ▶

Texas Corporation purchased residential real estate several years ago for \$125,000, of which \$25,000 was allocated to the land and \$100,000 to the building. Texas took straight-line MACRS depreciation deductions of \$10,606 on the building during the period it held the building. In December of the current year, Texas sells the property for \$155,000, of which \$45,000 is allocated to the land and \$110,000 to the building. Texas has a \$20,000 (\$45,000 – \$25,000) gain on the land sale, all of which is Sec. 1231 gain. This gain is not affected by Sec. 291 because land is not Sec. 1250 property. Texas has a \$20,606 [\$110,000 sales price – (\$100,000 original cost – \$10,606 depreciation)] gain on the sale of the building. If Texas were an individual taxpayer, \$10,606 would be an unrecaptured Sec. 1250 gain subject to a 25% tax rate, and the remaining \$10,000 would be a Sec. 1231 gain. However, a corporate taxpayer reports \$2,121 of gain as ordinary income. These amounts are summarized below:

	Land	Building	Total
Amount of gain:			
Sales price	\$45,000	\$110,000	\$155,000
Minus: Adjusted basis	(25,000)	(89,394)	(114,394)
Recognized gain	<u>\$20,000</u>	<u>\$ 20,606</u>	<u>\$ 40,606</u>
Character of gain:			
Ordinary income	\$ —0—	\$ 2,121 ^a	\$ 2,121
Sec. 1231 gain	<u>20,000</u>	<u>18,485</u>	<u>38,485</u>
Recognized gain	<u>\$20,000</u>	<u>\$ 20,606</u>	<u>\$ 40,606</u>

^a0.20 × lesser of \$10,606 depreciation claimed or \$20,606 recognized gain. ▶

ADDITIONAL COMMENT

Section 291 results in the recapture, as ordinary income, of up to 20% of the gain on sales of Sec. 1250 property. This recapture requirement reduces the amount of net Sec. 1231 gains that can be offset by corporate capital losses.

ADDITIONAL COMMENT

If an individual sold the same business property as in Example C:3-4, he or she would recognize \$10,606 of nonrecaptured Sec. 1250 gain, \$30,000 of Sec. 1231 gain, and no ordinary income.

BUSINESS EXPENSES

Corporations are allowed deductions for ordinary and necessary business expenses, including salaries paid to officers and other employees of the corporation, rent, repairs, insurance premiums, advertising, interest, taxes, losses on sales of inventory or other property, bad debts, and depreciation. No deductions are allowed, however, for interest on amounts borrowed to purchase tax-exempt securities, illegal bribes or kickbacks, fines or penalties imposed by a government, or insurance premiums incurred to insure the lives of officers and employees when the corporation is the beneficiary.

Organizational Expenditures. When formed, a corporation may incur some organizational expenditures such as legal fees and accounting fees incident to the incorporation process. These expenditures normally must be capitalized. Nevertheless, under Sec. 248, a corporation may elect to deduct the first \$5,000 of organizational expenditures. However, the corporation must reduce the \$5,000 by the amount by which cumulative organizational expenditures exceed \$50,000 although the \$5,000 cannot be reduced below zero. The corporation can amortize the remaining organizational expenditures over a 180-month period beginning in the month it begins business.

EXAMPLE C:3-5 ► Sigma Corporation incorporates on January 10 of the current year, and begins business on March 3. Sigma elects a September 30 year-end. Thus, it conducts business for seven months during its first tax year. During the period January 10 through September 30, Sigma incurs \$52,000 of organizational expenditures. Because these expenditures exceed \$50,000, Sigma must reduce the first \$5,000 by \$2,000 (\$52,000 – \$50,000), leaving a \$3,000 deduction. Sigma amortizes the remaining \$49,000 (\$52,000 – \$3,000) over 180 months beginning in March of its first year. This portion of the deduction equals \$1,906 (\$49,000/180 × 7 months). Accordingly, its total first-year deduction is \$4,906 (\$3,000 + \$1,906). ◀

BOOK-TO-TAX ACCOUNTING COMPARISON

Most corporations amortize organizational expenditures for tax purposes over the specified period. For financial accounting purposes, they are expensed currently under ASC 720-15. Thus, the differential treatment creates a deferred tax asset.

A corporation is deemed to have made the Sec. 248 election for the tax year the corporation begins business.¹³ If the corporation chooses to forgo the deemed election, it can elect to capitalize the expenditures (without amortization) on a timely filed tax return for the tax year the corporation begins business. Either election, to amortize or capitalize, is irrevocable and applies to all organizational expenditures of the corporation.

A corporation begins business when it starts the business operations for which it was organized. Merely coming into existence is not sufficient. For example, obtaining a corporate charter does not in itself establish the beginning of business. However, acquiring assets necessary for operating the business may be sufficient.

Organizational expenditures include expenditures (1) incident to the corporation's creation; (2) chargeable to the corporation's capital account; and (3) of a character that, if expended incident to the creation of a corporation having a limited life, would be amortizable over that life.

WHAT WOULD YOU DO IN THIS SITUATION?



You are a CPA with a medium-size accounting firm. One of your corporate clients is an electrical contractor in New York City. The client is successful and had \$10 million of sales last year. The contracts involve private and government electrical work. Among the corporation's expenses are \$400,000 of kickbacks paid to people working for general contractors who award electrical subcontracts to the corporation, and \$100,000 of payments to individuals in

the electricians' union. Technically, these payments are illegal. However, your client says that everyone in this business needs to pay kickbacks to obtain contracts and to have enough electricians to finish the projects in a timely manner. He maintains that it is impossible to stay in business without making these payments. In preparing its tax return, your client wants you to deduct these expenses. What is your opinion concerning the client's request?

¹³ Reg. Sec. 1.248-1(c) and 1(f).

Specific organizational expenditures include

- ▶ Legal services incident to the corporation's organization (e.g., drafting the corporate charter and bylaws, minutes of organizational meetings, and terms of original stock certificates)
- ▶ Accounting services necessary to create the corporation
- ▶ Expenses of temporary directors and of organizational meetings of directors and stockholders
- ▶ Fees paid to the state of incorporation¹⁴

Organizational expenditures do not include expenditures connected with issuing or selling the corporation's stock or other securities (e.g., commissions, professional fees, and printing costs) and expenditures related to the transfer of assets to the corporation.

EXAMPLE C:3-6 ▶ Omega Corporation incorporates on July 12 of the current year, starts business operations on August 10, and elects a tax year ending on September 30. Omega incurs the following expenditures while organizing the corporation:

<u>Date</u>	<u>Type of Expenditure</u>	<u>Amount</u>
June 10	Legal expenses to draft charter	\$ 2,000
July 17	Commission to stockbroker for issuing and selling stock	40,000
July 18	Accounting fees to set up corporate books	2,400
July 20	Temporary directors' fees	1,000
August 25	Directors' fees	1,500

Omega's first tax year begins July 12 and ends on September 30. Omega has organizational expenditures of \$5,400 (\$2,000 + \$2,400 + \$1,000). The commission for selling the Omega stock is treated as a reduction in the amount of Omega's paid-in capital. Omega deducts the directors' fees incurred in August as a trade or business expense under Sec. 162 because Omega had begun business operations by that date. Assuming a deemed election to amortize its organizational expenditures, Omega can deduct \$5,000 in its first tax year and amortize the remaining \$400 over 180 months. Thus, its first year deduction is \$5,004 [$\$5,000 + (\$400/180) \times 2$ months].

The following table summarizes the classification of expenditures:

<u>Date</u>	<u>Expenditure</u>	<u>Amount</u>	<u>Type of Expenditure</u>		
			<u>Organizational</u>	<u>Capital</u>	<u>Business</u>
June 10	Legal	\$ 2,000	\$2,000		
July 17	Commission	40,000		\$40,000	
July 18	Accounting	2,400	2,400		
July 20	Temporary directors' fees	1,000	1,000		
August 25	Directors' fees	1,500			\$1,500
	Total	<u>\$46,900</u>	<u>\$5,400</u>	<u>\$40,000</u>	<u>\$1,500</u> ▶

BOOK-TO-TAX ACCOUNTING COMPARISON

For tax purposes, a corporation amortizes start-up expenditures over 180 months (after the initial deduction). ASC 915 holds that the financial accounting practices and reporting standards used for development stage businesses should be no different for an established business. The two different sets of rules can lead to different reporting for tax and book purposes.

Start-Up Expenditures. A distinction must be made between a corporation's organizational expenditures and its start-up expenditures. Start-up expenditures are ordinary and necessary business expenses paid or incurred by an individual or corporate taxpayer

- ▶ To investigate the creation or acquisition of an active trade or business
- ▶ To create an active trade or business
- ▶ To conduct an activity engaged in for profit or the production of income before the time the activity becomes an active trade or business

Examples of start-up expenditures include the costs for a survey of potential markets; an analysis of available facilities; advertisements relating to opening the business; the training of employees; travel and other expenses for securing prospective distributors, suppliers, or customers; and the hiring of management personnel and outside consultants. The

¹⁴ Reg. Sec. 1.248-1(b)(2).

expenditures must be such that, if incurred in connection with the operation of an existing active trade or business, they would be allowable as a deduction in the year paid or incurred.

Under Sec. 195, a corporation may elect to deduct the first \$5,000 of start-up expenditures. However, this amount is reduced (but not below zero) by the amount by which the cumulative start-up expenditures exceed \$50,000. The corporation can amortize the remaining start-up expenditures over a 180-month period beginning in the month it begins business.

A corporation is deemed to have made the Sec. 195 election for the tax year the business to which the expenditures relate begins.¹⁵ If the corporation chooses to forgo the deemed election, it can elect to capitalize the expenditures (without amortization) on a timely filed tax return for the tax year the business to which the expenditures relate begins. Either election, to amortize or capitalize, is irrevocable and applies to all start-up expenditures related to the business.

STOP & THINK

Question: What is the difference between an organizational expenditure and a start-up expenditure?

Solution: Organizational expenditures are outlays made in forming a corporation, such as fees paid to the state of incorporation for the corporate chapter and fees paid to an attorney to draft the documents needed to form the corporation. Start-up expenditures are outlays that otherwise would be deductible as ordinary and necessary business expenses but that are capitalized because they were incurred prior to the start of the corporation's business activities.

A corporation may elect to deduct the first \$5,000 of organizational expenditures and the first \$5,000 of start-up expenditures. The corporation can amortize the remainder of each set of expenditures over 180 months. Like a corporation, a partnership can deduct and amortize its organizational and start-up expenditures. A sole proprietorship may incur start-up expenditures, but sole proprietorships do not incur organizational expenditures.

Limitation on Deductions for Accrued Compensation. If a corporation accrues an obligation to pay compensation, the corporation must make the payment within 2½ months after the close of its tax year. Otherwise, the deduction cannot be taken until the year of payment.¹⁶ The reason is that, if a payment is delayed beyond 2½ months, the IRS treats it as a deferred compensation plan. Deferred compensation cannot be deducted until the year the corporation pays it and the recipient includes the payment in income.¹⁷

EXAMPLE C:3-7 ► On December 10 of the current year, Bell Corporation, a calendar year taxpayer, accrues an obligation for a \$100,000 bonus to Marge, a sales representative who has had an outstanding year. Marge owns no Bell stock. Bell must make the payment by March 15 of next year. Otherwise, Bell Corporation cannot deduct the \$100,000 in its current year tax return but must wait until the year it pays the bonus. ◀

Limitation on Net Business Interest. For tax years beginning after December 31, 2017, the deductibility of business interest in a given year is limited to the sum of the following amounts:¹⁸

- Business interest income
- 30% of adjusted taxable income (but not less than zero)
- Floor plan financing interest for motor vehicles

Any amount disallowed because of the above limitation carries over to the next year. The carryover period is indefinite. Corporations meeting the \$26 million (in 2019) gross receipts

¹⁵ Reg. Sec. 1.195-1(b) and 1(d).

¹⁶ Temp. Reg. Sec. 1.404(b)-1T.

¹⁷ Sec. 404(b).

¹⁸ Sec. 163(j).

test for small businesses are exempt from this limitation. Business interest does not include investment interest, and business income does not include investment income. For C corporations, adjusted taxable income means taxable income computed without regard to:

- ▶ Income, gain, deduction, or loss not allocable to a trade or business
- ▶ Business interest or business interest income
- ▶ Any NOL deduction
- ▶ For years beginning before 2022, any deduction allowable for depreciation, amortization, or depletion
- ▶ Any other adjustments provided by the Treasury Department

Regarding the first item, a C corporation usually is deemed to be a trade or business. The term trade or business, however, does not include performing services as an employee, an electing real property trade or business, an electing farming business, or certain regulated utilities. (See Chapters C:9 and C:11 for application of the business interest limitation to partnerships and S corporations.)

EXAMPLE C:3-8 ▶ Iota Corporation reports the following income and expenses for the current year:

Gross profit from operations	\$50,000,000
Long-term capital gain from investments	7,000,000
Operating business expenses	20,000,000
Depreciation deductions	10,000,000
Business interest expense	15,000,000

Assume that Iota's average gross receipts for the preceding three years exceeded \$26 million, so it does not qualify for the small business exemption. Iota's adjusted taxable income for purposes of the business interest limitation is \$30 million (\$50,000,000 – \$20,000,000). Therefore, its business interest deduction is limited to \$9 million (\$30,000,000 × 0.30). The remaining \$6 million of business interest expense carries over to the next year, subject to the limitation in that year. ◀

Entertainment Expenses. For amounts incurred after 2017, no deduction is allowed for any activities involving entertainment, amusement, or recreation, including expenses related to a facility used in connection with these activities. With some exceptions, this disallowance applies even if the expenses are related to the taxpayer's trade or business.

Executive Compensation. Section 162(m) limits the deduction for compensation paid to a "covered" employee to \$1 million. A covered employee includes the principal (chief) executive officer and principal (chief) financial officer plus the three highest compensated officers (other than the CEO or CFO) if the compensation of such other officers is required by the Securities Exchange Act of 1934 to be reported to shareholders. In addition, the Tax Cuts and Jobs Act of 2017 removed the exception to the \$1 million limitation for performance-based compensation.

Charitable Contributions. The treatment of charitable contributions by individual and corporate taxpayers differs in three ways: the timing of the deduction, the amount of the deduction permitted for the contribution of certain noncash property, and the maximum deduction permitted in any given year.

Timing of the Deduction. Corporations may deduct contributions to qualified charitable organizations.¹⁹ Generally, the contribution must have been paid during the year (not just pledged) for a deduction to be allowed for a given year. A special rule, however, applies to corporations using the accrual method of accounting (corporations using the cash or hybrid methods of accounting are not eligible). These corporations may elect to treat part or all of a charitable contribution as having been made in the year it accrued (instead of the year paid) if

¹⁹ Sec. 170.

- The board of directors authorizes the contribution in the year it accrued
- The corporation pays the contribution on or before the fifteenth day of the fourth month following the end of the accrual year (third month if the corporation has a June 30 year-end).

The corporation makes the election by deducting the contribution in its tax return for the accrual year and by attaching a copy of the board of director's resolution to the return. Any portion of the contribution for which the corporation does not make the election is deducted in the year paid.

EXAMPLE C:3-9 ► Echo Corporation is a calendar year taxpayer using the accrual method of accounting. In the current year, its board of directors authorizes a \$10,000 contribution to the Girl Scouts. Echo pays the contribution on March 10 of next year. Echo may elect to treat part or all of the contribution as having been paid in the current year. If the corporation pays the contribution after April 15 of next year, it may not deduct the contribution in the current year but may deduct it next year. ◀

TAX STRATEGY TIP

The tax laws do not require a corporation to recognize a gain when it contributes appreciated property to a charitable organization. Thus, except for inventory and limited other properties, a corporation can deduct the FMV of its donation without having to recognize any appreciation in its gross income. On the other hand, a decline in the value of donated property is not deductible. Thus, the corporation should sell the loss property to recognize the loss and then donate the sales proceeds to the charitable organization.

Deducting Contributions of Nonmonetary Property. If a taxpayer donates money to a qualified charitable organization, the amount of the charitable contribution deduction equals the amount of money donated. If the taxpayer donates property, the amount of the charitable contribution deduction generally equals the property's fair market value (FMV). However, special rules apply to donations of appreciated nonmonetary property known as ordinary income property and capital gain property.

In this context, ordinary income property is property whose sale would have resulted in a gain other than a long-term capital gain (i.e., ordinary income or short-term capital gain). Examples of ordinary income property include investment property held for one year or less, inventory property, and property subject to depreciation recapture under Secs. 1245 and 1250. The deduction allowed for a donation of such property is limited to the property's FMV minus the amount of ordinary income or short-term capital gain the corporation would have recognized had it sold the property.

In some cases, a corporation may deduct the donated property's adjusted basis plus one-half of the excess of the property's FMV over its adjusted basis (not to exceed twice the property's adjusted basis). This special rule applies to inventory if

1. The use of the property is related to the donee's exempt function, and it is used solely for the care of the ill, the needy, or infants;
2. The property is not transferred to the donee in exchange for money, other property, or services; and
3. The donor receives a statement from the charitable organization stating that conditions (1) and (2) will be complied with.

A similar rule applies to contributions of scientific research property if the corporation created the property and contributed it to a college, university, or tax-exempt scientific research organization for its use within two years of creating the property.

EXAMPLE C:3-10 ► King Corporation donates inventory having a \$26,000 adjusted basis and a \$40,000 FMV to a qualified public charity. A \$33,000 [$\$26,000 + (0.50 \times \$14,000)$] deduction is allowed for the contribution of the inventory if the charitable organization will use the inventory for the care of the ill, needy, or infants, or if the donee is an educational institution or research organization that will use the scientific research property for research or experimentation. Otherwise, the deduction is limited to the property's \$26,000 adjusted basis. If instead the inventory's FMV is \$100,000 and the donation meets either of the two sets of requirements outlined above, the charitable contribution deduction is limited to \$52,000, the lesser of the property's adjusted basis plus one-half of the appreciation [$\$63,000 = \$26,000 + (0.50 \times \$74,000)$] or twice the property's adjusted basis ($\$52,000 = \$26,000 \times 2$). ◀

When a corporation donates appreciated property whose sale would result in long-term capital gain (also known as capital gain property) to a charitable organization, the amount of the contribution deduction generally equals the property's FMV. However, special restrictions apply if

- ▶ The corporation donates a patent, copyright, trademark, trade name, trade secret, know-how, certain software, or other similar property;
- ▶ A corporation donates tangible personal property to a charitable organization and the organization's use of the property is unrelated to its tax-exempt purpose; or
- ▶ A corporation donates appreciated property to certain private nonoperating foundations.²⁰

In these cases, the amount of the corporation's contribution is limited to the property's FMV minus the long-term capital gain that would have resulted from the property's sale.

EXAMPLE C:3-11

▶ Fox Corporation donates artwork to the MacNay Museum. The artwork, purchased two years earlier for \$15,000, is worth \$38,000 on the date Fox donates it. At the time of the donation, the museum's directors intend to sell the work to raise funds to conduct museum activities. Fox's deduction for the gift is limited to \$15,000. If the museum plans to display the artwork to the public, the entire \$38,000 deduction is permitted. Fox can avoid losing a portion of its charitable contribution deduction by, as a condition of the donation, placing restrictions on the sale or use of the property. ◀

Substantiation Requirements. Section 170(f)(11) imposes substantiation requirements for noncash charitable contributions. If the corporation does not comply, it will lose the charitable contribution deduction. The requirements are as follows:

ADDITIONAL COMMENT

The \$500, \$5,000, and \$500,000 thresholds apply on an aggregate basis for similar property donated to one or more donees.

- ▶ If the contribution deduction exceeds \$500, the corporation must include with its tax return a description of the property and any other information required by Treasury Regulations.
- ▶ If the contribution deduction exceeds \$5,000, the corporation must obtain a qualified appraisal and include with its tax return any information and appraisal required by Treasury Regulations.
- ▶ If the contribution deduction exceeds \$500,000, the corporation must attach a qualified appraisal to the tax return.

The second and third requirements, however, do not apply to contributions of cash; publicly traded securities; inventory; or certain motor vehicles, boats, or aircraft the donee organization sells without any intervening use or material improvement. With regard to these vehicles, the donor corporation's deduction is limited to the amount of gross proceeds the donee organization receives on the sale.

Maximum Deduction Permitted. A limit applies to the amount of charitable contributions a corporation can deduct in a given year. The limit is calculated differently for corporations than for individuals. Contribution deductions by corporations are limited to 10% of adjusted taxable income. Adjusted taxable income is the corporation's taxable income computed without regard to any of the following amounts:

- ▶ The charitable contribution deduction
- ▶ The dividends-received deduction²¹
- ▶ A capital loss carryback

Contributions that exceed the 10% limit are not deductible in the current year. Instead, they carry forward to the next five tax years. Any excess contributions not deducted within those five years expire. The corporation may deduct excess contributions in the carryover year only after it deducts any contributions made in that year. The total charitable contribution deduction (including any deduction for contribution carryovers) is limited to 10% of the corporation's adjusted taxable income in the carryover year.²²

**BOOK-TO-TAX
ACCOUNTING
COMPARISON**

For financial accounting purposes, all charitable contributions can be claimed as an expense without regard to the amount of profits reported. For tax purposes, however, the charitable contribution deduction may be limited. Thus, the charitable contribution carryover for tax purposes creates a deferred tax asset, possibly subject to a valuation allowance.

²⁰ Sec. 170(e)(5). The restriction on contributions of appreciated property to private nonoperating foundations does not apply to contributions of stock for which market quotations are readily available.

²¹ Sec. 170(b)(2).

²² Sec. 170(d)(2).

EXAMPLE C:3-12 ► Golf Corporation reports the following results in Year 1 and Year 2:

	<u>Year 1</u>	<u>Year 2</u>
Adjusted taxable income	\$200,000	\$300,000
Charitable contributions	35,000	25,000

Golf's Year 1 contribution deduction is limited to \$20,000 ($0.10 \times \$200,000$). Golf has a \$15,000 ($\$35,000 - \$20,000$) contribution carryover to Year 2. The Year 2 contribution deduction is limited to \$30,000 ($0.10 \times \$300,000$). Golf's deduction for Year 2 is composed of the \$25,000 donated in Year 2 and \$5,000 of the Year 1 carryover. The remaining \$10,000 carryover from Year 1 carries over to the next four years. ◀

Topic Review C:3-1 summarizes the basic corporate charitable contribution deduction rules.

SPECIAL DEDUCTIONS

C corporations are allowed two special deductions: the dividends-received deduction and the NOL deduction.

Dividends-Received Deduction. A corporation must include in its gross income any dividends received on stock it owns in another corporation. As described in Chapter C:2, the taxation of dividend payments to a shareholder generally results in double taxation. When a distributing corporation pays a dividend to a corporate shareholder and the recipient corporation subsequently distributes these earnings to its shareholders, potential triple taxation of the earnings can result.

TOPIC REVIEW C:3-1**Corporate Charitable Contribution Rules**

1. Timing of the contribution deduction
 - a. General rule: A deduction is allowed for contributions paid during the year.
 - b. Accrual method corporations can accrue contributions approved by their board of directors prior to the end of the accrual year and paid within 3½ months of that year-end (2½ months for corporations having a June 30 year-end).
2. Amount of the contribution deduction
 - a. General rule: A deduction is allowed for the amount of money and the FMV of other property donated.
 - b. Exceptions for ordinary income property:
 1. If donated property would result in ordinary income or short-term capital gain if sold, the deduction is limited to the property's FMV minus this potential ordinary income or short-term capital gain. Thus, for gain property the deduction equals the property's cost or adjusted basis.
 2. Special rule: For donations of (1) inventory used for the care of the ill, needy, or infants, or (2) scientific research property or computer technology and equipment to certain educational institutions, a corporate donor may deduct the property's basis plus one-half of the excess of the property's FMV over its adjusted basis. The deduction may not exceed twice the property's adjusted basis.
 - c. Exceptions for capital gain property: If the corporation donates tangible personal property to a charitable organization for a use unrelated to its tax-exempt purpose, or the corporation donates appreciated property to a private nonoperating foundation, the corporation's contribution is limited to the property's FMV minus the long-term capital gain that would result if the corporation sold the property.
3. Limitation on contribution deduction
 - a. The contribution deduction is limited to 10% of the corporation's taxable income computed without regard to the charitable contribution deduction, the dividends-received deduction, and any capital loss carryback (if the limitation is being calculated for a carryback year)
 - b. Excess contributions carry forward for a five-year period.

EXAMPLE C:3-13 ▶

Adobe Corporation owns stock in Bell Corporation. Bell reports taxable income of \$100,000 and pays federal income taxes on its income. Bell distributes its after-tax income to its shareholders. The dividend Adobe receives from Bell must be included in its gross income and, to the extent it reports a profit for the year, Adobe will pay taxes on the dividend. Adobe distributes its remaining after-tax income to its shareholders. The shareholders must include Adobe's dividends in their gross income and pay federal income taxes on the distribution. Thus, Bell's income in this example potentially is taxed three times. ▶

**BOOK-TO-TAX
ACCOUNTING
COMPARISON**

A corporation includes dividends in its financial accounting income but does not subtract a dividends-received deduction in determining its book net income. Thus, the dividends-received deduction creates a permanent difference that affects the corporation's effective tax rate but not its deferred taxes.

To partially mitigate the effects of multiple taxation, corporations are allowed a dividends-received deduction for dividends received from other domestic corporations and from certain foreign corporations.

General Rule for Dividends-Received Deduction. Corporations that own less than 20% of the distributing corporation's stock may deduct 50% of the dividends received. If the shareholder corporation owns 20% or more of the distributing corporation's stock (both voting power and value) but less than 80% of such stock, it may deduct 65% of the dividends received.²³

EXAMPLE C:3-14 ▶

Hale Corporation reports the following results in the current year:

Gross income from operations	\$300,000
Dividends from 15%-owned domestic corporation	100,000
Operating expenses	280,000

Hale's dividends-received deduction is \$50,000 ($0.50 \times \$100,000$). Thus, Hale's taxable income is computed as follows:

Gross income	\$400,000
Minus: Operating expenses	(280,000)
Taxable income before special deductions	\$120,000
Minus: Dividends-received deduction	(50,000)
Taxable income	<u>\$ 70,000</u> ▶

ADDITIONAL COMMENT

Limitations do not apply to the 100% deduction for dividends received from an 80% or more owned affiliated corporation. See discussion beginning on the next page.

Limitation on Dividends-Received Deduction. In the case of dividends received from corporations that are less than 20% owned, the deduction is limited to the lesser of 50% of dividends received or 50% of taxable income computed without regard to any NOL deduction, the dividends-received deduction itself, or any capital loss carryback (if being calculated for a carryback year).²⁴ In the case of dividends received from a 20% or more owned (but less than 80% owned) corporation, the dividends-received deduction is limited to the lesser of 65% of dividends received or 65% of taxable income computed without regard to the same deductions.

EXAMPLE C:3-15 ▶

Assume the same facts as in Example C:3-14 except Hale Corporation's operating expenses for the year are \$320,000. Hale's taxable income before the dividends-received deduction is \$80,000 ($\$300,000 + \$100,000 - \$320,000$). The dividends-received deduction is limited to the lesser of 50% of dividends received ($\$50,000 = \$100,000 \times 0.50$) or 50% of taxable income before the dividends-received deduction ($\$40,000 = \$80,000 \times 0.50$). Thus, the dividends-received deduction is limited to \$40,000. Hale's taxable income is \$40,000 ($\$80,000 - \$40,000$). ▶

A corporation that receives dividends eligible for both the 65% dividends-received deduction and the 50% dividends-received deduction must compute the 65% dividends-received deduction first and then reduce taxable income by the aggregate amount of dividends eligible for the 65% deduction before computing the 50% deduction.

²³ Secs. 243(a) and (c).

²⁴ Sec. 246(b).

EXAMPLE C:3-16 ► Assume the same facts as in Example C:3-15 except Hale Corporation receives \$70,000 of the dividends from a 25%-owned corporation and the remaining \$30,000 from a 15%-owned corporation. The tentative dividends-received deduction from the 25%-owned corporation is \$45,500 ($\$70,000 \times 0.65$), which is less than the \$52,000 ($\$80,000 \times 0.65$) limitation. Thus, Hale can deduct the entire \$45,500. The tentative dividends-received deduction from the 15%-owned corporation is \$15,000 ($\$30,000 \times 0.50$). The limitation, however, is \$5,000 [$(\$80,000 - \$70,000) \times 0.50$]. Note that, in computing this limitation, Hale reduces its taxable income by the entire \$70,000 dividend received from the 25%-owned corporation. Thus, Hale can deduct only \$5,000 of the \$15,000 amount. Hale's taxable income is \$29,500 ($\$80,000 - \$45,500 - \$5,000$). ◀

Exception to the Limitation. The taxable income limitation on the dividends-received deduction does not apply if the tentative dividends-received deduction creates or increases an NOL for the year.

EXAMPLE C:3-17 ► Assume the same facts as in Example C:3-15 except Hale Corporation's operating expenses for the year are \$351,000. Hale's taxable income before the dividends-received deduction is \$49,000 ($\$300,000 + \$100,000 - \$351,000$). The tentative dividends-received deduction is \$50,000 ($\$100,000 \times 0.50$). Hale's dividends-received deduction is not restricted by the limitation of 50% of taxable income before the dividends-received deduction because, after taking into account the tentative \$50,000 dividends-received deduction, the corporation has a \$1,000 ($\$49,000 - \$50,000$) NOL for the year. If Hale's operating expenses were \$410,000 instead of \$351,000, it would have a \$10,000 NOL before the dividends-received deduction ($\$300,000 + \$100,000 - \$410,000$). Again, the dividends-received deduction is not restricted by the limitation because it increases the NOL. In this case, the corporation has a \$60,000 [$\$10,000 - \$50,000$] NOL for the year. ◀

The following table compares the results of Examples C:3-14, C:3-15, and C:3-17:

ADDITIONAL COMMENT

When the dividends-received deduction creates (or increases) an NOL, the corporation gets the full benefit of the deduction because it can carry over the NOL.

	<i>Example C:3-14</i>	<i>Example C:3-15</i>	<i>Example C:3-17</i>	
Gross income	\$400,000	\$400,000	\$400,000	\$400,000
Minus: Operating expenses	(280,000)	(320,000)	(351,000)	(410,000)
Taxable income (NOL) before special deductions	\$120,000	\$ 80,000	\$ 49,000	\$(10,000)
Minus: Dividends-received deduction	(50,000)	(40,000)	(50,000)	(50,000)
Taxable income (NOL)	<u>\$ 70,000</u>	<u>\$ 40,000</u>	<u>\$ (1,000)</u>	<u>\$(60,000)</u>

TAX STRATEGY TIP

A corporation can avoid the dividends-received deduction limitation either by (1) increasing its taxable income before the dividends-received deduction so the limitation exceeds the tentative dividends-received deduction or (2) decreasing its taxable income before the dividends-received deduction so the tentative dividends-received deduction creates an NOL.

ADDITIONAL COMMENT

If the affiliated group files a consolidated tax return, the recipient of the dividend does not claim the 100% dividends received deduction because the intercompany dividend gets eliminated in the consolidation. See Chapter C:8 for a more detailed definition of affiliated corporations and discussion of consolidated tax returns.

Of these three examples, the only case where the dividends-received deduction does not equal the full 50% of the \$100,000 dividend is Example C:3-15. In that case, the deduction is limited to \$40,000 because taxable income before special deductions is less than the \$100,000 dividend *and* because the full \$50,000 deduction would not create an NOL. The special exception to the dividends-received deduction can create interesting situations. For example, the additional \$31,000 of deductions incurred in Example C:3-17 (as compared to Example C:3-15) resulted in a \$41,000 reduction in taxable income. Corporate taxpayers should be aware of these rules and consider deferring income or recognizing expenses to ensure being able to deduct the full 50% or 65% dividends-received deduction. If the taxable income limitation applies, the corporation loses the unused dividends-received deduction.

Members of an Affiliated Group. Members of an affiliated group of corporations can claim a 100% dividends-received deduction with respect to dividends received from other group members.²⁵ A group of corporations is affiliated if a parent corporation owns at least 80% of the stock (both voting power and value) of at least one subsidiary corporation, and at least 80% of the stock (both voting power and value) of each other corporation is owned by other group members. The 100% dividends-received deduction is not subject to a taxable income limitation and is taken before the 65% or 50% dividends-received deduction.²⁶

²⁵ Sec. 243(a)(3).

²⁶ Secs. 243(b)(5) and 1504.

EXAMPLE C:3-18 ▶ Hardy Corporation reports the following results for the current year:

Gross income from operations	\$520,000
Dividend received from an 80%-owned affiliated corporation	100,000
Dividend received from a 20%-owned corporation	250,000
Operating expenses	550,000

Hardy does not file a consolidated tax return with the 80%-owned affiliate. Hardy's taxable income before any dividends-received deduction is \$320,000 (\$520,000 + \$100,000 + \$250,000 – \$550,000). Hardy can deduct the entire dividend received from the 80%-owned affiliate without limitation. The tentative dividends-received deduction from the 20%-owned corporation is \$162,500 (\$250,000 × 0.65). The limitation, however, is \$143,000 [(\$320,000 – \$100,000) × 0.65]. Note that, in computing this limitation, Hardy first reduces its taxable income by the \$100,000 dividends-received deduction pertaining to the 80%-owned affiliate. Thus, Hardy can deduct only \$143,000 of the \$162,500 tentative dividends-received deduction. Hardy's taxable income is \$77,000 (\$320,000 – \$100,000 – \$143,000). ◀

Dividends Received from Foreign Corporations. A U.S. corporation that owns at least 10% of the stock in a foreign corporation can claim a 100% dividends-received deduction for the foreign-source portion of dividends received.²⁷ The amount of the so-called Sec. 245A dividend is based on the ratio of the foreign corporation's undistributed foreign earnings and profits to its total undistributed earnings and profits as of the close of the foreign corporation's tax year. No foreign tax credit or deduction is available to the U.S. corporation with respect to a Sec. 245A dividend. This system is designed to encourage repatriation to the United States of foreign earnings that otherwise might be retained in corporations operating abroad.

ADDITIONAL COMMENT

Stock purchased on which a dividend has been declared has an increased value. This value will drop when the corporation pays the dividend. If the dividend is eligible for a dividends-received deduction and the drop in value also creates a capital loss, corporate shareholders could use this event as a tax planning device. To avoid this result, no dividends-received deduction is available for stock held 45 days or less.

Stock Held 45 Days or Less. A corporation may not claim a dividends-received deduction if it holds the dividend paying stock for less than 46 days during the 91-day period that begins 45 days before the stock becomes ex-dividend with respect to the dividend.²⁸ This rule prevents a corporation from claiming a dividends-received deduction if it purchases stock shortly before an ex-dividend date and sells the stock shortly thereafter. (The ex-dividend date is the first day on which a purchaser of stock is not entitled to a previously declared dividend.) Absent this rule, such a purchase and sale would allow the corporation to receive dividends at a low tax rate—for example, a 10.5% [(100% – 50%) × 0.21] effective tax rate—and to recognize a capital loss on the sale of stock that could offset capital gains taxed at a 21% corporate tax rate.

EXAMPLE C:3-19 ▶ Theta Corporation purchases 100 shares of Maine Corporation's stock for \$100,000 one day before Maine's ex-dividend date. Theta receives a \$5,000 dividend on the stock and then sells the stock for \$95,000 shortly after the dividend payment date, which occurs within 45 days of the ex-dividend date. Because the stock is worth \$100,000 immediately before the ex-dividend date, its value would have dropped to \$95,000 (\$100,000 – \$5,000) immediately after that date. The sale results in a \$5,000 (\$100,000 – \$95,000) capital loss that may offset a \$5,000 capital gain. Assuming a 21% corporate tax rate, the following table summarizes the profit (loss) to Theta with and without the 45-day rule.

	<i>If Deduction Is Allowed</i>	<i>If Deduction Is Not Allowed</i>
Dividends	\$5,000	\$5,000
Minus: 21% tax on dividend	(525) ^a	(1,050)
Dividend (after taxes)	<u>\$4,475</u>	<u>\$3,950</u>
Capital loss	\$5,000	\$5,000
Minus: 21% tax savings on loss	(1,050)	(1,050)
Net loss on stock	<u>\$3,950</u>	<u>\$3,950</u>
Dividend (after taxes)	\$4,475	\$3,950
Minus: Net loss on stock ^b	(3,950)	(3,950)
Net profit (loss)	<u>\$ 525</u>	<u>\$ –0–</u>

^a[\$5,000 – (0.50 × \$5,000)] × 0.21 = \$525

^bThis example assumes the corporation has capital gains against which to deduct this capital loss.

²⁷ Sec. 245A, which was enacted as part of the Tax Cuts and Jobs Act of 2017.

²⁸ Sec. 246(c)(1).

ADDITIONAL COMMENT

Borrowing money with deductible interest to purchase a tax-advantaged asset, such as stock eligible for the dividends-received deduction, is an example of "tax arbitrage." Many provisions in the IRC, such as the limits on debt-financial stock, are aimed at curtailing tax arbitrage transactions.

The net profit shown in the first column is not available if Theta sells the stock shortly after receiving the dividend because Theta must hold the Maine stock for at least 46 days to obtain the dividends-received deduction. ◀

Debt-Financed Stock. The dividends-received deduction is not allowed to the extent the corporation borrows money to acquire the dividend paying stock.²⁹ This rule prevents a corporation from deducting interest paid on money borrowed to purchase the stock, while paying little or no tax on the dividends received on the stock.

EXAMPLE C:3-20 ►

Palmer Corporation, whose tax rate is 21%, borrows \$100,000 at a 10% interest rate to purchase 30% of Sun Corporation's stock. The Sun stock pays an \$10,000 annual dividend. If a dividends-received deduction were allowed for this investment, Palmer would have a net profit of \$1,365 annually on owning the Sun stock even though the dividend received is less than the interest paid. The following table summarizes the profit (loss) to Palmer with and without the debt-financing rule.

REAL-WORLD EXAMPLE

Although sound in theory, the debt-financed stock limitation may be difficult to apply in practice. This difficulty became particularly apparent in a district court case, *OBH, Inc. v. U.S.*, 96 AFTR 2d, 2005-6801, 2005-2 USTC ¶150,627 (DC NB, 2005), where the IRS failed to establish that a corporation's debt proceeds were directly traceable to the acquisition of dividend paying stock.

	<i>If Deduction Is Allowed</i>	<i>If Deduction Is Not Allowed</i>
Dividends	\$ 10,000	\$ 10,000
Minus: 21% tax on dividend	(735) ^a	(2,100)
Dividend (after taxes)	<u>\$ 9,265</u>	<u>\$ 7,900</u>
Interest paid	\$ 10,000	\$ 10,000
Minus: 21% tax savings on deduction	(2,100)	(2,100)
Net cost of borrowing	<u>\$ 7,900</u>	<u>\$ 7,900</u>
Dividend (after taxes)	\$ 9,265	\$ 7,900
Minus: Net cost of borrowing	(7,900)	(7,900)
Net profit (loss)	<u>\$ 1,365</u>	<u>\$ -0-</u>

^a[\$10,000 - (\$10,000 × 0.65)] × 0.21 = \$735

This example illustrates how the rule disallowing the dividends-received deduction on debt-financed stock prevents corporations from making an after-tax arbitrage profit by borrowing funds to purchase stocks paying dividends that are less than the cost of the borrowing. ◀

Net Operating Losses (NOLs). If a corporation's deductions exceed its gross income for the year, the corporation has a **net operating loss (NOL)**. The NOL is the amount by which the corporation's deductions (including any dividends-received deduction) exceed its gross income.³⁰ In computing an NOL for a given year, no deduction is permitted for a carryover of an NOL from a preceding year. However, unlike an individual's NOL, no other adjustments are required to compute a corporation's NOL.

NOLs arising in tax years *ending* after 2017 carry over to succeeding tax years indefinitely (i.e., they do not expire). Also, deductibility of NOLs arising in tax years *beginning* after 2017 will be limited in the carryover year to 80% of taxable income before the NOL deduction. Thus, the NOL deduction is the lesser of post-2017 aggregate carryovers or 80% of taxable income computed without regard to the NOL deduction. Any amount of NOL carryover deduction disallowed because of the 80% limit carries over indefinitely.³¹ NOLs incurred before 2018 carry over 20 years and are not subject to the 80% of taxable income limitation.

**BOOK-TO-TAX
ACCOUNTING
COMPARISON**

An NOL carryover for tax purposes creates a deferred tax asset, possibly subject to a valuation allowance.

EXAMPLE C:3-21 ►

In the current (post-2017) year, Gray Corporation, a calendar year taxpayer, has gross income of \$150,000 from operations and \$215,000 of expenses. Thus, Gray has a \$65,000 (\$150,000 - \$215,000) NOL. The \$65,000 NOL carries over to next year, where Gray has \$60,000 of taxable income before the NOL deduction. However, the NOL deduction next year is limited to \$48,000 (\$60,000 × 0.80). The remaining \$17,000 (\$65,000 - \$48,000) NOL carries over to the following year, subject to the limitation in that year. ◀

²⁹ Sec. 246A.

³⁰ Sec. 172(c).

³¹ Secs. 172(a) and (b). Special rules apply to farming losses and insurance companies.

If the corporation has both pre-2018 and post-2017 NOL carryovers, the corporation calculates the NOL deduction as follows:

1. Deduct pre-2018 NOL carryovers without regard to the 80% of taxable income limitation (but not more than taxable income).
2. Deduct post-2017 NOL carryovers limited to the lesser of (1) the post-2017 NOL carryovers or (2) 80% of taxable income minus the NOL deduction attributable to pre-2018 NOL carryovers.

EXAMPLE C:3-22 ▶

ADDITIONAL COMMENT

The procedure for calculating the interaction of pre-2018 and post-2017 NOL carryovers and its application in Example C:3-22 are based on the explanation provided in General Explanation of Public Law 115-97 (the Tax Cuts and Jobs Act of 2017) prepared by the Staff of the Joint Committee on Taxation, December 2018. In footnote 903 of the JCT explanation, the Staff acknowledges that a "technical correction may be necessary to reflect this intent."

Kappa Corporation is a calendar year corporation that, in the current year, has a \$60,000 NOL carryover from pre-2018 tax years and a \$35,000 NOL carryover from post-2017 tax years. Kappa's current year taxable income before any NOL deduction is \$50,000. Kappa deducts \$50,000 of the pre-2018 NOL carryover in the current year and has a \$10,000 pre-2018 NOL carryover and a \$35,000 post-2017 NOL carryover to next year. Next year, Kappa's taxable income before any NOL deduction again is \$50,000. Kappa's NOL deduction is \$10,000 from the pre-2018 NOL carryover plus \$32,000 $[(\$50,000 - \$10,000) \times 0.80]$ from the post-2017 NOL carryover, for a total NOL deduction of \$42,000. Kappa's post-2017 NOL carryover to the following year is \$3,000 $(\$35,000 - \$32,000)$, subject to the 80% limitation in that year.

Suppose instead that Kappa's taxable income next year is \$70,000 instead of \$50,000. In that case, the 80% limitation would be \$48,000 $[(\$70,000 - \$10,000) \times 0.80]$, which is greater than the post-2017 NOL carryover. Thus, Kappa's total NOL deduction would be \$45,000 $(\$10,000 + \$35,000)$, with no NOL carryovers to the next year. ▶

Sequencing the Deduction Calculations. The rules for charitable contributions, dividends-received, and NOL deductions require that these deductions be calculated in the following sequence:

1. All deductions other than the charitable contributions deduction, the dividends-received deduction, and the NOL deduction
2. The charitable contributions deduction
3. The dividends-received deduction
4. The NOL deduction

In the current year, the charitable contributions deduction is limited to 10% of taxable income before the charitable contributions deduction and the dividends-received deduction, but *after* any NOL carryovers. Once the corporation determines its charitable contributions deduction, it adds back any NOL carryovers and subtracts the charitable contributions deduction before computing the dividends-received deduction. The corporation then deducts the NOL carryover, subject to the 80% of taxable income limitation if applicable.

EXAMPLE C:3-23 ▶

East Corporation reports the following results for the current year:

Gross income from operations	\$150,000
Dividends from 30%-owned domestic corporation	100,000
Operating expenses	100,000
Charitable contributions	35,000

East also has a \$40,000 NOL carryover from the previous year. East's charitable contributions deduction is computed as follows:

Gross income from operations	\$150,000
Plus: Dividends	100,000
Gross income	\$250,000
Minus: Operating expenses	(100,000)
NOL carryover	(40,000)
Base for charitable contributions limitation (adjusted taxable income)	<u>\$110,000</u>

ADDITIONAL COMMENT

If the NOL carryover to the current year is not fully used in the current year such that some of the NOL carries over to the next year, both the NOL carryover and charitable deduction carryover to the next year must be adjusted [IRC Sec. 170(d)(2)(B)]. The situation becomes even more complex when considering the 80% of taxable income limitation on NOL deductions for NOLs arising after 2017. These adjustments are beyond the scope of this text.

East's charitable contributions deduction is limited to \$11,000 $(\$110,000 \times 0.10)$. The \$11,000 limitation means that East has a \$24,000 $(\$35,000 - \$11,000)$ excess contribution that carries over for five years. East Corporation computes its taxable income as follows:

Gross income	\$250,000
Minus: Operating expenses	(100,000)
Charitable contributions deduction	(11,000)
Taxable income before special deductions	\$139,000
Minus: Dividends-received deduction ($\$100,000 \times 0.65$)	(65,000)
NOL deduction	(40,000)
Taxable income	<u>\$ 34,000</u>

The NOL deduction is not limited in this example because it does not exceed 80% of taxable income before the NOL deduction. 

EXCEPTIONS FOR CLOSELY HELD CORPORATIONS

Congress has placed limits on certain transactions to prevent abuse in situations where a corporation is closely held. Some of these restrictions are explained below.

Transactions Between a Corporation and Its Shareholders. Special rules apply to transactions between a corporation and a controlling shareholder. Section 1239 may convert a capital gain realized on the sale of depreciable property between a corporation and a controlling shareholder into ordinary income. Section 267(a)(1) denies a deduction for losses realized on property sales between a corporation and a controlling shareholder. Section 267(a)(2) defers a deduction for accrued expenses and interest on certain transactions involving a corporation and a controlling shareholder.

In all three of the preceding situations, a controlling shareholder is one who owns more than 50% (in value) of the corporation's stock.³² In determining whether a shareholder owns more than 50% of a corporation's stock, certain constructive stock ownership rules apply.³³ Under these rules, a shareholder is considered to own not only his or her own stock, but stock owned by family members (e.g., brothers, sisters, spouse, ancestors, and lineal descendants) and entities in which the shareholder has an ownership or beneficial interest (e.g., corporations, partnerships, trusts, and estates).

Gains on Sale or Exchange Transactions. If a controlling shareholder sells depreciable property to a controlled corporation (or vice versa) and the property is depreciable in the purchaser's hands, any gain on the sale is treated as ordinary income under Sec. 1239(a).

EXAMPLE C:3-24

Ann owns all of Cape Corporation's stock. Ann sells a building to Cape and recognizes a \$25,000 gain, which usually would be Sec. 1231 gain or unrecaptured Sec. 1250 gain taxed at the applicable capital gains rates. However, because Ann owns more than 50% of the Cape stock and the building is a depreciable property in Cape's hands, Sec. 1239 requires that Ann recognize the entire \$25,000 gain as ordinary income. 

BOOK-TO-TAX ACCOUNTING COMPARISON

The denial of deductions for losses involving related party transactions is unique to the tax area. Financial accounting rules contain no such disallowance provision.

Losses on Sale or Exchange Transactions. Section 267(a)(1) denies a deduction for losses realized on a sale of property by a corporation to a controlling shareholder or on a sale of property by the controlling shareholder to the corporation. If the purchaser later sells the property to another party at a gain, that seller recognizes gain only to the extent it exceeds the previously disallowed loss.³⁴ Should the purchaser instead sell the property at a loss, the previously disallowed loss is never recognized.

EXAMPLE C:3-25

Quattros Corporation sells an automobile to Juan, its sole shareholder, for \$6,500. The corporation's adjusted basis for the automobile is \$8,000. Quattros realizes a \$1,500 (\$6,500 – \$8,000) loss on the sale. Section 267(a)(1), however, disallows the loss to the corporation. If Juan later sells the auto for \$8,500, he realizes a \$2,000 (\$8,500 – \$6,500) gain. He recognizes only \$500 of

³² Sec. 267(b)(2).

³³ Sec. 267(c)(3).

³⁴ Sec. 267(d).

KEY POINT

Section 267(a)(2) is primarily aimed at the situation involving an accrual method corporation that accrues compensation to a cash method shareholder-employee. This provision forces a matching of the income and expense recognition by deferring the deduction to the year the shareholder recognizes the income.

that gain, the amount by which his \$2,000 gain exceeds the \$1,500 loss previously disallowed to Quattros. If Juan instead sells the auto for \$7,500, he realizes a \$1,000 (\$7,500 – \$6,500) gain but recognizes no gain or loss. The previously disallowed loss reduces the gain to zero but may not create a loss. Finally, if Juan instead sells the auto for \$4,000, he realizes and may be able to recognize a \$2,500 (\$4,000 – \$6,500) loss. However, the \$1,500 loss previously disallowed to Quattros is permanently lost.

Corporation and Controlling Shareholder Using Different Accounting Methods. Section 267(a)(2) defers a deduction for accrued expenses or interest owed by a corporation to a controlling shareholder or by a controlling shareholder to a corporation when the two parties use different accounting methods and the payee thereby includes the amount in gross income later than when the payer accrues the deduction. Under this rule, accrued expenses or interest owed by a corporation to a controlling shareholder may not be deducted until the shareholder includes the payment in gross income.

EXAMPLE C:3-26

Hill Corporation uses the accrual method of accounting. Hill's sole shareholder, Ruth, uses the cash method of accounting. Both taxpayers use the calendar year as their tax year. The corporation accrues a \$25,000 interest payment to Ruth on December 20 of the current year. Hill makes the payment on March 20 of next year. Hill, however, cannot deduct the interest in the current year but must wait until Ruth reports the income next year. Thus, the expense and income are matched.

Loss Limitation Rules

At-Risk Rules. If five or fewer shareholders own more than 50% (in value) of a C corporation's outstanding stock at any time during the last half of the corporation's tax year, the corporation is subject to the at-risk rules.³⁵ In such case, the corporation can deduct losses pertaining to an activity only to the extent the corporation is at risk for that activity at year-end. Any losses not deductible because of the at-risk rules must be carried over and deducted in a succeeding year when the corporation's risk with respect to the activity increases. (See Chapter C:9 for additional discussion of the at-risk rules.)

Passive Activity Limitation Rules. Personal service corporations (PSCs) and closely held C corporations (those subject to the at-risk rules described above) also may be subject to the passive activity limitations.³⁶ If a PSC does not meet the material participation requirements, its net passive losses and credits must be carried over to a year when it has passive income. In the case of closely held C corporations that do not meet material participation requirements, passive losses and credits are allowed to offset the corporation's net active income but not its portfolio income (i.e., interest, dividends, annuities, royalties, and capital gains on the sale of investment property).³⁷

CONTROLLED GROUPS OF CORPORATIONS

OBJECTIVE 3

Recognize what a controlled group is and determine the tax consequences of being a controlled group

Special tax rules apply to corporations under common control to prevent them from falling below specified limitations by spreading certain transactions across a number of small corporations. Three key limitations to which the controlled group rules apply are those pertaining to the Sec. 179 expense, the minimum accumulated earnings credit, and the general business credit.³⁸ The rules apply to corporations that meet the definition of a controlled group. This section explains how the IRC defines controlled groups and how the special rules apply to controlled groups.

EXAMPLE C:3-27

Claire plans to form a corporation with a \$3 million contribution of cash with the plan to have the corporation invest in business property eligible for the Sec. 179 expensing election. For the sake of this example, assume bonus depreciation rules are not in effect. If a single corporation,

³⁵ Sec. 465(a).

³⁶ Secs. 469(a)(2)(B) and (C).

³⁷ Sec. 469(e)(2).

³⁸ Secs. 38(c)(6)(B), 179(d)(6), 1561, and 1563.

the corporation could expense only \$570,000 for the investment because the invested amount exceeds the \$2.55 million threshold (in 2019) for phasing out the Sec. 179 limitation. Accordingly, the \$1.02 million limitation (in 2019) would be reduced by \$450,000 (\$3,000,000 – \$2,550,000). To avoid this result, Claire instead considers contributing \$1 million to each of three separate 100% owned corporations. Her intention is to have each corporation expense the entire \$1 million investment, thereby achieving a \$3 million current deduction rather than just \$570,000. However, this plan would not accomplish her goal because the controlled group rules require that she apportion the single Sec. 179 limitation among the three corporations such that the final result would be the same as having one corporation make the investment. ◀

WHAT IS A CONTROLLED GROUP?

A controlled group is comprised of two or more corporations owned directly or indirectly by the same shareholder or group of shareholders. Controlled groups fall into three categories: a parent-subsidary controlled group, a brother-sister controlled group, and a combined controlled group. Each of these groups is subject to the limitations described above.

ADDITIONAL COMMENT

For purposes of the Sec. 179 expense dollar limitation, a more-than-50% threshold replaces the at-least-80% threshold in defining a parent-subsidary controlled group.

Parent-Subsidiary Controlled Groups. In a parent-subsidiary controlled group, one corporation (the parent corporation) must directly own at least 80% of the voting power of all classes of voting stock, or 80% of the total value of all classes of stock, of a second corporation (the subsidiary corporation).³⁹ The group can contain more than one subsidiary corporation. If the parent corporation, the subsidiary corporation, or any other members of the controlled group in total own at least 80% of the voting power of all classes of voting stock, or 80% of the total value of all classes of stock, of another corporation, that other corporation also is included in the parent-subsidiary controlled group.

EXAMPLE C:3-28 ► Parent Corporation owns 80% of Axle Corporation's single class of stock and 40% of Wheel Corporation's single class of stock. Axle also owns 40% of Wheel's stock. (See Figure C:3-2.) Parent, Axle, and Wheel are members of the same parent-subsidiary controlled group because Parent directly owns 80% of Axle's stock and therefore is its parent corporation, and Wheel's stock is 80% owned by Parent (40%) and Axle (40%).

If Parent and Axle together owned only 70% of Wheel's stock and an unrelated shareholder owned the remaining 30%, Wheel would not be included in the parent-subsidiary group. The controlled group then would consist only of Parent and Axle. ◀

EXAMPLE C:3-29 ► Beta Corporation owns 70% of Spectrum Corporation's single class of stock and 60% of Red Corporation's single class of stock. Blue Corporation owns the remaining stock of Spectrum (30%) and Red (40%). No combination of these corporations forms a parent-subsidiary group because no corporation has direct stock ownership of at least 80% of any other corporation's stock. ◀

Brother-Sister Controlled Groups. The IRC contains two definitions of a brother-sister controlled group. This textbook will refer to them as the 50%–80% definition and the 50%-only definition. Under the 50%-80% definition, a group of two or more corporations

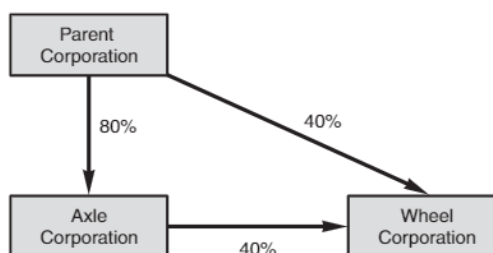


FIGURE C:3-2 ► PARENT-SUBSIDIARY CONTROLLED GROUP (EXAMPLE C:3-28)

³⁹ Sec. 1563(a)(1). Section 1563(d)(1) requires that certain attribution rules apply to determine stock ownership for parent-subsidiary controlled groups. If any person has an option to acquire stock, such stock is considered owned

by the person having the option. Section 1563(c) excludes certain types of stock from the controlled group definition of stock.

is a brother-sister controlled group if five or fewer individuals, trusts, or estates own stock that meets both of the following conditions:

- ▶ More than 50% of the voting power of all classes of stock (or more than 50% of the total value of the outstanding stock) of each corporation, taking into account only the stock ownership that is common with respect to each corporation.⁴⁰ A common ownership is the percentage of stock a shareholder owns that is common or identical in each of the corporations. For example, if a shareholder owns 30% of New Corporation and 70% of Old Corporation, his or her common ownership is 30%.
- ▶ At least 80% of the voting power of all classes of voting stock (or at least 80% of the total value of the outstanding stock) of each corporation.

Thus, under the 50%-80% definition, the five or fewer shareholders not only must have more than 50% common ownership in the corporations, they also must own at least 80% of the stock of each corporation in the brother-sister group. This definition is narrow because the shareholders must meet two tests.

The 50%-only definition, on the other hand, is broader than the 50%–80% definition in that the five or fewer shareholders must satisfy only the 50% common ownership test described above. Consequently, in situations where the 50%-only definition applies, more corporations may be pulled into the controlled group than under the 50%–80% definition. Table C:3-2 indicates which definition applies to specific situations.

EXAMPLE C:3-30 ▶ North and South Corporations have only one class of stock outstanding, owned by the following individuals:

<u>Shareholder</u>	<u>Stock Ownership Percentages</u>		<u>Common Ownership</u>
	<u>North Corp.</u>	<u>South Corp.</u>	
Walt	30%	70%	30%
Gail	70%	30%	30%
Total	100%	100%	60%

Five or fewer individuals (Walt and Gail) together own at least 80% (actually 100%) of each corporation's stock, and the same individuals own more than 50% (actually 60%) of the corporations' stock taking into account only their common ownership in each corporation. Because their ownership satisfies both tests, North and South are a brother-sister controlled group under the 50%-80% definition. ▶

▼ **TABLE C:3-2**

Items That Must Be Apportioned if a Controlled Group Exists

Item	Brother-Sister		Parent-Subsidiary	
	50%-Only	50%–80%	≥ 80%	> 50%
Section 179 expense limitation		x	x	x
Minimum accumulated earnings credit	x	x	x	
General business credit limitation		x	x	

⁴⁰ Sec. 1563(a)(2). Section 1563(d)(2) requires that certain attribution rules apply to determine stock ownership for brother-sister controlled groups. If any person has an option to acquire stock, such stock is considered to be owned by the person having the option. A proportionate amount of stock owned by a partnership, estate, or trust is attributed to partners having an interest of 5% or more in the capital or profits of the partnership or

beneficiaries having a 5% or more actuarial interest in the estate or trust. A proportionate amount of stock owned by a corporation is attributed to shareholders owning 5% or more in value of the corporate stock. Family attribution rules also can cause an individual to be considered to own the stock of a spouse, child, grandchild, parent, or grandparent.

EXAMPLE C:3-31 ► East and West Corporations have only one class of stock outstanding, owned by the following individuals:

<u>Shareholder</u>	<u>Stock Ownership Percentages</u>		
	<u>East Corp.</u>	<u>West Corp.</u>	<u>Common Ownership</u>
Javier	80%	25%	25%
Sara	20%	75%	20%
Total	100%	100%	45%

Five or fewer individuals (Javier and Sara) together own at least 80% (actually 100%) of each corporation's stock. However, those same individuals own only 45% of the corporations' stock taking into account only their common ownership. Because their ownership does not satisfy the more-than-50% test, East and West are not a brother-sister controlled group under either the 50%-80% or the 50%-only definition. ◀

An individual's stock ownership can be counted for the 80% test only if that individual owns stock in each and every corporation in the controlled group.⁴¹

EXAMPLE C:3-32 ► Long and Short Corporations each have only a single class of stock outstanding, owned by the following individuals:

<u>Shareholder</u>	<u>Stock Ownership Percentages</u>		
	<u>Long Corp.</u>	<u>Short Corp.</u>	<u>Common Ownership</u>
Al	50%	40%	40%
Beth	20%	60%	20%
Carol	30%	—	—
Total	100%	100%	60%

Carol's stock does not count for purposes of Long's 80% stock ownership requirement because she owns no stock in Short. Only Al's and Beth's stock holdings count, and together they own only 70% of Long's stock. Thus, the 80% test fails. Consequently, Long and Short are not a brother-sister controlled group under the 50%-80% definition, but they are a brother-sister controlled group under the 50%-only definition. ◀

Combined Controlled Groups. A combined controlled group is comprised of three or more corporations meeting the following criteria:

- Each corporation is a member of a parent-subsidiary controlled group or a brother-sister controlled group.
- At least one of the corporations is both the parent corporation of a parent-subsidiary controlled group and a member of a brother-sister controlled group.⁴²

EXAMPLE C:3-33 ► Able, Best, and Coast Corporations each have a single class of stock outstanding, owned by the following shareholders:

KEY POINT

The combined controlled group definition does just what its name implies: It combines a parent-subsidiary controlled group and a brother-sister controlled group. Thus, instead of trying to apply the controlled group rules to two different groups, the combined group definition eliminates the issue by combining the groups into one controlled group.

<u>Shareholder</u>	<u>Stock Ownership Percentages</u>		
	<u>Able Corp.</u>	<u>Coast Corp.</u>	<u>Best Corp.</u>
Art	50%	50%	—
Barbara	50%	50%	—
Able Corp.	—	—	100%

Able and Coast are a brother-sister controlled group under the 50%-80% definition because Art's and Barbara's ownership satisfy both the 80% and 50% tests. Able and Best are a parent-subsidiary controlled group because Able owns all of Best's stock. Each of the three corporations is a member of either the parent-subsidiary controlled group (Able and Best) or the brother-sister controlled group (Able and Coast), and the parent corporation (Able) of the

⁴¹ Reg. Sec. 1.1563-1(a)(3).

⁴² Sec. 1563(a)(3).

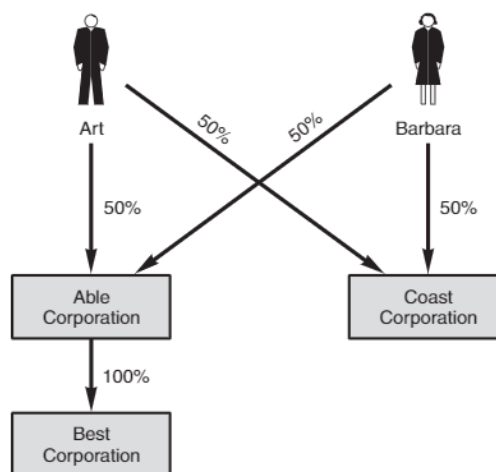


FIGURE C:3-3 ► COMBINED CONTROLLED GROUP (EXAMPLE C:3-33)

parent-subsidary controlled group also is a member of the brother-sister controlled group. Therefore, Able, Best, and Coast Corporations are members of a combined controlled group. (See Figure C:3-3.)

APPLICATION OF THE CONTROLLED GROUP TEST

Controlled group status generally is tested on December 31. A corporation is included in a controlled group if it is a group member on December 31 and has been a group member on at least one-half of the days in its tax year that precede December 31. A corporation that is not a group member on December 31, nevertheless, is considered a member for the tax year if it has been a group member on at least one-half the days in its tax year that precede December 31. Corporations are excluded from the controlled group if they were members for less than one-half the days in their tax year that precede December 31 or if they retain certain special tax statuses such as being a tax-exempt corporation.

EXAMPLE C:3-34 ► Ace and Copper Corporations are members of a parent-subsidary controlled group of which Ace is the common parent. Both corporations are calendar year taxpayers and have been group members for the entire year. They do not file a consolidated return. Bell Corporation, which has a fiscal year ending on August 31, becomes a group member on December 1 of the current year. Although Bell is a group member on December 31 of the current year, it has been a group member for less than half the days in its tax year that precede December 31—only 30 of 121 days starting on September 1. Therefore, Bell is not a member of the Ace-Copper *controlled* group for its tax year beginning on September 1 of the current year.

TAX STRATEGY TIP

A controlled group of corporations should elect to apportion the tax benefits in a manner that maximizes the tax savings from the tax benefits.

SPECIAL RULES APPLYING TO CONTROLLED GROUPS

A controlled group must apportion certain items among its group members, some of which are shown in Table C:3-2 on page C:3-23. For purposes of apportioning the Sec. 179 expense dollar limitation in a parent-subsidary situation, the corporations are considered a controlled group if the ownership percentage is more than 50% rather than at least 80%.⁴³

In addition to the above restrictions, Sec. 267(a)(1) allows no deduction for any loss on the sale or exchange of property between two members of the same controlled group, with control defined as more than 50% rather than as at least 80%. However, in contrast to losses between a corporation and controlling shareholder described earlier in this chapter, a loss realized on a transaction between members of a controlled group is deferred (instead of being disallowed). The original selling member recognizes the deferred loss when the property sold or exchanged in the intragroup transaction is sold outside the controlled group.

⁴³ Secs. 179(d)(6) and (7).

TYPICAL MISCONCEPTION

The definitions of a parent-subsidary controlled group and an affiliated group are similar, but not identical. For example, the 80% stock ownership test for controlled group purposes is satisfied if 80% of the voting power or 80% of the FMV of a corporation's stock is owned. For purposes of an affiliated group, 80% of both the voting power *and* the FMV of a corporation's stock must be owned.

BOOK-TO-TAX ACCOUNTING COMPARISON

The corporations included in a consolidated tax return may differ from those included in consolidated financial statements. Page 1 of Schedule M-3 reconciles financial statement worldwide consolidated net income to financial statement net income (loss) of corporations included in the consolidated tax return.

SELF-STUDY QUESTION

What is probably the most common reason for making a consolidated return election?

ANSWER

Filing consolidated returns allows the group to offset losses of one corporation against the profits of other members of the group.

Section 267(a)(2) allows no deduction for certain accrued expenses or interest owed by one member of a controlled group to another member of the same controlled group when the two corporations use different accounting methods so that the payments would be reported in different tax years. (See pages C:3-20 and C:3-21 for a detailed discussion of Sec. 267.) The Sec. 1239 rules that convert capital gain into ordinary income on depreciable property sales between related parties also apply to sales or exchanges involving two members of the same controlled group. Sections 267 and 1239, however, provide special definitions of controlled groups that differ somewhat from those described above. These details are beyond the scope of this textbook.

CONSOLIDATED TAX RETURNS

Who Can File a Consolidated Return. Some groups of related corporations (i.e., affiliated groups) may elect to file a single income tax return called a **consolidated tax return**. An affiliated group is one or more chains of includible corporations connected through stock ownership with a common parent. In general, includible corporations are those other than foreign corporations, certain insurance companies, tax-exempt organizations, S corporations, and a few other specially defined corporations. The required ownership criteria are as follows:

- The common parent must directly own stock with at least 80% of the voting power *and* 80% of the value of at least one includible corporation.
- One or more group members must directly own stock with at least 80% of the voting power *and* 80% of the value of each other corporation included in the affiliated group.⁴⁴

Many parent-subsidary controlled groups also qualify as affiliated groups and thus are eligible to file a consolidated return in place of separate tax returns for each corporation. The parent-subsidary portion of a combined group also can file a consolidated tax return if it also qualifies as an affiliated group. Brother-sister controlled groups, however, are not eligible to file consolidated returns because the requisite parent-subsidary relationship does not exist.

An affiliated group elects to file a consolidated tax return by filing Form 1120, which includes all the income and expenses of each of its members. Each corporate member of the affiliated group must consent to the original election. Thereafter, any new member of the affiliated group must join in the consolidated return.

Advantages of Filing a Consolidated Return. A consolidated return, in effect, is one tax return for the entire affiliated group of corporations. The main advantages of filing a consolidated return are

- Losses of one member of the group can offset profits of another member of the group.
- Capital losses of one member of the group can offset capital gains of another member of the group.
- Profits or gains realized on intercompany transactions are deferred until a sale outside the group occurs (i.e., if one member sells property to another member, the gain is postponed until the member sells the property to someone outside the affiliated group).

In contrast, if the group members file separate returns, members with NOLs or capital losses must carry these losses to other years rather than offset another member's profits or gains in the current year.

Although the losses of one group member can offset the profits of another group member when the group files a consolidated return, some important limitations apply to the use of a member corporation's NOL. These limitations prevent one corporation from purchasing another corporation's NOL carryovers to offset its own taxable income or purchasing a profitable corporation to facilitate the use of its own NOL carryovers. (See Chapters C:7 and C:8.)

The following example illustrates the advantage of a consolidated return election.

⁴⁴ Sec. 1504(a).

EXAMPLE C:3-35 ▶ Parent Corporation owns 100% of Subsidiary Corporation's stock. Parent reports \$110,000 of taxable income, including a \$10,000 capital gain. Subsidiary incurs a \$100,000 NOL and a \$10,000 capital loss. If Parent and Subsidiary file separate returns, Parent has a \$23,100 ($\$110,000 \times 0.21$) tax liability. Subsidiary has no tax liability but may be able to use its \$100,000 NOL and \$10,000 capital loss to offset income and capital gains in other years. On the other hand, if Parent and Subsidiary file a consolidated return, the group's consolidated taxable income is zero and the group has no tax liability. By filing a consolidated return, the group saves \$23,100 in taxes for the current year. ◀

ADDITIONAL COMMENT

Under Sec. 267 discussed earlier, intercompany losses may be deferred even if the corporations file separate tax returns.

Disadvantages of Filing a Consolidated Return. The main disadvantages of a consolidated return election are

- ▶ The election is binding on all subsequent tax years unless the IRS grants permission to discontinue filing consolidated returns or the affiliated group terminates.
- ▶ Losses on intercompany transactions are deferred until a sale outside the group takes place.
- ▶ One member's Sec. 1231 loss offsets another member's Sec. 1231 gain instead of being reported as an ordinary loss.
- ▶ Losses of an unprofitable member of the group may reduce the deduction or credit limitations of the group below what would be available had the members filed separate tax returns.
- ▶ The group may incur additional administrative costs in maintaining the records needed to file a consolidated return.

Determining whether to make a consolidated tax return election is a complex decision because of the various advantages and disadvantages and because the election is so difficult to revoke once made. Chapter C:8 provides detailed coverage of the consolidated return rules.

TAX PLANNING CONSIDERATIONS

OBJECTIVE 4

Identify planning strategies to reduce taxes for corporations and their shareholders

COMPENSATION PLANNING FOR SHAREHOLDER-EMPLOYEES

Compensation paid to a shareholder-employee in the form of salary has the advantage of single taxation because, while taxable to the employee, salary is deductible by the corporation. Dividend payments, on the other hand, are taxed twice. The corporation is taxed on its income when earned, and the shareholder is taxed on profits distributed as dividends. Double taxation occurs because the corporation may not deduct dividend payments. However, with dividends being taxed at preferential capital gains rates and the corporation being taxed at a low 21% tax rate, the double taxation of corporate income is not as onerous as it has been under past higher tax rate regimes. Moreover, the 21% corporate tax rate provides less of a tax benefit for a salary deduction than in the past.

EXAMPLE C:3-36 ▶ Delta Corporation earns \$100,000 and wishes to distribute \$100,000 or as much of the \$100,000 as possible to Mary, its sole shareholder and CEO. Mary's ordinary marginal tax rate is 35%, her capital gains rate is 23.8% (20% plus the 3.8% rate on net investment income), and the corporation's tax rate is 21%. Ignoring payroll taxes, the following table compares salary and dividend payments to Mary with respect to the \$100,000 of partial earnings:

	<u>Salary</u>	<u>Dividend at Capital Gains Tax Rate</u>
1. Corporate earnings	\$100,000	\$100,000
2. Minus: Salary deduction	(100,000)	-0-
3. Corporate taxable income	\$ -0-	\$100,000
4. Times: Corporate tax rate	0.21	0.21
5. Corporate income tax	\$ -0-	\$ 21,000
6. Dividend to Mary (Line 1 – Line 5)	\$100,000	\$ 79,000
7. Times: Mary's tax rate	0.35	0.238
8. Mary's tax	\$ 35,000	\$ 18,802
9. Total tax (Line 5 + Line 8)	\$ 35,000	\$ 39,802
10. Overall tax rate (Line 9 ÷ Line 1)	35%	39.8%

Thus, in this situation, the double taxation due to paying nondeductible dividends instead of deductible salary increases Mary's overall tax rate from 35% to 39.8%. ◀

The overall tax rates in the previous example can be generalized as follows:

- Salary situation: The individual's marginal tax rate on ordinary income
- Dividend situation: $21\% + \text{capital gains tax rate} \times (1 - 0.21)$

EXAMPLE C:3-37 ► Using the above formulations, the following table shows results for various levels of assumed individual marginal tax rates and capital gains tax rates along with a 21% corporate tax rate.

ADDITIONAL COMMENT

See the Quick Reference section of the text for a table of breakpoints for the capital gains tax rates based on filing status and taxable income levels.

<u>Individual Marginal Tax Rate</u>	<u>Capital Gains Tax Rate</u>	<u>Salary Overall Tax Rate</u>	<u>Dividend Overall Tax Rate</u>	<u>Dividend Minus Salary Overall</u>
12%	0%	12%	21.00%	9.00%
24%	15%	24%	32.85%	8.85%
32%	15%	32%	32.85%	0.85%
35%	18.8%	35%	35.85%	0.85%
35%	23.8%	35%	39.80%	4.80%
37%	23.8%	37%	39.80%	2.80%

Note that the overall tax rate in the dividend situation increases as the tax rate on capital gains increases, while the overall tax rate in the salary situation increases with the taxpayer's marginal tax rate. In this example, the difference between the two is small in the third and fourth rows where the two overall rates are nearly the same. Also, this example assumes the dividend or salary all remains in one tax bracket. If the amounts cross through more than one bracket, the analysis becomes more complex. For example, see Problem C:3-53 at the end of this chapter. ◀

To avoid double taxation, some owners of closely held corporations prefer to be taxed under the rules of Subchapter S (see Chapter C:11). Other owners of closely held corporations retain C corporation status to benefit from nontaxable fringe benefits such as health and accident insurance. These fringe benefits are nontaxable to the employee and deductible by the corporation. For both tax and nontax reasons, closely held corporations must determine the appropriate level of earnings to be withdrawn from the business in the form of salary and fringe benefits and the amount of earnings to be retained in the business.

ADDITIONAL COMMENT

Reasonableness of a salary payment is a question of fact to be determined in each case. No formula can be used to determine a reasonable amount.

Advantage of Salary Payments. If a corporation distributes all its profits as deductible salary and fringe benefit payments, it will eliminate double taxation. However, the following considerations limit such tax planning opportunities:

- Regulation Sec. 1.162-7(a) requires salary or fringe benefit payments to be reasonable in amount and to be paid for services rendered by the employee. If the IRS deems

compensation to be unreasonable, it may disallow the portion of the salary it deems unreasonable while still requiring the employee to include all compensation in gross income (see Chapter C:4). This disallowance will result in double taxation. The reasonable compensation restriction primarily affects closely held corporations.

- ▶ A corporation may not deduct compensation exceeding \$1 million paid to certain executives of publicly traded corporations. This limitation, however, applies only to compensation paid to the chief executive officer (CEO), chief financial officer (CFO), and the three top earning executives other than the CEO and CFO. After 2017, the limitation includes performance-based compensation in the amount subject to the \$1 million limitation.⁴⁵
- ▶ A corporation is a taxpaying entity independent of its owners and is taxed at a 21% rate. This rate may be lower than the marginal tax rate that applies to an individual taxpayer and provides an incentive to retain some earnings in the corporation instead of paying them out as salaries.
- ▶ A combined employee–employer Social Security tax rate of 15.3% generally applies to salaries and wages. Employers and employees are each liable for 6.2% of old age security and disability insurance tax, for a total of 12.4% on wages up to the salary cap (\$128,400 in 2018 and \$132,900 in 2019). Employers and employees also are each liable for a 1.45% Medicare hospital insurance tax, for a total of 2.9% of all wages. An additional 0.9% for the Medicare hospital insurance tax applies to the employee's portion of wages exceeding \$200,000 (\$250,000 for married filing jointly). In addition to these taxes, state and federal unemployment taxes may be imposed on a portion of wages paid.

TAX STRATEGY TIP

A fringe benefit probably is the most cost effective form of compensation because the amount of the benefit is deductible by the employer and never taxed to the employee. Thus, where possible, fringe benefits are an excellent compensation planning tool. For closely held corporations, however, the tax savings to shareholder-employees are reduced because the fringe benefit must be offered to all employees without discrimination.

Advantage of Fringe Benefits. Fringe benefits provide two types of tax advantages: a tax deferral or an exclusion. Qualified pension, profit-sharing, and stock bonus plans provide a tax deferral; that is, the corporation's contribution to such a plan is not taxable to the employees when the corporation makes the contribution. Instead, employees are taxed on the benefits when they receive them. Other common fringe benefits, such as group term life insurance, accident and health insurance, and disability insurance, are exempt from tax altogether; that is, the employee never is taxed on the value of these fringe benefits.

Because the employee excludes the value of fringe benefits from gross income, the marginal individual tax rate applicable to these benefits is zero. Thus, conversion of salary into a fringe benefit provides tax savings for the shareholder-employee equal to the amount of the converted salary times the employee's marginal tax rate, assuming the shareholder-employee could not purchase the same fringe benefit and deduct its cost on his or her individual tax return.

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 5

Comply with corporate tax filing requirements

ESTIMATED TAXES

Every corporation that expects to owe more than \$500 in tax for the current year must pay four installments of estimated tax, each equal to 25% of its required annual payment.⁴⁶ For corporations that are not large corporations (defined below), the required annual payment is the lesser of 100% of the tax shown on the current year return or 100% of the tax shown on the preceding year return. A corporation may not base its required estimated tax amount on the tax shown on the preceding year return if the preceding year tax return showed a zero tax liability.⁴⁷ The estimated tax amount is the corporation's income tax liability that exceeds its tax credits. The amount of estimated tax due may be computed on Schedule 1120-W (Estimated Tax for Corporations).

⁴⁵ Sec. 162(m).

⁴⁶ Sec. 6655.

⁴⁷ Rev. Rul. 92-54, 1992-2 C.B. 320.

Estimated Tax Payment Dates. A calendar year corporation must deposit estimated tax payments in a Federal Reserve bank or authorized commercial bank on or before April 15, June 15, September 15, and December 15.⁴⁸ This schedule differs from that of an individual taxpayer. The final estimated tax installment for a calendar year corporation is due in December of the tax year rather than in January of the following tax year, as is the case for individual taxpayers. For a fiscal year corporation, the due dates are the fifteenth day of the fourth, sixth, ninth, and twelfth months of the tax year.

EXAMPLE C:3-38 ► Garden Corporation, a calendar year taxpayer, expects to report \$144,000 of tax for the current year. Garden's tax liability last year was \$120,000. Assuming Garden is not a large corporation, its required annual payment for the current year is \$120,000, the lesser of its prior year liability (\$120,000) or its current year tax return liability (\$144,000). Garden will not incur a penalty if it deposits four equal installments of \$30,000 ($\$120,000 \div 4$) on or before April 15, June 15, September 15, and December 15 of the current year. ◀

TYPICAL MISCONCEPTION

The easiest method of determining a corporation's estimated tax payments is to pay 100% of last year's tax liability. Unfortunately, for "large corporations," other than for its first quarterly payment, last year's tax liability is not an acceptable method of determining the required estimated tax payments. Also, last year's tax liability cannot be used if no tax liability existed in the prior year or if the corporation filed a short-year return for the prior year.

Different estimated tax payment rules apply to large corporations. A large corporation's required annual payment is 100% of the tax shown on the current year return. A large corporation's estimated tax payments cannot be based on the prior year's tax liability except the first installment. If a large corporation bases its first estimated tax installment on the prior year's liability, any shortfall between the required payment based on the current year's tax liability and the actual payment must be made up with the second installment.⁴⁹ A large corporation is one whose taxable income was \$1 million or more in any of its three immediately preceding tax years. Controlled groups of corporations must allocate the \$1 million amount among its group members.

EXAMPLE C:3-39 ► Assume the same facts as in Example C:3-38 except Garden is a large corporation (i.e., it had more than \$1 million of taxable income in one of its prior three years). Garden can base its first estimated tax payment on either 25% of its current year tax liability or 25% of last year's tax liability. Garden should use its prior year tax liability as the basis for its first installment because it can reduce the needed payment from \$36,000 ($0.25 \times \$144,000$) to \$30,000 ($0.25 \times \$120,000$). However, it must recapture the \$6,000 ($\$36,000 - \$30,000$) shortfall when it pays its second installment. Therefore, the total second installment is \$42,000 ($\$36,000$ second installment + \$6,000 recapture from first installment). The third and fourth installments are \$36,000 each. ◀

KEY POINT

The amount of penalty depends on three factors: the applicable underpayment rate, the amount of the underpayment, and the amount of time that lapses until the corporation makes the payment.

Penalties for Underpayment of Estimated Tax. The IRS will assess a nondeductible penalty if a corporation does not deposit its required estimated tax installment on or before the due date for that installment. The penalty is the underpayment rate found in Sec. 6621 times the amount by which the installment due by a payment date exceeds the payment actually made.⁵⁰ The penalty accrues from the payment due date for the installment until the earlier of the actual date of the payment or the due date for the tax return (excluding extensions).

EXAMPLE C:3-40 ► Globe Corporation is a calendar year taxpayer that reported a \$100,000 tax liability for 2018. Globe's tax liability for 2017 was \$125,000. It should have made estimated tax payments of \$25,000 ($\$100,000 \div 4$) on or before April 15, June 15, September 15, and December 15, 2018. If any of these dates fall on a weekend or holiday, a payment made on the next business day is considered

⁴⁸ Sec. 6655(c)(2). Fiscal year corporations must deposit their taxes on or before the fifteenth day of the fourth, sixth, ninth, and twelfth month of their tax year. If the fifteenth falls on a weekend or holiday, a payment made on the next business day is considered made on the fifteenth due date. Regarding an April 15 due date, the filer also must consider Emancipation Day, which is an observed holiday in Washington, D.C. on April 16. If April 16 falls on Saturday, the observed holiday is the preceding Friday. If it falls on Sunday, the observed holiday is the succeeding Monday.

⁴⁹ Sec. 6655(d)(2)(B). A revision to the required estimated tax payment amount also may be needed if the corporation is basing its quarterly payments

on the current year's tax liability. Installments paid after the estimate of the current year's liability has been revised must take into account any shortage or excess in previous installment payments resulting from the change in the original estimate.

⁵⁰ Sec. 6621. This interest rate is the short-term federal rate as determined by the Secretary of the Treasury plus three percentage points. It is subject to change every three months. The interest rate for large corporations is the short-term federal rate plus five percentage points. This higher interest rate begins 30 days after the issuance of either a 30-day or 90-day deficiency notice.

ADDITIONAL COMMENT

This illustration pertains to 2018 because tax forms for that year are the latest available at the time this textbook was published.

to have been made on the due date. No penalty is assessed if Globe deposited or is considered to have deposited the requisite amounts on or before each of those dates. However, if Globe deposited only \$16,000 (\$9,000 less than the required \$25,000) on April 15, 2018, and did not deposit the remaining \$9,000 before the due date for the 2018 return, the corporation must pay a penalty on the \$9,000 underpayment for the period of time from April 16, 2018, through April 15, 2019. If Globe deposits, or is considered to have deposited, \$34,000 on the second installment date (June 15, 2018), so that it has paid a total of \$50,000 by the second installment due date, the penalty runs only from April 16, 2018, through June 15, 2018.

Now assume that Globe instead made, or is considered to have made, the following estimated tax payments in 2018:

<u>Date</u>	<u>Amount</u>
April 15	\$16,000
June 15	16,000
September 15	21,000
December 15	35,000

Form 2220 in Appendix B calculates the underpayments and resultant penalty given this pattern of payments.

Special Computation Methods. In lieu of the current year and prior year methods, corporations can use either of two special methods for calculating estimated tax installments:

- ▶ The annualized income method
- ▶ The adjusted seasonal income method

The Annualized Income Method. This method is useful if a corporation's income is likely to increase a great deal toward the end of the year. It allows a corporation to base its first and second quarterly estimated tax payments on its annualized taxable income for the first three months of the year. The corporation then bases its third payment on its annualized taxable income for the first six months of the year and its fourth payment on annualized taxable income for the first nine months of the year. (Two other options for the number of months used for each installment also are available.)

EXAMPLE C:3-41

Erratic Corporation, a calendar year taxpayer, reports current year taxable income of: \$10,000 in each of January, February, and March; \$20,000 in each of April, May, and June; and \$50,000 in each of the last six months of the current year. Assuming a 21% tax rate, Erratic's annualized taxable income and annualized tax are calculated as follows:

TAX STRATEGY TIP

Both the "annualized income exception" and the "adjusted seasonal income exception" are complicated computations. However, due to the large amounts of money involved in making corporate estimated tax payments along with the possible underpayment penalties, the time and effort spent in determining the least amount necessary for a required estimated tax payment are often worthwhile.

<u>Through</u>	<u>Cumulative Taxable Income</u>	<u>Annualization Factor</u>	<u>Annualized Taxable Income</u>	<u>Tax on Annualized Taxable Income</u>
Third month	\$ 30,000	12/3	\$120,000	\$ 25,200
Sixth month	90,000	12/6	180,000	37,800
Ninth month	240,000	12/9	320,000	67,200

Assuming Erratic uses the annualized method for all four estimated tax payments, its installments will be as follows:

<u>Installment Number</u>	<u>Annualized Tax</u>	<u>Applicable Percentage</u>	<u>Installment Amount</u>	<u>Cumulative Installment</u>
One	\$ 25,200	25%	\$ 6,300 ^a	\$ 6,300
Two	25,200	50	6,300 ^b	12,600
Three	37,800	75	15,750 ^c	28,350
Four	67,200	100	38,850 ^d	67,200

^a\$25,200 × 0.25

^b(\$25,200 × 0.50) – \$6,300

^c(\$37,800 × 0.75) – \$12,600

^d(\$67,200 × 1.00) – \$28,350

A corporation may use the annualized income method for an installment payment only if it is less than the regular required installment (including the recapture described in the next sentence). It must recapture any reduction in an earlier required installment resulting from use of the annualized income method by increasing the amount of the next installment that does not qualify for the annualized income method.

For small corporations, the sure way to avoid a penalty for the underpayment of estimated tax is to base the current year's estimated tax payments on 100% of last year's tax. This approach is not possible, however, for large corporations or for corporations that owed no tax in the prior year or that filed a short period tax return for the prior year. This approach also is not advisable if the corporation had a high tax liability in the prior year and expects a low tax liability in the current year.

Adjusted Seasonal Income Method. A corporation may base its installments on its adjusted seasonal income. This method permits corporations that earn seasonal income to annualize their income by assuming income earned in the current year is earned in the same pattern as in preceding years. As in the case of the annualized income exception, a corporation can use the seasonal income exception only if the resulting installment payment is less than the regular required installment. Once the exception no longer applies, any savings resulting from its use for prior installments must be recaptured.

Reporting the Underpayment. A corporation reports its underpayment of estimated taxes and the amount of any penalty on Form 2220 (Underpayment of Estimated Tax by Corporations). A completed Form 2220 using the facts from Example C:3-40 appears in Appendix B.

Paying the Remaining Tax Liability. A corporation must pay its remaining tax liability for the year when it files its corporate tax return. An extension of time to file the tax return, however, does *not* extend the time to pay the tax liability. If any tax remains unpaid after the original due date for the tax return, the corporation must pay interest at the underpayment rate prescribed by Sec. 6621 from the due date until the corporation pays the tax. In addition to interest, the IRS assesses a penalty if the corporation does not pay the tax on time and cannot show reasonable cause for the failure to pay. The IRS presumes that reasonable cause exists if the corporation requests an extension of time to file its tax return and the amount of tax shown on the request for extension (Form 7004) or the amount of tax paid by the original due date of the return is at least 90% of the corporation's tax shown on its Form 1120.⁵¹ A discussion of the failure-to-pay penalty and the interest calculation can be found in Chapter C:15.



STOP & THINK

Question: Why does the tax law permit a corporation to use special methods such as the annualized income method to calculate its required estimated tax installments?

Solution: A large corporation whose income varies widely may not be able to estimate its taxable income for the year until late in the year, and it is not allowed to base its estimates on last year's income. If, for example, a calendar year corporation earns income of \$100,000 per month during the first six months of its year, it might estimate its first two installments on the assumption that it will earn a total taxable income of \$1.2 million for the year. But if its income unexpectedly increases to \$500,000 per month in the seventh month, it would need an annualized method to avoid an underpayment penalty for the first two installments. Were it not for the ability to use the annualized method, the corporation would have no way to avoid an underpayment penalty even though it could not predict its taxable income for the year when it made the first two installment payments.

⁵¹ Reg. Sec. 301.6651-1(c)(4).

REQUIREMENTS FOR FILING AND PAYING TAXES

A corporation must file a tax return, Form 1120 (U.S. Corporation Income Tax Return), even if it has no taxable income for the year.⁵² If the corporation did not exist for its entire annual accounting period (either calendar year or fiscal year), it must file a short period return for the part of the year it did exist. For tax purposes, a corporation's existence ends when it ceases business and dissolves, retaining no assets, even if state law treats the corporation as continuing for purposes of winding up its affairs.⁵³

A completed Form 1120 corporate income tax return appears in Appendix B. A spreadsheet that converts book income into taxable income for the Johns and Lawrence business enterprise (introduced in Chapter C:2) is presented with the C corporation tax return.

REAL-WORLD EXAMPLE

In 2017, the IRS collected \$338.5 billion from corporations, which was 9.9% of the \$3.4 trillion collected by the IRS. This percentage is down from 10.4% in 2016.

WHEN THE RETURN MUST BE FILED

In general, the due date for a corporate tax return is the fifteenth day of the fourth month after the end of the corporation's tax year. However, if a corporation has a June 30 year-end, the filing deadline remains as the fifteenth day of the third month after the end of its taxable year (i.e., September 15) until tax years beginning after 2025. For corporations with taxable years ending on June 30, the extension for filing the tax return is seven months until 2026.⁵⁴ The corporation can obtain a six-month (or seven-month if a June 30 year-end) extension for filing the tax return if the corporation files Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns).

EXAMPLE C:3-42 ▶

Palmer Corporation's fiscal tax year ends on September 30. Its corporate tax return for the year ending September 30, 2019, is due on or before January 15, 2020. If Palmer files Form 7004 by January 15, 2020, it can obtain an automatic extension of time to file until July 15, 2020. Palmer expects its tax liability for the year ending September 30, 2019 to be \$72,000, and it has paid \$68,000 in estimated tax during the year. Accordingly, Palmer pays \$4,000 with its Form 7004. A completed Form 7004 appears in Appendix B. ▶

ADDITIONAL COMMENT

The IRS will not assess a late payment penalty if the corporation extends its due date and pays 90% of its total tax liability by the unextended due date and pays the balance by the extended due date.

Additional extensions beyond the automatic six-month (or seven-month if a June 30 year-end) period generally are not available. The IRS can rescind the extension period by mailing a ten-day notice to the corporation before the end of the six-month period.⁵⁵

BOOK-TO-TAX ACCOUNTING COMPARISON

Schedule L (of Form 1120) requires a financial accounting (book) balance sheet rather than a tax balance sheet.

TAX RETURN SCHEDULES

Schedule L (of Form 1120): The Balance Sheet. Schedule L of Form 1120 requires a balance sheet showing the financial accounting results at the beginning and end of the tax year.

Reconciliation Schedules. The IRS also requires the reconciliation of the corporation's financial accounting income (also known as book income) and its taxable income (before special deductions). Book income is calculated according to generally accepted accounting principles (GAAP) including rules promulgated by the Financial Accounting Standards Board (FASB). On the other hand, taxable income must be calculated using tax rules. Therefore, book income and taxable income usually differ.

Some small corporations that do not require audited statements keep their books on a tax basis. For example, they may calculate depreciation for book purposes the same way they do for tax purposes. Income tax expense for book purposes may simply reflect the federal income tax liability. Most corporations, however, must use GAAP to calculate net income per books. For such corporations, taxable income and book income may differ significantly. The reconciliation of book income and taxable income provides the IRS with information that helps it audit a corporation's tax return.

⁵² Sec. 6012(a)(2).

⁵³ Reg. Sec. 1.6012-2(a)(2).

⁵⁴ Sec. 6072(a) and Sec. 2006(a)(3)(B) of P.L. 113. If the due date falls on a weekend or holiday, the return is due on the next business day. Regarding an April 15 due date, the filer also must consider Emancipation Day, which

is an observed holiday in Washington, D.C. on April 16. If April 16 falls on Saturday, the observed holiday is the preceding Friday. If it falls on Sunday, the observed holiday is the succeeding Monday.

⁵⁵ Reg. Sec. 1.6081-3 and instructions to Form 7004.

ADDITIONAL COMMENT

For examples of Schedules M-1, M-2, and M-3 (of Form 1120), see Figure C:3-4, Figure C:3-5, and tax forms in Appendix B.

BOOK-TO-TAX ACCOUNTING COMPARISON

The Internal Revenue Code and related authorities determine the treatment of items in the tax return while Accounting Standards Codification (ASC) 740 (Income Taxes) dictates the treatment of tax items in the financial statements.

SELF-STUDY QUESTION

Why might the IRS be interested in reviewing a corporation's Schedule M-1 or M-3?

ANSWER

Schedule M-1 or M-3 adjustments reconcile book income to taxable income. Thus, these schedules can prove illuminating to an IRS agent who is auditing a corporate return. Because Schedule M-1 or M-3 highlights each departure from the financial accounting rules, the schedules sometimes help the IRS identify tax issues it may want to examine further.

For many corporations, the reconciliation must be provided on Schedule M-1 of Form 1120. Corporations with total assets of \$10 million or more on the last day of the tax year, however, must complete Schedule M-3 instead of Schedule M-1. This schedule provides the IRS with much more detailed information on differences between book income and taxable income than does Schedule M-1. This additional transparency of corporate transactions will increase the IRS's ability to audit corporate tax returns. Form 1120 also requires an analysis of unappropriated retained earnings on Schedule M-2.

Book-Tax Differences. A corporation's book income usually differs from its taxable income for a large number of transactions. Some of these differences are permanent. Permanent differences arise because:

- Some book income is never taxed. Examples include:
 1. Tax-exempt interest received on state and municipal obligations
 2. Proceeds of life insurance carried by the corporation on the lives of key officers or employees
- Some book expenses are never deductible for tax purposes. Examples include:
 1. Expenses incurred in earning tax-exempt interest
 2. Premiums paid for life insurance carried by the corporation on the lives of key officers or employees
 3. Fines and expenses resulting from a violation of law
 4. Disallowed travel and entertainment costs
 5. Political contributions
 6. Federal income taxes per books, which is based on GAAP (ASC 740)
- Some tax deductions are never taken for book purposes. Examples include:
 1. The dividends-received deduction
 2. Percentage depletion of natural resources in excess of their cost

Some of the differences are temporary. Temporary differences arise because:

- Some revenues or gains are recognized for book purposes in the current year but not reported for tax purposes until later years. Examples include:
 1. Installment sales reported in full for book purposes in the year of sale but reported over a period of years using the installment method for tax purposes
 2. Gains on involuntary conversions recognized currently for book purposes but deferred for tax purposes
- Some revenues or gains are taxable before they are reported for book purposes. These items are included in taxable income when received but are included in book income as they accrue. Examples include:
 1. Prepaid rent or interest income
 2. Advance subscription revenue
- Some expenses or losses are deductible for tax purposes after they are recognized for book purposes. Examples include:
 1. Excess of capital losses over capital gains, which are expensed for book purposes but carry back or over for tax purposes
 2. Book depreciation in excess of tax depreciation
 3. Charitable contributions exceeding the 10% of taxable income limitation, which are currently expensed for book purposes but carry over for tax purposes
 4. Bad debt accruals using the allowance method for book purposes and the direct write-off method for tax purposes
 5. Organizational and start-up expenditures, which are expensed currently for book purposes but partially deducted and amortized for tax purposes
 6. Product warranty liabilities expensed for book purposes when estimated but deducted for tax purposes when the liability becomes fixed
 7. Net operating losses (NOLs) that, for tax purposes, carry over to subsequent years

- ▶ Some expenses or losses are deductible for tax purposes before they are recognized for book purposes. Examples include:
 1. Tax depreciation in excess of book depreciation
 2. Prepaid expenses deducted on the tax return in the period paid but accrued over a period of years for book purposes

For book purposes, temporary differences listed under the first and fourth bullets create deferred tax liabilities while those listed under the second and third bullets create deferred tax assets. The Financial Statement Implications section later in this chapter discusses the financial accounting treatment of book-tax differences.

Schedule M-1 (of Form 1120). The Schedule M-1 reconciliation of book to taxable income begins with net income per books and ends with taxable income before special deductions, which corresponds with Line 28 of Form 1120. Thus, some book-tax differences enumerated above do not appear in the reconciliation, for example, the dividends-received deduction and the net operating loss deduction.

The left side of Schedule M-1 contains items the corporation adds back to book income. These items include the following categories:

- ▶ Federal income tax expense (per books)
- ▶ Excess of capital losses over capital gains
- ▶ Income subject to tax but not recorded on the books in the current year
- ▶ Expenses recorded on the books but not deductible for tax purposes in the current year

The right side of the schedule contains items the corporation deducts from book income. These items include the following categories:

- ▶ Income recorded on the books in the current year that is not taxable in the current year
- ▶ Deductions or losses claimed in the tax return that do not reduce book income in the current year

These categorizations, however, do not distinguish between permanent and temporary differences as does Schedule M-3 discussed below. Example C:3-43 and Figure C:3-4 on the next page illustrate a Schedule M-1 reconciliation.

BOOK-TO-TAX ACCOUNTING COMPARISON

Schedules M-1 and M-3 adjustments highlight the fact that financial accounting and tax accounting differ in many ways. A review of Schedule M-1 or M-3 is an excellent way to compare the financial accounting and tax accounting differences in a corporation.

Schedule M-3 (of Form 1120). Schedule M-3 requires extensive detail in its reconciliation. Moreover, the schedule has the corporation distinguish between its permanent and temporary differences. The schedule contains three parts. Part I adjusts worldwide income per books to worldwide book income for only includible corporations. As described in Chapter C:8, some corporations may be included in the financial statement consolidation that might be excluded from the tax consolidated tax return. This resulting figure is then reconciled to taxable income before special deductions (again Line 28 of Form 1120). Part II enumerates the corporation's income and loss items, and Part III enumerates the expense and deduction items. The total items from Part III carry over to Part II for the final reconciliation. Both Parts II and III contain the following four columns: (a) book items, (b) temporary differences, (c) permanent differences, and (d) tax items.

Appendix B provides an example of Schedule M-3 using the information from Example C:3-43. Valley Corporation in that example is too small to be required to use Schedule M-3 although it may elect to do so. Nevertheless, that information is used to allow for comparison of Schedules M-1 and M-3. Note that Lines 1 and 2 of Schedule M-3, Part III, break the \$94,710 federal income tax expense into its current and deferred components. In this example, the current expense ties to the current tax liability (\$77,700), and the deferred expense ties to the change in net deferred tax liabilities and assets arising from temporary differences, specifically, depreciation, net capital loss, prepaid rent, and bad debt expense [$\$17,010 = 0.21 \times (\$110,000 - \$12,000 - \$8,000 - \$9,000)$]. These temporary differences appear in Column b of Schedule M-3, Parts II and III.

EXAMPLE C:3-43 ► Valley Corporation reports the following items for book and tax purposes in its first year of operations (Year 1):

	<u>Book</u>	<u>Tax</u>	<u>Difference</u>
Gross receipts	\$1,500,000	\$1,500,000	
Minus: Cost of goods sold	(550,000)	(550,000)	
Gross profit from operations	\$ 950,000	\$ 950,000	
Plus: Dividends from less than 20%-owned corporations	10,000	10,000	
Tax-exempt income	3,000	—0—	\$ (3,000)
Prepaid rental income	—0—	8,000	8,000
Minus: Operating expenses	(300,000)	(300,000)	
Depreciation	(60,000)	(170,000)	(110,000)
Bad debt expense	(25,000)	(16,000)	9,000
Business interest expense	(75,000)	(75,000)	
State income taxes	—0—	(32,000)	*
Insurance premiums on life for key employee (Valley is the beneficiary)	(2,800)	—0—	2,800
Net capital loss disallowed for tax purposes	(12,000)	—0—	12,000
Net income before income taxes	\$ 488,200		
Taxable income before special deductions		\$ 375,000	
Minus: State income tax expense per books	(32,000)	—0—	*
Federal income tax expense per books	(94,710)	—0—	94,710
Dividends-received deduction	—0—	(5,000)	(5,000)
Net income per books / Taxable income	<u>\$ 361,490</u>	<u>\$ 370,000</u>	
Federal tax liability (\$370,000 × 0.21)		<u>\$ 77,700</u>	

*No difference shown because the state income tax is the same for book and tax.

Valley's Schedule M-1 reconciliation appears in Figure C:3-4. 

1	Net income (loss) per books	361,490	7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books	94,710	a	Tax-exempt interest \$ 3,000	
3	Excess of capital losses over capital gains	12,000	b	Other (itemize):	
4	Income subject to tax not recorded on books this year (itemize):				3,000
	Prepaid rent	8,000	8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):		a	Depreciation . . . \$ 110,000	
a	Depreciation \$		b	Charitable contributions \$	
b	Charitable contributions \$		c	Other (itemize):	
c	Travel and entertainment \$				110,000
d	Other (itemize): Bad debt expense 9,000		9	Add lines 7 and 8	113,000
	Premiums on life insurance 2,800	11,800	10	Income—line 6 less line 9	375,000
6	Add lines 1 through 5	488,000			

FIGURE C:3-4 ► VALLEY CORPORATION'S FORM 1120 SCHEDULE M-1 (EXAMPLE C:3-43)

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books

1	Balance at beginning of year	400,000	5	Distributions: a Cash	250,000
2	Net income (loss) per books	350,000		b Stock	
3	Other increases (itemize): -----			c Property	
	-----		6	Other decreases (itemize): -----	
	Change in accounting principle	5,000	7	Add lines 5 and 6	250,000
4	Add lines 1, 2, and 3	755,000	8	Balance at end of year (line 4 less line 7) .	505,000

FIGURE C:3-5 ▶ BETA CORPORATION'S FORM 1120 SCHEDULE M-2 (EXAMPLE C:3-44)**BOOK-TO-TAX
ACCOUNTING
COMPARISON**

Schedule M-2 requires an analysis of a corporation's retained earnings. Retained earnings is a financial accounting number that has little relevance to tax accounting. A more relevant analysis for tax purposes is one of current and accumulated earnings and profits (E&P). If a corporation distributes more than its E&P, the excess is a nondividend distribution. In this case, the corporation must file Form 5452, Corporate Report of Nondividend Distributions, which requires an analysis of E&P along with other supporting information.

Schedule M-2 (of Form 1120). Schedule M-2 of Form 1120 requires an analysis of changes in unappropriated retained earnings from the beginning of the year to the end of the year. The schedule supplies the IRS with information regarding dividends paid during the year and any special transactions that caused a change in retained earnings for the year.

Schedule M-2 starts with the balance in the unappropriated retained earnings account at the beginning of the year. The following items, which must be added to the beginning balance amount, are listed on the left side of the schedule:

- ▶ Net income per books
- ▶ Other increases (e.g., cumulative effect of a change in accounting principle)

The following items, which must be deducted from the beginning balance amount, are listed on the right side of the schedule:

- ▶ Dividends (e.g., cash or property)
- ▶ Other decreases (e.g., appropriation of retained earnings made during the tax year)

The result is the amount of unappropriated retained earnings at the end of the year.

EXAMPLE C:3-44 ▶

In the current year, Beta Corporation reports net income and other capital account items as follows:

Unappropriated retained earnings, January 1, current year	\$400,000
Net income	350,000
Cumulative effect of a change in accounting principle	5,000
Cash dividends paid in the current year	250,000
Unappropriated retained earnings, December 31, current year	505,000

Beta Corporation's Schedule M-2 appears in Figure C:3-5. ◀

Topic Review C:3-2 summarizes the requirements for paying the taxes due and filing the corporate tax return.

FINANCIAL STATEMENT IMPLICATIONS

OBJECTIVE 6

Determine the financial statement implications of corporate federal income taxes

The book-tax differences discussed on pages C:3-34 and C:3-35 have implications not only for preparing the reconciliation Schedules M-1 and M-3 but also affect how a firm's financial statements present income taxes. Income taxes impact both the income statement and balance sheet. For example, the tax section of the income statement might appear as follows:

Net income before federal income taxes
Minus: Income tax expense
Net income

TOPIC REVIEW C:3-2

Requirements for Paying Taxes Due and Filing Tax Returns

1. Estimated Tax Requirement
 - a. Corporations that expect to owe more than \$500 in tax for the current year must pay four installments of estimated tax, each equal to 25% of its required annual payment.
 - b. Taxes for which estimated payments are required of a C corporation include regular tax and alternative minimum tax, minus any tax credits.
 - c. If a corporation is not a large corporation, its required annual payment is the lesser of 100% of the tax shown on the current year's return or 100% of the tax shown on the preceding year's return.
 - d. If a corporation is a large corporation, its required annual payment is 100% of the tax shown on the current year's return. Its first estimated tax payment may be based on the preceding year's tax liability, but any shortfall must be made up when the second installment is due.
 - e. Special rules apply if the corporation bases its estimated tax payments on the annualized income or adjusted seasonal income method.
2. Filing Requirements
 - a. The corporate tax return is due by the fifteenth day of the fourth month after the end of the tax year (fifteenth day of the third month for corporations whose tax year ends on June 30, and begins before 2026).
 - c. A corporate taxpayer may request an automatic six-month extension to file its tax return (but not to pay its tax due). For corporations with taxable years ending on June 30 (and beginning before 2026), the extension is seven months.

ADDITIONAL COMMENT

The breakdown between current versus deferred taxes and the detail of the federal, state, and foreign components of the income tax expense usually appear in the tax footnote to the financial statements.

Moreover, the **income tax expense** (also called the total tax provision) usually breaks down into a current component and a deferred component. The current component ties into the taxes payable for the current year, and the deferred component arises from book-tax temporary differences. The income tax expense also can contain state and foreign tax components. For this textbook, however, we focus primarily on federal income taxes, with some discussion of state income taxes. Financial statements usually publish details concerning its tax provision in a footnote to the financial statements. Temporary differences also create deferred tax liabilities and deferred tax assets, which appear on the balance sheet.

The primary standard that dictates financial statement treatment is Accounting Standards Codification (ASC) 740, issued by the Financial Accounting Standards Board (FASB). This section first describes the basic principles of ASC 740 and then presents a comprehensive example to demonstrate its application.

SCOPE, OBJECTIVES, AND PRINCIPLES OF ASC 740

ASC 740 establishes principles of accounting for current income taxes and for deferred taxes arising from temporary differences. Specifically, ASC 740 addresses the financial statement consequences of the following events:

- Revenues, expenses, gains, or losses recognized for tax purposes in an earlier or later year than recognized for financial statement purposes
- Other events that create differences between book and tax bases of assets and liabilities
- Operating loss and tax credit carrybacks or carryforwards

ASC 740 sets out two objectives: (1) to recognize current year taxes payable or refundable and (2) to recognize deferred tax liabilities and assets for the future tax consequences of events recognized in a firm's financial statements or tax return. To implement these objectives, ASC 740 applies the following principles:

- Recognize a current tax liability or asset for taxes payable or refundable on current year tax returns
- Recognize a deferred tax liability or asset for future tax effects attributable to temporary differences and carryforwards
- Measure current and deferred tax liabilities and assets using only enacted tax law, not anticipated future changes

- ▶ Reduce deferred tax assets by the amount of tax benefits the firm does not expect to realize, based on available evidence and adjusted via a valuation allowance
- ▶ Establish a liability for uncertain tax positions if necessary

Interestingly, the only comment ASC 740 makes about permanent differences is that “[s]ome events do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible.” In this context, ASC 740 does not mention certain events that do have tax consequences but, nevertheless, create permanent differences, for example, the dividends-received deduction and tax-exempt income. As we show later, permanent differences do not affect deferred taxes, but they do impact the firm’s effective tax rate.

TEMPORARY DIFFERENCES

Similarly to the discussion on pages C:3-34 and C:3-35, the following lists describe events that generate (1) taxable temporary differences and thus deferred tax liabilities and (2) deductible temporary differences and thus deferred tax assets. Deferred tax liabilities and assets appear on a firm’s balance sheet.

Taxable temporary differences and deferred tax liabilities occur when:

- ▶ Revenue or gains are recognized earlier for book purposes than for tax purposes
- ▶ Expenses or losses are deductible earlier for tax purposes than for book purposes
- ▶ Tax basis of an asset is less than its book basis
- ▶ Tax basis of a liability exceeds its book basis

Deductible temporary differences and deferred tax assets occur when:

- ▶ Revenue or gains are recognized earlier for tax purposes than for book purposes
- ▶ Expenses or losses are deductible earlier for book purposes than for tax purposes
- ▶ Tax basis of an asset exceeds its book basis
- ▶ Tax basis of a liability is less than its book basis
- ▶ Operating loss or tax credit carryforwards exist

DEFERRED TAX ASSETS AND THE VALUATION ALLOWANCE

A deferred tax asset indicates that a firm will realize the tax benefit of an event some time in the future. For example, if the firm generates a net operating loss or net capital loss in the current year and, for tax purposes carries the loss forward, the firm will realize a tax benefit only if it earns sufficient future income or capital gains to use any carryover. If the firm likely will not realize the entire tax benefit, it must record a valuation allowance to reflect the unrealizable portion. The valuation allowance is a contra-type account that reduces the deferred tax asset.

EXAMPLE C:3-45 ▶ Delta Corporation’s net capital loss carryover is \$200,000, and it expects to realize (deduct) the entire carryover at a 21% tax rate. Thus, Delta’s deferred tax asset is \$42,000 ($\$200,000 \times 0.21$), and it makes the following book journal entry:

Deferred tax asset	42,000	
Deferred federal income tax expense (benefit)		42,000

Consequently, the deferred tax asset reduces the income tax expense or creates an income tax benefit.

If Delta determines that it likely will realize (deduct) only \$150,000 of the capital loss carryover, it must record a \$10,500 ($\$50,000 \times 0.21$) valuation allowance. Accordingly, Delta makes the following book journal entry:

Deferred tax asset	42,000	
Valuation allowance		10,500
Deferred federal income tax expense (benefit)		31,500

ASC 740 specifically states that a deferred tax asset must be reduced by a valuation allowance if, based on the weight of evidence available, the firm *more likely than not* will fail to realize the benefit of the deferred tax asset. For this purpose, the term *more likely than not* means a greater than 50% likelihood. In assessing this likelihood, a firm must consider both negative and positive evidence, where negative evidence leads toward establishing a valuation allowance while positive evidence helps avoid a valuation allowance. ASC 740 lists several examples of each type of evidence. Examples of negative evidence include the following items:

- Cumulative losses in recent years
- A history of expiring loss or credit carryforwards
- Expected losses in the near future
- Unfavorable contingencies with future adverse effects
- Short carryback or carryover periods that might limit realization of the deferred tax asset

Examples of positive evidence include the following items:

- Existing contracts or sales backlogs that will produce sufficient income to realize the deferred tax asset
- Excess of appreciated asset value over tax basis (i.e., built-in gain) sufficient to realize the deferred tax asset
- A strong earnings history aside from the event causing the deferred tax asset along with evidence that the event is an aberration

In essence, a firm can realize a deferred tax asset when it has sufficient taxable income to offset the reversal of the underlying deductible temporary differences. ASC 740 suggests the following potential sources of such income:

- Future reversals of taxable temporary differences (and deferred tax liabilities)
- Future taxable income other than reversing taxable temporary differences (and deferred tax liabilities)
- Taxable income or capital gain in carryback years assuming the tax law allows a carryback (e.g., for net capital losses)
- Taxable income from prudent and feasible tax planning strategies that a firm ordinarily would not take but nevertheless would pursue to realize an otherwise expiring deferred tax asset

ADDITIONAL COMMENT

Given that NOLs carryover indefinitely, corporations may be less inclined to establish a valuation allowance for them.

ACCOUNTING FOR UNCERTAIN TAX POSITIONS

ASC 740 also prescribes acceptable accounting for uncertain tax positions. This standard addresses the following basic situation: For tax purposes, a firm may take a position in claiming a tax benefit that might not be sustained under IRS scrutiny. The FASB, however, believes that, for determining the financial statement tax provision, such uncertain tax positions either should not be recognized or should be recognized only partially.

In applying the tax position standard, a firm takes a two-step approach. First, the firm determines whether the tax position has a *more likely than not* (greater than 50%) probability of being sustained upon an IRS examination. This determination requires substantial judgment and necessitates careful documentation for the financial statement audit and any IRS examination. If the tax position does not exceed this threshold, the firm cannot recognize the tax benefit for financial reporting purposes until one of the following three events occur:

- The position subsequently meets the *more likely than not* threshold.
- The firm favorably settles the tax issue with the IRS or in court.
- The statute of limitations on the transaction expires.

If the firm determines that a tax position meets the *more likely than not* threshold, it then must measure the amount of benefit it can recognize for financial reporting purposes. This measure is the largest amount of tax benefit that exceeds a 50% probability of realization upon settlement with the taxing authorities. Further details of this measurement process and other procedures under the tax position standard become quite complex and are beyond the scope of this textbook.

ADDITIONAL COMMENT

This financial statement standard used to be referred to as FIN 48, a pre-codification designation. Many practitioners, however, still use the FIN 48 terminology.

REAL-WORLD EXAMPLE

The IRS has developed Schedule UTP for inclusion in Form 1120. This schedule requires certain taxpayers to provide information about their uncertain tax positions. The required information will provide the IRS a road map for auditing the tax return.

EXAMPLE C:3-46 ▶ Lambda Corporation claims a \$1 million deduction on its tax return, which provides a \$210,000 tax savings, assuming a 21% tax rate. After some analysis and judgment, management determines the deduction has only a 45% chance of being allowed should the IRS audit Lambda's tax return. Assume for simplicity that Lambda has no deferred tax assets or liabilities. Assume further that Lambda's pretax book income and taxable income equal \$20 million after taking the \$1 million deduction. Thus, Lambda's tax liability is \$4.2 million. Under the tax position standard, Lambda makes the following journal entry (ignoring potential penalties and interest):

Current federal income tax expense	4,410,000	
Liability for unrecognized tax benefits		210,000
Federal income taxes payable		4,200,000

Suppose in a subsequent period Lambda negotiates a settlement with the IRS that allows \$200,000 of the deduction, and Lambda pays \$168,000 tax on the \$800,000 disallowed portion. Ignoring penalties and interest, Lambda would make the following journal entry:

Liability for unrecognized tax benefits	210,000	
Cash		168,000
Current federal income tax expense (benefit)		42,000

EXAMPLE C:3-47 ▶ Assume the same facts as in Example C:3-46 except Lambda meets the *more likely than not* threshold. Lambda then measures the benefit more than 50% likely to be realized as \$600,000 of the \$1 million deduction taken. Thus, Lambda may not recognize \$400,000 in determining its federal income tax expense for financial reporting purposes and, accordingly, makes the following journal entry:

Current federal income tax expense	4,284,000	
Liability for unrecognized tax benefits		84,000
Federal income taxes payable		4,200,000

BALANCE SHEET CLASSIFICATION

Prior to a recent FASB accounting standards update, deferred tax assets and liabilities had to be classified as current or noncurrent depending on the related asset, liability, or expected reversal date. The update simplifies the classification rules by requiring that all deferred tax assets and liabilities be presented in financial statements as noncurrent. The change was effective for annual periods beginning after December 15, 2016, for public entities and for annual periods beginning after December 15, 2017, for other entities. The update, however, allowed entities to adopt the changes earlier than these dates.

For brevity, this text will refer only to deferred tax assets and deferred tax liabilities without the noncurrent designation attached to the terms. Nevertheless, the noncurrent status should be considered implied in the abbreviated terms. For financial statement presentation, the accounting standard also requires that deferred tax liabilities and assets (as well as any related valuation allowance) be netted and presented as a single (noncurrent) amount for each taxing jurisdiction.

TAX PROVISION PROCESS

The following steps outline the approach used in this chapter to provide for income taxes in the financial statements. This process addresses federal and, to some extent, state income taxes.

1. Identify temporary differences by comparing the book and tax bases of assets and liabilities, and identify tax carryovers.
2. Prepare "roll forward" schedules of temporary differences that tabulate cumulative differences and current year changes.
3. In the roll forward schedules, apply the appropriate statutory tax rates to determine the ending balances of deferred tax assets and liabilities.
4. Adjust deferred tax assets by a valuation allowance if necessary.
5. Adjust the income tax expense for uncertain tax positions if necessary.

ADDITIONAL COMMENT

Determining the valuation allowance and uncertain tax position adjustments requires a great deal of professional judgment.

6. Determine current federal income taxes payable, which, in many cases, also is the current federal income tax expense for book purposes.
7. Determining the total federal income tax expense (benefit).
8. Prepare and record tax related journal entries.
9. Prepare a tax provision reconciliation.
10. Prepare the tax rate reconciliation.
11. Prepare financial statements.

In practice, various firms may use different approaches. For this chapter, however, the above steps provide a logical and systematic approach.

ADDITIONAL COMMENT

The format used in this example is a basic framework. Each firm preparing or reviewing the tax provision will have its own workpaper format for this process.

COMPREHENSIVE EXAMPLE – YEAR 1

To provide comprehensiveness, this example continues with the facts set forth in Example C:3-43. Thus, when completed, the two examples together provide the financial statement implications of federal income taxes as well as the tax return reporting in Schedules M-1 and M-3 for Year 1. We then continue the example with events occurring in Year 2.

In addition to the facts stated in Example C:3-43, Valley reports the following book and tax balance sheet items at the end of Year 1, prior to adjustment for tax related items. Step 11 below presents the completed book balance sheet after making tax related journal entries.

<i>Assets:</i>	<i>Book</i>	<i>Tax</i>	<i>Difference</i>
Cash	\$ 230,200	\$ 230,200	
Accounts receivable	300,000	300,000	
Minus: Allowance for bad debts	(9,000)	–0–	
Net accounts receivable	291,000	300,000	\$ 9,000
Investment in corporate stock	90,000	90,000	
Investment in tax-exempt bonds	50,000	50,000	
Inventory	500,000	500,000	
Fixed assets	1,200,000	1,200,000	
Minus: Accumulated depreciation	(60,000)	(170,000)	
Net fixed assets	1,140,000	1,030,000	110,000
<i>Liabilities and stock equity:</i>			
Accounts payable	225,000	225,000	
Unearned rental income	8,000	–0–	8,000
Long-term liabilities	930,000	930,000	
Common stock	650,000	650,000	

Steps 1 through 3.

The book and tax balance sheets above indicate the items where the book and tax bases differ, thereby indicating temporary differences. In addition, the facts from Example C:3-43 indicates a nondeductible net capital loss, which creates a capital loss carryover.

The following two roll forward schedules calculate the deferred tax assets and deferred tax liability associated with these temporary differences. The beginning and ending balances for the balance sheet items reflect the differences between the book and tax bases for these assets and liabilities. The first schedule also reflects changes in the capital loss carryover.

<i>Deferred tax asset:</i>	<i>Beg. of Year 1</i>	<i>End of Year 1</i>	<i>Change</i>
Net accounts receivable	\$ –0–	\$ 9,000	\$ 9,000
Unearned rental income	–0–	8,000	8,000
Capital loss carryover	–0–	12,000	12,000
Total	\$ –0–	\$ 29,000	\$ 29,000
Times: Tax rate	0.21	0.21	
Deferred tax asset	\$ –0–	\$ 6,090	\$ 6,090

<i>Deferred tax liability:</i>	<i>Beg. of Year 1</i>	<i>End of Year 1</i>	<i>Change</i>
Net fixed assets	\$ -0-	\$110,000	\$110,000
Times: Tax rate	0.21	0.21	
Deferred tax liability	\$ -0-	\$ 23,100	\$ 23,100

The amounts in the change column also appear as book-tax differences in the book and tax income schedules in Example C:3-43. In those schedules, the differences occur in the related income or expense accounts, specifically, bad debt expense, prepaid rental income, and depreciation.

One last aspect of these schedules needs mentioning. Specifically, the changes in the deferred tax assets and liabilities also represent the deferred federal tax expense or benefit for the current year. See Step 7 below.

Step 4

Assuming evidence supports that Valley will realize the entire amount of its deferred tax assets, Valley need not establish a valuation allowance.

Step 5

Assume that Valley requires no adjustments for uncertain tax positions.

Step 6

As provided in Example C:3-43, current federal income taxes payable is \$77,700. In this example, the current payable amount also is the current federal income tax expense for book purposes. (The equality of the current payable amount and the federal income tax expense may not occur, however, under some uncertain tax position situations and in other special circumstances.)

Step 7

The increase in the net deferred federal tax expense from the roll forward schedules equals \$17,010 (\$23,100 – \$6,090). Therefore, the total federal income tax expense for this year can be calculated as shown:

Current federal income tax expense	\$77,700
Deferred federal income tax expense	17,010
Total federal income tax expense	<u>\$94,710</u>

Step 8

Given the amounts determined in previous steps, Valley makes the following book journal entry:

Current federal income tax expense	77,700	
Deferred federal income tax expense	17,010	
Deferred tax asset	6,090	
Deferred tax liability		23,100
Federal income taxes payable		77,700

Also, Valley could make the following combined book journal entry for financial statement presentation and also record the state income tax expense and liability:

Total federal income tax expense	94,710	
Net deferred tax liability (23,100 – 6,090)		17,010
Federal income taxes payable		77,700
State income tax expense	32,000	
State income tax payable		32,000

ADDITIONAL COMMENT

The state income tax provision also could entail book-tax differences, but in this example, the facts assume that the state income tax expense and liability are the same for both book and tax purposes.

ADDITIONAL COMMENT

In practice, this reconciliation can be much more complex than the one shown here. For example, changes in the valuation allowance and in the liability for unrecognized tax benefits can complicate the analysis, as can tax credits. Note also that the permanent difference part of the provision reconciliation ties into the tax rate reconciliation shown in Step 10 below.

ADDITIONAL COMMENT

This approach and the balance sheet approach may not always lead to the same result when enacted tax rates change, in some situations involving uncertain tax positions, and in other special circumstances.

ADDITIONAL COMMENT

We are looking only at federal and state income taxes in these examples. Foreign taxes also can affect a firm's total effective tax rate.

Step 9.

As a cross check on the previous steps, Valley can prepare the following tax provision reconciliation:

Net income before income taxes	\$488,200
State income tax expense	(32,000)
Net income before federal income taxes	456,200
Permanent differences:	
Nondeductible insurance premiums	2,800
Tax-exempt income	(3,000)
Dividends-received deduction	(5,000)
Net income after permanent differences	\$451,000
Temporary differences:	
Unearned rental income	8,000
Net capital loss disallowed for tax	12,000
Net accounts receivable (bad debt expense)	9,000
Net fixed assets (depreciation)	(110,000)
Taxable income	<u>\$370,000</u>

Assuming no enacted change in future tax rates, net income after permanent differences times the tax rate results in the total federal income tax expense. Specifically, $\$451,000 \times 0.21 = \$94,710$. Similarly, taxable income times the tax rate results in current federal income taxes payable and current federal income tax expense. Specifically, $\$370,000 \times 0.21 = \$77,700$.

Step 10.

A firm's effective tax rate is its income tax expense divided by its pretax book income. Thus, Valley's effective tax rates are as follows:

Federal effective tax rate ($\$94,710/\$488,200$)	19.40%
State effective tax rate ($\$32,000/\$488,200$)	6.55%
Total effective tax rate ($\$126,710/\$488,200$)	<u>25.95%</u>

Because the income tax expense is based on net income after adjustment for permanent differences (see Step 9), these differences cause a firm's effective tax rate to differ from the statutory tax rate. In the footnotes to financial statements, firms reconcile the statutory tax rate to their effective tax rate. Accordingly, Valley's effective tax rate reconciliation is as follows:

Statutory tax rate	21.00%
State income tax net of federal tax [$6.55\% \times (1 - 0.21)$]	5.18%
Nondeductible insurance premiums ($\$2,800/\$488,200 \times 21\%$)	0.12%
Tax-exempt income [$(\$3,000)/\$488,200 \times 21\%$]	(0.13)%
Dividends-received deduction [$(\$5,000)/\$488,200 \times 21\%$]	<u>(0.22)%</u>
Total effective tax rate	<u>25.95%</u>

In practice, a firm would not disclose the detail shown here but would aggregate small percentage amounts into an "other" category. Also, if the enacted future tax rate changes, that change also would be reflected in this schedule. The state income tax reconciling item is shown net of federal income taxes because state income taxes are deductible for arriving at federal taxable income.

Step 11.

At this point, Valley can complete its financial statements. The income statement appears in Example C:3-43, but the tax portion is repeated here.

Partial income statement:

Net income before income taxes	\$488,200
Minus: State income tax expense	(32,000)
Federal income tax expense	(94,710)
Net income	<u>\$361,490</u>

As shown in Step 7, the total federal income tax expense has two components as follows:

Current federal income tax expense	\$77,700
Deferred federal income tax expense	<u>17,010</u>
Total federal income tax expense	<u>\$94,710</u>

The book balance sheet for Year 1 is as follows:

Assets:

Cash		\$ 230,200
Accounts receivable	\$ 300,000	
Minus: Allowance for bad debts	<u>(9,000)</u>	291,000
Investment in corporate stock		90,000
Investment in tax-exempt bond		50,000
Inventory		500,000
Fixed assets	\$1,200,000	
Minus: Accumulated depreciation	<u>(60,000)</u>	1,140,000
Total assets		<u>\$2,301,200</u>

Liabilities and equity:

Accounts payable	\$ 225,000
Unearned rental income	8,000
State income taxes payable	32,000
Federal income taxes payable	77,700
Net deferred tax liability (\$23,100 – \$6,090)	17,010
Long-term liabilities	930,000
Common stock	650,000
Retained earnings	<u>361,490</u>
Total liabilities and equity	<u>\$2,301,200</u>

ADDITIONAL COMMENT

This example ignores estimated tax payments, so that the entire amount of federal and state income taxes payable appears on the balance sheet.

COMPREHENSIVE EXAMPLE – YEAR 2

Valley reports the following book and tax balance sheet items at the end of Year 2, prior to adjustment for tax related items. Pertinent to the temporary differences, in Year 2 Valley earned the rental income that was prepaid in Year 1 and did not collect additional amounts. It also adjusted its allowance for bad debts and claimed additional depreciation on fixed assets. It did not recognize any capital gains to offset the capital loss carryover. Step 11 below presents the completed book balance sheet after making tax related journal entries.

<i>Assets:</i>	<i>Book</i>	<i>Tax</i>	<i>Difference</i>
Cash	\$ 333,200	\$ 333,200	
Accounts receivable	400,000	400,000	
Allowance for bad debts	<u>(37,000)</u>	<u>–0–</u>	
Net accounts receivable	363,000	400,000	\$ 37,000
Investment in corporate stock	90,000	90,000	
Investment in tax-exempt bonds	50,000	50,000	
Inventory	600,000	600,000	
Fixed assets	1,200,000	1,200,000	
Accumulated depreciation	<u>(180,000)</u>	<u>(465,000)</u>	
Net fixed assets	<u>1,020,000</u>	<u>735,000</u>	285,000

Liabilities and stock equity:

Accounts payable	295,000	295,000
Unearned rental income	—0—	—0—
Long-term liabilities	530,000	530,000
Common stock	650,000	650,000

Valley also reports the following book income statement through net income before federal income taxes and tax return schedule through taxable income. The tax portion of the book income statement appears in Step 11.

	<u>Book</u>	<u>Tax</u>	<u>Difference</u>
Gross receipts	\$2,000,000	\$2,000,000	
Minus: Cost of goods sold	(700,000)	(700,000)	
Gross profit from operations	\$1,300,000	\$1,300,000	
Plus: Dividends from less than 20%-owned corporations	15,000	15,000	
Tax-exempt income	3,200	—0—	\$ (3,200)
Prepaid rental income	8,000	—0—	(8,000)
Minus: Operating expenses	(500,000)	(500,000)	
Depreciation	(120,000)	(295,000)	(175,000)
Bad debt expense	(40,000)	(12,000)	28,000
Business interest expense	(60,000)	(60,000)	
State income taxes	—0—	(42,000)	*
Insurance premiums on life insurance for key employee (Valley is the beneficiary)	(3,500)	—0—	3,500
Dividends-received deduction	—0—	(7,500)	(7,500)
Net income before income taxes	\$ 602,700		
State income tax expense	(42,000)		*
Net income before federal income taxes	\$ 560,700		
Taxable income		\$ 398,500	

*No difference shown because the state income tax is the same for book and tax.

Step 1 through 3.

The book and tax balance sheets above indicate the items where the book and tax bases differ, thereby indicating temporary differences. In addition, the net capital loss carryover remains unused.

The following two roll forward schedules calculate the deferred tax assets and deferred tax liability associated with these temporary differences. The beginning and ending balances for the balance sheet items reflect the differences between the book and tax bases for these assets and liabilities. In the first schedule, the net accounts receivable temporary difference increases, and the unearned rental income item reverses. Also, in the first schedule, Valley has not realized the deferred tax asset related to the capital loss carryover because it recognized no capital gains in Year 2. Therefore, this deferred tax asset has not yet reversed. In the second schedule, the fixed asset temporary difference increases.

<i>Deferred tax asset:</i>	<u>Beg. of Year 2</u>	<u>End of Year 2</u>	<u>Change</u>
Net accounts receivable	\$ 9,000	\$37,000	\$28,000
Unearned rental income	8,000	—0—	(8,000)
Capital loss carryover	12,000	12,000	—0—
Total	\$29,000	\$49,000	\$20,000
Times: Tax rate	0.21	0.21	
Deferred tax asset	\$ 6,090	\$10,290	\$ 4,200

<i>Deferred tax liability:</i>	<u>Beg. of Year 2</u>	<u>End of Year 2</u>	<u>Change</u>
Net fixed assets	\$110,000	\$285,000	\$175,000
Times: Tax rate	0.21	0.21	
Deferred tax liability	<u>\$ 23,100</u>	<u>\$ 59,850</u>	<u>\$ 36,750</u>

The amounts in the change column also appear as book-tax differences in the above book and tax income schedules. In those schedules, the differences occur in the related income or expense accounts, specifically, bad debt expense, prepaid rental income, and depreciation.

As before, the changes in the deferred tax assets and liabilities also represent the deferred federal tax expense or benefit for the current year. See Step 7 below.

ADDITIONAL COMMENT

If a firm has reversing taxable differences in an amount equal to or exceeding reversing deductible temporary differences, the firm can be fairly certain that it can realize the benefit of its deferred tax assets, which is the case in this example as indicated by the firm having a net deferred tax liability.

Step 4.

Assuming evidence supports that Valley still will realize the entire amount of its deferred tax assets, Valley need not establish a valuation allowance.

Step 5.

Assume again that Valley requires no adjustments for uncertain tax positions.

Step 6.

As provided in the schedule above, taxable income is \$398,500. Therefore, current federal income taxes payable is \$83,685 ($\$398,500 \times 0.21$). In this example, the current payable amount also is the current federal income tax expense for book purposes. (The equality of the current payable amount and the federal income tax expense may not occur, however, under some uncertain tax position situations and in other special circumstances.)

Step 7.

The increase in the net deferred federal tax expense from the roll forward schedules equals \$32,550 ($\$36,750 - \$4,200$). Therefore, the total federal income tax expense for this year can be calculated as follows:

Current federal income tax expense	\$ 83,685
Deferred federal income tax expense	32,550
Total federal income tax expense	<u>\$116,235</u>

Step 8.

Given the amounts determined in previous steps, Valley makes the following book journal entry:

Current federal income tax expense	83,685	
Deferred federal income tax expense	32,550	
Deferred tax asset	4,200	
Deferred tax liability		36,750
Federal income taxes payable		83,685

Also, Valley could make the following combined book journal entry and also record the state income tax expense and liability:

Total federal income tax expense	116,235	
Net deferred tax liability		32,550
Federal income taxes payable		83,685
State income tax expense	42,000	
State income tax payable		42,000

ADDITIONAL COMMENT

In practice, this reconciliation can be much more complex than the one shown here. For example, changes in the valuation allowance and in the liability for unrecognized tax benefits (both discussed earlier) can complicate the analysis, as can tax credits. Note also that the permanent difference part of the provision reconciliation ties into the tax rate reconciliation shown in Step 10 below.

Step 9.

As a cross check on the previous steps, Valley can prepare the following tax provision reconciliation:

Net income before income taxes	\$602,700
State income tax expense	<u>(42,000)</u>
Net income before federal income taxes	560,700
Permanent differences:	
Nondeductible insurance premiums	3,500
Tax-exempt income	<u>(3,200)</u>
Dividends-received deduction	<u>(7,500)</u>
Net income after permanent differences	\$553,500
Temporary differences:	
Unearned rental income	(8,000)
Net accounts receivable (bad debt expense)	28,000
Net fixed assets (depreciation)	<u>(175,000)</u>
Taxable income	<u>\$398,500</u>

ADDITIONAL COMMENT

This approach and the balance sheet approach may not always lead to the same result when enacted tax rates change, in some situations involving uncertain tax positions, and in other special circumstances.

Assuming no enacted change in future tax rates, net income after permanent differences times the tax rate results in the total federal income tax expense. Specifically, $\$553,500 \times 0.21 = \$116,235$. Similarly, taxable income times the tax rate results in current federal income taxes payable and current federal income tax expense. Specifically, $\$398,500 \times 0.21 = \$83,685$.

Step 10.

Valley's effective tax rates are as follows:

Federal effective tax rate ($\$116,235/\$602,700$)	19.29%
State effective tax rate ($\$42,000/\$602,700$)	<u>6.97%</u>
Total effective tax rate ($\$158,235/\$602,700$)	<u>26.26%</u>

Valley's effective tax rate reconciliation is as follows:

Statutory tax rate	21.00%
State income tax net of federal tax [$6.97\% \times (1 - 0.21)$]	5.51%
Nondeductible insurance premiums ($\$3,500/\$602,700 \times 21\%$)	0.12%
Tax-exempt income [$(\$3,200)/\$602,700 \times 21\%$]	(0.11)%
Dividends-received deduction [$(\$7,500)/\$602,700 \times 21\%$]	<u>(0.26)%</u>
Total effective tax rate	<u>26.26%</u>

Step 11.

At this point, Valley can complete its financial statements. The first part of the income statement appears in the schedule shown before Steps 1 through 3, and the tax portion is as follows:

Partial income statement:

Net income before income taxes	\$602,700
Minus: State income tax expense	(42,000)
Federal income tax expense	<u>(116,235)</u>
Net income	<u>\$444,465</u>

As shown in Step 7, the federal income tax expense has two components as follows:

Current federal income tax expense	\$ 83,685
Deferred federal income tax expense ($\$36,750 - \$4,200$)	<u>32,550</u>
Total federal income tax expense	<u>\$116,235</u>

The book balance sheet for Year 2 is as follows:

Assets:

Cash		\$ 333,200
Accounts receivable	\$ 400,000	
Minus: Allowance for bad debts	(37,000)	363,000
Investment in corporate stock		90,000
Investment in tax-exempt bond		50,000
Inventory		600,000
Fixed assets	\$1,200,000	
Minus: Accumulated depreciation	(180,000)	1,020,000
Total assets		<u>\$2,456,200</u>

Liabilities and equity:

Accounts payable	\$ 295,000
Unearned rental income	—
State income taxes payable	42,000
Federal income taxes payable	83,685
Net deferred tax liability (\$59,850 – \$10,290)	49,560
Long-term liabilities	530,000
Common stock	650,000
Retained earnings (\$361,490 + \$444,465)	805,955
Total liabilities and equity	<u>\$2,456,200</u>

ADDITIONAL COMMENT

This example ignores estimated tax payments, so the entire amount of federal income taxes payable appears on the balance sheet.

OTHER TRANSACTIONS

Other chapters describe the financial statement implications of corporate acquisitions (Chapter C:7), intercompany transactions (Chapter C:8), and the foreign tax credit (Chapter C:16).

PROBLEM MATERIALS

DISCUSSION QUESTIONS

- C:3-1** High Corporation incorporates on May 1 and begins business on May 10 of the current year. What alternative tax years can High elect to report its initial year's income?
- C:3-2** Port Corporation wants to change its tax year from a calendar year to a fiscal year ending June 30. Port is a C corporation owned by 100 shareholders, none of whom own more than 5% of the stock. Can Port change its tax year? If so, how can it accomplish the change?
- C:3-3** Stan and Susan, two calendar year taxpayers, are starting a new business to manufacture and sell digital circuits. They intend to incorporate the business with \$600,000 of their own capital and \$2 million of equity capital obtained from other investors. The company expects to incur organizational and start-up expenditures of \$100,000 in the first year. Inventories are a material income-producing factor. The company also expects to incur losses of \$500,000 in the first two years

of operations and substantial research and development expenses during the first three years. The company expects to break even in the third year and be profitable at the end of the fourth year, even though the nature of the digital circuit business will require continual research and development activities. What accounting methods and tax elections must Stan and Susan consider in their first year of operation? For each method and election, explain the possible alternatives and the advantages and disadvantages of each alternative.

- C:3-4** Compare the tax treatment of capital gains and losses by a corporation and by an individual.
- C:3-5** What are organizational expenditures? How are they treated for tax purposes?
- C:3-6** What are start-up expenditures? How are they treated for tax purposes?
- C:3-7** What limitations apply to a corporation's deduction for business interest?

- C:3-8** Describe three ways in which the treatment of charitable contributions by individual and corporate taxpayers differ.
- C:3-9** Carver Corporation uses the accrual method of accounting and the calendar year as its tax year. Its board of directors authorizes a cash contribution on November 3 of Year 1, that the corporation pays on March 9 of Year 2. In what year(s) is it deductible? What happens if the corporation does not pay the contribution until April 20 of Year 2?
- C:3-10** Zero Corporation contributes inventory (computers) to State University for use in its mathematics program. The computers have a \$1,225 cost basis and a \$2,800 FMV. How much is Zero's charitable contribution deduction for the computers? (Ignore the 10% limit.)
- C:3-11** Why are corporations allowed a dividends-received deduction? What dividends qualify for this special deduction?
- C:3-12** Why is a dividends-received deduction disallowed if the stock on which the corporation pays the dividend is debt-financed?
- C:3-13** Crane Corporation incurs a \$75,000 NOL in the current year. In which years can Crane use this NOL? What limitations might apply?
- C:3-14** What special restrictions apply to the deduction of a loss realized on the sale of property between a corporation and a shareholder who owns 60% of the corporation's stock? What restrictions apply to the deduction of expenses accrued by a corporation at year-end and owed to a cash method shareholder who owns 60% of the corporation's stock?
- C:3-15** Deer Corporation is a C corporation. Its taxable income for the current year is \$200,000. What is Deer Corporation's income tax liability for the year?
- C:3-16** Budget Corporation is a personal service corporation. Its taxable income for the current year is \$75,000. What is Budget's income tax liability for the year?
- C:3-17** Describe the three types of controlled groups.
- C:3-18** Why do special restrictions on using the progressive corporate tax rates apply to controlled groups of corporations? List three restrictions on claiming multiple tax benefits that apply to controlled groups of corporations.
- C:3-19** What are the major advantages and disadvantages of filing a consolidated tax return?
- C:3-20** What are the tax advantages of substituting fringe benefits for salary paid to a shareholder-employee?
- C:3-21** Explain the tax consequences to both the corporation and a shareholder-employee if an IRS agent determines that a portion of the compensation paid in a prior tax year exceeds a reasonable compensation level.
- C:3-22** What corporations must pay estimated taxes? When are the estimated tax payments due?
- C:3-23** What is a "large" corporation for purposes of the estimated tax rules? What special rules apply to such large corporations?
- C:3-24** What penalties apply to the underpayment of estimated taxes? The late payment of the remaining tax liability?
- C:3-25** Describe the situations in which a corporation must file a tax return.
- C:3-26** When is a corporate tax return due for a calendar-year taxpayer? What extension(s) of time in which to file the return are available?
- C:3-27** List four types of differences that can cause a corporation's book income to differ from its taxable income.

ISSUE IDENTIFICATION QUESTIONS

- C:3-28** X-Ray Corporation received a \$100,000 dividend from Yancey Corporation this year. X-Ray owns 10% of the Yancey's single class of stock. What tax issues should X-Ray consider with respect to its dividend income?
- C:3-29** Williams Corporation sold a truck with an adjusted basis of \$100,000 to Barbara for \$80,000. Barbara owns 25% of the Williams stock. What tax issues should Williams and Barbara consider with respect to the sale/purchase?
- C:3-30** You are the CPA who prepares the tax returns for Don, his wife, Mary, and their two corporations. Don owns 100% of Pencil Corporation's stock. Pencil's current year taxable income is \$100,000. Mary owns 100% of Eraser Corporation's stock. Eraser's current year taxable income is \$150,000. Don and Mary file a joint federal income tax return. What issues should Don and Mary consider with respect to the calculation of the three tax return liabilities?
- C:3-31** Epsilon Corporation, which does not qualify as a small business corporation, incurred a \$10 million NOL in the current year. It expects to earn relatively low amounts of net income for the next several years and also to incur substantial interest costs on amounts borrowed to finance operations and growth in the coming years. What tax issues does Epsilon face in the upcoming years?

PROBLEMS

C:3-32 *Depreciation Recapture.* Young Corporation purchased residential real estate several years ago for \$225,000, of which \$25,000 was allocated to the land and \$200,000 was allocated to the building. Young took straight-line MACRS deductions of \$30,000 during the years it held the property. In the current year, Young sells the property for \$285,000, of which \$60,000 is allocated to the land and \$225,000 is allocated to the building. What are the amount and character of Young's recognized gain or loss on the sale?

C:3-33 *Depreciation Recapture, Sec. 1231, and Capital Gains and Losses.* Gamma Corporation sold the following property on March 3 of the current year:

	<i>Securities</i>	<i>Equipment</i>	<i>Building</i>	<i>Land</i>
Selling price	\$ 65,000	\$210,000	\$385,000	\$175,000
Cost	\$100,000	\$200,000	\$400,000	\$190,000
Accumulated depreciation	—0—	(125,000)	(120,000)	—0—
Adjusted basis	\$100,000	\$ 75,000	\$280,000	\$190,000
Gain (loss)	\$ (35,000)	\$135,000	\$105,000	\$ (15,000)

The corporation used the equipment, building, and land in its business and has held all the property for more than one year. Aside from these transactions, Gamma had \$720,000 of operating net income during the current year. Gamma has a \$24,000 nonrecaptured Sec. 1231 loss from prior years. Determine the character of the gains and losses, and calculate the corporation's taxable income.

C:3-34 *Organizational and Start-Up Expenditures.* Delta Corporation incorporates on January 7, begins business on July 10, and elects to have its initial tax year end on October 31. Delta incurs the following expenses between January and October related to its organization during the current year:

<i>Date</i>	<i>Expenditure</i>	<i>Amount</i>
January 30	Travel to investigate potential business site	\$2,000
May 15	Legal expenses to draft corporate charter	2,500
May 30	Commissions to stockbroker for issuing and selling stock	4,000
May 30	Temporary directors' fees	2,500
June 1	Expense of transferring building to Delta	3,000
June 5	Accounting fees to set up corporate books	1,500
June 10	Training expenses for employees	5,000
June 15	Rent expense for June	1,000
July 15	Rent expense for July	1,000

- What alternative treatments are available for Delta's expenditures?
- What amount of organizational expenditures can Delta Corporation deduct on its first tax return for the fiscal year ending October 31?
- What amount of start-up costs can Delta Corporation deduct on its first tax return?

C:3-35 *Charitable Contribution of Property.* Yellow Corporation donates the following property to the State University:

- ABC Corporation stock purchased two years ago for \$18,000. The stock, which trades on a regional stock exchange, has a \$25,000 FMV on the contribution date.
- Inventory with a \$17,000 adjusted basis and a \$22,000 FMV. State will use the inventory for scientific research that qualifies under the special Sec. 170(e)(4) rules.
- An antique vase purchased two years ago for \$10,000 and having an \$18,000 FMV. State University plans to sell the vase to obtain funds for educational purposes.

Yellow Corporation's taxable income before any charitable contributions deduction or dividends-received deduction is \$300,000.

- What is Yellow Corporation's charitable contributions deduction for the current year?
- What is the amount of its charitable contributions carryover (if any)?

C:3-36 *Charitable Contributions of Property.* Blue Corporation donates the following property to Johnson Elementary School:

- XYZ Corporation stock purchased two years ago for \$25,000. The stock has a \$19,000 FMV on the contribution date.
- ABC Corporation stock purchased three years ago for \$2,000. The stock has a \$16,000 FMV on the contribution date.
- PQR Corporation stock purchased six months ago for \$12,000. The stock has an \$18,000 FMV on the contribution date.

The school will sell the stock and use the proceeds to renovate a classroom to be used as a computer laboratory. Blue's taxable income before any charitable contributions deduction or dividends-received deduction is \$400,000.

- What is Blue's charitable contributions deduction for the current year?
- What is Blue's charitable contribution carryover (if any)? In what years can it be used?
- What would have been a better tax plan concerning the XYZ stock donation?

C:3-37 *Charitable Contribution Deduction Limitation.* Zeta Corporation reports the following results for Year 1 and Year 2:

	<u>Year 1</u>	<u>Year 2</u>
Adjusted taxable income	\$180,000	\$125,000
Charitable contributions (cash)	20,000	12,000

The adjusted taxable income is before Zeta claims any charitable contributions deduction or dividends-received deduction.

- How much is Zeta's charitable contributions deduction in Year 1? In Year 2?
- What is Zeta's contribution carryover to Year 3, if any?

C:3-38 *Taxable Income Computation.* Omega Corporation reports the following results for the current year:

Gross profits on sales	\$120,000
Dividends from less-than-20%-owned domestic corporations	40,000
Operating expenses	100,000
Charitable contributions (cash)	11,000

- What is Omega's charitable contributions deduction for the current year and its charitable contributions carryover to next year, if any?
- What is Omega's taxable income for the current year?

C:3-39 *Dividends-Received Deduction.* Theta Corporation reports the following results for the current year:

Gross profits on sales	\$220,000
Dividends from less-than-20%-owned domestic corporations	100,000
Operating expenses	218,000

- What is Theta's taxable income for the current year?
- How would your answer to Part a change if Theta's operating expenses are instead \$234,000?
- How would your answer to Part a change if Theta's operating expenses are instead \$272,000?
- How would your answers to Parts a, b, and c change if Theta received \$70,000 of the dividends from a 20%-owned corporation and the remaining \$30,000 from a less-than-20%-owned corporation?

C:3-40 *Stock Held 45 Days or Less.* Beta Corporation purchased 100 shares of Gamma Corporation common stock (less than 5% of the outstanding stock) two days before the ex-dividend date for \$200,000. Beta receives a \$10,000 cash dividend from Gamma. Beta sells the Gamma stock one week after purchasing it for \$190,000. What are the tax consequences of these three events?

C:3-41 *Debt-Financed Stock.* Cheers Corporation purchased for \$500,000 5,000 shares of Beer Corporation common stock (less than 5% of the outstanding Beer stock) at the beginning of the current year. It used \$400,000 of borrowed money and \$100,000 of its own cash to make this purchase. Cheers paid \$50,000 of interest on the debt this year. Cheers received a \$40,000 cash dividend on the Beer stock on September 1 of the current year. Cheers has \$5 million of taxable income before any dividends-received deduction.

- What amount can Cheers deduct for the interest paid on the loan?
- What dividends-received deduction can Cheers claim with respect to the dividend?

- C:3-42** *Net Operating Loss Carryovers.* In 2019, Ace Corporation reports gross income of \$200,000 (including \$150,000 of profit from its operations and \$50,000 in dividends from less-than-20%-owned domestic corporations) and \$230,000 of operating expenses.
- What is Ace's NOL for 2019?
 - Assume that Ace expects 2020's taxable income to be \$20,000 and 2021's taxable income to be \$100,000, both before any NOL deduction in the carryover year. What NOL deductions can Ace expect to claim in 2020 and 2021?
 - How would your answer to Part b change if, in addition to the 2019 NOL, Ace also had a \$5,000 NOL carryover from a loss occurring before 2018?
- C:3-43** *Business Interest and Net Operating Loss Carryovers.* Delta Corporation incurs a \$100,000 NOL in 2019. In 2020, the corporation reports the following items:
- | | |
|--|-----------|
| Gross profit from operations | \$200,000 |
| Operating expenses other than interest expense | 120,000 |
| Business interest expense | 30,000 |
- Even though the numbers in this problem are small, assume that Delta does not qualify for the small business exemption from the net business interest limitation.
- What is Delta's taxable income in 2020?
 - What are Delta's carryovers to 2021?
- C:3-44** *Ordering of Deductions.* Beta Corporation reports the following results for the current year:
- | | |
|--|-----------|
| Gross income from operations | \$180,000 |
| Dividends from less-than-20%-owned domestic corporations | 100,000 |
| Operating expenses | 150,000 |
| Charitable contributions | 20,000 |
- In addition, Beta has a \$10,000 NOL carryover from the preceding tax year.
- What is Beta's taxable income for the current year?
 - What carryovers are available to other tax years?
- C:3-45** *Sale to a Related Party.* Union Corporation sells a truck for \$18,000 to Jane, who owns 70% of its stock. The truck has a \$24,000 adjusted basis on the sale date. Jane sells the truck to an unrelated party, Mike, for \$28,000 two years later after claiming \$5,000 in depreciation.
- What is Union's realized and recognized gain or loss on selling the truck?
 - What is Jane's realized and recognized gain or loss on selling the truck to Mike?
 - How would your answers to Part b change if Jane instead sold the truck for \$10,000?
- C:3-46** *Payment to a Cash Basis Employee-Shareholder.* Value Corporation is a calendar year taxpayer that uses the accrual method of accounting. On December 10 of the current year, Value accrues a bonus payment of \$100,000 to Brett, its president and sole shareholder. Brett is a calendar year taxpayer who uses the cash method of accounting. When can Value deduct the bonus if it pays it to Brett early next year?
- C:3-47** *Capital Gains and Losses.* Western Corporation reports the following results for the current year:
- | | |
|-------------------------|-----------|
| Gross profits on sales | \$150,000 |
| Long-term capital gain | 8,000 |
| Long-term capital loss | 15,000 |
| Short-term capital gain | 10,000 |
| Short-term capital loss | 2,000 |
| Operating expenses | 61,000 |
- What are Western's taxable income and income tax liability for the current year?
 - How would your answers to Part a change if Western's short-term capital loss is \$5,000 instead of \$2,000?
- C:3-48** *Corporate Taxable Income and Tax Liability.* Alpha Corporation has been in business for two years. It incurred the following items last year (Year 1):
- | | |
|-------------------------|-----------|
| Gross profits on sales | \$240,000 |
| Operating expenses | 100,000 |
| Long-term capital gain | 8,000 |
| Short-term capital loss | 12,000 |

Alpha reported the following items this year (Year 2):

Gross profits on sales	\$600,000
Operating expenses	165,000
Long-term capital gain	10,000

Compute Alpha's taxable income and tax liability for Year 1 and Year 2.

C:3-49 *Computing the Corporate Income Tax Liability.* What is Beta Corporation's income tax liability assuming its taxable income is (a) \$50,000, (b) \$500,000, and (c) \$50 million. How would your answers change if Beta were a personal service corporation?

C:3-50 *Computing Taxable Income and Income Tax Liability.* Pace Corporation reports the following results for the current year:

Gross profit on sales	\$120,000
Long-term capital loss	10,000
Short-term capital loss	5,000
Dividends from 40%-owned domestic corporation	30,000
Operating expenses	65,000
Charitable contributions	10,000

- What are Pace's taxable income and income tax liability?
- What carrybacks and carryovers (if any) are available and to what years must they be carried?

C:3-51 *Computing Taxable Income and Income Tax Liability.* Roper Corporation reports the following results for the current year:

Gross profits on sales	\$80,000
Short-term capital gain	40,000
Long-term capital gain	25,000
Dividends from 25%-owned domestic corporation	15,000
NOL carryover from the preceding tax year	9,000
Operating expenses	45,000

What are Roper's taxable income and income tax liability?

C:3-52 *Controlled Groups.* Which of the following groups constitute controlled groups? (Any stock not listed below is held by unrelated individuals each owning less than 1% of the outstanding stock.) For brother-sister corporations, which definition applies?

- Judy owns 100% of the single classes of stock of Hot and Ice Corporations.
- Jones and Kane Corporations each have only a single class of stock outstanding. The two controlling individual shareholders own the stock as follows:

Shareholder	Stock Ownership Percentages	
	Jones Corp.	Kane Corp.
Tom	60%	100%
Mary	40%	

- Link, Model, and Name Corporations each have a single class of stock outstanding. The stock is owned as follows:

Shareholder	Stock Ownership Percentages	
	Model Corp.	Name Corp.
Link Corp.	80%	50%
Model Corp.		40%
Unrelated individuals	20%	10%

Link Corporation's stock is widely held by over 1,000 shareholders, none of whom owns directly or indirectly more than 1% of Link's stock.

- Oat, Peach, Rye, and Seed Corporations each have a single class of stock outstanding. The stock is owned as follows:

Shareholder	Stock Ownership Percentages			
	Oat Corp.	Peach Corp.	Rye Corp.	Seed Corp.
Bob	100%	90%		
Oat Corp.			80%	30%
Rye Corp.				60%
Unrelated individuals		10%	20%	10%

- C:3-53** *Salary vs. Dividends.* Elizabeth owns 100% of Omega Corporation's stock and also runs the company as its CEO. Omega is a C corporation that expects to earn \$400,000 before deducting any salary paid to Elizabeth. Elizabeth wants the corporation to pay her \$250,000 for the current year in pre-tax dollars. She is considering three different options: (1) a \$250,000 dividend, (2) a \$125,000 dividend plus a \$125,000 salary, or (3) a \$250,000 salary. Any dividends qualify for the preferential capital gains tax rates. Elizabeth's husband has no earnings of his own in the current year, so her income is the sole source for the family. Elizabeth and her husband file a joint tax return and claim the \$24,400 standard deduction. Calculate the total tax liability (corporate and individual) for each of the three options, and determine which option results in the lowest overall tax.
- C:3-54** *Fringe Benefits.* Refer to the facts in Problem C:3-53. Elizabeth has read an article explaining the advantages of paying nontaxable fringe benefits (premiums on group term life insurance, accident and health insurance, etc.) and having deferred compensation plans (e.g., qualified pension and profit-sharing plans). Provide Elizabeth with information on the tax savings associated with converting \$3,000 of her salary into nontaxable fringe benefits. What additional costs might Omega Corporation incur if it adopts a fringe benefit plan?
- C:3-55** *Estimated Tax Requirement.* Zeta Corporation's taxable income for 2018 was \$1.1 million, on which Zeta paid federal income taxes of \$231,000. Zeta estimates calendar year 2019's taxable income to be \$2 million, on which it will owe \$420,000 in federal income taxes.
- What are Zeta's minimum quarterly estimated tax payments for 2019 to avoid an underpayment penalty?
 - When is Zeta's 2019 tax return due?
 - When are any remaining taxes due? What amount of taxes are due when Zeta files its return assuming Zeta timely pays estimated tax payments equal to the amount determined in Part a?
 - If Zeta obtains an extension to file, when is its tax return due? Will the extension permit Zeta to delay making its final tax payments?
- C:3-56** *Filing the Tax Return and Paying the Tax Liability.* Wright Corporation's taxable income for calendar years 2016, 2017, and 2018 was \$120,000, \$150,000, and \$100,000, respectively. Its total tax liability for 2018 was \$21,000. Wright estimates that its 2019 taxable income will be \$600,000, on which it will owe federal income taxes of \$126,000. Assume Wright earns its 2019 taxable income evenly throughout the year.
- What are Wright's minimum quarterly estimated tax payments for 2019 to avoid an underpayment penalty?
 - When is Wright's 2019 tax return due?
 - When are any remaining taxes due? What amount of taxes are due when Wright files its return assuming it timely paid estimated tax payments equal to the amount determined in Part a?
 - How would your answer to Part a change if Wright's tax liability for 2018 had been \$168,000?
- C:3-57** *Converting Book Income to Taxable Income.* The following income and expense accounts appeared in the book accounting records of Rocket Corporation, an accrual basis taxpayer, for the current calendar year.

<u>Account Title</u>	<u>Book Income</u>	
	<u>Debit</u>	<u>Credit</u>
Net sales		\$3,230,000
Dividends received		10,000 (1)
Interest income		18,000 (2)
Gain on sale of stock		9,000 (3)
Key-person life insurance proceeds		100,000
Cost of goods sold	\$2,000,000	
Salaries and wages	500,000	
Bad debts	13,000 (4)	
Payroll taxes	62,000	
Interest expense	12,000 (5)	

Charitable contributions	50,000 (6)	
Depreciation	70,000 (7)	
Other expenses	40,000 (8)	
Federal income taxes	108,465	
Net income	511,535	
Total	<u>\$3,367,000</u>	<u>\$3,367,000</u>

The following additional information applies.

- Dividends were from Star Corporation, a 30%-owned domestic corporation.
- Interest revenue consists of interest on corporate bonds, \$15,000; and municipal bonds, \$3,000.
- The stock is a capital asset held for three years prior to sale.
- Rocket uses the specific writeoff method of accounting for bad debts.
- Interest expense consists of \$11,000 interest incurred on funds borrowed for working capital and \$1,000 interest on funds borrowed to purchase municipal bonds.
- Rocket paid all contributions in cash during the current year to State University.
- Rocket calculated depreciation per books using the straight-line method. For income tax purposes, depreciation amounted to \$95,000.
- Other expenses include premiums of \$5,000 on the key-person life insurance policy covering Rocket's president, who died in December.
- Rocket has a \$90,000 NOL carryover from prior years.

Required:

- Prepare a worksheet reconciling Rocket's book income with its taxable income (before special deductions). Six columns should be used—two (one debit and one credit) for each of the following three major headings: book income, Schedule M-1 adjustments, and taxable income. (See the sample worksheet with Form 1120 in Appendix B if you need assistance).
- Prepare a tax provision reconciliation as in Step 9 of the Tax Provision Process. Assume a 21% corporate tax rate.

C:3-58 *Reconciling Book Income and Taxable Income.* Omega Corporation reports the following results for the current year:

Net income per books (before federal income taxes)	\$738,000
Federal income tax expense per books	(156,240)
Net income per books (after federal income taxes)	\$581,760
Tax-exempt interest income	10,000
Interest on loan to purchase tax-exempt bonds	7,000
MACRS depreciation exceeding book depreciation	40,000
Net capital loss	8,000
Insurance premium on life of corporate officer where Omega is the beneficiary	9,000
Excess charitable contributions carried over to next year	4,000

- Prepare a reconciliation of Omega's taxable income before special deductions with its book income. See Problem C:3-68 for related Form 1120, Schedule M-1.
- Prepare a tax provision reconciliation as in Step 9 of the Tax Provision Process. Assume a 21% tax rate.

C:3-59 *Reconciling Unappropriated Retained Earnings.* White Corporation's financial accounting records disclose the following results for the period ending December 31 of the current year:

Retained earnings balance on January 1	\$246,500
Net income for year	259,574
Contingency reserve established on December 31	60,000
Cash dividend paid on July 23	23,000

What is White's unappropriated retained earnings balance on December 31 of the current year?

C:3-60 *Tax Reconciliation Process.* Omega Corporation, a regular C corporation, presents you with the following partial *book* income statement for the current year:

Sales	\$1,900,000	
Cost of goods sold	(1,100,000)	
Gross profit		\$800,000
Operating expenses:		
Depreciation	\$ 80,000	
Interest expense	18,000	
Warranty expense	12,000	
Fines and penalties	10,000	
Other business expenses	220,000	(340,000)
Net operating income		\$460,000
Other income (losses):		
Interest received on municipal bonds	\$ 1,000	
Income on installment sale	9,000	
Net losses on stock sales	(20,000)	(10,000)
Net income before state and federal income taxes		\$450,000

Omega also provides the following partial balance sheet information:

	<i>Book</i>		<i>Tax</i>	
	<i>Beg. of Year</i>	<i>End of Year</i>	<i>Beg. of Year</i>	<i>End of Year</i>
Installment note receivable	\$ -0-	\$ 30,000	\$ -0-	\$ 30,000
Minus: Unrecognized income on note	-0-	-0-	-0-	(9,000)
Net basis of note receivable	-0-	30,000	-0-	21,000
Tax-exempt bonds	18,000	18,000	18,000	18,000
Deferred tax asset	3,150	?	-0-	-0-
Investment stocks	100,000	40,000	100,000	40,000
Fixed assets	400,000	400,000	400,000	400,000
Minus: Accumulated depreciation	(40,000)	(120,000)	(80,000)	(208,000)
Net basis of fixed assets	360,000	280,000	320,000	192,000
Liability for warranties	-0-	12,000	-0-	-0-
Deferred tax liability	8,400	?	-0-	-0-

You have gathered the following additional information:

1. Depreciation for tax purposes is \$128,000.
2. Of the \$18,000 interest expense, \$2,000 is allocable to a loan used to purchase the municipal bonds.
3. The warranty expense is an estimated amount for book purposes. Omega expects actual claims on these warranties to be filed and paid next year.
4. Your research determines that the fines and penalties are not deductible for tax purposes.
5. In the current year, Omega sold property using the installment method as follows:

Selling price	\$30,000
Adjusted basis	(21,000)
Gain	\$9,000

Omega obtains a \$30,000 installment note receivable this year and will receive the \$30,000 sales proceeds next year. For book purposes, Omega recognizes the \$9,000 gain in the current year. For tax purposes, Omega will recognize the \$9,000 gain next year when it receives the \$30,000 sales proceeds.

6. Omega sold a significant portion of its stock portfolio in the current year. The \$20,000 net loss per books from these stock sales includes the following components:

Long-term capital gain	\$15,000
Long-term capital loss	(38,000)
Short-term capital gain	3,000

Omega had no capital gains in prior years, so it cannot carry the net capital losses back.

7. Omega does not expect to realize capital gains next year, but it does expect sufficient capital gains within the next five years so that it can use the capital loss carryover before it expires. Thus, Omega determines that it needs no valuation allowance.
8. Omega has a \$15,000 net operating loss carryover from last year, which it then expected to use in the next year (now the current year).
9. Omega incurred and paid \$27,000 of state income taxes for the year.
10. Omega's tax rate is 21% and will remain so in future years.
11. The beginning deferred tax asset pertains to the NOL carryover, and the beginning deferred tax liability pertains to fixed assets. Other deferred tax assets and deferred tax liabilities may arise in the current year.
12. Omega determines that it needs no adjustment for uncertain tax positions.

Required: Perform the tax provision process steps as outlined in the text. For Step 11, just present partial income statement and balance sheet disclosures as allowed by the given facts. See Problem C:3-69 for related Form 1120, Schedule M-3.

C:3-61

Valuation Allowance. In the current year, Alpha Corporation generated \$500,000 of ordinary operating income and incurred a \$20,000 capital loss on the sale of marketable securities from its investment portfolio. Alpha expects to generate \$500,000 of ordinary operating income in each of the next five years. Alpha incurred no capital gains in its previous three years, so it must carry over the \$20,000 capital loss for up to five years. Alpha estimates that its remaining marketable securities would produce a \$12,000 capital gain if sold. Thus, Alpha determines that, more likely than not, the corporation will not realize (deduct) \$8,000 of the current year capital loss. Alpha has no other book-tax differences and is subject to a 21% tax rate.

Required:

- a. Determine Alpha's deferred tax asset and valuation allowance for the current year.
- b. Determine Alpha's current federal income tax expense, deferred federal income tax expense (benefit), total federal income tax expense, and federal income taxes payable.
- c. Prepare the journal entry necessary to record the above amounts.
- d. Prepare a tax provision reconciliation and effective tax rate reconciliation for the current year.

C:3-62

Uncertain Tax Positions. In the current year, Kappa Corporation earned \$1 million of net income before federal income taxes. This amount of book income includes a \$100,000 expense for what the company considers an ordinary and necessary business expense. Kappa also deducted the entire \$100,000 for tax purposes. In assessing the expense for its tax provision, Kappa determines that it has a more-likely-than-not probability of sustaining some portion of the deduction upon an IRS examination. However, some uncertainty remains as to whether the entire amount is deductible. Any amount ultimately disallowed by the IRS would be a permanent disallowance and not merely a temporary item that could be amortized over time. Upon further analysis, Kappa measures the benefit that is more than 50% likely to be realized as \$70,000. Thus, Kappa may not recognize \$30,000 of the expense in determining its federal income tax provision. In addition, Kappa has a \$25,000 temporary difference that decreases its taxable income to \$975,000 and increases its deferred tax liability.

Required:

- a. Determine Kappa's liability for unrecognized tax benefits, total federal income tax expense, deferred federal income tax expense, current federal income tax expense, increase in deferred tax liability, and federal income taxes payable. Assume a 21% tax rate.
- b. Prepare the journal entry necessary to record the current year tax provision.

COMPREHENSIVE PROBLEM

C:3-63

Jackson Corporation prepared the following book income statement for its year ended December 31, 2019:

Sales		\$950,000
Minus: Cost of goods sold		(450,000)
Gross profit		\$500,000
Plus: Dividends received on Invest Corporation stock	\$ 3,000	
Gain on sale of Invest Corporation stock	30,000	
Total dividends and gain		33,000

Minus: Depreciation (\$7,500 + \$16,700)	\$ 24,200	
Bad debt expense	22,000	
Other operating expenses	105,500	
Loss on sale of Equipment 1	70,000	
Total expenses and loss		(221,700)
Net income per books before taxes		\$311,300
Minus: Federal income tax expense		(65,100)
Net income per books		<u>\$246,200</u>

Information on equipment depreciation and sale:

Equipment 1:

- Acquired March 3, 2017 for \$180,000
- For books: 12-year life; straight-line depreciation
- Sold February 17, 2019 for \$80,000

Sales price		\$ 80,000
Cost		\$180,000
Minus: Depreciation for 2017 (½ year)	\$ 7,500	
Depreciation for 2018 (\$180,000/12)	15,000	
Depreciation for 2019 (½ year)	7,500	
Total book depreciation		(30,000)
Book value at time of sale		(150,000)
Book loss on sale of Equipment 1		<u>\$(70,000)</u>

- For tax: Seven-year MACRS property for which the corporation made no Sec. 179 election in the acquisition year and elected out of bonus depreciation.

Equipment 2:

- Acquired February 16, 2019 for \$334,000
- For books: 10-year life; straight-line depreciation (½ year taken in first year)
- Book depreciation in 2019: $\$334,000/10 \times 0.5 = \$16,700$
- For tax: Seven-year MACRS property for which the corporation claimed 100% bonus depreciation for the entire cost.

Other information:

- Under the direct writeoff method, Jackson deducts \$15,000 of bad debts for tax purposes.
- Jackson has a \$40,000 NOL carryover and a \$6,000 capital loss carryover, both incurred last year.
- Jackson purchased the Invest Corporation stock (less than 20% owned) on June 21, 2017, for \$25,000 and sold the stock on December 21, 2019, for \$55,000.

Required:

- For 2019, calculate Jackson's tax depreciation deduction for Equipment 1 and Equipment 2, and determine the tax loss on the sale of Equipment 1.
- For 2019, calculate Jackson's taxable income and tax liability.
- Prepare a schedule reconciling net income per books to taxable income before special deductions (Form 1120, line 28).

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

C:3-64

Mike Barton owns Barton Products, Inc. The corporation has 30 employees. Barton Corporation expects \$800,000 of net income before taxes in 2019. Mike is married and files a joint return with his wife, Elaine, who has no earnings of her own. Mike and Elaine have no other income, file a joint tax return, and claim the standard deduction. Mike's salary is \$200,000 per year (already deducted in computing Barton Corporation's \$800,000 net income).

- With the given facts, calculate the tax liability for Barton Corporation and for Mike and Elaine.
- Should Mike increase his salary from Barton by \$50,000 to reduce the overall tax burden to himself and Barton Products? Because of the Social Security cap, the corporation and Mike each would incur a 1.45% payroll tax with the corporate portion being deductible.

- c. Should Barton employ Mike's wife Elaine for \$50,000 rather than increase Mike's salary? Take into consideration employment taxes as well as federal income taxes. Note, that Elaine's salary would be well below the Social Security cap, so that she and the corporation each would incur the full amount of payroll taxes with the corporate portion being deductible. Both Elaine's and the corporation's portion is 7.65%.

- C:3-65** Rho Corporation owns 22% of Divvy Corporation's stock. Divvy has paid Rho \$100,000 in dividends for the current year with the last dividend payment made on December 15. Rho is doing some year-end tax planning and, as of now, expects an operating loss of \$35,000 not counting the dividend income. Thus, Rho expects \$65,000 (\$100,000 – \$35,000) of taxable income before the dividends-received deduction.
- Calculate Rho's expected taxable income and tax liability for the current year using the given facts.
 - Given the result in Part a, what year-end tax planning strategies can you suggest to improve Rho's benefit of the dividends-received deduction for the current year?

TAX FORM/RETURN PREPARATION PROBLEMS

- C:3-66** Melodic Musical Sales, Inc. is located at 5500 Fourth Avenue, City, ST 98765. The corporation uses the calendar year and accrual basis for both book and tax purposes. It is engaged in the sale of musical instruments with an employer identification number (EIN) of XX-2020018. The company incorporated on December 31, 2014, and began business on January 2, 2015. Table C:3-3 contains balance sheet information at January 1, 2018, and December 31, 2018. Table C:3-4 presents an unaudited GAAP income statement for 2018. These schedules are presented on a book basis. Other information follows the tables.

▼ **TABLE C:3-3**

Melodic Musical Sales, Inc.—Book Balance Sheet Information

Account	January 1, 2018		December 31, 2018	
	Debit	Credit	Debit	Credit
Cash	\$ 516,774		\$ 815,494	
Accounts receivable	400,000		500,000	
Allowance for doubtful accounts		\$ 20,000		\$ 25,000
Inventory	2,500,000		3,500,000	
Investment in corporate stock	260,000		50,000	
Investment in municipal bonds	30,000		30,000	
Cash surrender value of insurance policy	60,000		80,000	
Land	200,000		200,000	
Buildings	2,000,000		2,000,000	
Accumulated depreciation—Buildings		100,000		140,000
Equipment	750,000		1,100,000	
Accumulated depreciation—Equipment		187,500		205,000
Trucks	100,000		100,000	
Accumulated depreciation—Trucks		30,000		50,000
Accounts payable		300,000		270,000
Notes payable (short-term)		800,000		640,000
Accrued payroll taxes		14,880		18,600
Accrued state income taxes		4,500		7,500
Accrued federal income taxes		2,500		77,361
Bonds payable (long-term)		1,800,000		600,000
Net deferred tax liability		57,394		167,593
Capital stock—Common		1,500,000		1,500,000
Retained earnings—Unappropriated		2,000,000		4,674,440
Totals	\$6,816,774	\$6,816,774	\$8,375,494	\$8,375,494

▼ **TABLE C:3-4****Melodic Musical Sales, Inc.—Book Income Statement 2018**

Sales		\$ 10,000,000
Returns		(250,000)
Net sales		<u>\$ 9,750,000</u>
Beginning inventory	\$2,500,000	
Purchases	5,500,000	
Ending inventory	<u>(3,500,000)</u>	
Cost of goods sold		<u>(4,500,000)</u>
Gross profit		\$ 5,250,000
Expenses:		
Depreciation	\$ 152,500	
Repairs	20,500	
General insurance	55,000	
Net premium-Officers' life insurance	30,000	
Officers' compensation	650,000	
Other salaries	400,000	
Utilities	72,000	
Advertising	48,000	
Legal and accounting fees	50,000	
Charitable contributions	30,000	
Payroll taxes	62,000	
Interest expense	210,000	
Bad debt expense	<u>45,000</u>	
Total expenses		(1,825,000)
Gain on sale of equipment		105,000
Interest on municipal bonds		5,000
Net gain on stock sales		45,000
Dividend income		<u>12,000</u>
Net income before income taxes		\$ 3,592,000
Federal income tax expense		(742,560)
State income tax expense		<u>(75,000)</u>
Net income		<u><u>\$ 2,774,440</u></u>

Estimated Tax Payments (Form 2220):

The corporation deposited estimated tax payments as follows:

April 15, 2018	\$ 75,000
June 15, 2018	150,000
September 15, 2018	165,000
December 15, 2018	<u>165,000</u>
Total	<u><u>\$555,000</u></u>

Taxable income in 2017 was \$1.2 million, and the 2017 tax was \$408,000 (at the 34% tax rate in effect in 2017). The corporation earned its 2018 taxable income evenly throughout the year. Therefore, it does not use the annualization or seasonal methods.

Inventory and Cost of Goods Sold (Form 1125-A):

The corporation uses the periodic inventory method and prices its inventory using the lower of FIFO cost or market. Only beginning inventory, ending inventory, and purchases should be reflected on Form 1125-A. No other costs or expenses are allocated to cost of goods sold.

Note: Assume the corporation is exempt from the uniform capitalization (UNICAP) rules.

Line 9 (a)
(b), (c) & (d)
(e) & (f)

Check (ii)
Not applicable
No

Compensation of Officers (Form 1125-E):

<u>(a)</u>	<u>(b)</u>	<u>(c)</u>	<u>(d)</u>	<u>(f)</u>
Mary Travis	XXX-XX-XXXX	100%	50%	\$290,000
John Willis	XXX-XX-XXXX	100%	25%	180,000
Chris Parker	XXX-XX-XXXX	100%	25%	180,000
Total				<u>\$650,000</u>

Bad Debts:

For tax purposes, the corporation uses the direct writeoff method of deducting bad debts. For book purposes, the corporation uses an allowance for doubtful accounts. During 2018, the corporation charged \$40,000 to the allowance account, such amount representing actual writeoffs for 2018.

Additional Information (Schedule K):

1 b	Accrual	9	Fill in the correct amount
2 a	451140	10	3
b	Retail sales	11	Do not check box
c	Musical instruments	12	Not applicable
3	No	13-14	No
4 a	No	15 a	No
b	Yes; omit Schedule G	b	Do not check box
5 a	No	16-23	No
b	No	24	Yes
6-7	No	25	No
8	Do not check box		

Organizational Expenditures:

The corporation incurred less than \$5,000 of organizational expenditures in the year it began business. For book purposes, the corporation expensed the entire expenditure. For tax purposes, the corporation elected under Sec. 248 to deduct the entire amount of expenditures in the year it began business. Therefore, no amortization expenditures appear in the tax return or book financial statements for the current year.

Capital Gains and Losses:

The corporation sold 100 shares of PDQ Corp. common stock on October 8, 2018, for \$145,000. The corporation acquired the stock on December 15, 2017, for \$90,000. The corporation also sold 75 shares of JSB Corp. common stock on June 18, 2018, for \$110,000. The corporation acquired this stock on September 18, 2016, for \$120,000. The corporation has a \$15,000 capital loss carryover from 2017. These transactions were not reported to the corporation on Form 1099-B.

Fixed Assets and Depreciation:

For book purposes: The corporation uses straight-line depreciation over the useful lives of assets as follows: store building, 50 years; equipment, ten years; and trucks, five years. The corporation takes a half-year's depreciation in the year of acquisition and the year of disposition and assumes no salvage value. The book financial statements in Tables C:3-3 and C:3-4 reflect these calculations.

For tax purposes: All assets are MACRS property as follows: store building, 39-year nonresidential real property; equipment, seven-year property; and trucks, five-year property. The corporation acquired the store building for \$2 million and placed it in service on January 2, 2015. The corporation acquired two pieces of equipment for \$250,000 (Equipment 1) and \$500,000 (Equipment 2) and placed them in service on January 2, 2015. The corporation acquired the trucks for \$100,000 and placed them in service on July 18, 2016. The trucks are not listed property and are not subject to the limitation on luxury automobiles.

The corporation did not make the expensing election under Sec. 179 or take bonus depreciation on any property acquired before 2018. Accumulated tax depreciation through December 31, 2017, on these properties is as follows:

Store building	\$ 151,780
Equipment 1	140,675
Equipment 2	281,350
Trucks	52,000

On October 16, 2018, the corporation sold for \$280,000 Equipment 1 that originally cost \$250,000 on January 2, 2015. The corporation had no Sec. 1231 losses from prior years. In a separate transaction on October 17, 2018, the corporation acquired and placed in service a piece of equipment costing \$600,000. Assume these two transactions do not qualify as a like-kind exchange. The new equipment is seven-year property. The corporation made the Sec. 179 expensing election with regard to the new equipment for the entire cost of this property. Where applicable, use published IRS depreciation tables to compute 2018 depreciation (reproduced in Appendix C of this text).

Other Information:

- Ignore the accumulated earnings tax.
- The corporation received dividends (see Income Statement in Table C:3-4) from taxable, domestic corporations, the stock of which Melodic Musical Sales, Inc. owns less than 20%.
- The corporation paid \$100,000 in cash dividends to its shareholders during the year and charged the payment directly to retained earnings.
- The state income tax in Table C:3-4 is the exact amount of such taxes incurred during the year.
- The corporation is not entitled any credits.
- Ignore the financial statement impact of any underpayment penalties incurred on the tax return.

Required: Prepare the 2018 corporate tax return for Melodic Musical Sales, Inc. along with any necessary supporting schedules.

Optional: Prepare both Schedule M-3 (but omit Schedule B and Form 8916-A) and Schedule M-1 even though the IRS does not require both Schedule M-1 and Schedule M-3.

Note to Instructor: See solution in the Instructor's Resource Manual for other optional information to provide to students.

C:3-67 Permtemp Corporation formed in 2017 and, for that year, reported the following book income statement and balance sheet, excluding the federal income tax expense, deferred tax assets, and deferred tax liabilities:

Sales		\$20,000,000
Cost of goods sold		<u>(15,000,000)</u>
Gross profit		\$ 5,000,000
Dividend income		50,000
Tax-exempt interest income		<u>15,000</u>
Total income		\$ 5,065,000
Expenses:		
Depreciation	\$ 800,000	
Bad debts	400,000	
Charitable contributions	100,000	
Interest	475,000	
Meals and entertainment	45,000	
Other	<u>3,855,000</u>	
Total expenses		<u>(5,675,000)</u>
Net loss before federal income taxes		<u>\$ (610,000)</u>

Cash		\$ 500,000
Accounts receivable	\$ 2,000,000	
Allowance for doubtful accounts	<u>(250,000)</u>	1,750,000
Inventory		4,000,000
Fixed assets	\$10,000,000	
Accumulated depreciation	<u>(800,000)</u>	9,200,000
Investment in corporate stock		1,000,000
Investment in tax-exempt bonds		<u>50,000</u>
Total assets		<u>\$16,500,000</u>
Accounts payable		\$ 2,610,000
Long-term debt		8,500,000
Common stock		6,000,000
Retained earnings		<u>(610,000)</u>
Total liabilities and equity		<u>\$16,500,000</u>

Additional information for 2017:

- The investment in corporate stock is comprised of less-than-20%-owned corporations. The dividends-received deduction percentage in 2017 was 70% for less than 20%-owned property.
- Depreciation for tax purposes is \$1.4 million under MACRS.
- Bad debt expense for tax purposes is \$150,000 under the direct writeoff method.
- Because of limitations, none of the charitable contributions will be deductible for tax purposes, and \$22,500 of the meals and entertainment expenses will be disallowed for tax purposes.
- Ignore the U.S. production activities deduction.
- The corporate tax rate in 2017 was 34%. However, at the end of 2017, Congress reduced the corporate tax rate to 21% effective for 2018.

Required for 2017:

- Prepare page 1 of the 2017 Form 1120, computing the corporation's NOL.
- Determine the corporation's deferred tax asset and deferred tax liability situation, and then complete the income statement and balance sheet to reflect proper GAAP accounting under ASC 740. Because of the enacted tax rate change, deferred assets and liabilities at the end of 2017 will need to be valued at 21%. Use the balance sheet information to prepare Schedule L of the 2017 Form 1120.
- Prepare the 2017 Schedule M-3 for Form 1120.
- Prepare a schedule that reconciles the corporation's effective tax rate to the statutory 34% tax rate. This schedule will need a line to reflect the change in the future tax rate to 21%.

For 2018, Permtemp reported the following book income statement and balance sheet, excluding the federal income tax expense, deferred tax assets, and deferred tax liabilities:

Sales		\$33,000,000
Cost of goods sold		<u>(22,000,000)</u>
Gross profit		\$11,000,000
Dividend income		55,000
Tax-exempt interest income		<u>15,000</u>
Total income		\$11,070,000
Expenses:		
Depreciation	\$ 800,000	
Bad debts	625,000	
Charitable contributions	40,000	
Interest	455,000	
Meals and entertainment	60,000	
Other	<u>4,675,000</u>	
Total expenses		<u>(6,655,000)</u>
Net income before federal income taxes		<u>\$ 4,415,000</u>

ADDITIONAL COMMENT

For 2017 forms, go to forms and publications, prior year, at the IRS website, www.irs.gov.

Cash		\$ 2,125,000
Accounts receivable	\$ 3,300,000	
Allowance for doubtful accounts	(450,000)	2,850,000
Inventory		6,000,000
Fixed assets	\$10,000,000	
Accumulated depreciation	(1,600,000)	8,400,000
Investment in corporate stock		1,000,000
Investment in tax-exempt bonds		50,000
Total assets		<u>\$20,425,000</u>
Accounts payable		\$ 2,120,000
Long-term debt		8,500,000
Common stock		6,000,000
Retained earnings		3,805,000
		<u>\$20,425,000</u>

Additional information for 2018:

- Assume that \$40,000 of the \$60,000 meals and entertainment expenses pertained to entertainment and \$20,000 pertained to business meals. Because of limitations effective in 2018, \$50,000 of the meals and entertainment expenses will be disallowed for tax purposes.
- Depreciation for tax purposes is \$2.45 million under MACRS.
- Bad debt expense for tax purposes is \$425,000 under the direct writeoff method.
- The corporate tax rate in 2018 is 21%.

Required for 2018:

- Prepare page 1 of the 2018 Form 1120, computing the corporation's taxable income and tax liability.
- Determine the corporation's deferred tax asset and deferred tax liability situation, and then complete the income statement and balance sheet to reflect proper GAAP accounting ASC 740. Use the balance sheet information to prepare Schedule L of the 2018 Form 1120.
- Prepare the 2018 Schedule M-3 for Form 1120.
- Prepare a schedule that reconciles the corporation's effective tax rate to the statutory 21% tax rate.

C:3-68 *Short Tax Form.* Refer to the facts in Problem C:3-58, and prepare Form 1120, Schedule M-1 based on these facts.

C:3-69 *Short Tax Form.* Refer to the facts in Problem C:3-60. Assume that Omega Corporation's employer identification number is XX-2020183 and that Omega's income statement is unaudited and non-tax based (it is GAAP based). Prepare Form 1120, Schedule M-3 based on these facts.

CASE STUDY PROBLEMS



C:3-70 Susan Smith accepted a new corporate client, Winter Park Corporation. One of Susan's tax managers conducted a review of Winter Park's prior year tax returns. The review revealed that an NOL for a prior tax year was incorrectly computed, resulting in an overstatement of NOL carryovers to subsequent prior tax years. Apply the Statements on Standards for Tax Services (SSTSs) to the following situations. The SSTSs are in Appendix E of this text.

- Assume the incorrect NOL calculation does not affect the current year's tax liability. What recommendations (if any) should Susan make to the new client? See SSTS No. 6.
- Assume the IRS is currently auditing a prior year. What are Susan's responsibilities in this situation? See SSTS No. 6.
- Assume the NOL carryover is being carried to the current year, and Winter Park does not want to file amended tax returns to correct the error. What should Susan do in this situation? See SSTS No. 1.

- C:3-71** The Chief Executive Officer of a client of your public accounting firm saw the following advertisement in a financial newspaper:

DONATIONS WANTED
The Center for Restoration of Waters
A Nonprofit Research and Educational Organization
Needs Donations—Autos, Boats, Real Estate, Etc.
ALL DONATIONS ARE TAX-DEDUCTIBLE

Prepare a memorandum to your client Phil Nickelson explaining how the federal income tax laws regarding donations of cash, automobiles, boats, and real estate apply to corporate taxpayers.

TAX RESEARCH PROBLEMS

- C:3-72** Wicker Corporation made estimated tax payments of \$6,000 in Year 1. On March 12 of Year 2, it filed its Year 1 tax return showing a \$20,000 tax liability, and it paid the \$14,000 balance at that time. On April 20 of Year 2, it discovers an error and files an amended return for Year 1 showing a reduced tax liability of \$8,000. Prepare a memorandum for your tax manager explaining whether Wicker can base its estimated tax payments for Year 2 on the amended \$8,000 tax liability for Year 1, or whether it must use the \$20,000 tax liability reported on its original Year 1 return. Your manager has suggested that, at a minimum, you consult the following resources:

- IRC Sec. 6655(d)(1)
- Rev. Rul. 86-58, 1986-1 C.B. 365

- C:3-73** For many years preceding 2018, Minimis Corporation, a calendar year corporation, had incurred the alternative minimum tax (AMT) and as a result has a \$2 million minimum tax carryover into 2018. However, the Tax Cuts and Jobs Act of 2017 repealed the corporate AMT for tax years beginning after 2017. Minimis expects its regular tax liability to be \$100,000 per year for 2018, 2019, 2020, and 2021. Your supervisor has asked you to determine how Minimis treats the minimum tax credit carryover in these four years now that the corporate AMT has been repealed. Your supervisor has suggested that you start by looking at IRC Sec. 53.

- C:3-74** James Bowen owns 100% of Bowen Corporation stock. Bowen is a calendar year, accrual method taxpayer. During the current year, Bowen made three charitable contributions:

<u>Donee</u>	<u>Property Donated</u>	<u>FMV of Property</u>
State University	Bates Corporation stock	\$110,000
Red Cross	Cash	5,000
Girl Scouts	Pledge to pay cash	25,000

Bowen purchased the Bates stock three years ago for \$30,000. Bowen holds a 28% interest, which it accounts for under GAAP using the equity method of accounting. The current carrying value for the Bates stock for book purposes is \$47,300. Bowen will pay the pledge to the Girl Scouts by check on March 3 of next year. Bowen's taxable income for the current year before the charitable contributions deduction, dividends-received deduction, NOL deduction, and U.S. production activities deduction is \$600,000. Your tax manager has asked you to prepare a memorandum explaining how these transactions are to be treated for tax purposes and for accounting purposes. Your manager has suggested that, at a minimum, you should consult the following resources:

- IRC Sec. 170
- Accounting Standards Codification (ASC) 720