OBJECTIVES

After completing Chapter 14, you should be able to:
1. Identify which entities are classified as corporations.
2. Discuss tax-free organizations and transfers to controlled corporations.
3. Understand the use of debt in the corporate capital structure.
4. Apply the ordinary loss deduction rules of Code Sec. 1244 on disposi- tions of stock.
5. Use the gain exclusion of Code Sec. 1202 on disposi- tions of stock.
6. Determine corporate taxable income, including special deductions available to corporations.
7. Compute corporate income tax, including the regular tax and the alternative minimum tax.
8. Describe controlled and affiliated groups and the filing of consolidated returns.
9. Know corporate income tax return requirements.
OVERVIEW

Corporate taxation is divided into six areas. They are (1) formation, (2) operation, (3) distributions, (4) redemptions, (5) liquidations, and (6) reorganizations. In this chapter, the formation and operation of corporations are discussed. Chapter 15 describes distributions and redemptions, Chapter 16 presents liquidations, and Chapter 17 details reorganizations. Chapter 18 discusses the penalty taxes, such as the accumulated earnings tax and the personal holding company tax, that may be imposed on corporations.

Chapters 14 through 18 limit their discussion to regular corporations taxed under Subchapter C of the Internal Revenue Code. Special corporations taxed under Subchapter S are discussed in Chapter 21. These S corporations have features closer to the partnership form of organization than the corporate form of organization.

Special rules allow assets and liabilities to be transferred to corporations tax free. There is a carryover of basis and tacking of holding periods in these tax-free exchanges.

Code Sec. 1244 allows the original shareholders of small business stock to obtain an ordinary deduction for a loss on dispositions of the stock rather than receive capital loss treatment. Gain on the sale still remains capital gain. Code Sec. 1202 also enables noncorporate taxpayers to exclude 50 percent on any gain from the sale or exchange of qualified small business stock held for more than five years which was originally issued after August 10, 1993.

A corporation is a separate legal entity and taxpayer. A corporation computes its taxable income in much the same manner as an individual. However, there are special deductions available to corporations. Dividends received by a corporation from other domestic corporations are deductible to the extent of 70 to 100 percent. The first $5,000 of organizational expenditures may be expensed in the first year and the remaining expenditures may be deducted ratably over a period of not less than 180 months. Charitable contributions are limited to 10 percent of taxable income. Corporations may claim capital losses only against capital gains. Disallowed capital losses are carried back three years and forward five years. Net operating losses are normally carried back two years and forward 20 years.

Corporate income tax rates vary from 15 to 39 percent of taxable income. Corporations may be subject to a 20 percent tax on net alternative minimum taxable income, which is taxable income with certain adjustments and tax preferences. If the alternative minimum tax exceeds the regular tax, the excess is added to the regular tax. Dividends must be paid out of after-tax income and included in taxable income of the shareholders receiving the dividends.

Affiliated groups may elect to file consolidated returns rather than separate returns. Members of controlled groups must share certain tax benefits. Corporations use Form 1120 in filing their annual income tax returns.
Entity Choice

Many issues must be addressed when forming a business. A major concern is the type of entity. The three major types are sole proprietorships, partnerships, and corporations. Each entity has certain tax and nontax advantages and disadvantages; therefore, a decision must be made regarding which entity is most beneficial. The initial choice of entity is very important. However, under certain circumstances, the entity structure can be changed at a later date. Following is a brief discussion of each entity.

SPECIFIC ENTITIES

Sole Proprietorships

A sole proprietorship is a form of business in which one person owns all the assets and is fully responsible for all the liabilities. While this entity is treated as a separate entity for accounting purposes, it is not a separate legal entity. As such, a separate tax return is not filed for a sole proprietorship. Instead, its results from operations are reported on Schedule C (Profit or Loss From Business (Sole Proprietorship)) of Form 1040 (U.S. Individual Income Tax Return). The net income or loss is included with the taxpayer’s other income, losses, and deductions for the year and is subject to a tax rate from 10 percent to 35 percent.

Partnerships

A partnership is a form of business in which two or more persons or entities own all the assets and are responsible for the liabilities. It is based on a voluntary contract between these parties. The partnership is formed with the intent that the owners (partners) will contribute assets and/or labor in return for a share of the profits. Most states have adopted the Uniform Partnership Act which governs partnership activities.

A partnership is similar to a sole proprietorship in that it is not a separate entity. However, for accounting and tax-reporting purposes, it is treated as a separate entity. Thus, a tax return, Form 1065 (U.S. Partnership Return of Income), is filed for the partnership. Although a tax return is filed, a partnership is not a taxpaying entity; rather, the income, expenses, gains, losses, credits, etc. pass through to its owners. Schedule K-1 (Partner’s Share of Income, Credits, Deductions, etc.) of Form 1065 contains an indication of each partner’s share of such items. The partner includes these items with the personal activities reported on Form 1040.

Corporations

A corporation is a legal entity created by the authority of state law. It is separate and distinct from its owners (shareholders). A corporation may be owned by one or more persons or entities. However, some states require at least two owners. For income tax purposes, there are two business types of corporations: regular corporations (C corporations) and electing corporations (S corporations). Both corporations are separate legal entities. The distinction between them is for income tax purposes only.

A C corporation is a separate taxpaying entity. It files Form 1120 (U.S. Corporation Income Tax Return). All its income and expenses are reported in this return and it pays a tax that ranges from 15 percent to 39 percent. The shareholders are not liable for a tax based on the corporation’s income. However, shareholders must include dividend distributions in their taxable income.

An S corporation is not a separate taxpaying entity. It files Form 1120S (U.S. Income Tax Return for an S Corporation), but in general does not pay an income tax. Like a partnership, the income, expenses, gains, losses, credits, etc. pass through to the shareholders. Schedule K-1 (Shareholders’ Share of Income, Credits, Deductions, etc.) contains each shareholder’s share of these items.
Limited Liability Companies

In 1977, Wyoming passed the first limited liability company (LLC) legislation. Florida passed LLC legislation in 1982. In 1988, the IRS issued Rev. Rul. 88-76, 1988-2 CB 360, holding that a Wyoming LLC would be treated as a partnership for federal income tax purposes. Since then, all 50 states and the District of Columbia have passed LLC legislation and now recognize LLCs. However, the legislation is not similar across all jurisdictions, and technical requirements vary. Regardless, the number of LLCs in the United States has grown quickly and continues to grow at a very fast pace.

The LLC has corporate and partnership characteristics. From a nontax perspective, LLCs provide flexibility to a firm’s structure and operations, and they also provide their owners (members) with limited liability with respect to firm debts and obligations. For tax purposes, the LLC is treated as a conduit entity whereby its income passes through to its owners, thereby eliminating the double taxation associated with corporations other than S corporations; however, it may elect to be taxed as a corporation. See ¶14,015 for a discussion.

Limited Liability Partnerships

A limited liability partnership (LLP) is similar to an LLC and is organized under each state’s statutes. These statutes generally apply to service organizations that are organized as partnerships and are most beneficial to large partnerships such as large public accounting firms. LLP status enables the firm to achieve limited liability benefits but be taxed as a partnership.

Comparative Advantages and Disadvantages

Each entity has certain tax and nontax attributes associated with it. Knowledge of these attributes enables taxpayers to select an entity which is most appropriate for them. Some of these attributes are briefly discussed below.

Limited Liability

Limited liability is one of the major advantages of a corporation. The shareholders’ personal assets are not subject to claims of the corporation’s creditors; only their investment in the corporation is subject to these claims. However, certain professional corporations do not have limited liability. Similarly, owners of small corporations usually have to guarantee the loans of their corporations which precludes limited liability. Partners and sole proprietors have unlimited liability unless the partners are limited partners in a limited partnership or unless the firm is organized as a limited liability partnership (LLP) or a limited liability company (LLC).

Employee Status

Sole proprietors and partners are not considered employees of their firms. This is a disadvantage because certain tax-exempt fringe benefits are not available to them and the firm cannot deduct the costs of these benefits. Similarly, their shares of self-employment income are subject to the self-employment tax of 15.3 percent on a maximum of $102,000, plus 2.90 percent on amounts over $102,000. However, one-half of this amount qualifies as a deduction for adjusted gross income in computing taxable income. Shareholders employed by their corporation have employee status, although there are restrictions on shareholders who also are employees of their S corporation. Code Sec. 1372(a).

Double Taxation

A disadvantage of C corporations is that they are subject to a form of double taxation. An income tax is imposed on the taxable income of the corporation, and no deduction is allowed for distributions to shareholders. When after-tax profits are distributed to shareholders as dividends, the shareholders generally must include the amounts in their taxable income. However, the tax rate applied to dividends received by shareholders is as follows: 5% for taxpayers in the 10% or 15% bracket and 15% for taxpayers in all other brackets. Partnerships, S corporations, and sole proprietorships are not subject to this because they are conduits. Their income passes through to the owners and is taxed at that level only.
Pass-Through Benefits
Corporate losses cannot pass through to shareholders. Also, dividend distributions generally are treated by shareholders as ordinary income, regardless of the type of income (tax-exempt, capital gains, etc.) that generated the earnings and profits from which the dividends came. Since sole proprietorships, partnerships, and S corporations are conduits, all income, gains, losses, credits, etc. pass through to their owners. These items retain their identity when they pass through. Thus, the firms’ net losses can be used to offset personal income. Also, tax-exempt income passes through as such and is not taxable to the sole proprietor or partner. Additionally, the owners can use their shares of capital losses to offset their personal capital gains. Conversely, their shares of capital gains could be offset by their personal capital losses (or carryovers). Regular corporations do not provide these benefits.

Capital Formation
Corporations are better able to raise funds via owner-financing because of the comparative ease to expand ownership. The issuance of stock does not change the entity. A proprietor is solely responsible for owner-financing. The issuance of ownership interest in return for funds terminates the sole proprietorship. A partnership is better able to owner-finance than is a sole proprietorship because it has more owners.

Fiscal Period
A regular corporation can elect a fiscal period different from that of its owners. A sole proprietorship must have the same fiscal period as its owner. A partnership must have the same fiscal period as its partners who have a majority interest. In general, an S corporation must use a calendar year as its tax year unless it can establish a business purpose for using another tax year.

DEFINITION OF A CORPORATION
If the corporate form of business is selected, the owners must be certain that their entity is treated as a corporation for federal income tax purposes. A corporation is a legal entity owing its existence to the laws of the state in which it is incorporated. The state laws define all legal relationships of the corporation. Prior to 1997, a legal corporation was not guaranteed corporate status for federal tax purposes unless it had a majority of corporate characteristics (centralized management, continuity of life, free transferability of interests, and limited liability). Similarly, noncorporate entities sometimes could and would be taxed as corporations if they had a majority of these characteristics. This created much uncertainty for many organizations.

Regulations to Code Sec. 7701 have simplified the entity classification issue. Under the “check-the-box” system, certain business entities (entities other than trusts or those subject to special rules) automatically will be treated as corporations for federal tax purposes. These entities are: firms incorporated under federal or state law, associations, joint-stock companies, or joint-stock associations (as organized under a state statute), insurance companies, banks, business entities wholly owned by a state or political subdivision of the state, business entities that are taxed as corporations under another Code section, and certain foreign entities. Eligible entities (entities other than trusts or those subject to special rules) that are not automatically treated as a corporation may elect (“check-the-box”) to be treated as a corporation for federal tax purposes.

If an entity has one owner, it may elect to be treated as a corporation or by default it will be treated as an entity not separate from its owner (sole proprietorship). If an entity has two or more owners, it can elect to be taxed as a corporation for federal tax purposes, otherwise it will be taxed as a partnership.

An eligible entity makes its election to change its default classification by filing Form 8832 (Entity Classification Election). The entity also indicates the effective date of the election. The effective date cannot be more than 75 days prior to the date Form 8832 is filed nor more than 12 months after it is filed. Also, a copy of Form 8832 must be attached to the entity’s tax return for the year of election. Finally, once the election is made, the election cannot generally be changed for five years.
EXAMPLE 14.1  Gary, Richard, and Tom formed GRT partnership on February 1, 2009. GRT is an eligible entity; thus, if it wants to be taxed as a corporation for federal tax purposes, it must file Form 8832 within 75 days.

Organization of and Transfers to a Corporation

¶14,101  USE OF CORPORATE FORM

If the corporate form isdesired, the owners must be certain that they meet all filing requirements of the state in which the company is organized. After completing this, the owners must decide what type of property to transfer to the corporation and how this property should be transferred. For example, should the owners transfer cash to purchase stock or make loans to the corporation? Similarly, should land or other assets be sold to the corporation, contributed in return for its stock, or leased to the corporation? The answers to these questions have significant tax implications.

In general, taxpayers who exchange property other than cash for other property recognize a gain or loss. The difference between the value of the property received and the adjusted basis of the property given up produces a realized gain or loss. Under Code Sec. 1001 this gain or loss is recognized by the taxpayer unless another section of the Internal Revenue Code provides for nonrecognition of the gain or loss.

There are several reasons why nonrecognition treatment is preferable with respect to corporate formation and transfers to corporations. The owners who receive stock in return for their property are not cashing in on their investment. There has been no change in their wherewithal to pay taxes, rather the stock represents a continuation of their investment in a different form. There is no substantive change in the owners' investments. Additionally, the government does not want to discourage corporate formation and subsequent transfers to corporations. Taxing such transfers when there has been no change in wherewithal to pay would act as a deterrent. Thus, under certain conditions Code Sec. 351 provides for nonrecognition of gain or loss upon transfer of property to a corporation in return for its stock.

¶14,105  GENERAL REQUIREMENTS

The rule under Code Sec. 351 is mandatory and provides that no gain or loss is recognized upon the transfer of property to a corporation solely in exchange for its stock if the taxpayer transferring the property (the transferor) is in control of the corporation immediately after the exchange. The basis rules provided in Code Secs. 358 and 362 assure that the nonrecognition is deferred and not permanent. These sections generally apply a carryover basis to the stock received by the transferor and to the property received by the transferee corporation. Code Sec. 1223 also enables both parties to tack on the holding period of the property transferred to the stock and the property, respectively, if they constitute capital assets or Section 1231 assets.

There are three major requirements of Code Sec. 351: (1) the transfer must consist of property, (2) the transfer must be solely in exchange for stock, and (3) the transferors must be in control immediately after the exchange. Each requirement is discussed separately.

Tax Blunder

Susan Jones is in the 35 percent tax bracket. She transfers property with an adjusted basis of $50,000 and a fair market value of $30,000 to X Co. in a transaction that qualifies under Code Sec. 351. Under Code Sec. 351, Jones will not recognize a loss on the transfer. Jones should not have transferred the property. She would have been better off selling the property to the corporation (assuming the related-party loss rules of Code Sec. 267 do not apply) and recognizing the $20,000 loss this year. Both the time value of money and her tax bracket favor such action.
14.111 TRANSFERS OF PROPERTY

Code Sec. 351 does not define property. However, it does indicate what is not property. Services, certain debt of the transferee corporation, and certain accrued interest on the transferee’s debt are not treated as property. Code Sec. 351(d). Other than these exceptions, the definition of property is very comprehensive and includes all types of property such as cash, accounts receivables, inventories, patents, installment obligations, equipment, and buildings.

**Example 14.2**
Jerome Smith transfers land to North Corporation in return for 90 percent of its stock. The adjusted basis of the land is $40,000. The fair market value of the stock is $90,000. Jerome has a realized gain of $50,000 ($90,000 – $40,000) and no recognized gain. Jay Jones performs accounting services for North Corporation in return for 10 percent of its stock (fair market value is $10,000). Jay has $10,000 of ordinary income. The receipt of the stock is treated as compensation for services rendered. Jay’s basis in the stock is its fair market value, $10,000.

14.115 TRANSFERS FOR STOCK

Code Sec. 351 requires that the transferor receive the corporation’s stock. The receipt of securities in exchange for property does not qualify as a Section 351 transfer. If the transferor receives stock and securities, (assuming other conditions are met) the exchange qualifies under Code Sec. 351, but the securities are treated as boot, regardless of the life of the securities. Also, receipt of anything else constitutes boot and may cause gain recognition. Common and preferred stock and voting and nonvoting stock are acceptable.

However, “nonqualified preferred stock” is considered boot. Nonqualified preferred stock is preferred stock that: (1) the holder has the right to require the issuer or a related party to redeem or purchase; (2) the issuer or a related party is required to redeem or purchase; (3) the issuer or a related party has the right to redeem or purchase, and, as of the issue, it is more likely than not that such right will be exercised; or (4) the dividend rate varies in whole or in part with reference to interest rates, commodity prices, or other similar indices. There are a few exceptions to this definition (and exceptions to these exceptions), such as the right cannot be exercised for 20 years or the right only may be exercised upon the death, disability, or mental incompetence of the holder. Finally, for Code Sec. 351 purposes, stock rights and stock warrants are not considered stock. Reg. §1.351-1(a)(1)(i) and (ii).

Stock that enables the shareholder to participate in corporate growth to a significant extent avoids being classified as preferred stock for Code Section 351 purposes, and therefore qualifies as stock for nonrecognition purposes. Such stock is not treated as participating in corporate growth unless there is a real and meaningful likelihood of the shareholder participating in the earnings and growth of the corporation. Code Sec. 351(g).

**Example 14.3**
Jay Smith transfers land to Hext Corporation in exchange for 100 percent of its stock and four 10-year bonds. The exchange qualifies under Code Sec. 351, but the receipt of the four bonds constitutes boot.

**Example 14.4**
Gina West contributes property to Franken Inc. in a transaction that qualifies as a Code Sec. 351 transfer. In return for the property, she received common stock worth $20,000 and nonqualified preferred stock worth $15,000. The nonqualified stock is considered boot; thus, Gina has received $15,000 boot in the exchange and may be required to recognize a gain. (See ¶14,135 for the treatment of boot.)
CONTROL OF THE CORPORATION

For purposes of Code Sec. 351, control is defined in Code Sec. 368(c). The transferors must be in control immediately after the transfer, regardless of whether they were in control prior to the transfer. Further, the transferors must possess at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. With respect to the nonvoting stock, the IRS has indicated that control requires the ownership of at least 80 percent of the total number of shares of each class of outstanding nonvoting stock. Rev. Rul. 59-259, 1959-2 CB 115.

Control can apply to one person or a group of people. If more than one person transfers property, the aggregate ownership of the group is used to determine if control exists immediately after the exchange. “Persons” is defined as including individuals, trusts, estates, partnerships, associations, companies, or corporations. Reg. §1.351-1(a)(1). This Regulation also indicates that the term “immediately after the exchange” does not require simultaneous exchanges by two or more persons as long as the rights of each party have been previously defined. The execution of this prearranged plan also must proceed in an expeditious and orderly manner.

EXAMPLE 14.5
Roger Caldwell and Charles Mann transfer property to Bond Corporation in return for 60 percent and 40 percent of its stock, respectively. Although neither has control individually, together they own 100 percent of the stock and meet the control requirements.

The stock received by the transferors does not have to be in proportion to the value of the property transferred. However, if the stocks received are disproportionate to the value of properties transferred, the transaction will be closely scrutinized to determine the true nature of the transaction. If the disproportionality is suspect, the transaction may be treated as if the stock had first been received in proportion and then been used to make gifts, to pay compensation, or to satisfy liabilities among the transferors. Reg. §1.351-1(b)(1).

EXAMPLE 14.6
Mark Smith and Ralph Jones transfer property worth $150,000 and $50,000, respectively, to Best Corporation in return for 100 percent of its stock. Mark and Ralph each receive 100 shares of stock. The exchanges qualify under Code Sec. 351 because together Mark and Ralph are in control immediately after the exchange. However, the IRS may tax the transaction as if Mark had received 150 shares and then transferred 50 shares to Ralph. This subsequent transfer to Ralph might be treated as a compensation payment to Ralph, in which case Ralph would have ordinary income of $50,000. Mark would have income (loss) if the value of the stock ($50,000) is different from Mark’s adjusted basis. Also, Ralph’s basis in the 50 shares would be $50,000. Recasting the transaction as, in part, a gift or loan repayment also would impact income and/or basis computations.

EXAMPLE 14.7
Bill Roe transfers property to a new corporation for 70 percent of the stock. Joe Brown receives 30 percent of the stock in the corporation for his work in organizing the corporation. Joe must recognize income upon receipt of his stock and the stock does not qualify for the 80 percent control test. Bill’s transfer is a taxable event since he does not have at least 80 percent control after the transfer.
EXAMPLE 14.8  Sebastian Corporation has 100 shares of stock outstanding. Jan Kruger contributes an asset with a basis of $10,000 and a fair market value of $19,000 along with services worth $1,000 to the corporation for 400 shares of the corporation’s stock. The transfer would qualify under Code Sec. 351 since, as the transferor, she has 80 percent of the stock in the corporation. Jan would have to recognize $1,000 of income from the services but would not recognize the $9,000 gain on the asset. If the property were worth only $1,000 and the services $19,000, the transfer would not qualify under Code Sec. 351.

A loss of control shortly after the transfer could cause the transaction to fail to qualify under Code Sec. 351. If the loss of control was due to the disposition of stock according to a prearranged plan, the transferors will not, in most cases, have control immediately after the exchange.

EXAMPLE 14.9  Bill Bradley and Joe Crawford each receive 50 percent of the stock of Block Corporation upon incorporation. Unknown to Bill, Joe has committed himself to sell more than 40 percent of his stock (bringing Joe’s and Bill’s control under 80 percent) to Max even before the transfer. Section 351 treatment will be denied to both parties.

Planning Pointer  Once the stock is received, the transferor may, of course, do whatever is desired with it, after a reasonable time. A highly recommended device is to set the stage for future capital gains by giving some stock, say 10 or 20 percent, to a spouse and/or children. After more than 10 years, the corporation may purchase back this stock (a redemption), resulting in capital gains to the family members upon the termination of their interest. Code Sec. 302(b)(3). Alternatively, property may be gifted so as to qualify donees as transferors.

14,135 RECEIPT OF BOOT  If all the requirements of Code Sec. 351 are met, the transferors recognize no gain or loss. Also, their basis in stock received is equal to the adjusted basis of property surrendered.

EXAMPLE 14.10  Larry Lewis and Lance Thompson decide to form Sands Corporation. Larry transfers $10,000 in cash and property with an adjusted basis of $25,000 and a fair market value of $90,000 in return for 100 shares of stock. Lance transfers $20,000 in cash and property with an adjusted basis of $110,000 and a fair market value of $80,000. Lance also receives 100 shares of stock. Since they own 100 percent of the stock, they are in control and the transaction qualifies under Code Sec. 351. Larry has a realized gain of $65,000 ($100,000 – $35,000) and no recognized gain. His basis in the 100 shares of Sands Corporation is $35,000 ($10,000 + $25,000). Lance has a realized loss of $30,000 ($100,000 – $130,000), of which none is recognized. His basis in the 100 shares of Sands Corporation is $130,000 ($20,000 + $110,000).

Property other than stock is considered boot. (Although, as noted earlier, nonqualified preferred stock is considered to be boot.) The receipt of limited amounts of boot does not disqualify a transfer from Code Sec. 351. However, gain must be recognized to the extent of the lesser of the realized gain or the fair market value of the boot received. Code Sec. 351(b). The character of the gain depends on the property transferred. Losses are never recognized under Code Sec. 351.
**Example 14.11** Max Murphy and Jake Jones form Small Corporation. Max transfers land with an adjusted basis of $10,000 for stock worth $15,000 and $5,000 cash. Jake transfers equipment with an adjusted basis of $25,000 for stock worth $10,000 and $7,000 cash. Max has a realized gain of $10,000, but only $5,000 is recognized. Jones has a realized loss of $8,000 and none of it is recognized.

**Example 14.12** Same as Example 14.11, except that Max’s land has an adjusted basis of $16,000. Max has a realized gain of $4,000 which is fully recognized. Jake has an unrecognized $8,000 loss because Code Sec. 351 still applies to the exchange.

If more than one asset is transferred, the boot must be allocated among the assets. The IRS endorses the view that the boot is to be allocated in accordance with fair market values. Reg. §1.358-2(b). This is necessary because gain or loss must be computed on each asset. Rev. Rul. 68-55, 1968-1 CB 140. Since no losses are recognized in a Section 351 transaction, and there are assets transferred with realized losses, less gain will be recognized on the appreciated assets because boot is allocated to loss assets as well. In addition to affecting the amount of gain recognized, the allocation also impacts the character of gain (e.g., ordinary income, capital gain, Section 1231 gain) because the character depends on the asset transferred.

**Example 14.13** George Anderson transfers land and inventory to Candle Corporation in return for 100 percent of its stock. The land has a fair market value of $120,000 and an adjusted basis of $40,000. The inventory has a fair market value of $80,000 and an adjusted basis of $90,000. George receives stock worth $150,000 and $50,000 in cash. The effects of this transfer are illustrated below.

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Inventory</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value</td>
<td>$120,000</td>
<td>$80,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>40,000</td>
<td>90,000</td>
<td>130,000</td>
</tr>
<tr>
<td>Realized gain (loss)</td>
<td>$80,000</td>
<td>$(10,000)</td>
<td>$70,000</td>
</tr>
<tr>
<td>Boot allocation</td>
<td>$30,000</td>
<td>$20,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>(60%)</td>
<td></td>
<td>(40%)</td>
<td></td>
</tr>
<tr>
<td>Recognized gain (loss)</td>
<td>$30,000</td>
<td>$ None</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Thus, if the land is a capital asset to George, he would recognize a $30,000 capital gain.

14,141 **TRANSFERS OF LIABILITIES**

There are many instances when property transferred to a corporation is subject to a liability. The corporation usually assumes the liability as part of the transaction. Because transfers to controlled corporations usually involve transfers of liabilities, especially when existing businesses such as sole proprietorships or partnerships incorporate, taxing the transfer could be a deterrent to corporate formation. Code Sec. 357 provides relief in this situation by not treating the transfer of liabilities as boot if the transaction qualifies under Code Sec. 351. The assumption of a liability by the transferee corporation will not be treated as boot for gain recognition purposes and will not disqualify Code Sec. 351 treatment. Code Sec. 357(a). (As discussed later, the assumption of the liability will affect basis considerations).

**Example 14.14** Sally Flowers transfers a building with an adjusted basis of $100,000 and a fair market value of $140,000 to Inter Corporation in return for all of its stock worth $60,000. The building is subject to a mortgage of $80,000 which Inter Corporation assumes. The transaction qualifies as a Code Sec. 351 transfer. Sally has a realized gain of $40,000 ($60,000 + $80,000 – $100,000). None of the gain is recognized.
There are two exceptions to the general rule under Code Sec. 357(a). These exceptions result if the transfer of liabilities had a tax avoidance purpose or if the sum of liabilities assumed exceeds the adjusted basis of all properties transferred by the transferor.

**Tax Avoidance or No Business Purpose**

All liabilities transferred to the corporation will be treated as boot if the principal purpose of the liability assumption was to avoid federal income tax or if there was no bona fide business purpose for the transfer. Code Sec. 357(b). The taxpayer must overcome these appearances by the clear preponderance of the evidence.

Tax avoidance generally is not a problem. The lack of a bona fide business purpose also is not a problem if the liabilities were incurred in the normal course of business. The time between when the funds are borrowed and when the transfer to the corporation occurs is an important factor.

If funds were borrowed just prior to the transfer, it will be difficult to overcome the lack of a business purpose, especially if the proceeds were used for personal benefit. In such instances, the transferor should be prepared to provide clear evidence to verify the business purpose for the loan and its transfer.

**EXAMPLE 14.15**

George Small transfers land with an adjusted basis of $40,000 and a fair market value of $95,000 to Giant Corporation in return for all of its stock. The stock is worth $65,000. Two days prior to the transfer, George borrowed $30,000 against the land. The $30,000 liability was assumed by Giant Corporation as part of the exchange. George has a realized gain of $55,000 (($65,000 + $30,000) – $40,000). George has a recognized gain of $30,000 because it appears that there was no business purpose for the loan or its transfer.

**Liability in Excess of Basis**

If the sum of the liabilities assumed exceeds the total adjusted basis of all properties transferred, the transferor must recognize gain on the exchange to the extent of such excess. Code Sec. 357(c). Without the recognition of gain, the stock received by the transferor would have a negative basis. With the application of this provision and related basis rules, the transferor’s basis in the stock is zero.

**EXAMPLE 14.16**

Sara Topper transfers a building with an adjusted basis of $30,000 and a fair market value of $100,000 to Sunny Corporation in return for 100 percent of its stock. The building is subject to a $50,000 mortgage which Sunny Corporation assumes. Sara must recognize a gain of $20,000 equal to the excess of the mortgage over the adjusted basis of the building.

If there is more than one transferor, gains should be recognized on a person-by-person basis.

**EXAMPLE 14.17**

Fred Smart transfers property with an adjusted basis of $45,000, a fair market value of $80,000, and a mortgage of $59,000 to a new corporation. Ginger Snow simultaneously invests $14,000 in cash. Fred must recognize a gain of $14,000 because the liability exceeds his basis in the asset. He is not allowed to count Ginger’s investment in the total basis contribution.

**Planning Pointer**

An individual wishes to incorporate by transferring an asset to the corporation for all of the corporation’s stock. The asset has a fair market value of $200,000 and a basis of $50,000. The asset has a liability attached in the amount of $80,000. This transfer would result in a $30,000 recognition of income because the liability exceeds the basis of the asset. The individual would be well advised to include other assets in the transfer with a net basis of at least $30,000 to avoid any income recognition.
If the transferor transfers more than one asset and fewer than all of them are encumbered, but liabilities exceed aggregate basis, gain is recognized on all assets. The recognized gain is to be allocated among the assets in accordance with fair market values.

**Example 14.18**

Mary Meyers transfers inventory worth $20,000 with an adjusted basis of $10,000 and a building worth $100,000 with an adjusted basis of $50,000 and a mortgage of $90,000 in return for 100 percent of Sage Corporation’s stock. Sage Corporation also assumes the mortgage. Mary’s recognized gain is $30,000 ($90,000 – ($50,000 + $10,000)). $5,000 is recognized on the inventory ($30,000 × 20/120) and $25,000 is recognized on the building ($30,000 × 100/120). Without the transfer of inventory, Mary would have recognized a $40,000 gain on the building ($90,000 – $50,000).

Code Sec. 357(c) presents potential problems for taxpayers who incorporate their cash-basis businesses. Usually, these firms have a large amount of unrealized accounts receivables (zero basis). They also have unrealized accounts payable, which are treated as liabilities, and could create a liability in excess of basis problem. However, liabilities that would give rise to a deduction when paid (i.e., accounts payable of a cash-basis taxpayer) and amounts payable under Code Sec. 736 (i.e., payments to a retiring partner or to liquidate a deceased partner’s interest) are excluded in determining the amount of liabilities assumed by the corporation. Code Sec. 357(c)(3).

**Example 14.19**

Matilda Worth incorporates her sole proprietorship operated on the cash method of accounting. She transfers equipment with an adjusted basis of $10,000 and zero basis accounts receivable and accounts payable. The accounts payable have an outstanding balance of $17,000 but no basis because of the cash method of accounting. Without the relief provision, an automatic gain of $7,000 would result (liabilities in excess of basis). Under Code Sec. 357(c), Matilda will recognize no gain. The corporation succeeds to her zero basis in the accounts receivables and accounts payable. Upon payment, the corporation will deduct the accounts payable as a business expense.

Transfer of zero basis receivables will result in double taxation of the receivables. A tax will be imposed when the corporation collects the receivables and there will be a second tax imposed on the shareholders when dividends are paid by the corporation. It would be better not to transfer the zero base receivables to the corporation. The shareholder will then report the income upon collection, and the receivables are taxed only once.

**Recourse vs. Nonrecourse Debt**

Code Sec. 357(d) addresses recourse and nonrecourse liabilities. Recourse liabilities are considered to be assumed if the transferee-corporation has agreed (and is expected) to satisfy the obligation, regardless of whether the transferor-shareholder has been relieved of such liability. In general, nonrecourse liabilities also are treated as having been assumed by the corporation for property subject to the liability. However, if the nonrecourse liability is on multiple assets and some of those assets were not transferred to the corporation then the amount of liability considered assumed is reduced by the amount that the shareholder and corporation agree will be satisfied by the shareholder. This reduction is limited to the fair market value of the assets not transferred.
**Example 14.20** Jessica owns four assets (A, B, C and D). Each asset’s adjusted basis and fair market value is as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$300,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>B</td>
<td>400,000</td>
<td>700,000</td>
</tr>
<tr>
<td>C</td>
<td>600,000</td>
<td>900,000</td>
</tr>
<tr>
<td>D</td>
<td>200,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Total</td>
<td>$1,500,000</td>
<td>$2,400,000</td>
</tr>
</tbody>
</table>

The assets are encumbered with a $1,000,000 nonrecourse debt. Jessica transferred assets A, B, and C to Mumper Corporation in a transaction that qualified under Code Sec. 351. Jessica and Mumper agree that she will satisfy $150,000 of the nonrecourse debt; as such, Mumper is treated as having assumed $850,000 of the nonrecourse debt. The most that Mumper will be considered as assuming is $700,000, regardless of what Jessica and it agree to because the amount assumed cannot be reduced by more than asset D’s fair market value.

### Basis Determination

#### Shareholder’s Basis

Code Sec. 358 provides that the shareholder’s basis in stock received in a Section 351 transfer is equal to the adjusted basis of property exchanged, increased by the amount of gain recognized on the exchange, and decreased by the fair market value of boot received. Code Sec. 358. The basis of the boot received is its fair market value. Also, the assumption of a liability is considered boot for basis purposes even though it was not for gain purposes under Code Sec. 357. If more than one class of stock is received, the property basis must be allocated to the classes of stock in proportion to their fair market value.

**Example 14.21** Bob Ripon transfers land with an adjusted basis of $5,000 and a fair market value of $14,000 to Wendy Corporation in return for all its stock. Bob has a realized gain of $9,000, but no gain is recognized. Bob’s basis in the stock is $5,000.

**Example 14.22** Same as Example 14.21, except that Bob also receives a $1,000 short-term note (boot). Bob has a realized gain of $9,000 and a recognized gain of $1,000 (the lesser of the realized gain or the fair market value of the boot received). Bob’s basis in the stock is $5,000 ($5,000 + $1,000 – $1,000). Bob’s basis in the short-term note is $1,000, its fair market value.

**Example 14.23** Jane Seaman transfers land with an adjusted basis of $7,000 and a fair market value of $5,000 to Wall Corporation. Jane receives $800 in cash and all of Wall Corporation’s stock. Jane has a realized loss of $2,000, and none of the loss is recognized. Jane’s basis in the stock is $6,200 ($7,000 – $800).

**Example 14.24** Harry Bold transfers land with an adjusted basis of $40,000 and a fair market value of $50,000 to Handy Corporation in return for all its stock and $12,000 in cash. Harry has a realized gain of $10,000. Even though he received $12,000 in cash, Harry’s recognized gain is limited to the realized gain; thus, he has a recognized gain of $10,000. Harry’s basis in the stock is $38,000 ($40,000 + $10,000 – $12,000).
EXAMPLE 14.25  Hal Lamb transfers property with a fair market value of $90,000 and an adjusted basis of $50,000 to X Corporation for all its stock. The land is subject to a $30,000 mortgage. Hal has a realized gain of $40,000 but no recognized gain. His basis in the stock is $20,000 ($50,000 − $30,000).

EXAMPLE 14.26  Assume the same facts as Example 14.25, except that the mortgage is $70,000. Hal’s realized gain is $40,000 and his recognized gain is $20,000 (liability in excess of basis). Hal’s basis in the stock is zero ($50,000 + $20,000 − $70,000).

EXAMPLE 14.27  Susan Anders transferred assets with a fair market value of $100,000 and an adjusted basis of $60,000 to a corporation in return for 100 shares of its Class A stock (100 percent) and 100 shares of its Class B stock (100 percent). The fair market value of the Class A stock was $80,000. The fair market value of the Class B stock was $20,000. Susan had a realized gain of $40,000 (($80,000 + $20,000) − $60,000) but no recognized gain. Her basis in both classes of stock was $60,000. This was allocated to the classes in accordance with their relative fair market values. Thus,

\[
\text{Basis of Class A stock} = \frac{\$60,000 \times \$80,000}{\$80,000 + \$20,000} = \$48,000
\]

\[
\text{Basis of Class B stock} = \frac{\$60,000 \times \$20,000}{\$80,000 + \$20,000} = \$12,000
\]

EXAMPLE 14.28  Assume the same facts as in Example 14.27, except that Susan received five 10-year bonds instead of Class B stock. Susan’s realized gain still is $40,000. However, her recognized gain is $20,000, the lesser of the $40,000 realized gain or the fair market value of boot received ($20,000 bonds). Her basis in the bonds is $20,000 (fair market value) and her basis in the stock is $60,000 ($60,000 + $20,000 − $20,000).

**Stockholder’s Holding Period**

The shareholder’s holding period in stock received in a Section 351 transfer includes the holding period of property transferred if the assets were capital assets or Section 1231 assets (recapture potential is irrelevant). Code Sec. 1223(1). If both ordinary income property and capital or Section 1231 assets are transferred, the shareholder winds up with two holding periods in the stock since the holding period of stock issued for ordinary income property begins upon receipt. Tacking is permitted even if realized gains are recognized in full or in part because of the receipt of boot. The holding period for boot received begins on the date of the transaction.

EXAMPLE 14.29  Kerry Brooks transfers a capital asset to a corporation under Code Sec. 351. Kerry held the capital asset long term before the transfer. The stock received from the transfer is considered held long term regardless of the length of time held before any sale of the stock. The holding period of the capital asset tacks on to the holding period of the stock.

**Corporation’s Basis**

The corporation’s basis in property received is equal to the transferor’s adjusted basis increased by any gain recognized by the transferor. Code Sec. 362. Liabilities assumed by a corporation do not affect the basis of the assets received from shareholders in Section 351 transfers. If the
liability exceeds the basis of the asset transferred, gain equal to the excess liability will be recognized by the transferor and cause the property’s basis to increase.

**Example 14.30**
Peter Rhone transfers property with an adjusted basis of $3,000 and a fair market value of $5,000 to Pest Corporation in a Section 351 transfer. Peter’s realized gain is $2,000, of which none is recognized. His basis in the stock is $3,000. Pest Corporation’s basis in the property is $3,000.

**Example 14.31**
Assume the same facts as Example 14.30, except that the property is subject to a $1,000 liability which Pest Corporation assumes. Peter has a realized gain of $2,000. None of the gain is recognized. His basis in the stock is $2,000 ($3,000 – $1,000). Pest Corporation’s basis in the property is $3,000.

**Example 14.32**
Assume the same facts as Example 14.31, except that the property is subject to a liability of $3,500. Peter has a realized gain of $2,000 and a recognized gain of $500 (liability in excess of basis). Peter’s basis in the stock is zero ($3,000 + $500 – $3,500). Pest Corporation’s basis in the property is $3,500 ($3,000 + $500).

**Transfers of Property with Built-In Losses**
Sometimes property whose adjusted basis exceeds its fair market value is transferred to a corporation (a built-in loss at the time of transfer). The normal basis rules would give the corporation a basis in such property that is greater than its fair market value, effectively creating a built-in loss for the corporation. Code Sec 362(e) prohibits this by requiring the corporation to reduce its basis in such property. If the corporation’s aggregate adjusted basis of property received exceeds the fair market value of such property then the corporation’s basis in such property is limited to the property’s fair market value. If more than one asset is transferred in the transaction then the corporation’s basis in each asset is reduced in proportion to each property’s built-in loss. However, the corporation does not have to make this basis reduction if both it and the transferor-shareholder elect to reduce the shareholder’s basis in the corporation’s stock (to the fair market value of the property transferred).

**Example 14.33**
Jacob transfers a machine with an adjusted basis of $150,000 and a fair market value of $100,000 to Jules Corporation in return for its stock. The transfer qualified under Code Sec. 351. Under the general basis rules of Code Sec. 362, Jules Corporation’s basis in the machine would be $150,000 (the shareholder’s adjusted basis at the time of transfer); however, since the property’s adjusted basis exceeds its fair market value, Jules’s basis is limited to $100,000 (the property’s fair market value). Alternatively, Jacob may take a basis in his Jules Corporation stock of $100,000 (instead of $150,000) and Jules Corporation will take a $150,000 basis in the machine if both Jules and he elect this treatment.
Kristin transferred three machines (A, B and C) to Shull Corporation in a transfer that qualified under Code Sec. 351. Each asset’s adjusted basis and fair market value is as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
<th>Built-In Gain (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$200,000</td>
<td>$150,000</td>
<td>($50,000)</td>
</tr>
<tr>
<td>B</td>
<td>250,000</td>
<td>180,000</td>
<td>(70,000)</td>
</tr>
<tr>
<td>C</td>
<td>350,000</td>
<td>410,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Total</td>
<td>$800,000</td>
<td>$740,000</td>
<td>($60,000)</td>
</tr>
</tbody>
</table>

The $60,000 built-in loss is distributed to assets A and B according to their relative built-in losses, so $25,000 ($60,000 x ($50,000/$120,000)) is allocated to A and $35,000 ($60,000 x ($70,000/$120,000)) is allocated to B. Accordingly, Shull Corporation’s basis in each asset is as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$200,000 - $25,000 = $175,000</td>
</tr>
<tr>
<td>B</td>
<td>$250,000 - $35,000 = 215,000</td>
</tr>
<tr>
<td>C</td>
<td>$350,000 - 0 = $350,000</td>
</tr>
<tr>
<td>Total</td>
<td>$740,000</td>
</tr>
</tbody>
</table>

Again, if Kristin and Shull Corporation elect, Shull Corporation will take a basis in each asset equal to its adjusted basis at the time of transfer ($200,000, $250,000 and $350,000 in A, B and C, respectively, if Kristin takes a $740,000 basis in the Shull Corporation’s stock).

**Corporation’s Holding Period**

The corporation tacks on the shareholder’s holding period in assets transferred if the asset is a capital asset or a Section 1231 asset in the corporation’s hands. The transferor may transfer ordinary income property to a corporation, in whose hands it becomes a capital asset or vice versa.

**RECAPTURE RULES**

**Depreciation Recapture**

In a Section 351 transfer in which no boot is received and, therefore, no gain is recognized, there is no recapture of depreciation. Code Secs. 1245(b)(3) and 1250(d)(3). The recapture potential shifts to the corporation. If gain is recognized on the exchange because boot is received, it is characterized as ordinary income to the extent of depreciation recapture. If only part of the depreciation is recaptured, the remaining portion is shifted to the corporation.

**Example 14.35**

Larry Bloom purchased a truck for $14,000 and took $8,000 in depreciation prior to transferring it to Vail Corporation in a Section 351 exchange. The truck had a fair market value of $10,000 at the time of the exchange. Larry has a realized gain of $4,000 but no recognized gain ($10,000 – $6,000). His basis in the stock is $6,000. Vail Corporation’s basis in the truck is $6,000. It also inherits the $8,000 recapture potential.

**Example 14.36**

Assume the same facts as Example 14.35, except that in addition to receiving stock, Larry also receives $2,000 in cash. Larry has a realized gain of $6,000 and a recognized gain of $2,000 as ordinary income. His basis in the stock is $6,000 ($6,000 + $2,000 – $2,000). Vail Corporation’s basis in the truck is $8,000 ($6,000 + $2,000). Vail Corporation also inherits the remaining depreciation recapture potential of $6,000.
EXAMPLE 14.37

Assume the same facts as in Example 14.35 except that the fair market value of the truck is $12,000, and Larry received stock worth $5,000 and $7,000 in cash. Larry’s realized gain is $6,000 ($12,000 – $6,000). Although he received $7,000 boot, his recognized gain is limited to the realized gain. Thus, Larry’s recognized gain is $6,000 of ordinary income. His basis in the stock is $5,000 ($6,000 – $7,000 + $6,000). Vail Corporation’s basis in the truck is $12,000 ($6,000 + $6,000), and it inherits $2,000 recapture potential.

General Business Credit Recapture

A premature disposition of business property in which the general business tax credit has been taken (i.e., Section 38 property) generally triggers recapture of the portion not earned. (See ¶9045 for a discussion of the credit.) Unlike depreciation recapture, the recapture of the general business tax credit occurs regardless of whether any gain was realized or recognized on the transaction. However, no recapture is triggered if the taxpayer changes only “the form of conducting the trade or business as Section 38 property and the taxpayer retains a substantial interest in such trade or business.” Code Sec. 50(a)(1).

What constitutes a substantial interest is not defined in the Internal Revenue Code and has been a source of contention and controversy. For example, exchanging a 50 percent interest in a partnership for a 35 percent interest in a corporation probably would qualify for exemption from recapture. However, in one case the Tax Court has held that exchanging a 48 percent partnership interest for a 7.22 percent stock interest did not qualify. J. Soares, 50 TC 909, CCH Dec. 29,138 (1968).

If no general business tax credit recapture is triggered on the transfer, the recapture potential stays with the shareholder. Future recapture is triggered when the corporation disposes of the property or when the shareholder disposes of a substantial interest in the business.

EXAMPLE 14.38

In 2008, Bill and Joe incorporated their equally-owned partnership and each received 50 percent of the stock in the new corporation, Fecowycz Incorporated. On January 2, 2006, the partnership had purchased energy property for $50,000 (five-year property) and had claimed a general business credit of $5,000. No general business credit was recaptured upon incorporation.

On January 3, 2009, Fecowycz Incorporated sold the energy property. The sale triggers a $2,000 recapture of the general business credit. Both Bill and Joe must recapture $1,000 of the credit in 2009.

Tax Blunder

Susan transferred equipment to ABC Co. in a Code Sec. 351 transfer. Susan purchased the equipment for $60,000. The adjusted basis of the equipment was $40,000 and its fair market value was $50,000. Susan had a choice; she could receive 100 shares of ABC Co. or 90 shares of ABC Co. and $5,000. She chose the stock plus cash option. Susan has a realized gain of $10,000 ($50,000-$40,000) and a recognized gain of $5,000 (boot received). Additionally, the recognized gain is all Code Sec 1245 gain (ordinary income) because of the depreciation recapture rules. Susan should have chosen the stock only option. This option would have shifted the depreciation recapture potential to ABC Co.
SECTION 351 TRANSFER OR TAXABLE EXCHANGE

Code Sec. 351 is a mandatory provision. Gain or loss is not recognized on a transfer which qualifies under Code Sec. 351. The corporation’s basis in the property is a carryover basis equal to the shareholder’s adjusted basis in the property. Also, the shareholder’s basis in the stock received is equal to the adjusted basis of property transferred.

There may be times when taxpayers want recognition on the exchange. If taxpayers have property whose fair market value is less than the adjusted basis, they may want to recognize this loss. Code Sec. 351 must be avoided to accomplish this. An arm’s-length sale or an exchange for short-term debt would be a transaction outside the purview of Code Sec. 351. The loss will not be recognized if the shareholder and corporation are related parties as defined in Code Sec. 267 (i.e., if the shareholder owns directly or indirectly more than 50 percent in value of the corporation’s outstanding stock).

The shareholder might want to recognize gain on the transaction because this provides the corporation with a stepped-up basis (fair market value), especially if the shareholder is in a lower tax bracket than the corporation. However, under Code Sec. 1239 capital gain treatment will be denied the shareholder if the property is depreciable property in the hands of the corporation and the shareholder and corporation are related parties. Thus, the ordinary income treatment under Code Sec. 1239 will apply if the shareholder directly or indirectly owns more than 50 percent of the value of the corporation’s stock.

Example 14.39
Jim Jones, who owns 70 percent of Best Corporation, sells Section 1231 property to Best Corporation for $100,000 (the property’s fair market value). The adjusted basis of the property is $60,000. Jim has a realized and recognized gain of $40,000 ($100,000 – $60,000). The gain will be a Section 1231 gain. However, if the property is depreciable property for the corporation (e.g., a building), the $40,000 gain is ordinary income.

Shareholders must determine whether a Section 351 transfer is most advantageous for them. The transaction must be structured properly so that either it falls under Code Sec. 351 or is beyond its control, depending upon which result is desired.

Keystone Problem
The sole proprietor of a printing shop is in the fortunate position of having greatly appreciated assets (the land and building where the business is located) as well as an exceedingly competent business manager. The manager is in fact so good that another position elsewhere has been offered. The owner persuades the manager to stay by giving 25 percent of the business. This is accomplished by incorporating the business and signing over 25 percent of the common stock to the manager. No tax advice is sought and the tax consequences are rather severe:

1. Code Sec. 351 has not been met, so the owner has “sold” the assets to the corporation. The gain will equal the value of the full 100 percent stock interest less the basis in the assets on a item-by-item basis.

2. The manager has taxable compensation in the amount of the value of the 25 percent stock interest since property received for services is taxable under Code Sec. 83. (However, an offsetting deduction is available.)

The two main requirements for incorporating tax free are that the transferors of property must be in at least 80 percent control after the transfer and that they received only stock for their property. In accordance with these two requirements, there are several alternative ways to handle this transaction so as to limit taxes or avoid them completely. Explain.
Shareholders and corporations who are parties to a Section 351 exchange must attach statements to their income tax returns for the period in which the exchange occurred. Reg. §1.351-3(a) and (b). The shareholder’s statement must include the following:
1. A description of the property transferred and its adjusted basis
2. A description of the type and number of shares of stock received, including its fair market value
3. A description of the securities received, including principal, terms, and fair market value
4. An indication of the amount of money received
5. A description of any other property received (i.e., boot), including its fair market value
6. A description of the liabilities assumed by the corporation, including when and why they were created and the business reason for the assumption

The statement of the controlled corporation must include:
1. A description of all property received from transferors
2. An indication of the transferor’s adjusted basis in the property
3. An indication of the number and type of stock issued, including its fair market value
4. A description of the stock issued and outstanding prior to and immediately after the exchange
5. A description of the securities issued, including fair market value
6. A description of all securities outstanding prior to and immediately after the exchange
7. An indication of the amount of money distributed to the transferors
8. A description of any other property distributed, including its fair market value
9. A description of liabilities assumed by the corporation, including when and why they were created and the business reason for the assumption

Corporate Capital Structure
A corporation’s capital structure consists of the stock and debt it issues. Capital is raised from shareholders by issuing stock. Different classes of stock (i.e., common, preferred, voting, nonvoting) can be issued. Capital is raised from nonshareholders by issuing debt, in which case a formal debtor-creditor relationship is established. Additionally, shareholders and/or nonshareholders may contribute assets to the corporation not in return for stock or debt. These contributions to capital are motivated for different reasons. For example, a city might donate land to a corporation so that it may build a factory. The city will benefit from increased employment opportunities and tax revenues. Each method of raising capital can have significant consequences to the transferor and the corporation.

Shareholder Contributions
A corporation does not recognize a gain or loss on the receipt of money or other property in exchange for its stock. Code Sec. 1032. Also, it does not recognize income when it receives money or other property as a contribution to capital (i.e., the corporation does not issue stock, debt, money, or property in return for the contributed property). Code Sec. 118. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the corporation to limit production.

The corporation’s basis in the property depends upon the nature of the transaction. If stock is issued in return for the property and Code Sec. 351 applies to the transaction, the corporation’s basis equals the transferor’s adjusted basis increased by any gain recognized by said transferor. If the transaction is a taxable exchange (i.e., the corporation purchases land by issuing its stock), the corporation’s basis is the fair market value of the stock.
The shareholder’s basis in the stock is equal to the adjusted basis of the property transferred, increased by any recognized gain and decreased by the fair market value of boot received if it is a Section 351 transfer. The shareholder’s basis in stock received in a taxable exchange is equal to the fair market value of the property transferred.

The corporation’s basis of property received from a shareholder as a contribution to capital equals the shareholder’s adjusted basis increased by any gain recognized by the shareholder. Code Sec. 362. Since the shareholder receives no stock, the shareholder’s basis in the stock owned prior to the contribution is increased by the amount of cash and adjusted basis of the property transferred plus any gain recognized by the shareholder on the transfer. Usually shareholders do not recognize a gain or loss when they transfer property as a contribution to capital.

Similarly, amounts received from voluntary pro rata payments from shareholders are not income to the corporation even though no stock is issued. The payments represent an addition to the price paid for the shares of stock held by the shareholders. Reg. §1.118-1.

**Example 14.40**

Cindy Blair, a sole shareholder in Alpha Inc., contributed land to be used by the corporation as a parking lot. She receives no additional stock in the corporation. The land has a fair market value of $10,000 and an adjusted basis of $8,000. Cindy has a $2,000 realized gain but no recognized gain. Her basis in Alpha stock is increased by $8,000. Alpha Inc. recognizes no gain or loss. The corporation’s basis in the land is $8,000.

**Example 14.41**

Dancing Shoes Corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders. The payments are credited to a special paid-in capital account and no additional shares are issued. The amounts received from the shareholders do not constitute income to the corporation. The payments are in the nature of assessments upon the shareholders and represent an additional price paid for the shares of stock held by the individual shareholders.

Special rules apply to the forgiveness of corporate debts by shareholders. As a general rule, when a debt is cancelled, the debtor must recognize income. However, if a shareholder in a corporation which is indebted to the shareholder gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

**Example 14.42**

Mary Sullivan owns stock in Dogette Corporation and also lent the corporation $10,000. Mary gratuitously cancels the $10,000 debt. The forgiveness of the debt is a nontaxable contribution to capital. The corporation recognizes no income and Mary increases her stock basis by $10,000.

**Nonshareholder Contributions**

Contributions by nonshareholders also are excluded from gross income of the corporation as long as the transfer is not for goods and services. Nonshareholder contributions are usually prompted by expectation of some indirect benefit. Cities often provide corporations with land or other property as an inducement to locate in their area.

The basis to the corporation of property received from a nonshareholder is zero. Where the corporation receives a cash contribution from a nonshareholder, the corporation is required to reduce the basis of any property acquired during the next 12-month period by the amount of cash received. When all of the money has not been spent in the 12-month period, the basis of other property must be reduced by the amount not spent. Property subject to depreciation must be reduced first, then property subject to amortization, then property subject to depletion, and finally any other remaining property. The reduction of the basis of each of the properties within each category is to be made in proportion to the relative basis of such properties. Code Sec. 362(c)(1) and (2); Reg. §1.362-2.
EXAMPLE 14.43  
Calumet City donates land to Wilder Corporation as an inducement for the corporation to expand operations. The land has a basis of $10,000 and a fair market value of $25,000. Wilder recognizes no income and will have a zero basis in the land.

EXAMPLE 14.44  
Hamilton City donates $50,000 in cash and land with a fair market value of $75,000 to Miler Corporation as an inducement to locate there. Within the next 12 months, it purchased property for $40,000 with the donated cash. Miler Corporation has no income. Its basis in the land and property purchased for $40,000 is zero. Additionally, starting with depreciable assets, the basis of Miler’s other properties must be reduced by the $10,000 not spent.

The corporation recognizes no income from nonshareholder contributions. However, since any basis in the property received or acquired is zero, the normal benefits of depreciation, amortization, or depletion are denied. Thus in the long run, the corporation recognizes income when the asset is sold.

14,215  DEBT IN THE CAPITAL STRUCTURE

In addition to issuing stock during corporate formation, the corporation also should issue long-term debt because debt has certain advantages over equity. Interest payments on the debt are deductible by the corporation while dividends are not deductible. Additionally, debt repayment is an acceptable reason for accumulating income and, therefore, avoiding the accumulated earnings tax under Code Sec. 531. Most redemptions of stock are not acceptable reasons. Repayment of the principal is tax free to the creditor, whereas payments made to shareholders for their stock may be considered dividends or taxable redemptions. Finally, should the debt instrument become worthless, then the loss may be an ordinary loss if the debt is business related (if nonbusiness bad debt, then it is treated as a short-term capital loss).

There are some disadvantages to debt. Interest payments are income to the debtholder. Similarly, the debtholder will have income for amounts received in excess of basis. Additionally, if the debtholder is a corporation, it is not entitled to the dividends-received deduction when it receives interest payments. Finally, the corporation issuing the debt must make timely payments of interest and principal in accordance with the terms of the debt instrument. Stock does not have this constraint; that is, dividends usually are voluntary distributions.

EXAMPLE 14.45  
John Jones invests cash in Adams Corporation in return for stock and long-term debt in a Section 351 transfer. During the year, John receives a dividend of $5,000 and interest payments of $6,000. Jones has $11,000 of gross income. Adam Corporation has a $6,000 deduction for the interest payment. No deduction is allowed for the dividend payment. Assuming Adams Corporation’s tax rate is 34 percent, the after-tax cost of the interest payment is $3,960 ($6,000 × (1.00 – .34)); the deduction saved it taxes of $2,040 ($6,000 × .34). The after-tax cost of the dividend was $5,000 because it was not deductible.

However, the interest income is taxed at Jones’ regular tax rate, whereas the dividend income is taxed at a reduced rate. Assuming that Jones is in the 35 percent tax bracket, the interest income is taxed at 35%, or $2,100 ($6,000 × .35) and the dividend income is taxed at 15%, or $750 ($5,000 × .15). Thus, the debt still is preferable but the benefit of interest versus dividends is not as great as it used to be because the difference in treatment at the individual shareholder level offsets some of the benefits at the corporate level.

Because of the advantages of debt financing, there are instances when taxpayers attempt to treat equity instruments as debt. Usually these instruments are debt in legal form but
in substance are equity. Using the doctrine of substance over form, the IRS will attempt to reclassify this debt as equity. Code Sec. 385 provides guidance in classifying an instrument as debt or equity. The section lists five factors that may be considered:
1. Does the instrument contain an unconditional promise to pay on demand or on a specified date a definite amount for adequate consideration and at a fixed rate of interest?
2. Is the debt preferred over or subordinated to other debts?
3. How high is the corporation’s debt to equity ratio (is the corporation thinly capitalized)?
4. Is the debt convertible into stock?
5. What is the relationship between stock and debt ownership (is it proportionate)?

Regulations were to be prescribed which would contain factors and/or tests that would be used to classify an instrument as debt or equity. No such regulations exist. Thus, the area remains subject to uncertainty. However, the classification of a corporate instrument issued after October 24, 1992, as stock or debt by the corporate issuer is binding on the issuer and all holders. Code Sec. 385(c). This classification is not binding on the IRS.

**Example 14.46**

Maurice Severs starts a new corporation with $50,000 and receives $40,000 of 12-year notes and $10,000 of stock. The full $50,000 will most likely be viewed as equity by the IRS because of the debt-to-equity ratio (4-to-1). If Maurice issued $25,000 of debt and $25,000 of equity, the arrangement would probably be respected. Thus, the corporation may deduct interest on the notes and Maurice may receive $25,000 tax free as repayment of principal.

**SECTION 1244 STOCK**

Although debt can be more advantageous than equity, certain stock issuances receive special treatment which makes them favorable. Shareholders are permitted to deduct losses on the worthlessness or sale (including redemptions and liquidations) of Section 1244 stock as ordinary. Gains on the disposition of such stock are capital gains. Thus, the shareholders receive the best of both situations, ordinary loss treatment (up to a statutory limit) if the corporation fails and capital gain treatment if the corporation is successful.

The reason for this treatment is to place shareholders of small corporations on a more nearly equal basis with sole proprietors and partners and to encourage the flow of funds into small corporations. Certain restrictions apply to ensure that the provision benefits small corporations.

**Eligible Shareholders**

Only individuals and partnerships are eligible for ordinary loss treatment if they were original holders of the stock. The stock loses its Section 1244 status when it is transferred. If a partnership is an original holder, the subsequent loss is passed through to those partners who were partners when the stock was issued. Reg. §1.1244(a)-1(b)(2).

**Loss Limitation**

Ordinary loss treatment is limited to an annual $50,000 per shareholder and $100,000 on a joint return regardless of which spouse owns the stock. If the loss is greater than these limits ($50,000 or $100,000), the excess is treated as a capital loss. Section 1244 losses are treated as attributable to the taxpayer’s trade or business. As such, they have business status for net operating loss purposes. Thus, if the Section 1244 loss exceeds the shareholder’s taxable income, the excess is carried over under the net operating loss provisions.

**Example 14.47**

Marge Summers, a single taxpayer, has a basis of $120,000 in Section 1244 stock when it becomes worthless. She incurs a $50,000 ordinary loss and a $70,000 capital loss. If she is married by year-end, even if the loss had been sustained months earlier, a $100,000 ordinary loss and a $20,000 capital loss would result on a joint return.
Corporate Requirements

Only a domestic small business corporation can issue Section 1244 stock. The stock can be common or preferred and voting or nonvoting. The corporation must qualify as a small business at the time the stock is issued. The total dollar amount of money and property received by the corporation for its stock, as a contribution to capital and as paid-in capital, cannot exceed $1,000,000 at the time the stock is issued. The property’s fair market value is not used in determining the $1,000,000 limit. Property received by the corporation is valued at its adjusted basis, reduced by any liabilities that were assumed by the corporation. Stock issued for services rendered does not qualify as Section 1244 stock.

The issuing corporation does not need to adopt a plan to issue Section 1244 stock. Determination of Section 1244 stock is made at the time of issuance. All stock issued qualifies as Section 1244 stock as long as the firm has not issued more than $1,000,000 of stock. Regulation 1.1244-(c)-2 provides special rules for determining which shares of stock are eligible for Section 1244 treatment if the firm has issued more than $1,000,000 of stock (however, this is beyond the scope of this text).

If the adjusted basis of the property transferred in return for Section 1244 stock exceeds its fair market value, the adjusted basis of such stock for the sole purpose of computing the Section 1244 loss is reduced by the amount of such excess. This treatment prevents the conversion of a capital loss on the property into an ordinary loss on the Section 1244 stock. Increases in basis through contributions to capital or otherwise are not counted for ordinary loss computation purposes. Code Sec. 1244(d)(1)(B).

Example 14.48

Roy Ready incorporated a truck with a basis of $20,000 and a fair market value of $13,000. He subsequently contributed another $11,000 in the business before his stock became worthless. Since his basis in the stock was $31,000 ($20,000 + $11,000), his loss also is $31,000; only $13,000 is an ordinary loss under Code Sec. 1244. The remaining loss of $18,000, consisting of the paper loss at the time of incorporation plus capital contributions, is capital in nature.

Planning Pointer

In Example 14.48, the taxpayer could have maintained the $11,000 capital contributions as a Section 1244 deduction by purchasing stock in the corporation for $11,000 instead of contributing the $11,000 and adjusting the basis of the stockholdings. The purchase price of the stock would have been its adjusted basis for gain or loss purposes and for determining the Code Sec. 1244 loss.

The corporation must be an operating company at the time the loss is sustained. The corporation’s gross receipts from sources other than dividends, interest, royalties, rents, annuities, and sales or exchanges from stock or securities must exceed 50 percent of the corporation’s gross receipts for the five most recent tax years. The operating company requirement need not be satisfied if the total deductions allowed the corporation—other than the dividends-received deduction and the net operating loss deduction—exceeds the total gross income for the five-year period.

Reporting Requirements

Taxpayers must substantiate their claims of a Section 1244 loss. The taxpayer is required to maintain records sufficient to distinguish Section 1244 stock from any other stock the taxpayer may own in the corporation. The corporation also should maintain records showing all of the following:
1. The persons to whom stock was issued, the date of issuance to these persons, and a description of the amount and type of consideration received from each person.
2. The basis to the shareholder of any property received by the corporation and the fair market value of the property at the time it is received by the corporation.
3. The amount of money and the basis to the corporation of other property received for its stock as a contribution to capital and as paid-in capital.
4. Financial statements of the corporation, such as its income tax returns, that identify the sources of the gross receipts of the corporation for the period consisting of the five most recent tax years.
5. Information relating to any tax-free stock dividends made with respect to Section 1244 stock and any reorganization in which stock is transferred by the corporation in exchange for Section 1244 stock.

SECTION 1202 STOCK

Code Sec. 1202 is designed to aid small business capital formation. Within limits, Code Sec. 1202 enables noncorporate taxpayers to exclude 50 percent of the gain from the sale or exchange on qualified small business stock held for more than five years. The definition of small business stock is not the same as that used in Code Sec. 1244. Assuming all requirements are met, the stock effectively is identified as Code Sec. 1202 stock when issued.

Eligible Shareholders

Only individuals are eligible for the 50 percent exclusion if they were the original holders of the stock and the stock was issued in exchange for money, property other than stock, or compensation for services rendered to the corporation. If a conduit entity was an original holder, the subsequent gain is passed through to those owners who were owners when the stock was issued. Conduits can be holders of Section 1202 stock. Partnerships, S corporations, regulated investment companies, and common trust funds qualify as conduits for purposes of Code Sec. 1202. The gain and share of the stock’s adjusted basis pass through proportionately to the owners (e.g., partners) of the conduit. Code Sec. 1202 applies only to stock originally issued after August 10, 1993, which is held for more than five years by the taxpayer. The stock generally loses its Section 1202 status when it is transferred unless the transfer is tax free and by gift, by death, from a partnership to a partner, or a stock-for-stock transfer. Finally, the Code Sec. 1202 gain is a long-term capital gain subject to the 28 percent tax rate if it is less than the taxpayer’s regular tax rate and 7 percent of the excluded gain is a tax preference.

Gain Limitation

Only gain from the sale or exchange of qualified small business stock is eligible for the 50 percent exclusion. Exclusion treatment is subject to per-issuer cumulative limitations. The amount of eligible gain is limited to the greater of:

1. $10,000,000 reduced by the aggregate of eligible gain recognized from the sale of the corporation’s stock which has been taken into account by the taxpayer in prior years, or
2. 10 times the aggregate adjusted basis of qualified small business stock issued by the corporation and disposed of by the taxpayer during the taxable year. For this purpose only, the adjusted basis of the stock is not increased for additions to basis which took place after the date of original issuance.

In determining the taxpayer’s eligible gain, if the stock was acquired in exchange for property (other than money or stock), then for Code Sec. 1202 purposes only, the basis of the stock shall be no less than the property’s fair market value at the time of transfer. The basis adjustment for any subsequent contribution to capital also shall be no less than the property’s fair market value at the time of the transfer. This prevents taxpayers from converting gain on the contributed property to Code Sec. 1202 gain eligible for the 50 percent exclusion. Assuming all requirements are met, the stock effectively is identified as Code Sec. 1244 stock when issued.
EXAMPLE 14.49
On January 10, 2004, Sara Shertzer acquired stock in Snave Co. for $300,000. Snave Co. is a qualified small business for Code Sec. 1202 purposes. On January 18, 2009, Sara sold the stock for $600,000. Sara’s realized gain is $300,000, and her recognized gain is $150,000. One-half of the $300,000 capital gain is excluded since it is within the limits of (1) $10,000,000 or (2) 10 × $300,000 = $3,000,000.

EXAMPLE 14.50
On February 14, 2004 Sam Ellsworth transferred property to Maxo Co. in return for 100 percent of its common stock. The corporation is a qualified small business for Code Sec. 1202 purposes. Sam’s adjusted basis in the property was $500,000, and it had a fair market value of $2,000,000. On February 17, 2009, Sam sold one-fourth of his shares for $800,000. Sam’s realized gain is $675,000 ($800,000 − ($500,000 × .25)). His recognized gain is $525,000 ($675,000 − $150,000). In this situation the fair market value of the property will be used to determine the excluded gain. One-fourth of $2,000,000 is $500,000, so the gain for Code Sec. 1202 purposes is $300,000 ($800,000 − $500,000). One-half of the $300,000 is the excluded gain. The $150,000 excluded gain is within the limits of (1) $10,000,000 or (2) 10 × ($2,000,000 × .25) = $5,000,000.

Corporate Requirements
Only a domestic C corporation can issue Section 1202 stock. The stock can be common or preferred and voting or nonvoting. The corporation must qualify as a small business at the time the stock is issued. The corporation’s aggregate gross assets cannot exceed $50,000,000 anytime before the issuance of the stock and immediately after the issuance. Aggregate basis is equal to cash and the aggregate adjusted basis of property held. For this test only, the adjusted basis of contributed property is equal to its fair market value at the time of transfer. If aggregate gross assets subsequently exceed $50,000,000, the corporation no longer can issue Section 1202 stock; however, previously issued Section 1202 stock is not disqualified.

The corporation must be an operating company which is actively engaged in a trade or business during substantially all of the time the taxpayer held its stock. A corporation meets this requirement if at least 80 percent of its assets are used in the active conduct of one or more qualified trades or businesses as defined in Code Sec. 1202(e)(3). Most services and financing businesses would not qualify. If more than 10 percent of the total value of its assets consists of real estate not used in the active conduct of a qualified trade or business, then the corporation fails the active business test.

Code Sec. 1045 enables a taxpayer other than a corporation to roll over tax-free gains on the sale of qualified small business stock held for more than six months if the proceeds from the sale are used to purchase other qualified small business stock within 60 days of the sale. The taxpayer’s basis in the newly acquired stock is reduced by the amount of capital gain not recognized. Also, the holding period of the stock sold is tacked on to the holding period of the newly acquired stock.

EXAMPLE 14.51
Justin Wells invests $300,000 in Shapot Corporation on September 1, 2006. Shapot Corporation qualifies as a small business corporation. On August 14, 2008, Justin sells his Shapot Corporation stock for $550,000. He then buys stock in Clerici Inc., also a small business corporation, for $525,000. Since Justin did not reinvest all $550,000, he must recognize a $25,000 gain.

Code Sec. 1044 Rollovers
Code Sec. 1044 allows individual and corporate (not an S corporation) taxpayers to roll over their gains on the sale of publicly traded securities into a Specialized Small Business Invest-
ment Company (SSBIC). An SSBIC is any partnership or corporation which is licensed under Section 301(d) of the Small Business Investment Act of 1958. The taxpayer must make the rollover into the SSBIC within 60 days of the sale of the publicly traded securities, and the taxpayer will only recognize his or her gains to the extent that the sale amount exceeds the cost of the SSBIC interest.

The amount of gain that can be rolled over in any one year is limited. For individuals it cannot exceed the lesser of (a) $50,000 or (b) $500,000, reduced by the amount of gain from prior years that has already been deferred due to this rollover provision. The rollover limit for C corporations is the lesser of (a) $250,000 or (b) $1,000,000, reduced by the amount of gain from prior years that has already been deferred due to this rollover provision. The deferred gain is a basis adjustment (reduction) to the newly acquired SSBIC interest.

Stock or Debt

Whether stock or debt is preferable depends on many considerations. Individual shareholders are entitled to the benefits of Code Secs. 1202 and 1244, which make stock advantageous to them. Corporate shareholders are not entitled to the benefits of Code Secs. 1244 and 1202, but they are entitled to the dividends-received deduction (discussed at ¶14,385), which also makes stock advantageous to them.

A major advantage of debt to the issuing corporation is that the corporation is entitled to a deduction for interest payments but not for dividend payments. The recipient shareholder has gross income regardless of whether it is interest or dividends (except for corporate shareholders entitled to the dividends-received deduction), although dividends are taxed at a reduced rate for individual shareholders. A disadvantage of debt is that a loss upon its sale or worthlessness usually results in a nonbusiness bad debt (which is treated as a short-term capital loss by individuals) or a capital loss. Corporate shareholders might be able to claim a business bad debt deduction.

Thus, whether stock or debt is preferred depends in part on the type of shareholders, the marginal tax rates of the shareholders and the corporation, and the possibility of a Section 531 tax imposition (discussed in Chapter 18). Nontax factors also are important.

Planning Pointer

Toni Travels invested $50,000 cash in a wholly-owned corporation. Since she was aware of the advantages of debt in the capital structure, she received $25,000 in stock and $25,000 in debt. A few years later, the corporation became worthless. Only the $25,000 basis in the stock is eligible for ordinary loss treatment under Code Sec. 1244. The worthless debt is deductible only as a capital loss. Toni may have been better advised to have taken only stock in the original transfer to the corporation.

Tax Blunder

Sally Rogers owns 100 shares of Dino Co. She acquired the shares on January 15, 2004, for $100,000. Dino Co. qualifies as a small business corporation for Code Sec. 1202 purposes. Sally believed she would have a very large estimated tax payment due on January 15, 2008, so she sold the shares on January 2, 2008, for $250,000. Sally’s estimated tax payment was much less than she expected. Sally was uncertain of (and somewhat indifferent about) what to do with the proceeds from the sale of the Dino Co. shares, so she put the proceeds into a three-month certificate of deposit. The result of these events is that Sally must recognize the $150,000 fully in 2008. Sally did not hold the stock for more than five years, so the sale does not qualify for the 50 percent exclusion. However, she still could have deferred gain recognition by reinvesting in shares of a small business corporation. Had she not been indifferent regarding her investment choice, she might have made a much better decision.
**Determination of Corporate Taxable Income**

**GENERAL RULES**

There are many similarities between the rules used to determine taxable income for corporations and those used for individuals. Gross income is determined in the same manner for corporations and individuals. That is, Code Sec. 61, which defines gross income, applies to both types of taxpayers, although some deductions, such as alimony, apply only to individuals. Corporations also are entitled to exclusions from gross income. Thus, corporations can exclude interest income on municipal bonds. However, most of the statutory exclusions in Code Secs. 101 to 139 pertain to individuals only.

All corporate deductions are business deductions. Ordinary and necessary expenses incurred to carry on a trade or business are deductible. Code Sec. 162. These are similar to some of the for adjusted gross income deductions (for AGI) allowed to individuals. However, some of the for AGI deductions, such as alimony payments and contributions to IRAs, apply only to individuals. Corporations do not have from adjusted gross income deductions (from AGI). They are not entitled to deductions for personal expenses. Also, they do not have itemized deductions, a standard deduction, or deductions for personal exemptions. However, there are some deductions that apply to corporations only, such as the dividends-received deduction under Code Sec. 243.

Because corporations do not have itemized deductions, the limitations and reductions used to compute deductions are different. For example, corporations do not reduce a casualty loss by $100 or a net casualty loss by 10 percent of adjusted gross income. Interest expense is not classified as personal interest under Code Sec. 163 if incurred by corporations and, therefore, is fully deductible.

Property transactions are taxed similarly. The determination of realized gain or loss and the classification of this gain or loss as capital, ordinary, or Code Sec. 1231 is similar. Both corporations and individuals are subject to depreciation recapture rules under Code Secs. 1245 and 1250. The deferral provisions for like-kind exchanges under Code Sec. 1031 and involuntary conversions under Code Sec. 1033 apply to corporations and individuals.

**ACCOUNTING PERIODS**

One of the elections a new corporation must make is its choice of an accounting period. In general, corporations have the same choices as do individuals. They may choose a calendar year or a fiscal year. However, a corporation has more flexibility in choosing its accounting period. It may choose any calendar or fiscal tax year regardless of the tax years of its owners. This ability to have a tax year different from that of its owners can produce tax savings, especially in the year of incorporation.

Other entities do not have this freedom. For example, S corporations are required to adopt the calendar year unless they can establish a business purpose for a fiscal year. Deferral of income to shareholders is not a business purpose. Code Sec. 1378(b). Partnerships must have the same tax year as their partners who have a majority interest. If there is no majority interest, the partnership uses the tax year of all its principal partners. If there are no principal partners, the least aggregate deferral method must be used unless the partnership can establish a business purpose for using a fiscal year. Code Sec. 706(b).

Personal service corporations are corporations whose primary activity is the performance of personal services. These services are primarily performed by employee-owners. Personal-service corporations must use a calendar year for their tax year unless they can establish a business purpose for a fiscal year. Code Sec. 441(i).
ACCOUNTING METHODS

The corporation must select an accounting method in its initial tax year. Generally, the cash basis, accrual basis, or a hybrid basis which contains elements of the cash and accrual methods may be elected. Most corporations, however, must use the accrual method. However, this constraint does not apply to S corporations, qualified farming businesses, qualified personal service corporations, and corporations with average annual receipts of $5 million or less for the three prior tax years.

A corporation that meets the exception above (e.g., an S corporation) may use any of the three methods. However, corporations that maintain inventory for sale to customers are required to use the accrual method of accounting for determining sales and cost of goods sold.

CAPITAL GAINS AND LOSSES

The process used to determine a corporation's capital gains and losses is similar to that used by individuals. Gains and losses resulting from the taxable sale or exchange of capital assets must be reclassified as short-term or long-term. Next, the net short-term and the net long-term positions must be computed. If the short-term gains exceed the short-term losses, a net short-term gain results. If the short-term losses exceed the short-term gains, a net short-term loss results. Long-term gains and losses are netted in similar manner to determine the net long-term gain or loss.

The next step is to determine the corporation's overall capital asset position. This is dependent upon the two net positions. If they are opposite (i.e., a net loss and a net gain), then they are combined. If they are similar (i.e., both net gains or net losses), then they are kept separate. Thus, there are six possible combinations:

1. Net long-term capital gain greater than net short-term capital loss. These are combined to produce a net capital gain.
2. Net long-term capital gain less than net short-term capital loss. These are combined to produce a net capital loss.
3. Net short-term capital gain greater than net long-term capital loss. These are combined to produce capital gain net income.
4. Net short-term capital gain less than net long-term capital loss. These are combined to produce a net capital loss.
5. Net long-term capital gain and net short-term capital gain. These are not combined. The net long-term capital gain is treated as a net capital gain, and the net short-term capital gain is treated as capital gain net income.
6. Net long-term capital loss and net short-term capital loss. These are not combined.

The taxation of corporate capital gains and losses depends on the net position (i.e., combinations one to six above).

Net Capital Gain

Corporations do not receive preferential treatment of net long-term capital gains. Net capital gains (combinations 1, 3, and 5, above) must be included in the corporation's gross income and are taxed at the same rate as ordinary income, a flat 35 percent in the case of many corporations (the alternative tax rate of 35 percent is now applied to the lesser of the corporation's net capital gain or its taxable income).

Example 14.52

Hands Corporation has gross receipts from sales of $230,000, deductible expenses of $75,000, and a net capital gain of $48,000. Hands’ gross income is $278,000 ($230,000 + $48,000). Its taxable income is $203,000 ($278,000 – $75,000). Its tax liability will be computed on the $203,000; the $48,000 net capital gain does not receive preferential treatment.
Net Capital Losses
Unlike individuals, corporations may not take a deduction for net capital losses in the year in which they occur. The net capital loss can never be used to reduce ordinary income. Corporate taxpayers may claim capital losses only against capital gains.

Net capital losses (combinations 2, 4, and 6, above) of a corporation are carried back to the three preceding tax years to offset net capital gains claimed in those years. If some net capital loss remains, it is carried forward for a period of five tax years. The carryovers must be taken back to the third, second, and first preceding tax years in that order, and any remaining losses carried forward to the five succeeding tax years in order. Unused losses at the end of the five-year carryforward period are lost forever. Also, all net capital losses carried back or forward become short-term capital losses regardless of their original status.

Example 14.53
Civic Corporation incurred a net long-term capital loss of $15,000 in 2008. It also had gross receipts from sales of $120,000 and deductible expenses of $70,000 in 2008. Civic’s gross income is $120,000, and its taxable income is $50,000 ($120,000 – $70,000). The $15,000 net capital loss does not affect taxable income in 2008. Civic Corporation carries the loss back to 2005, 2006, and 2007, in that order, to offset any net capital gains of those years. If the loss is not exhausted, the remainder is carried, in order, forward to 2009, 2010, 2011, 2012, and 2013. The $15,000 is treated as a short-term capital loss in any of the carryback or carryforward years.

Example 14.54
Assume the same facts as in Example 14.53, except that Civic Corporation had a net short-term capital gain of $7,000 in 2005, a net short-term capital gain of $2,000 and a net long-term capital gain of $3,000 in 2006, and no capital gains or losses in 2007. The $15,000 net capital loss incurred in 2008 first is carried back to 2005 and offsets the $7,000 net short-term capital gain. Civic will receive a refund of taxes paid on that gain. The remaining $8,000 loss ($15,000 – $7,000) is carried to 2006 where it offsets the $2,000 net short-term capital gain and then the $3,000 net long-term capital gain. Civic will receive a refund of taxes paid on both gains. The remaining loss of $3,000 ($8,000 – ($2,000 + $3,000)) is carried to 2007. Since there were no net capital gains in that year, the $3,000 loss will be carried to 2009.

\(\text{Section 14.325} \) 
DEPRECIATION RECAPTURE
Corporations generally compute the ordinary income recapture on Section 1245 and Section 1250 assets in the same manner as individuals. Section 1245 assets are generally subject to ordinary income recapture to the extent of the full depreciation taken on the asset. Section 1250 assets acquired before 1981 are generally subject to ordinary income recapture to the extent of the cumulative excess of the depreciation taken over the amount allowed using straight-line depreciation. Nonresidential real property placed in service in years 1981 through 1986 is subject to depreciation recapture to the extent of the full depreciation taken if an accelerated depreciation method was used. Residential real estate continues to use the pre-1981 recapture rules. Post-1986 acquisitions of buildings are depreciated on a straight-line basis.

However, corporations have special recapture rules under Code Sec. 291. Application of these rules may result in a greater amount of ordinary income than the Section 1250 recapture rules for other business organizations. Code Sec. 291 requires that 20 percent of the excess of any amount that would be treated as ordinary income under Code Sec. 1245 over the amount treated as ordinary income under Code Sec. 1250 is additional depreciation recapture, and thus, ordinary income. Similar rules apply to amortization of pollution control facilities and intangible drilling costs incurred by corporate taxpayers. The computation of Section 291 gain is shown below.

\(\text{Section 14.325} \)
Amount that would have been ordinary income if Section 1245 property.......................................................... $XXX
Less: Amount of ordinary income under Section 1250................................................................. (XX)
Excess of Section 1245 gain over Section 1250 gain......................................................... $XXX
Section 291 applicable percentage......................................................................................... × 20%
Section 291 gain (ordinary income)...................................................................................... $XXX

If the gain recognized on the transaction exceeds the ordinary income recognized under Code Sec. 1245, 1250, or 291, then such excess is a Section 1231 gain. The effect of Section 291 is to reduce the amount of capital gain available to offset capital losses.

**Example 14.55**

Computer Services Corporation acquired an office building for $450,000. The building was depreciated under the straight-line method. The building was sold nine years later for $240,000. Depreciation taken on the building up to the time of sale was $270,000 ($30,000 per year for nine years). The adjusted basis at the time of sale was $180,000 ($450,000 – $270,000). Computer Services Corporation has a $60,000 gain on the sale (amount realized of $240,000 less adjusted basis of $180,000). Since straight-line depreciation was used, there is no depreciation recapture under Code Sec. 1245 or 1250. However, ordinary income of $12,000 recognized under Code Sec. 291 is computed as follows:

Ordinary income if Section 1245 gain ................................................................. $60,000
Less: Ordinary income under Section 1250 ............................................................ 0
Excess Section 1245 gain...................................................................................... $60,000
Section 291 percentage......................................................................................... × 20%
Section 291 gain (ordinary income)............................................................ $12,000

The remaining $48,000 gain ($60,000 – $12,000) is Section 1231 gain.

**NET OPERATING LOSS**

A corporation is allowed to carry its net operating loss (NOL) back two years and forward 20 years. An election may be made to forego the carryback and to carry the NOL forward only. The election must be made by the due date (including extensions) of the tax return for the year in which the NOL occurred. Code Sec. 172(b). However, any unused NOL at the end of the carryforward period is lost forever. Thus, the carryover rules for NOLs are the same for corporations and individuals.

The election to not carry the loss back to the two preceding years may be advantageous if the prior years’ taxable incomes were in a lower tax bracket than the tax rate expected in the future. Also, the corporation would not want to carry back a NOL to a tax year in which the corporation had utilized a credit that is due to expire or that has expired.

**Example 14.56**

NIFFO incurs a net operating loss of $20,000 in 2008. Normally, the corporation would carry the loss back to 2006. However, during 2006 the corporation had only $25,000 of taxable income. The corporation incurred a tax liability of $3,750 ($25,000 × 15%). It is expected that the corporation will be in the 34 percent tax bracket in the future. By carrying back the $20,000 loss to 2006, the corporation will receive a refund of $3,000 ($20,000 × 15%). By carrying the loss forward, the corporation expects to receive a tax benefit of $6,800 ($20,000 × 34%).
Unlike individuals, corporations are not required to make adjustments to the NOL for capital gains and losses, nonbusiness expenses, or personal exemptions since they are not allowed deductions for these items in the computation of taxable income. Also, corporations are permitted the full dividends-received deduction (see ¶14,385) in computing their NOLs. Similar to individuals, NOL deductions for each year are considered separately. Thus, NOL carryovers from other years are omitted in computing the NOL for the present year.

**EXAMPLE 14.57**
In 2008, Mighty Corporation has $200,000 of gross income from operations and operating deductions of $300,000. The corporation also received $50,000 in dividends from a 30-percent owned domestic corporation. The corporation has a net operating loss for the year of $90,000, computed as follows:

<table>
<thead>
<tr>
<th>Gross Income</th>
<th></th>
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<tbody>
<tr>
<td>Operations</td>
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<tr>
<td>Dividends</td>
<td>50,000</td>
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<tr>
<td><strong>Total Gross Income</strong></td>
<td><strong>$250,000</strong></td>
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<thead>
<tr>
<th>Deductions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operations</td>
<td>$300,000</td>
</tr>
<tr>
<td>Dividends-received deduction ($50,000 × 80%)</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total Deductions</strong></td>
<td><strong>340,000</strong></td>
</tr>
<tr>
<td><strong>Net Operating Loss</strong></td>
<td><strong>$90,000</strong></td>
</tr>
</tbody>
</table>

Mighty Corporation may carry the $90,000 NOL back to 2006, and then 2007 if still not used, or may elect not to carry back and instead carry the NOL forward.

**EXAMPLE 14.58**
Assume the same facts as in Example 14.57. In addition, Mighty Corporation had taxable income of $40,000 in 2006. Mighty could carry back the $90,000 NOL to offset 2006 taxable income. It would receive a refund of taxes paid in 2006. The 2006 taxable income would use $40,000 of the NOL, leaving $50,000 to be carried to 2007.

The ability of corporations to carry back NOLs to claim a refund is restricted if the NOL is due to interest expense arising from debt used in corporate equity reduction transactions (CERTs) occurring after August 2, 1989. Code Sec. 172(b)(1)(E). A CERT is a transaction where either (1) the corporation acquires at least 50 percent (by value or vote) of the stock of another corporation—a major acquisition—or (2) the corporation makes an excess distribution. An excess distribution occurs if a corporation’s total distributions and redemptions exceed the lesser of (1) 150 percent of the corporation’s average annual distributions or redemptions for the preceding three years or (2) 10 percent of the fair market value of the stock at the beginning of the tax year.

The amount disallowed as a carryback is equal to the excess of the NOL for the tax year over the NOL reduced by the interest deductions incurred in a CERT. Code Sec. 172(b). The amount disallowed as a carryback is not lost forever; it is carried forward. However, to the extent that this carryover creates or adds to an NOL in the carryforward years, restrictions are placed on the corporation’s ability to carry back those NOLs.

**EXAMPLE 14.59**
Worldwide Corporation had an $8,000,000 NOL for the year. Included in the NOL were interest deductions of $5,000,000 on debt used in a CERT. The NOL without this deduction would have been $3,000,000. Worldwide can carry back only $3,000,000 of the NOL.
CHARITABLE CONTRIBUTIONS

The deductibility of charitable contributions is dependent upon (1) what type of property is donated, (2) when the property is donated, and (3) to whom the property is donated, as well as the corporation’s adjusted taxable income. In order to receive a deduction, the property must be donated to a qualified charitable organization. Code Sec. 170(c). A deduction is allowed only in the year of transfer or payment (i.e., when the contribution occurs). However, an accrual-basis corporation may claim a deduction in the year preceding payment if its board of directors authorized a charitable contribution during the year and payment of the contribution is made by the 15th day of the third month of the next tax year. Code Sec. 170(a).

EXAMPLE 14.60

The board of directors of Willis Corporation authorized a $3,000 cash donation to a qualified charitable organization on December 13, 2008. The payment was not made until February 25, 2009. Willis Corporation is a calendar-year corporation. If the corporation is on the accrual method of accounting, the charitable deduction will be allowed for 2008. Under the cash method, the deduction would not be allowed until 2009, the year paid.

The amount deductible is dependent upon the type of property contributed and the corporation’s adjusted taxable income. Property type determines the initial dollar measure of the contribution. The overall deduction for contributions by a corporation is limited to 10 percent of adjusted taxable income (as described below).

Ten Percent Limitation

The maximum amount deductible by a corporation for charitable contributions is 10 percent of its adjusted taxable income. Thus, the deduction is limited to the lesser of 10 percent of adjusted taxable income or the sum of the initial measures of all property donated during the tax year. Adjusted taxable income is equal to taxable income without regard to the charitable contribution deduction, the dividends-received deduction, any net operating loss carryback, and any capital loss carryback. Code Sec. 170(b)(2). If the charitable contributions for the tax year exceed the 10 percent limitation, the excess can be carried forward for five years. Carryovers are used on a first-in, first-out basis after first deducting the current year’s contributions. Code Sec. 170(b) and (d).
For charitable contribution purposes, adjusted taxable income equals $85,000; i.e., taxable income before the charitable contribution deduction and the dividends-received deduction ($325,000 – ($220,000 + $20,000). (No adjustment is made for the NOL carryover. An adjustment would have been made if it were a carryback.) Thus, the charitable contribution deduction is limited to $8,500 ($85,000 × 10 percent). The remaining $2,500 ($11,000 – $8,500) is carried forward to the following tax year.

For dividends-received deduction purposes, adjusted taxable income equals $96,500; i.e., taxable income before the dividends-received deduction and the NOL deduction ($325,000 – ($220,000 + $8,500). Thus, the dividends-received deduction is equal to 70% times the lesser of $15,000 or $96,500.

**Planning Pointer**

A number of corporations have set up their own private foundations so as to make contributions of up to 10 percent in good years.

**Initial Measure of Contribution**

The initial dollar measure of the contribution depends upon the property contributed to the charity. The initial measure of cash contributions is the amount of cash contributed. The initial measure of property contributions is their fair market value. However, under certain conditions fair market value is not allowed. Additionally, in order to receive a deduction for noncash contributions, the corporation must meet the qualified appraisal and documentation rules of Code Sec. 170(f)(11). These rules require special substantiation of deductions for contributions of more than $500, $5,000 and $500,000 (the requirements are greater as the amount increases).

**Long-Term Capital Gain Property**

If the corporation contributes property whose sale would have resulted in a long-term capital gain, the initial measure of the contribution is its fair market value (i.e., the appreciation also is deductible). However, if the property is tangible personal property not related to the charity’s tax-exempt purpose (e.g., donating a painting to a hospital), the appreciated property is donated to certain private nonoperating foundations (as defined in Code Sec. 509(a)), or the property is any patent, copyright, trademark, trade name, trade secret, know-how, software (with some exceptions), or similar property, or applications or registrations of such property then the initial measure is fair market value minus the amount of long-term capital gain that would have been recognized if the property had been sold. Code Sec. 170(e)(1).

**Example 14.62**

Blake Corporation donates a painting that it bought several years ago for $30,000 to Orleans City Museum. At the time of the contribution the painting had a fair market value of $75,000. The initial measure of the contribution is $75,000.

**Example 14.63**

Assume the same facts as in Example 14.62, except that Blake Corporation donates the painting to Orleans City Hospital. The initial measure of the contribution is $30,000 ($75,000 fair market value less the $45,000 long-term capital gain that would have been recognized if Blake Corporation had sold the painting).

Section 1231 property would be considered as long-term capital gain property unless it has depreciation recapture potential under Code Secs. 1245, 1250, and 291. To the extent of the recapture potential it is considered ordinary income property.
Corporations also are permitted an additional deduction equal to a percentage of the qualified donee income received or accrued by a charity on the corporation’s contribution of any patent, copyright, trademark, trade name, trade secret, know-how, software (with some exceptions), or similar property, or applications or registrations of such property. The amount of any additional charitable contribution deduction is based on a sliding scale and equals 100 percent in the first and second years following the date of the contribution, 90 percent in the third year and reduced by 10 percent each year such that it is 10 percent in the eleventh and twelfth years following the date of the contribution. This additional charitable deduction is allowed only to the extent that aggregate of the amounts that are calculated with these percentages exceed the amount of the deduction claimed on the contribution of the patent or other qualified intellectual property. Code Sec. 170(m)(4).

**Example 14.64**

On March 10, 2008, Hines Company contributed a patent to a qualified charity. The patent’s fair market value was $1,000,000 and its adjusted basis was $100,000. Hines Company obtained all the required documentation to substantiate the deduction. The charity did not receive any income from the patent in 2008, but in 2009, it received $150,000. Hines Company is entitled to a $100,000 charitable contribution deduction in 2008. In 2009, it is entitled to a $50,000 charitable contribution deduction computed as follows: 100% x $150,000 = $150,000 but the aggregate amount under the percentages only exceeds the claimed amount of the deduction ($100,000) by $50,000, thus the qualified donee income deduction is limited to $50,000.

**Ordinary Income Property**

Ordinary income property is property that, if sold, would produce ordinary income to the seller. Examples of such property are inventories, short-term capital assets, and property subject to recapture under Code Sec. 1245, 1250, or 291. The initial measure of these contributions is equal to the fair market value reduced by any ordinary income that would have been recognized if the property had been sold. Usually this is equal to the lesser of the property’s fair market value or adjusted basis. If the property is tangible personal property not related to the charity’s tax-exempt function, then the initial measure of the contribution is fair market value minus the gain that would have been recognized if the property were sold.

**Example 14.65**

Best Co. donated inventory to a public charity. At the time of donation, the inventory had a basis of $10,000 and a fair market value of $12,000. The initial measure of the contribution is $10,000 ($12,000 – $2,000).

**Example 14.66**

Assume the same facts as in Example 14.65, except that the inventory’s fair market value is $8,000. In this case, the initial measure of the contribution is $8,000.

**Example 14.67**

Sandy Corporation donated an automobile to a public charity. The charity will use the automobile in its operations. The automobile was acquired for $10,000. At the time of donation the automobile had a fair market value of $12,000 and an adjusted basis of $4,000. The initial measure of the contribution is $6,000 ($12,000 – $6,000 ordinary income recognized if property sold).

**Example 14.68**

Assume the same facts as in Example 14.67, except that the automobile will not be used by the charity. In this case, the initial measure of the contribution is $4,000 ($12,000 – $8,000 gain recognized if property sold).
Inventory and Research Property

Corporations contributing qualified inventory property to public charities or scientific research property to educational institutions can deduct the adjusted basis of the property plus one-half of the appreciation, not to exceed twice the amount of the adjusted basis. Code Sec. 170(e)(3) and (4). Qualified inventory must have use related to the function or purpose of the charitable organization. The inventory must be used for the care of the ill, the needy, or infants. The charitable organization cannot receive any money, property, or services for the transfer or the use of the qualified inventory.

Qualified research property must be constructed by the donor and contributed within two years after construction is substantially completed. The donee must be the original user of the property. The property must be scientific equipment used for research or experimentation or for research training in the United States in the physical or biological sciences.

Qualified property also includes computer technology, software, and equipment given to certain schools within two years of acquisition or construction. The original use of the property must begin with the donor or the donee, and the property must be used within the U.S. for educational purposes in any grade from kindergarten to 12.

**Example 14.69**
Block Inc. donated inventory to a charity. The fair market value of the inventory was $15,000 and its adjusted basis was $4,000. The initial measure of the contribution is $4,000 ($15,000 fair market value minus $11,000 ordinary income recognized if it had been sold).

**Example 14.70**
Assume the same facts as Example 14.69, except that the property donated was qualified inventory to be used for the ill, the needy, or infants. In this case, the initial measure of the contribution is $8,000 ($4,000 + one-half of the appreciation (1/2 of $11,000) = $9,500, but this is limited to twice the adjusted basis (2 × $4,000)).

**Tax Blunder**

X Company made a contribution of ordinary income property to a qualified charity. The adjusted basis of the property was $70,000, and its fair market value was $30,000. X Company received a charitable deduction of $30,000 (its fair market value, reduced by any gain recognized had it been sold). X Company should not have given this property to the charity. It never will recognize the $40,000 loss on the property. X Company would have been better off to have sold the property, recognize the $40,000 loss, and then make a $30,000 cash contribution to the charity. Under this scenario, X Company still would have had a $30,000 charitable contribution, and it also would have had a $40,000 recognized ordinary loss.

**14,355 RELATED TAXPAYERS—LOSSES AND EXPENSES**

A special rule applicable to related taxpayers may cause (1) the disallowance of deductions for losses on sales or exchange, directly or indirectly, of property between related taxpayers, and (2) the deferral of deductions for accrued business and interest expenses of the taxpayer which remain unpaid at the end of the taxpayer’s tax year and which are payable to a related cash-basis taxpayer. Code Sec. 267. Related taxpayers are viewed as consisting of a single economic unit. Thus, related parties are unable to artificially recognize losses and create deductions for tax purposes where no losses or deductions have been sustained within the economic unit.

In addition to certain family members, related persons include: (1) a corporation and an individual with direct and/or indirect ownership of more than 50 percent, (2) two corporations if the same persons own more than 50 percent in value of the outstanding stock in each corporation, and (3) a fiduciary of a trust and a corporation if the trust or grantor owns more than 50 percent of the stock. The constructive ownership rules apply in determining ownership. Code Sec. 267(b).
The loss disallowance rules apply to any sale at a loss even if no tax avoidance motive exists and the selling price is at fair market value. The disallowance of any loss is permanent for the seller. The buyer’s initial basis in the property is the purchase price (fair market value). However, the buyer is permitted to reduce any gain recognized on a subsequent sale by the amount of the previously disallowed loss.

**Example 14.71**

A corporation sells an asset to Barry Winslow, its sole shareholder, at its fair market value of $10,000. The corporation has an adjusted basis in the asset of $12,000. The corporation will not be allowed a deduction for its $2,000 loss incurred on the sale. Barry sells the asset several years later for $15,000. Barry has a realized gain of $5,000 ($15,000 – $10,000); however, his recognized gain is $3,000 ($5,000 realized gain – $2,000 loss previously unrecognized by the corporation).

Expenses commonly disallowed under the related taxpayer rule are interest and compensation payable by an accrual-basis corporation to its cash-basis shareholders. Persons who are related are required to use the same accounting method with respect to transactions between themselves in order to prevent a deduction without the corresponding inclusion in income. The accrual-basis taxpayer is allowed the deduction for expenses incurred to cash-basis taxpayers when the payment is made.

**Example 14.72**

Nation Corporation, using the accrual method of accounting, incurs a $2,000 salary expense due to its cash-basis sole shareholder at the end of 2008. The amount is paid on January 15, 2009. The corporation will not be allowed a deduction for the salary expense until 2009, when the salary is paid.

\[ \text{ORGANIZATIONAL EXPENDITURES} \]

Expenditures related to the organization process are incurred when a corporation is formed. Some of these expenditures benefit the corporation over its entire corporate life and are capitalized as organizational expenditures. Organizational expenditures are an intangible asset which have an indefinite life.

Generally, assets with indefinite lives may not be amortized for federal income tax purposes. However, the corporation may elect to expense organizational expenses in the year it begins business. The deduction is limited to the lesser of: (1) the actual organizational expenses or (2) $5,000. The $5,000 is reduced dollar-for-dollar by the amount that total organizational expenses exceed $50,000 (thus, at $55,000 there would be no deduction). The remaining organizational expenses may be amortized in a 180-month period beginning with the month the corporation begins business. Code Sec. 248(a). Only those expenditures incurred before the end of the tax year in which the corporation begins business are eligible for amortization. The election to amortize such expenditures must be made by the due date of the return, including extensions, for the first tax year in which the corporation begins business. If the election is not made at that time, the organizational expenses must be capitalized and are deductible only upon dissolution. If the election is made and the business is dissolved prior to the end of the amortization period, then the remaining organizational expenditures are deductible in the year of dissolution.

Organizational expenditures are any expenditures which are (1) incident to the creation of the corporation, (2) chargeable to a 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 such life. Typical organizational expenditures include legal and accounting fees, incorporation fees, and organizational meetings expenses. Note that expenses in connection with underwriting securities (e.g., commissions, printing costs, etc.) are not eligible. Expenses of transferring assets to the corporation also are not organizational expenditures. Reg. §1.248-1(a) and (b).
**Example 14.73**

Petit Corporation begins business on August 1, 2008, and adopts the calendar year. Petit incurs the following expenses in 2008:

- Expenses of organization meetings: $6,000
- Fee paid for incorporation: $3,200
- Legal services in setting up corporation: $3,000
- Expenses of printing and sale of stock certificates: $2,500
- Accounting fees for monthly statements: $2,000

Petit uses the cash method of accounting and paid all expenses in February 2009. Petit’s total organizational costs are $12,200 ($6,000 + $3,200 + $3,000). The expenses of printing and sale of stock certificates and the accounting fees do not qualify as organizational expenditures. If an election is made, then Petit’s first year deduction equals $5,200 ($5,000 + $200 ($7,200/180 = $40/month x 5 months = $200)).

**14.375 START-UP EXPENDITURES**

Start-up expenditures are different from organizational expenditures. Start-up expenditures are business expenses paid or incurred in connection with investigating the creation or acquisition of an active trade or business, creating an active trade or business, or conducting an activity engaged in for profit and for the production of income before the time in which the active trade or business begins. Code Sec. 195(c). Start-up expenditures must be capitalized. However, the corporation may elect to expense start-up expenses in the year it begins business. The deduction is limited to the lesser of: (1) the actual organizational expenses or (2) $5,000. The $5,000 is reduced dollar-for-dollar by the amount that total start-up expenses exceed $50,000 (thus, at $55,000 there would be no deduction). The remaining start-up expenses may be amortized a 180-month period beginning with the month the corporation begins business. Code Sec. 195(b). If the business is disposed of prior to the end of the amortization period, then any remaining start-up expenditures are deductible in the year of disposition. Code Sec. 195(b).

The election to amortize start-up expenditures must be made by the due date of the return, including extensions, for the first tax year in which the trade or business begins. Reg. §1.195-1. The expenditures must be such that if incurred in connection with the operation of an existing active trade or business would be deductible in the tax year paid or incurred. Code Sec. 195(c)(1)(B). Examples of start-up expenditures are market surveys, fees incurred for consultants, travel costs, legal fees, and advertising expenses. Where the taxpayer incurs investigation expenses for expanding a present trade or business, a deduction is allowed whether the decision is made to acquire or not acquire the business. The expenditures are not for the investigation of a “new” business.

**14.385 DIVIDENDS-RECEIVED DEDUCTION**

Corporation income is subject to double taxation, once at the corporate level and again at the shareholder level at the time of distribution of after-tax earnings. Triple taxation may occur if a corporation receives dividends out of after-tax earnings of another corporation. Without a special provision, the corporation earning the income would be subject to taxation and the income would be taxed a second time when paid as dividends to a recipient corporation. The income would be taxed a third time when the recipient corporation pays dividends to its shareholders. To provide some relief, a dividends-received deduction is allowed. Code Sec. 243.

The dividends qualifying for the dividends-received deduction are those dividends paid by domestic corporations subject to the corporate income tax. Only dividends paid out of a corporation’s earnings and profits qualify for the dividends-received deduction. Distributions received from S corporations are not eligible for the dividends-received deduction. The S corporation is exempt from the corporate income tax and distributions are not income to the recipients; thus, there is no need for the dividends-received deduction. However, distributions out of an S corporation’s earnings and profits are eligible for the dividends-received deduction.
The deduction allowed is a percentage of the dividend received. This percentage is based upon the percentage of ownership by the corporate shareholder. Corporations owning less than 20 percent of the distributing corporation may deduct 70 percent of the dividend received. If the corporate shareholder owns 20 percent or more but less than 80 percent of the distributing corporation, then the corporate shareholder is entitled to deduct 80 percent of the dividend received. Finally, if the corporate shareholder owns 80 percent or more of the distributing corporation and both corporations are members of an affiliated group, then a 100 percent deduction is permitted.

The firm’s dividends-received deduction is equal to the relevant percent (70% or 80%, depending on ownership) times the lesser of: (1) dividends received from taxable, unaffiliated domestic corporations or (2) the firm’s taxable income, as adjusted (described below). Taxable income, as adjusted, is not used if the firm has a current net operating loss or if the full dividends-received deduction (the relevant percent times the amount of dividends received) creates a net operating loss. In these situations, the firm takes the full dividends-received deduction (based on the amount of the dividend and not constrained by taxable income, as adjusted).

The limitations on the aggregate amount of dividends-received deductions are first determined for dividends received from 20 percent or more owned corporations and then separately determined for dividends received from under 20 percent owned corporations after taxable income is reduced by the former.

**Example 14.74**

Dade Corporation has the following income and expenses:

<table>
<thead>
<tr>
<th>Income / Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income from operations</td>
<td>$200,000</td>
</tr>
<tr>
<td>Expenses from operations</td>
<td>($150,000)</td>
</tr>
<tr>
<td>Dividends received from a 15%-owned domestic corporations</td>
<td>$100,000</td>
</tr>
<tr>
<td>Taxable income before the dividends-received deduction</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

The dividends-received deduction is $70,000 ($100,000 × 70%).

Taxable income, as adjusted, equals the corporation’s taxable income computed without regard to:
1. The dividends-received deduction
2. Any net operating loss carryback and carryforward deduction
3. Any capital loss carryback
4. A dividends-paid deduction (Code Sec. 246(b))

**Example 14.75**

Assume the same facts as in Example 14.74, except that the gross income is only $140,000 instead of $200,000. Taxable income before the dividends-received deduction is $90,000. Instead of a $70,000 deduction, the dividends-received deduction is limited to $63,000 (70% × $90,000).

**Example 14.76**

Assume the same facts as in Example 14.74, except that the gross income from operations is $110,000. Taxable income before the dividends-received deduction is $60,000 ($110,000 + $100,000 – $150,000). If the corporation received the full dividends-received deduction of $70,000 (70% × $100,000), then it would have an NOL of $10,000 ($60,000 – $70,000); thus, it is permitted the full deduction and is not limited to a $42,000 deduction (70% × $60,000).

In summary, the full dividends-received deduction is available if the corporation has an NOL or would have an NOL if it received the full deduction. Also, if taxable income, as adjusted, is greater than the dividend received, a full deduction is available. The full dividends-received deduction is not available if taxable income is less than the dividend received.
but large enough such that a full dividend-received deduction not make it negative. In this case, the deduction is limited to a percentage of taxable income, as adjusted.

**Example 14.77** Continuing Example 14.74, as long as the gross income from operations is $120,000 or more but less than $150,000, there will be taxable income not including the dividends-received deduction of $70,000 or more. The net loss from operations will be $30,000 or less. The dividends-received deduction will be limited to 70 percent of taxable income before the dividends-received deduction.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income from operations</td>
<td>$120,000</td>
</tr>
<tr>
<td>Expenses from operations</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Dividends received</td>
<td>100,000</td>
</tr>
<tr>
<td>Taxable income before dividends-received deduction</td>
<td>$70,000</td>
</tr>
<tr>
<td>Dividends-received deduction ($70,000 × 70%)</td>
<td>49,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$21,000</td>
</tr>
</tbody>
</table>

Since the full dividends-received deduction ($70,000) would make taxable income zero (not negative), the deduction is limited to $49,000 (70% × $70,000).

**Planning Pointer**

If there is any doubt prior to year-end whether the full dividends-received deduction is available, steps should be taken to defer income and accelerate deductions to ensure a net operating loss after the full deduction. Typical strategies include deferred payment sales, delaying shipping, stepping up acquisitions of cost recovery property, sales and leaseback at a loss, the use of escrow accounts, the payment of bonuses, stepping up repairs and maintenance, etc.

**Example 14.78** Continuing with Example 14.77, if gross income from operations decreased by $1 or operating expenses increased by $1, the corporation would be allowed the full dividends-received deduction of $70,000.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income from operations</td>
<td>$120,000</td>
</tr>
<tr>
<td>Expenses from operations</td>
<td>(150,001)</td>
</tr>
<tr>
<td>Dividends received</td>
<td>100,000</td>
</tr>
<tr>
<td>Taxable income before dividends-received deduction</td>
<td>$69,999</td>
</tr>
<tr>
<td>Dividends-received deduction</td>
<td>70,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>($ 1)</td>
</tr>
</tbody>
</table>

Stock must have been held for more than 45 days to be eligible for the dividends-received deduction. The stock also must be held without being protected by an offsetting short sale or option. Code Sec. 246(b) and (c). This restriction prevents corporations from purchasing dividend-paying stock shortly before the declaration of dividends and selling the stock immediately after receiving the right to the dividend. For example, without this requirement a corporation would pay tax of only $102 on $1,000 of dividend income ($1,000 × 30% dividend inclusion rate × 34% corporate tax rate) while generating a tax savings of $340 ($1,000 loss × 34%) if the stock were to decline by the amount of the dividend payment.
Debt-Financed Portfolio Stock

A restriction applies to the dividends-received deduction when a corporation has issued debt to finance its purchase of the stock. This reduction is equal to the ratio of the amount of portfolio indebtedness to the adjusted basis of the portfolio stock. Portfolio indebtedness means any debt directly attributable to the taxpayer corporation’s investment in portfolio stock. Without such a restriction, a corporation would be able to fully deduct interest paid to finance its investment in dividend-paying stock and be taxed on only 20 or 30 percent (100 percent minus dividends-received deduction) of the related dividend income.

**Example 14.79**

A corporation purchases 25 percent of the stock in another corporation for $300,000, of which $120,000 or 40 percent is borrowed. The corporation receives dividends of $24,000 from the investment. The allowable dividends-received deduction is limited to $11,520 ($24,000 × 80% × (100% – 40%)).

Extraordinary Dividends

The basis of stock held by a corporation must be reduced by the nontaxed portion of any extraordinary dividend received by the corporation with respect to stock. Code Sec. 1059. Stock basis is not reduced if the stock was held for more than two years before the earliest date that the dividend is declared, agreed to, or announced. The nontaxed portion of a cash distribution is the amount that is offset by the dividends-received deduction. The nontaxed portion of a property distribution is the fair market value of the property reduced by any liabilities assumed by the shareholder that is offset by the dividends-received deduction.

Generally, a dividend is deemed extraordinary when it exceeds 10 percent of a corporate taxpayer’s adjusted basis in a share of stock. The 10 percent becomes 5 percent in the case of preferred stock for purposes of determining whether the dividend is extraordinary. In determining whether the dividend is extraordinary, an alternative permits the taxpayer to substitute the fair market value of the share of stock on the day before the ex-dividend date for its adjusted basis. This is intended to mitigate the effect of basis reduction where a shareholder can demonstrate that the stock has appreciated significantly since the shareholder’s original investment.

The nontaxed portion of dividends on certain “disqualified” preferred stock issued after July 10, 1989, is treated as an extraordinary dividend (and therefore would be subject to basis reduction). The preferred stock is considered to be disqualified if (1) the preferred stock at the time it is issued has a dividend rate that declines, or can reasonably be expected to decline, in the future; (2) the issue price of the preferred stock exceeds its liquidation rights or its stated redemption price; or (3) the preferred stock is structured so as to avoid other provisions of Code Sec. 1059 and to enable corporate shareholders to reduce tax through a combination of dividends-received deductions and loss on the disposition of the stock. Code Sec. 1059(f).

The reduction in basis takes effect immediately before the disposition of the stock, except that earlier extraordinary dividends are taken into account in adjusting basis for purposes of determining whether a subsequent dividend is extraordinary.

**Example 14.80**

Matter Corporation purchases 100 shares of Fact Corporation stock for $3,000, or $30 per share, on February 2, 2007. On November 3, 2008, Matter Corporation receives a dividend of $4 per share. Matter deducts 70 percent of the $400 in dividends, or $280, on its tax return for the year. The dividend is considered to be extraordinary because it exceeds 10 percent of Matter’s adjusted basis in the shares. When it sells the stock, Matter will reduce its basis by $280 (the nontaxed portion of the distribution) for purposes of determining gain or loss. If Matter can show that the fair market value of the stock is at least $40 on the day before the ex-dividend date, the dividend would not be extraordinary because it would not exceed 10 percent of the fair market value. Thus, Matter would not have to reduce the basis of its stock.
Any basis adjustment may not reduce the corporation’s basis in the stock below zero. However, nontaxed portions of extraordinary dividends that otherwise would reduce basis below zero in the absence of this limitation are treated as gain from a sale or exchange of the stock in the year in which the extraordinary dividend is received.

An extraordinary dividend basis reduction will not apply if the stock was held by the taxpayer for the entire period the distributing corporation and any predecessor has been in existence. Also, dividends qualifying for the 100 percent dividend deduction are not subject to the extraordinary dividend rule.

**Dividends Received from Affiliated Corporations**

Where dividends are received from an affiliated corporation and the corporation group is not filing a consolidated return, a 100 percent dividends-received deduction may be elected by the group. An affiliated group exists where a corporation owns 80 percent or more of the outstanding voting stock and 80 percent or more of the value of all outstanding stock of another corporation. The election to deduct the entire dividend is made by the parent corporation for its tax year. Each member of the group must consent to the election. Members of the affiliated group must share one corporate tax rate schedule, one accumulated earnings credit, and one alternative minimum tax exemption.

**Example 14.81**

Parent Corporation owns 90 percent of the stock in Subsidiary Corporation. Subsidiary Corporation pays a $54,000 dividend to Parent Corporation. Parent Corporation can elect to deduct the full 100 percent of the dividend ($54,000) in the computation of taxable income. Subsidiary Corporation must consent to the election because it must also agree on the sharing of the corporate tax rate schedule, accumulated earnings credit, and the alternative minimum tax exemption.

**14,391 EXECUTIVE COMPENSATION**

In general, a corporation and its executives attempt to design a compensation package that maximizes the executives’ after-tax cash flows at the least cost and cash outflow to the corporation. Thus, the compensation package usually includes a combination of cash payments (salary and bonus), fringe benefits (nontaxable and taxable), and deferred compensation. However, in developing the package, the corporation is constrained in that the compensation package must be reasonable in amount Reg. §1.162-7(a). The Internal Revenue Service can use the substance over form doctrine to find that some of the compensation is unreasonable and in substance is a dividend (not deductible by the corporation) and not compensation.

Code Section 162(m) also limits the deductibility of executive compensation of publicly-traded corporations to $1 million. The restriction applies to the corporation’s five highest-paid executives (including the chief executive officer). Compensation in excess of this amount is not deductible unless it is based on a performance-based compensation plan.

**14,395 DOMESTIC PRODUCTION ACTIVITIES DEDUCTION**

Because the United States taxes worldwide income and has relatively high corporate income tax rates, Congress has passed various tax provisions that provide incentives to firms that export their products. Congress’s objective, in part, has been to make US firms more competitive in international markets. The World Trade Organization has declared many of these provisions to be illegal subsidies and has required the United States to repeal them. In response, Congress repealed the most recent tax provisions (incentives) dealing with extraterritorial income and replaced it with the domestic production activities deduction. This deduction is available to a wide-range of businesses and is not only an international activity deduction; it does not require exporting or any other activity outside the United States. The property must be manufactured, produced, grown or extracted in whole or in significant part in the United States (significant part means a firm would qualify if its direct labor and overhead costs incurred to manufacture or produce the product equal at least 20 percent of the product’s total cost. Reg. §1.199-3).
The American Jobs Creation Act of 2004 added new Code Sec. 199 which gives domestic manufacturers a deduction equal to a percentage of their taxable income (computed without regard to this new deduction). The purpose of the deduction is to reduce the effective tax rates for these firms. The deduction equals some percent \( x \) lesser of: (1) taxable income (before this deduction) for the taxable year or (2) qualified production activities income for the taxable year. The percent is 3\% for 2005 and 2006, 6\% for 2007, 2008, and 2009, and 9\% for taxable years after 2009. The deduction cannot exceed 50 percent of the firm’s W-2 wages for the taxable year that are allocable to qualified production activities.

Since taxable income is an upper bound, the maximum tax savings in dollars equals the appropriate percent \( x \) taxable income \( x \) the firm’s marginal tax rate, and since the deduction does not require any additional expenditures (unlike most other expense deductions), the tax savings also is the net cash flow associated with the deduction. Looking at the firm’s tax rate, the deduction effectively reduces the rate by an amount equal to the firm’s marginal tax rate \( x \) the appropriate percent (3\%, 6\% or 9\%, depending on the tax year).

**Example 14.82** Fry Corporation’s taxable income for 2008 before the domestic manufacturers’ deduction was $10,000,000. Its income from qualified production activities in 2008 was $8,000,000. Fry Corporation’s W-2 wages for 2008 were $3,000,000. Its domestic production activities deduction is $480,000 (6\% x lesser of: (1) $10,000,000 or (2) $8,000,000; and this amount does not exceed 50\% x W-2 wages ($1,500,000)).

**Example 14.83** Julia, Inc.’s taxable income is $15,000,000, and this is the lesser of all three constraints. For 2008 and 2010, the after-tax cash flow from the domestic production activities deduction equals $315,000 ($15,000,000 \times 35\% \times .06)$ and $472,500 ($15,000,000 \times 35\% \times .09)$, respectively. The reduction to its overall tax rate equals 2.10\% (35\% \times .06), and 3.15\% (35\% \times .09), respectively.

## Determination of Corporate Income Tax Liability

### ¶14,401 COMPUTATION OF TAX LIABILITY

After determining its taxable income, a corporation then must compute its income tax liability. This is a multiple-step process. The corporation first computes its regular tax liability. This amount is reduced by any tax credits to which it is entitled, such as the foreign tax credit (Code Sec. 27) and the general business credit (Code Sec. 38). Additionally, the corporation must compute an alternative minimum tax to which it may be subject. Any recapture of previously claimed tax credits is added to the resultant amount to produce the corporation’s income tax liability.

### ¶14,405 CORPORATE REGULAR INCOME TAX RATES

The marginal federal tax rate for corporations and associations taxed as corporations ranges from 15 to 39 percent (Code Sec. 11(b)) as follows:

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 to $50,000</td>
<td>15%</td>
</tr>
<tr>
<td>$50,001 to $75,000</td>
<td>25%</td>
</tr>
<tr>
<td>$75,001 to $100,000</td>
<td>34%</td>
</tr>
<tr>
<td>$100,001 to $335,000</td>
<td>39%</td>
</tr>
<tr>
<td>$335,001 to $10,000,000</td>
<td>34%</td>
</tr>
<tr>
<td>$10,000,001 to $15,000,000</td>
<td>35%</td>
</tr>
<tr>
<td>$15,000,001 to $18,333,333</td>
<td>38%</td>
</tr>
<tr>
<td>Over $18,333,333</td>
<td>35%</td>
</tr>
</tbody>
</table>
To discourage corporations from taking advantage of the lower brackets, certain affiliated corporations must share the lower brackets. Code Sec. 1563.

Corporations with over $100,000 in taxable income are subject to a 5 percent tax on such excess between $100,000 and $335,000. The maximum additional tax is $11,250 (($335,000 – $100,000) × 5%). This figure represents the savings from being in a tax bracket below 34 percent on the first $75,000. At $335,000 of taxable income, the result is the equivalent of a “flat tax” of 34 percent. The 34 percent “flat tax” is imposed on corporations whose taxable income ranges from $335,001 to $10,000,000. At $10,000,001, the tax rate increases to 35 percent. Corporations with over $15,000,000 in taxable income are subject to a 3 percent tax on the excess between $15,000,001 and $18,333,333. The maximum additional tax is $100,000 (($18,333,333 – $15,000,000) × 3%). This figure represents the savings from being in the 34 percent bracket on the first $10,000,000. At $18,333,333 of taxable income, the result is the equivalent of a “flat tax” of 35 percent. These tax rates are shown in the above tax rate schedule, and in the corporate tax rate schedule on the inside back cover of this book.

**Example 14.84** Alpha Corporation has taxable income of $85,000. The tax incurred would be $17,150, computed as follows:

<table>
<thead>
<tr>
<th>Bracket</th>
<th>Taxable Income</th>
<th>Tax Rate</th>
<th>Tax Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000 × 15%</td>
<td>$7,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25,000 × 25%</td>
<td></td>
<td>6,250</td>
<td></td>
</tr>
<tr>
<td>10,000 × 34%</td>
<td></td>
<td>3,400</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$17,150</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Example 14.85** Assuming a taxable income of $100,000, the tax would be $22,250, computed as follows:

<table>
<thead>
<tr>
<th>Bracket</th>
<th>Taxable Income</th>
<th>Tax Rate</th>
<th>Tax Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000 × 15%</td>
<td>$7,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25,000 × 25%</td>
<td></td>
<td>6,250</td>
<td></td>
</tr>
<tr>
<td>25,000 × 34%</td>
<td></td>
<td>8,500</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$22,250</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Example 14.86** Assuming a taxable income of $180,000, the tax would be $53,450, computed as follows:

<table>
<thead>
<tr>
<th>Bracket</th>
<th>Taxable Income</th>
<th>Tax Rate</th>
<th>Tax Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000 × 15%</td>
<td>$7,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25,000 × 25%</td>
<td></td>
<td>6,250</td>
<td></td>
</tr>
<tr>
<td>25,000 × 34%</td>
<td></td>
<td>8,500</td>
<td></td>
</tr>
<tr>
<td>80,000 × 39%</td>
<td></td>
<td>31,200</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$53,450</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Example 14.87** Assuming a taxable income of $335,000, the tax would be $113,900, computed as follows:

<table>
<thead>
<tr>
<th>Bracket</th>
<th>Taxable Income</th>
<th>Tax Rate</th>
<th>Tax Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000 × 15%</td>
<td>$7,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25,000 × 25%</td>
<td></td>
<td>6,250</td>
<td></td>
</tr>
<tr>
<td>25,000 × 34%</td>
<td></td>
<td>8,500</td>
<td></td>
</tr>
<tr>
<td>235,000 × 39%</td>
<td></td>
<td>91,650</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$113,900</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This is equivalent to $335,000 × 34%.
**EXAMPLE 14.88**  Assuming a taxable income of $5,000,000, the tax would be $1,700,000, computed as follows:

\[
\$5,000,000 \times 34\% 
\]

**EXAMPLE 14.89**  Assuming a taxable income of $14,000,000, the tax would be $4,800,000, computed as follows:

\[
\begin{align*}
\$10,000,000 \times 34\% & = \$3,400,000 \\
4,000,000 \times 35\% & = 1,400,000 \\
\hline
\text{Total} & = \$4,800,000
\end{align*}
\]

**EXAMPLE 14.90**  Assuming a taxable income of $17,000,000, the tax would be $5,910,000, computed as follows:

\[
\begin{align*}
\$10,000,000 \times 34\% & = \$3,400,000 \\
5,000,000 \times 35\% & = 1,750,000 \\
2,000,000 \times 38\% & = 760,000 \\
\hline
\text{Total} & = \$5,910,000
\end{align*}
\]

**EXAMPLE 14.91**  Assuming a taxable income of $18,333,333, the tax would be $6,416,666, computed as follows:

\[
\begin{align*}
\$10,000,000 \times 34\% & = \$3,400,000 \\
5,000,000 \times 35\% & = 1,750,000 \\
3,333,333 \times 38\% & = 1,266,666 \\
\hline
\text{Total} & = \$6,416,666
\end{align*}
\]

This is equivalent to $18,333,333 \times 35\%.$

**EXAMPLE 14.92**  Assuming a taxable income of $20,000,000, the tax would be $7,000,000, computed as follows:

\[
\$20,000,000 \times 35\%
\]

These rates are low enough to encourage incorporation for businesses that intend to retain their earnings. There is double taxation only if dividends are paid. Thus, if the corporation’s taxable income is $50,000 a year or less, a tax of 15 percent may be viewed as a reasonable price to pay for the indefinite deferral of the second tax at the shareholder level.

Personal service corporations are taxed at a flat tax rate of 35 percent. They are not given the benefit of the tax savings of the lower brackets. A personal service corporation is one in which substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. Substantially all of the stock (95 percent) must be held by employees, retired employees, or their estates.
### CORPORATE ALTERNATIVE MINIMUM TAX

Alternative minimum tax rules have been devised to ensure that no taxpayers with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. The underlying purpose was that Congress had concluded that both the perception and the reality of fairness in taxation had been harmed by instances in which corporations paid little or no tax in years when they reported substantial earnings, and may even have paid substantial dividends to shareholders.

The alternative minimum tax (AMT) assessed on corporations is similar to the AMT that individuals must pay. The AMT is payable to the extent that it exceeds the corporation’s regular income tax and must be taken into consideration in the corporate quarterly tax payments. Code Secs. 55-59. The starting point for computing the AMT is the corporation’s taxable income. Taxable income is modified for certain items such as tax preferences and reduced by an exemption amount. The resultant amount, the net alternative minimum taxable income, is multiplied by 20 percent to yield a tentative minimum tax (TMT). If TMT is greater than the corporation’s regular income tax, then the excess is the corporation’s AMT liability and must be added to its regular tax liability to determine the total tax due. If TMT is less than the corporation’s regular tax, then it has no AMT liability. In summary, the tax is computed as follows:

| Taxable Income | (+ or –) Adjustments to Taxable Income | + Tax Preference Items | (+ or –) Adjusted Current Earnings Adjustment | AMT-NOL Deduction (limited to 90 percent) | = Gross Alternative Minimum Taxable Income (AMTI) | = Exemption Amount | = Net Alternative Minimum Taxable Income | × 20% Tax Rate | = Gross Alternative Minimum Tax | – AMT Foreign Tax Credit | = Tentative Minimum Tax (TMT) | = Regular Income Tax (before credits but minus the regular Foreign Tax Credit and Possessions Tax Credit) | = Alternative Minimum Tax (AMT) |

Small corporations are not liable for the corporate AMT. A corporation qualifies as a small corporation if it had average gross receipts of $5,000,000 or less for its first three-year period beginning after December 31, 1993, and ending before the tax year for which the AMT exemption is being claimed. Once the corporation qualifies as a small corporation under the $5,000,000 test then it will continue to be exempt from the AMT as long as its average gross receipts for the prior three years do not exceed $7,500,000. A new corporation coming into existence after 1997 generally is considered to be an exempt corporation in its first year regardless of the size of its gross receipts for the year. To qualify as a small corporation for its second year, its average gross receipts for the first year must be $5,000,000 or less. Once it meets this test then the limit for subsequent years is $7,500,000; thus, to qualify as a small corporation for its third year its average gross receipts for the first two years must not exceed $7,500,000.

If a corporation loses its small corporation status because it has average gross receipts for the prior three-year period in excess of $7,500,000, it becomes liable for the AMT. However, the AMT liability is based only on certain preferences and adjustments that pertain to transactions that were entered into after the corporation lost its small corporation status.
EXAMPLE 14.93  James Co. is a small corporation for AMT purposes. In 2009, it determined that its average gross receipts for 2006, 2007, and 2008 was $7,900,000. James Co. is subject to the AMT for 2009. Its AMT will only be based on preferences and adjustments for transactions on or after January 1, 2009.

Adjustments to Taxable Income
The AMT is aimed at recovering some of the tax savings generated by a variety of other deductions and methods for computing tax liability. Thus, in determining AMTI, the taxpayer is required to make special adjustments to certain tax items that have been used to calculate regular taxable income. The adjustments may either increase or decrease alternative minimum taxable income. These adjustments reflect timing differences between the reporting methods for regular tax purposes and the alternative minimum tax. These adjustments are positive initially but reverse themselves in later years. The adjustments to taxable income are (Code Sec. 56):
1. Depreciation on post-1986 acquisitions and 1986 acquisitions using MACRS depreciation
2. Mining and exploration costs
3. Long-term contracts
4. Net operating losses
5. Pollution control facilities
6. Installment sales
7. Circulation expenses
8. Capital construction funds
9. Insurance companies deduction
10. Farming losses

Depreciation
The depreciation deduction for real property placed in service after 1986 and property placed in service in 1986 for which the MACRS depreciation rules are adopted must be recomputed for AMT purposes under the alternative depreciation system (ADS), generally the straight-line method, over 40 years. However, no adjustment is needed for real property placed in service after December 31, 1998.

Personal property placed in service after 1986 and property placed in service in 1986 under the MACRS depreciation rules must be depreciated using the 150 percent declining-balance method under the ADS, switching to straight-line in the year that maximizes the deduction.

Thus, two separate depreciation schedules must be computed: (1) depreciation for regular income tax purposes and (2) depreciation for AMT purposes. In the early years of an asset’s life, regular tax depreciation will exceed AMT depreciation and the difference will be a positive adjustment to taxable income in the AMT computation. In later years, AMT depreciation will exceed regular tax depreciation and cause a negative adjustment to taxable income.

EXAMPLE 14.94  A corporation purchases a $10,000 machine for use in business in 2004. Assuming the machine is a 5-year asset for both MACRS and ADS, the depreciation methods for regular tax and alternative minimum tax purposes along with the adjustment are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>200% Declining Balance</th>
<th>150% Declining Balance</th>
<th>Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$2,000</td>
<td>$1,500</td>
<td>+ $500</td>
</tr>
<tr>
<td>2005</td>
<td>3,200</td>
<td>2,550</td>
<td>+ 650</td>
</tr>
<tr>
<td>2006</td>
<td>1,920</td>
<td>1,785</td>
<td>+ 135</td>
</tr>
<tr>
<td>2007</td>
<td>1,152</td>
<td>1,666</td>
<td>– 514</td>
</tr>
<tr>
<td>2008</td>
<td>1,152</td>
<td>1,666</td>
<td>– 514</td>
</tr>
<tr>
<td>2009</td>
<td>576</td>
<td>833</td>
<td>– 257</td>
</tr>
</tbody>
</table>
In the first three years, the adjustment involves an amount that must be added to taxable income, while in the last three years the adjustment entails an amount that must be subtracted from taxable income. Thus, the corporation will make a $514 negative adjustment in 2008.

For AMT purposes, a property’s basis is only reduced by the amount of depreciation allowed in computing AMTI. Therefore, the adjusted basis of the property may differ for regular and minimum tax purposes. The gain or loss for AMTI upon disposition of the asset is determined by the AMTI basis.

**Mining Exploration and Development Costs**

Mining exploration and development costs that are generally deductible in the current year are required to be computed under the 10-year straight-line amortization for AMT purposes. The adjusted basis of property for which mining exploration and development costs are incurred may differ for regular tax and AMT purposes, giving rise to different amounts of gain or loss between the two systems upon the disposition of such property. The tax preference adjustment for mining exploration and development costs may be avoided if the taxpayer makes a regular tax election to deduct such expenditures over a 10-year period.

**Example 14.95**

Douglas Corporation’s taxable income for 2008 is $375,000. Included in its expenses was a $60,000 deduction for mining exploration costs incurred in 2008. Douglas Corporation had no other tax preferences (or adjustment items). Its AMTI for 2008 is $429,000, computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$375,000</td>
</tr>
<tr>
<td>Adjustment</td>
<td></td>
</tr>
<tr>
<td>Excess mining exploration costs (amount expensed minus amount allowed over a 10-year amortization period; $60,000 minus $6,000)</td>
<td>54,000</td>
</tr>
<tr>
<td>AMTI</td>
<td>$429,000</td>
</tr>
</tbody>
</table>

**Long-Term Contracts**

Taxpayers must use the percentage-of-completion method for long contracts entered into after March 1, 1986, to determine income for purposes of calculating the AMTI. In the case of small construction contracts (other than home construction contracts) entered into after June 21, 1988, the percentage of completion is determined under the simplified cost allocation method. Home construction contracts entered into in tax years beginning after September 30, 1990, are not required to use the percentage-of-completion method.

**Net Operating Losses**

The regular NOL deduction is replaced by the AMTI-NOL deduction. The regular NOL must be modified to take into account the same adjustments and tax preferences made to determine AMTI. The AMTI-NOL deduction cannot offset more than 90 percent of AMTI determined before the NOL deduction. The purpose of the limitation is to assure that corporations at least pay a minimum amount of taxes, 2 percent of AMTI each year (remaining AMTI (10%) × 20% tax rate). However, the exemption and credits might reduce this to zero.

**Pollution Control Facilities**

The five-year amortization method for depreciating pollution control facilities must be replaced by the alternative depreciation system. The adjusted basis used in AMTI calculations to determine the gain or loss on the sale of property for which depreciation has been adjusted must reflect the depreciation adjustments rather than the costs that were deductible in regular tax computations.
Effective for property placed in service after December 31, 1998, the recovery periods used for AMT purposes conform with the recovery periods used under MACRS using the straight-line method.

**Installment Sales**
Generally, the installment method is not available for dealer dispositions of stock in trade and other property held by the taxpayer primarily for sale to customers in the ordinary course of business. The realized gain is recognized in the year of sale. Thus, no AMT adjustments will generally be required for such dealer sales. The installment method may be used in determining AMTI for all nondealer dispositions of property.

**Circulation Expenditures**
The amount of circulation expenditures (i.e., the costs of establishing, maintaining, or increasing the circulation of newspapers, magazines, or other periodicals) allowed as a current deduction for regular tax purposes must be amortized over a three-year period for AMT purposes. This tax preference applies to personal holding companies. However, under the AMT rules, corporate taxpayers are free to capitalize or deduct their circulation expenditures. Thus, for most C corporations there is no AMT adjustment for circulation expenditures.

**Capital Construction Funds**
Contributions made by shipping companies to capital construction funds (established under Section 607 of the Merchant Marine Act of 1936) may not be deducted from AMTI and a fund’s earnings (including gains or losses) may not be excluded from AMTI. No reduction in the basis of a vessel, barge, or container need be made to reflect amounts withdrawn from a fund, if the amounts have been included in AMTI.

**Insurance Companies Deduction**
The special deduction from regular tax allowed to Blue Cross and Blue Shield organizations for one-fourth of their annual claims and administrative expenses (less the prior tax year’s adjusted surplus) may not be claimed against AMTI.

**Farming Losses**
No deduction is allowed for losses from any farming syndicate or any other farming activity in which the taxpayer does not materially participate. A loss from one farming activity may not be used to offset income from another farming activity. Disallowed losses are carried forward indefinitely and used for AMTI purposes to offset future income from the farming activity. Suspended losses are deductible when the activity is disposed. These provisions apply to personal service corporations.

**Tax Preference Items**
Tax preferences must be added back to the corporation’s taxable income to compute AMTI. These preferences are usually the result of some tax benefit received in the computation of taxable income. Unlike AMT adjustments which can either increase or decrease AMTI, tax preference items only increase AMTI. The tax preference items are (Code Sec. 57(a)):
1. Depletion
2. Intangible drilling costs
3. Private activity bonds interest
4. Accelerated depreciation and amortization on pre-1987 property

**Depletion**
The depletion preference for corporate taxpayers is the excess of the allowable percentage depletion deduction over the adjusted basis of the property at the end of the year. The preference applies to percentage depletion for all minerals, not just oil and gas. However, the preference does not apply to most oil and gas companies.
**Intangible Drilling Costs**

The amount of excess intangible drilling costs for the year is treated as a tax preference to the extent that it exceeds 65 percent of the corporate taxpayer’s net income for the tax year from oil, gas, and geothermal properties. The amount of excess intangible drilling costs, for this purpose, is the excess of the deduction for the current cost of drilling productive wells over the deduction that would have been allowable if such costs had been capitalized and either (1) amortized over a 10-year period or (2) deducted, at the election of the taxpayer, as cost depletion, whichever is more favorable. The intangible drilling costs preference is computed separately for geothermal properties and for oil and gas properties.

**Private Activity Bonds Interest**

A tax preference has been added for tax-exempt interest on private activity bonds issued after August 7, 1986. This preference does not apply to bonds issued for the benefit of tax-exempt charitable or educational institutions under Code Sec. 501(c)(3) or to bonds issued for public purposes such as schools and municipally owned public utilities.

**Accelerated Depreciation and Amortization on Pre-1987 Property**

There is a tax preference for excess depreciation and amortization taken on certain properties acquired before 1987. However, any properties acquired in 1986 that use the MACRS cost recovery rules are not subject to this tax preference.

1. Depreciation on real property acquired before 1987 that is in excess of straight-line depreciation over the useful life
2. Amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable)

**Example 14.96**

Hoover Inc. has taxable income of $230,000. Included in its expenses was a $50,000 deduction for percentage depletion. The $50,000 was in excess of the depletable property’s adjusted basis (i.e., the property has a zero adjusted basis). No other tax preferences or adjustments were needed. AMTI for Hoover Inc. is $280,000, computed as follows:

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>$230,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Preferences</td>
<td></td>
</tr>
<tr>
<td>Percentage depletion in excess of adjusted basis</td>
<td>50,000</td>
</tr>
<tr>
<td>AMTI</td>
<td>$280,000</td>
</tr>
</tbody>
</table>

**Adjusted Current Earnings**

Corporations are required to make an adjustment based on adjusted current earnings. The adjustment equals 75 percent of adjusted current earnings (ACE) less AMTI.

The adjusted current earnings adjustment may be either an increase or a decrease in taxable income when computing AMTI. The negative adjustment is limited to the aggregate positive adjustment for ACE in prior tax years, minus negative adjustments previously claimed. Code Sec. 56(g)(2). Any unused negative adjustment is lost forever.

**Example 14.97**

A corporation has the following AMTI (before ACE adjustments and alternative tax NOL deductions) and ACE for 2007 to 2010.

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMTI</td>
<td>$5,000</td>
<td>$4,000</td>
<td>$7,000</td>
<td>$9,200</td>
</tr>
<tr>
<td>ACE</td>
<td>7,000</td>
<td>4,000</td>
<td>6,000</td>
<td>8,000</td>
</tr>
</tbody>
</table>
A positive ACE adjustment of $1,500 (75% × ($7,000 – $5,000)) is made in 2007. No adjustment is needed in 2008 since ACE and unadjusted AMTI are equal. A negative ACE adjustment of $750 (75% × ($6,000 – $7,000)) is made in 2009. Finally, a negative ACE adjustment of $750 is made in 2010 because of the limitation on negative ACE adjustments. The computed adjustment is $900 (75% × ($8,000 – $9,200)) but this is constrained to $750, the aggregate positive adjustment ($1,500) reduced by the aggregate negative adjustment ($750). The remaining $150 is lost forever.

The determination of ACE is complicated and Reg. §1.56(g)-1 provides further guidance on its calculation. The starting point in determining ACE is AMTI, determined without regard to the alternative tax NOL deduction and the ACE adjustment, adjusted for several items. Many of these adjustments are similar to those required to compute corporate earnings and profits (E&P) under Code Sec. 312. However, ACE is not the same as E&P because not all items affect both similarly (for example, federal income taxes are deductible in computing E&P but are not deductible in computing ACE).

The adjustments to AMTI for purposes of computing ACE are as follows. AMTI is increased by items excluded from gross income in computing AMTI if the items increase a corporation’s earnings and profits (E&P). Examples of this adjustment are tax-exempt interest and key-person life insurance proceeds. These amounts are reduced by the nondeductible expenses incurred to produce them.

Deductions taken to compute AMTI that are not deductions for purposes of computing E&P must be eliminated (i.e., AMTI is increased). An example of this adjustment is the dividends-received deduction. However, although the dividends-received deduction (DRD) is not permitted for E&P purposes, the deduction is permitted for ACE purposes with respect to dividends received from 20 percent owned corporations (80 percent DRD) and for 100 percent dividends (100 percent DRD) to the extent that the dividend is attributable to taxable income of the paying corporation. The 70 percent DRD is not permitted for ACE purposes.

No adjustment is made to ACE related to the E&P effect of charitable contributions. Code Sec. 56(g)(4)(I). Thus, the excess of fair market value deduction allowed for tax purposes over the basis deduction for book purposes is not included in the ACE adjustment.

Adjustments also must be made so that ACE is computed as if the corporation did not use the installment method; ACE adjustments must reflect use of cost depletion, capitalized and amortized intangible drilling costs, use of the alternative depreciation system under Code Sec. 168(g) for assets placed in service after 1989, and straight-line depreciation for property depreciated under MACRS or ACRS. However, ACE adjustments are not required for intangible drilling, and for percentage depletion for oil and gas. Finally, other E&P-type adjustments include adjustments for circulation and organizational expenditures that are not amortizable for ACE purposes, mineral exploration and development costs that must be amortized for ACE purposes, and LIFO inventory adjustments.

**Exemption Amount**

Before the 20 percent tax rate is applied, corporations may be able to reduce AMTI by the exemption amount. Code Sec. 55(d). The allowed exemption amount is $40,000. The exemption amount is reduced by 25 cents for each $1 by which alternative minimum taxable income exceeds $150,000. Consequently, the exemption is completely eliminated for AMTI of $310,000 or more.

**Example 14.98**

A corporation with AMTI of $300,000 is allowed an exemption amount of $2,500 ($40,000 – .25 × ($300,000 – $150,000)). If the AMTI were $310,000 or more, there would be no deduction for the exemption amount.
**Tentative Minimum Tax**

AMTI is reduced by the allowable exemption amount resulting in the corporation’s net alternative minimum taxable income (the tax base for AMT purposes). This base is multiplied by the AMT tax rate of 20 percent to determine the gross alternative minimum tax. The tentative minimum tax is calculated by subtracting AMT foreign tax credits from the gross alternative minimum tax. Credits not allowed in the current year are carried over under the foreign tax carryover rules. Code Sec. 59.

**Net AMT Liability**

The corporate taxpayer’s AMT for a tax year is the excess of the tentative minimum tax over the regular tax. Following the computation of the tentative minimum tax \((20\% \times (\text{AMTI} - \text{exemption amount}) - \text{AMT foreign tax credit}) = \text{tentative minimum tax}\), a comparison must be made between the tentative AMT liability and the corporation’s regular tax liability. The regular tax figure to which the tentative minimum tax is compared is the regular tax on corporate income reduced by the foreign tax credit and the possessions tax credit. Furthermore, for comparative purposes, certain adjustments to the regular tax liability must be made.

The regular income tax does not include the tax on accumulated distributions of trusts. Nonrefundable credits (i.e., general business credit) generally cannot be used to reduce the regular tax liability to less than the tentative minimum tax. Credits that cannot be used by the taxpayer due to the effect of the alternative minimum tax can be carried over to other tax years under rules generally applicable to credit carryovers.

The following rules summarize the comparison process:

1. If the tentative AMT liability exceeds the regular tax liability (as modified by only the nonrefundable foreign tax credit and the possessions tax credit), then the corporate taxpayer pays the tentative AMT (which is comprised of the regular tax and the excess of the tentative AMT or net AMT liability).
2. If the tentative AMT liability is less than the regular tax liability, then all nonrefundable credits will be allowed to reduce the corporation’s regular tax liability to the extent of the tentative AMT liability but not below it. Thus, the corporate taxpayer must pay at least the tentative AMT liability.

**Example 14.99**  
Williams Inc. has taxable income of $400,000. Williams has alternative minimum tax adjustments and tax preferences of $300,000. The regular tax is a flat 34 percent of $400,000, or $136,000. The tentative minimum tax equals 20 percent of $700,000, or $140,000. The alternative minimum tax becomes $4,000. (No exemption was allowed since AMTI was $310,000 or more).

**Example 14.100**  
A corporation has taxable income of $500,000 along with a general business credit of $22,000. The corporation has adjustments and preferences of $300,000. The income tax before credits is $170,000 ($500,000 \times 34\%). The tentative minimum tax is $160,000 (($500,000 + $300,000) \times 20\%). The corporation is allowed only $10,000 of the general business credit. A $10,000 general business credit reduces the regular income tax to the tentative minimum tax, thus no alternative minimum tax is incurred. The remaining general business credit of $12,000 is carried over to other tax years.

**Minimum Tax Credit**

Adjustments and tax preferences used to modify taxable income to compute AMTI consist of items that are timing differences and permanent differences. Timing differences defer tax liability and permanent differences produce a permanent reduction in taxable income. For tax years beginning before 1990, AMT due to timing differences is available for the minimum tax credit. The entire amount of the AMT liability is available for the minimum tax credit in tax years beginning after 1989.
The purpose of the minimum tax credit is to prevent the double taxation of deferral preferences and adjustments. These deferral preferences and adjustments are subject to the alternative minimum tax in a tax year earlier than the year they are subject to the regular tax.

The extent to which deferral preference items cause tentative minimum tax to exceed the regular tax may be carried forward and used as an offsetting credit against regular tax to which the corporation may be subject in future years. For pre-1990 tax years only, minimum tax credit is generated where exclusion items cause tentative minimum tax to exceed the regular tax. A taxpayer is not allowed to take a credit larger than an amount necessary to reduce the regular tax to the amount of the tentative minimum tax.

**Example 14.101**

In 1989, Heit Corporation had taxable income of $350,000. For AMTI purposes it had $150,000 of deferral adjustments and $300,000 of exclusion preferences. Its regular tax was $119,000 ($350,000 × .34). Its net alternative minimum taxable income was $800,000 ($350,000 + $150,000 + $300,000; since AMTI was greater than $310,000 there is no exemption). The AMT was $41,000 ((20% × $800,000) – $119,000). If only the exclusion preferences were considered to compute AMTI, then AMT would have been $11,000 (20% × ($350,000 + $300,000) – $119,000). Thus, the minimum tax credit was $30,000 ($41,000 – $11,000). The $30,000 credit can be carried forward indefinitely by Heit Corporation. The credit can be used to offset its regular tax liability.

**Example 14.102**

Assume the same facts as in Example 14.101, except that the tax year is 2008. In this case, the entire amount of the AMT liability ($41,000) may be carried forward as a credit.

**Example 14.103**

A corporation has a tentative minimum tax of $100,000, a regular tax before the AMT credit of $120,000, and a minimum tax credit of $35,000. Without the minimum tax credit, the corporation would not have an alternative minimum tax because the regular tax exceeds the tentative minimum tax. Since the full minimum tax credit would reduce the regular tax below the tentative minimum tax, only $20,000 of the minimum tax credit carryforward may be used to reduce the regular tax.

The AMT credit is limited for small corporations currently not subject to the AMT. The credit is limited to the amount by which the corporation’s regular tax liability (reduced by other credits) exceeds 25 percent of the excess, if any, of the corporation’s regular tax liability (reduced by other credits) over $25,000.

**Example 14.104**

Niffo Company is a small corporation for 2009 and does not have an AMT liability. It has a large AMT carryover from previous years. Niffo’s regular tax liability (after other credits) in 2009 is $80,000. Its allowable credit for 2009 is $66,250, computed as follows: $80,000 – 25% ($80,000 – $25,000) = $66,250.

**Example 14.105**

SQ Corporation is a calendar-year taxpayer. For its tax year ended December 31, 2008, it had the following income and expenses.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross sales</td>
<td>$3,800,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>$140,000</td>
</tr>
<tr>
<td>Dividend income from 30% owned domestic corporation</td>
<td>$90,000</td>
</tr>
<tr>
<td>Short-term capital gain</td>
<td>$25,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Wage expense</td>
<td>$300,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>$40,000</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>$145,000</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>$26,000</td>
</tr>
<tr>
<td>Other expenses</td>
<td>$1,400,000</td>
</tr>
</tbody>
</table>
Included in the interest income is $100,000 from municipal bonds. Depreciation for book purposes is $110,000 and for AMT purposes is $128,000. The $26,000 charitable contribution is for a donation of long-term capital gain property whose adjusted basis is $12,000. Other expenses do not include the federal income tax. SQ’s alternative minimum tax is computed as follows.

### Income:
- Gross sales: $3,800,000
- Cost of goods sold: $1,800,000
- Gross profit: $2,000,000
- Interest income: $40,000
- Dividend income: $90,000
- Short-term capital gain: $25,000
- Total Income: $2,155,000

### Expenses:
- Wages expense: $300,000
- Interest expense: $40,000
- Depreciation expense: $145,000
- Other expenses: $1,400,000
- Total Expenses: $1,885,000

Charitable contribution deduction: $26,000
Dividends-received deduction: $72,000

Taxable income: $172,000
Tax Liability: $50,330

### Alternative Minimum Tax Computation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income (Income)</td>
<td>$172,000</td>
</tr>
<tr>
<td>Tax Preferences:</td>
<td></td>
</tr>
<tr>
<td>Excess depreciation</td>
<td>17,000</td>
</tr>
<tr>
<td>AMTI before ACE adjustment</td>
<td>$189,000</td>
</tr>
<tr>
<td>ACE adjustment</td>
<td>88,500</td>
</tr>
<tr>
<td>(.75 × (ACE – AMTI)), (.75 × ($307,000* – $189,000))</td>
<td></td>
</tr>
<tr>
<td>Alternative Minimum Taxable Income</td>
<td>$277,500</td>
</tr>
<tr>
<td>Alternative Minimum Tax Exemption</td>
<td>8,125</td>
</tr>
<tr>
<td>($40,000 – .25 × ($277,500 – $150,000))</td>
<td></td>
</tr>
<tr>
<td>Net AMTI</td>
<td>$269,375</td>
</tr>
<tr>
<td>20% Tax Rate</td>
<td>× .20</td>
</tr>
<tr>
<td>Gross AMT</td>
<td>$53,875</td>
</tr>
<tr>
<td>AMT Foreign Tax Credit</td>
<td>0</td>
</tr>
<tr>
<td>Tentative Minimum Tax</td>
<td>$53,875</td>
</tr>
<tr>
<td>Regular Income Tax</td>
<td>50,330</td>
</tr>
<tr>
<td>Alternative Minimum Tax</td>
<td>$3,545</td>
</tr>
</tbody>
</table>

* ACE = $189,000 (AMTI before ACE) + $100,000 (tax-exempt interest) + $18,000 (excess of depreciation for books over depreciation for AMT) = $307,000. The ACE adjustment does not include the 80 percent dividends-received deduction nor the $14,000 excess of charitable deduction for tax purposes over the deduction for book purposes.
Corporations subject to the alternative minimum tax generally benefit by accelerating income into an AMT year and delaying expenses until a regular tax year. Payment of allowable deductions, such as charitable contributions, provides a tax benefit in an AMT year of only 20 percent, while delaying the payment to a regular tax year may allow a deduction at 34 percent. Also, income recognized in an AMT year will generally be taxed at 20 percent rather than at the higher regular tax rate.

**CONTROLLED GROUPS OF CORPORATIONS**

The corporate tax rate varies from 15 percent on the first $50,000 of taxable income to a flat rate of 35 percent on taxable income in excess of $18,333,333. Instead of forming one corporation, shareholders could form several corporations in an attempt to distribute the income-generating property so as to assure that each corporation’s taxable income did not exceed $50,000. This would result in significant tax savings.

**Example 14.106**

A corporation with taxable income of $350,000 has a tax liability of $119,000 ($350,000 × 34%). If seven corporations were formed and the property distributed such that each corporation had $50,000 of taxable income, then the total tax liability of the corporations would be $52,500 (($50,000 × 15%) × 7). The result is a tax savings of $66,500 ($119,000 – $52,500).

Code Sec. 1561 was enacted to limit the benefits that taxpayers might receive by using multiple corporations. Multiple corporations that are members of a controlled group must share certain tax benefits as if they were one corporation. These benefits include the lower tax brackets, the alternative minimum tax exemption of $40,000, the Section 179 election to expense certain depreciable property, and the $250,000 accumulated earnings credit. The impact of Code Sec. 1561 may be illustrated as follows.

**Example 14.107**

If, in Example 14.106, the seven corporations are members of a controlled group, then they must share the tax brackets equally unless all the members agree to an unequal allocation of the brackets. Thus, each of the seven corporations will have $7,143 ($50,000 ÷ 7) taxed at 15 percent and $3,571 ($25,000 ÷ 7) taxed at 25 percent. Additionally, the 5 percent surtax on taxable income in excess of $100,000 is allocated. Thus, if the total taxable income for the group of corporations exceeds $335,000, then each member will have a tax rate of 34 percent.

Parent-subsidiary corporations, brother-sister corporations, combined groups, and certain insurance companies are controlled groups. Code Sec. 1563(a). Affiliated groups and controlled groups are not synonymous. An affiliated group always involves a parentsubsidiary relationship. Thus, parentsubsidiary corporations are both controlled groups and affiliated groups. However, two corporations owned by the same individual (brother-sister corporations) are a controlled group but not an affiliated group.

**Parent-Subsidiary Corporations**

A parent-subsidiary controlled group consists of one or more chains of corporations connected through stock ownership with a common parent corporation. Code Sec. 1563(a)(1). The parent corporation must own at least 80 percent of the total voting power of all classes of voting stock or at least 80 percent of the total value of shares of all classes of stock of at least one corporation (the subsidiary). Once this initial parentsubsidiary relationship is established, then another corporation can be included in the group if the parent corporation, the subsidiary corporation, or any other corporation in the group individually owns or collectively own at least 80 percent of the total voting power of all of its classes of voting stock or at least 80 percent of the total value of shares of all of its classes of stock.
EXAMPLE 14.108

Alpha Corporation  80%  Beta Corporation

Alpha and Beta are members of a parent-subsidiary controlled group. Alpha is the parent.

EXAMPLE 14.109

Alpha Corporation  80%  Beta Corporation

Beta Corporation  80%  Chi Corporation

Alpha, Beta, and Chi are members of a parent-subsidiary controlled group. Alpha is the parent.

EXAMPLE 14.110

Alpha Corporation  80%  Beta Corporation

Beta Corporation  80%  Chi Corporation

Delta Corporation  40%  25%  80%

15%

Alpha, Beta, Chi, and Delta are members of a controlled parent-subsidiary. Alpha is the parent.

The controlled parent-subsidiary group is subject to the restrictions of tax benefits mentioned earlier. However, a benefit of this controlled group is that it may elect to file a consolidated return.

Brother-Sister Corporations

In general, a brother-sister controlled group consists of two or more corporations owned by five or fewer individuals, estates, or trusts who (1) own at least 80 percent of the combined voting power of all voting stock or at least 80 percent of the total value of shares of all classes of stock of each corporation and (2) own more than 50 percent of total combined voting power of all voting stock or more than 50 percent of the total value of all classes of stock of each corporation. In calculating the 50 percent test, ownership of each person is included only to the extent that such ownership is identical with respect to each corporation. Thus, only the smallest percent-
age owned in any of the corporations is counted. Stock owned by family members or certain entities may be attributed to a taxpayer under the attribution rules. Code Sec. 1563(d)(2).

However, under Code Sec. 1563(a)(2) the 80 percent test is not used for purposes of Code Sec. 1561 rules only regarding sharing of lower tax brackets, the alternative minimum tax exemption, the Section 179 expenses, and the accumulated earnings credit. Thus, for Code Sec. 1561 purposes only, only the 50 percent test is used. Thus, a group could be a brother-sister controlled group for Code Sec. 1561 purposes but not be a brother-sister controlled group for all other purposes. Brother-sister controlled groups also may not file a consolidated tax return.

**Example 14.111** Alpha, Beta, and Chi Corporations each have only one class of stock outstanding. The ownership of this stock is as follows:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Alpha</th>
<th>Beta</th>
<th>Chi</th>
<th>Identical Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jones</td>
<td>25%</td>
<td>20%</td>
<td>55%</td>
<td>20%</td>
</tr>
<tr>
<td>Smith</td>
<td>25%</td>
<td>30%</td>
<td>35%</td>
<td>25%</td>
</tr>
<tr>
<td>Nelson</td>
<td>50%</td>
<td>50%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>55%</td>
</tr>
</tbody>
</table>

Alpha, Beta, and Chi are members of a controlled brother-sister group because both ownership tests are met. Five or fewer individuals own at least 80 percent of each corporation (they own 100 percent of each) and they have greater than a 50 percent common ownership (55 percent identical ownership).

**Example 14.112** Same as Example 14.111, except for the following ownership:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Alpha</th>
<th>Beta</th>
<th>Chi</th>
<th>Identical Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jones</td>
<td>5%</td>
<td>30%</td>
<td>45%</td>
<td>5%</td>
</tr>
<tr>
<td>Smith</td>
<td>65%</td>
<td>10%</td>
<td>35%</td>
<td>10%</td>
</tr>
<tr>
<td>Nelson</td>
<td>30%</td>
<td>60%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>35%</td>
</tr>
</tbody>
</table>

Alpha, Beta, and Chi are not members of a controlled brother-sister group. Although the 80 percent test is met, the identical ownership test of greater than 50 percent is not met. (In determining identical ownership, include the minimum ownership in each row.) Both tests must be met in order to have a brother-sister controlled group.

In determining ownership for the 80 percent test, only individuals who own stock in each and every corporation of the controlled group are counted. Reg. §1.1563-1(a)(3).

**Example 14.113** Alpha and Beta each have one class of stock outstanding. Ownership is as follows:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Alpha</th>
<th>Beta</th>
<th>Identical Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Boggs</td>
<td>55%</td>
<td>100%</td>
<td>55%</td>
</tr>
<tr>
<td>Lyle</td>
<td>45%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td>55%</td>
</tr>
</tbody>
</table>
At first glance it appears that both the 80 percent and greater than 50 percent tests are met. However, since Lyle does not own stock in Beta Corporation, his ownership is not counted in calculating the 80 percent test. Thus, the 80 percent test is not met and there is not a brother-sister controlled group. (See Vogel Fertilizer Co., 1982-1 USTC ¶9134, 455 U.S. 16, 102 S.Ct. 821 (1982).)

**Example 14.114** Alpha, Beta and Chi Corporations each have only one class of stock outstanding. The ownership of the stock is as follows:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Corporations</th>
<th>Identical Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Alpha</td>
<td>Beta</td>
</tr>
<tr>
<td>Jones</td>
<td>20%</td>
<td>15%</td>
</tr>
<tr>
<td>Smith</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Nelson</td>
<td>20%</td>
<td>35%</td>
</tr>
<tr>
<td>Delta Corp.</td>
<td>40%</td>
<td>30%</td>
</tr>
</tbody>
</table>

Although the 80 percent test is not met, the 50 percent test is met. Thus, Alpha, Beta and Chi are a brother-sister controlled group for Code Sec. 1561 purposes and must share tax brackets, the alternative minimum tax exemption, the Section 179 expenses, and the accumulated earnings credit.

**Combined Groups**

A combined group consists of three or more corporations of which each is a member of a parent-subsidiary controlled group or a brother-sister controlled group and one of the corporations is a common parent in the parent-subsidiary controlled group and also is a member of the brother-sister controlled group. Code Sec. 1563(a)(3).

**Example 14.115** Delta, Gamma, and Sigma Corporations each have only one class of stock outstanding. The ownership of their stock is as follows:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Corporations</th>
<th>Delta</th>
<th>Gamma</th>
<th>Sigma</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jones</td>
<td>60%</td>
<td>40%</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Hill</td>
<td>40%</td>
<td>60%</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Gamma Corp.</td>
<td>—</td>
<td>—</td>
<td>80%</td>
<td></td>
</tr>
</tbody>
</table>

Delta and Gamma are members of a brother-sister controlled group. Gamma and Sigma are members of a parent-subsidiary group. Since Gamma also is a member of the brother-sister group, Delta, Gamma, and Sigma are members of a combined group.

**Allocations of Income, Deductions, and Credit**

In addition to restrictions placed on controlled groups by Code Sec. 1561, Code Sec. 482 has the potential to effect further constraints. Members of controlled groups may attempt to minimize tax liability by shifting income, deductions, or credits in an advantageous fashion. Code Sec. 482 gives the IRS the power to rearrange the distribution, thereby reducing the controlled group’s ability to manipulate tax liabilities. Specifically, the IRS has the right to
reallocate gross income, deductions, and credits between two or more corporations owned or controlled by the same interests if such reallocation is necessary to prevent the evasion of taxes or to clearly reflect income.

\textbf{CONSOLIDATED RETURNS}

For tax planning purposes, a parent-subsidiary controlled group has three alternatives: (1) file separate returns, (2) file a consolidated return, or (3) file separate returns with a Code Sec. 243 election of a 100 percent dividends-received deduction. The parent-subsidiary group may make an irrevocable election to file a consolidated tax return. Code Sec. 1501. Each member must consent and each subsidiary must conform its tax year and accounting methods to those of the parent. Consolidated returns must continue to be filed until the IRS grants permission to stop or the group no longer qualifies. For example, if the parent’s stock ownership in the subsidiary falls below 80 percent, then the group no longer qualifies to file a consolidated return.

Certain corporations are precluded from being included in a consolidated return. Tax-exempt corporations, life and mutual insurance companies, foreign corporations, U.S. possessions corporations, regulated investment companies and real estate investment trusts, and foreign sales corporations are not eligible to be included in a consolidated return. Code Sec. 1504(b).

There are certain advantages in filing consolidated returns. Income from one member is offset by losses generated by other members. Also, capital losses of a member corporation that otherwise would not be deductible can be used to offset other members’ capital gains. Additionally, income from intercompany transactions is not included in the determination of consolidated income. Finally, the group does not have any allocation problems under Code Sec. 482.

There are certain disadvantages in filing a consolidated return. The election is irrevocable and is binding on all subsequent years unless the group is terminated or the IRS grants the group permission to discontinue filing consolidated returns. Also, losses on intercompany transactions are not deductible. Additionally, the recordkeeping needed to file a consolidated return can be significant and, therefore, more costly than if separate returns are filed.

Although the filing of a consolidated tax return has certain advantages, there are several limitations that affect the members’ ability to offset income by using the losses or deductions of other members. A loss corporation’s net operating loss carryover may be applied against the consolidated income of the group on consolidated returns. However, tax losses of other group members cannot offset the income of another member corporation to the extent that said income is paid out as dividends on certain nonvoting, nonconvertible preferred stock issued after November 17, 1989. Code Sec. 1503(f)[e]. Also, if the loss year was a separate return limitation year (SRLY), then the loss may be carried over only against income of the loss corporation. An SRLY is any year in which a member of the group filed a separate tax return. A separate return year is not an SRLY if the corporation was a member of the affiliated group for each day of that year. Under certain conditions, a loss corporation can acquire a profitable subsidiary and apply its loss carryover against the profits of that corporation.

An additional limitation is the inability to offset a built-in deduction of a subsidiary against consolidated income. Built-in deductions can arise if the subsidiary had an SRLY. Any built-in deductions are deducted only against income of the subsidiary that sustained the deductions. The built-in deduction rules do not apply if the group acquired the assets more than 10 years prior to the tax year or the total adjusted basis of all assets (other than cash, marketable securities, and goodwill) of the acquired subsidiary did not exceed the fair market value of all such assets by more than 15 percent. Reg. §1.1502-15.

\textbf{Example 14.116}

Maryland Corporation purchases all of the stock of Baltimore Corporation at the end of the year. Baltimore Corporation owns an asset with a basis of $5,000 and a fair market value of $3,000. The asset is sold in the following year for $2,200 and a consolidated return is filed. Of the $2,800 loss, $2,000 is treated as a built-in loss and can be deducted only against the separate income of Baltimore Corporation.
EXAMPLE 14.117  Assume the asset from Example 14.116 is depreciable property. Depreciation deductions attributable to the $2,000 difference between basis and fair market value are treated as built-in deductions and limited to deductions against the separate income of Baltimore.

The rules and regulations pertaining to consolidated income tax returns are very complex. Several treatises, each consisting of several volumes, exist on the subject.

CORPORATE TAX RETURNS

All corporations, with certain exceptions, are required to file a corporate tax return each year. A return must be filed even if the corporation has no taxable income. Code Sec. 6012(a)(2). A corporation that is in existence for only a portion of a tax year is required to file a tax return covering that partial tax year.

A corporation also is required to make estimated tax payments throughout the year unless its estimated tax for the year is less than $500. The corporation must make these payments by the 15th day of the 4th, 6th, 9th, and 12th month of its tax year. Code Sec. 6655(c). Corporations on a calendar year must make the payments by April 15, June 15, September 15, and December 15. In the aggregate these payments must be equal to the lesser of 100 percent of the corporation’s actual tax liability (including any alternative minimum tax) or 100 percent of the tax liability for the preceding tax year. The 100 percent test applies only if the preceding tax year was for 12 months and the corporation filed a tax return showing a tax liability. Code Sec. 6655(d). Large corporations (with taxable income of $1,000,000 or more in any one of the three preceding tax years) may use the preceding year’s tax liability to estimate the first quarterly payment only; subsequent quarterly payment must be based on this year’s expected taxable income. With few exceptions, the corporation will be assessed a nondeductible penalty if it does not make the required payments.

A corporation is required to file Form 1120 by the 15th day of the third month following the end of its tax year. Thus, a calendar-year corporation is required to file its return by March 15. Form 1120-A may be filed by corporations having gross receipts or sales, total income, and total assets not exceeding $500,000. A corporation may receive an automatic extension of six months from the original due date if it files for an extension by the due date of the return. Code Sec. 6081.

Form 1120 generally reports taxable income according to various tax rules. The corporation is required to report, on Schedule L, its beginning and ending balance sheets. The balance sheets are taken from the corporation’s basic financial accounting records.

Also included in Form 1120 are Schedule M-1 (Reconciliation of Income (Loss) per Books With Income per Return) and Schedule M-2 (Analysis of Unappropriated Retained Earnings per Books). Schedule M-3 (Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More) is required of large and midsize firms in lieu of Schedule M-1. The net income on the financial books of a corporation may differ from the taxable income on its return. This is caused by differences in accounting methods between financial and taxable income. For example, accelerated depreciation may be used for taxable income computations while straight-line depreciation may be used for financial accounting purposes. Schedule M-1 is used to reconcile these differences.

The reconciling elements of Schedule M-1 fall into four categories:
1. Expenses taken on the books but not taken on the tax return (e.g., federal income taxes)
2. Expenses not taken on the books but taken on the tax return (e.g., charitable contribution carryovers from earlier tax years)
3. Income reported on the books but not reported on the tax return (e.g., tax-exempt municipal bond interest)
4. Income not reported on the books but reported on the tax return (e.g., prepayments recognized as income because of the claim of right doctrine)
These differences are either permanent differences or temporary differences. Permanent differences are income, deduction, gain, or loss items which affect either taxable income or book income, but not both. An example of a permanent difference would be nontaxable municipal bond interest that is included in book income but excluded from taxable income determination. Temporary differences are income, deduction, gain, or loss items that affect both taxable income and book income, but not in the same tax year. A temporary difference exists where accelerated depreciation is taken for tax purposes but straight-line depreciation is used for book purposes. Temporary differences reverse themselves over the life of the business.

Schedule M-1 has two columns. In the left column, entries are made for book income, federal income tax, excess of capital losses over capital gains, income items in the return not included in the books (e.g., prepaid rent) and expenses deducted on the books but not on the return (e.g., gifts costing over $25). In the right hand column, entries are made for income reported on the books and not included in the return (e.g., tax-exempt interest) and expenses deducted on the return but not on the books (e.g., excess of accelerated depreciation used for tax purposes over straight-line used for book purposes). The difference between the right hand column and the left hand column should equal the corporation’s taxable income before the net operating loss deduction and special deductions.

**EXAMPLE 14.118**  
Harris Corporation had the following results from operations during 2008:

- Net income per books, after taxes .......................................................... $77,000
- Taxable income .................................................................................. 75,000
- Federal income taxes ........................................................................... 13,750
- Tax-exempt interest on municipal bonds .............................................. 3,000
- Net capital loss (capital losses in excess of capital gains) .................. 1,250
- Premiums paid on life insurance for key employees ......................... 1,000
- Life insurance proceeds received because of death of key employee .......................................................... 10,000
- MACRS depreciation in excess of straight-line depreciation used for book purposes .................................................. 5,000

Harris Corporation’s Schedule M-1 is as follows:

<table>
<thead>
<tr>
<th>Schedule M-1</th>
<th>Reconciliation of Income (Loss) per Books With Income per Return (See page 20 of instructions.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Income recorded on books this year not included in the return (itemized).</td>
</tr>
<tr>
<td>2</td>
<td>Tax-exempt interest $</td>
</tr>
<tr>
<td>3</td>
<td>Deductions on this return not charged against book income this year (itemized).</td>
</tr>
<tr>
<td>4</td>
<td>Add lines 7 and 8</td>
</tr>
<tr>
<td>5</td>
<td>Add lines 1 through 5</td>
</tr>
<tr>
<td>6</td>
<td>Income from 28, page 1—line 6 less line 9</td>
</tr>
<tr>
<td>7</td>
<td>13,000</td>
</tr>
<tr>
<td>8</td>
<td>5,000</td>
</tr>
<tr>
<td>9</td>
<td>18,000</td>
</tr>
<tr>
<td>10</td>
<td>75,000</td>
</tr>
</tbody>
</table>

Schedule M-2, which serves as a bridge of the two balance sheets, also has two columns. The left column is for opening retained earnings, book income for the year, and any increases in retained earnings. The right hand column is for distributions and other items that decrease retained earnings. For example, an adjustment to decrease revenues in a previous period would affect the right hand column. The difference between these two columns is the ending retained earnings. This figure should equal the corporation’s unappropriated retained earnings at the end of the tax year entered in the Schedule L balance sheet on Form 1120.

The reconciliation of retained earnings serves to disclose unusual transactions which have a bearing on the corporation or its shareholders. Where the reconciliation of retained
earnings shows distributions to the corporate shareholders, the IRS should establish that
the shareholders have reported the relevant income.

**EXAMPLE 14.119** Assume the same facts in Example 14.118 and the following additional facts. Harris
Corporation’s beginning balance of unappropriated retained earnings is $160,000. During the year it distributed a cash dividend of $25,000 to its shareholders. Harris Corporation’s Schedule M-2 is as follows:

<table>
<thead>
<tr>
<th>Schedule M-2</th>
<th>Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Balance at beginning of year</td>
</tr>
<tr>
<td>2</td>
<td>Net income (loss) per books</td>
</tr>
<tr>
<td>3</td>
<td>Other increases (decrease):</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Add lines 1, 2, and 3</td>
</tr>
<tr>
<td>5</td>
<td>Cash distributed</td>
</tr>
<tr>
<td>6</td>
<td>Stock distributed</td>
</tr>
<tr>
<td>7</td>
<td>Other decreases (increase):</td>
</tr>
<tr>
<td>8</td>
<td>Balance at end of year (line 4 less line 7)</td>
</tr>
</tbody>
</table>

Large and midsize corporations (those with total assets of $10 million or more) must file Schedule M-3 (Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More) in lieu of Schedule M-1 for tax years ending on or after December 31, 2004. Schedule M-3 requires more information than Schedule M-1. Its purpose is to make the differences between financial accounting net income and taxable income more transparent. It will provide the IRS information that will help it identify firms that have engaged in aggressive transactions and therefore improve the audit process of corporations.

Part I of Schedule M-3 requests financial information; e.g., the source of the financial information (audited financial statements, SEC Form 10-K, etc.), any restatements of the firm’s income statement items for the year and the previous five years, and any required adjustments to the firm’s net income (loss) due to restatements. The adjusted net income (loss) must then be reconciled to the firm’s taxable income reported on Form 1120.

Parts II and III of Schedule M-3 require the reconciliation of net income (loss) items and expense/deduction items, respectively, of includible corporations. Because of its complexity, there is no further discussion of Schedule M-3 (Schedule M-3 and its extensive instructions provide numerous examples of the reconciliation process).

**SUMMARY**

- Taxpayers have a choice of selecting a sole proprietorship, partnership, or corporation as the form to do business.
- Partnerships and sole proprietors may select to be taxed as a corporation for federal tax purposes by using the “check-the-box” system.
- The transfer of property solely for stock of a corporation that is at least 80 percent controlled by the transferor group is tax free.
- Realized gains are recognized on said transfers to the extent of boot received.
- Boot includes property other than stock (although nonqualified preferred stock is boot) as well as liabilities in excess of basis.
- Property basis carries over to the stock and to the corporation.
- Debt is favored over equity because interest is deductible by the corporation and dividends are not deductible.
- High debt-equity ratios are subject to IRS investigation and could lead to debt being classified as equity.
- If debt is reclassified as equity, the interest deduction is lost and interest and principal payments may be classified as dividends.
- Corporations with $1,000,000 or less in equity capital that issue stock for property generally qualify for Code Sec. 1244.
● Losses (except for built-in losses) on the sale of Code Sec. 1244 stock are ordinary up to $50,000 ($100,000 on a joint return), but gains are capital gains.

● Code Sec. 1202 also enables noncorporate taxpayers to exclude 50 percent of any gain from the sale or exchange of qualified small business stock held for more than five years which was originally issued after August 10, 1993.

● Taxpayers may rollover the gain from sale of Code Sec. 1202 stock if they invest the proceeds in a qualified small business corporation within 60 days of sale.

● Corporate tax rates vary from 15 to 39 percent.

● Very large corporations generally pay a flat 35 percent.

● Corporations also may be subject to the alternative minimum tax, although qualified small companies are exempt from it.

● Special features of corporate taxation include: (a) organization expenses are amortized over 180 months; (b) dividends received from U.S. corporations are subject to a dividends-received deduction of 70, 80, or 100 percent; (c) charitable deductions of up to 10 percent of taxable income (as adjusted) are allowed; and (d) capital losses in excess of capital gains must be carried back three years and then forward five years.

● Multiple corporations that are members of a controlled group (brother-sister, parent-subsidiary, or combined group) must share certain tax benefits as if they were one corporation (e.g., tax brackets, Code Sec. 179 election to expense).

● Parent-subsidiary controlled groups may file a consolidated return.

● The corporate annual tax return is due by the 15th day of the third month following the close of the tax year.

● Form 1120 is used and requires the computation of taxable income, the reporting of balance (analyzing sheets), and the completion of Schedules M-1 or M-3 (reconciling book income to taxable income) and M-2 (analyzing unappropriated retained earnings per books).

### QUESTIONS

1. Can a partnership elect to be taxed as a corporation?
2. Can a corporation elect to be taxed as a partnership?
3. What is the main tax advantage of the corporate form of organization?
4. What is the purpose of Code Sec. 351 in regard to transfers to corporations?
5. What is the basis of accounts receivable transferred to a corporation under Code Sec. 351 by a cash-basis taxpayer?
6. To qualify under Code Sec. 351, what is the control requirement?
7. How are securities treated in a Code Sec. 351 transfer?
8. When can a shareholder recognize a loss under Code Sec. 351?
9. How does boot affect any gain realized under Code Sec. 351?
10. When are liabilities treated as boot in a Code Sec. 351 exchange?
11. What is the basis in a shareholder’s stock after a Code Sec. 351 exchange?
12. What is the corporation’s basis in property received under Code Sec. 351?
13. What happens to the holding period of assets transferred to corporations under Code Sec. 351?
14. Is there any depreciation recapture under a Code Sec. 351 exchange?
15. What are the tax consequences of a cash contribution to capital by a nonshare-holder?
16. Why do taxpayers constantly try to increase the debt-equity ratio of a corporation?
17. What requirements must be met for stock to qualify as Code Sec. 1244 stock? What are the tax consequences of meeting these requirements?
18. To what extent is Code Sec. 1244 applicable to partnerships?
19. What is the “built-in loss” rule of Code Sec. 1244? What is the purpose of the rule?
20. What tax years are available to corporations? How do the options differ from other forms of business organizations?
21. When is the cash method of accounting not available to corporations?
22. What are the differences in the treatment of capital gains and capital losses of corporations and of individuals?
23. What is the special depreciation recapture rule that applies to corporations?
24. What is the purpose of the dividends-received deduction? What corporations are entitled to claim this deduction? What dividends qualify for this deduction?
25. Under what circumstances is the dividends-received deduction on a given dividend received not available?
26. When is the dividends-received deduction limited to 70 percent of taxable income?
27. What restrictions apply to the dividends-received deduction of dividends received from debt-financed stock purchases?
28. What happens to the basis of stock on which an “extraordinary” dividend has been received?
29. What are the main differences between net operating losses of individuals and corporations?
30. To what years may a net operating loss be carried?
31. In the absence of Code Sec. 248, how would organizational expenditures be treated?
32. What is the amortization period for organizational expenditures?
33. How do corporations treat start-up expenditures?
34. What is the maximum charitable contribution allowance for corporations? Is there a carryover to other years?
35. What is the corporate contribution base for charitable deductions?
36. When is the full fair market value deduction not available on a transfer of property to charity?
37. Describe the disallowed deductions and losses of corporations.
38. When may it be a tax advantage to incorporate even though the income may be double taxed?
39. What is the purpose of the additional 5 percent tax on corporate income between $100,000 and $335,000? The additional 3 percent tax on corporate income between $15,000,000 and $18,333,333?
40. Distinguish between adjustments to taxable income and tax preferences under the alternative minimum tax.
41. How does an asset’s regular tax basis differ from its AMT basis?
42. What is the adjusted current earnings adjustment in the computation of the alternative minimum tax?
43. Describe the appreciated property charitable deduction tax preference.
44. What is the purpose of the minimum tax credit?
45. What are the advantages of filing a consolidated tax return?
46. Are all affiliated corporations eligible to file consolidated returns?
47. What is a built-in deduction on a consolidated return?
48. Parent Corporation owns all the stock in Subsidiary Corporation and is on the calendar-year tax year. Subsidiary Corporation has a fiscal year ending on August 31. Are they allowed to file a consolidated tax return?
49. Must corporations make estimated tax payments? If so, when?
50. What form does a corporation use to file its annual tax return? When is this return due?
51. What is the purpose of the reconciliation of taxable income with book income?

**PROBLEMS**

52. Sam Rogers forms a corporation. Sam transfers to the corporation property having a basis to him of $15,000 and a fair market value of $27,000 for 900 shares of the $10 par stock of the corporation. A year later, Bill Morrison, who is not related to Sam, transfers property having a basis to him of $1,000 and a fair market value of $3,000 for 100 shares of the corporate stock. The corporation issued no other stock.
   a. How much gain does Sam recognize on his exchange? What is the basis to Sam of his 900 shares?
   b. How much gain does Bill recognize on his exchange? What is the basis to Bill of his 100 shares?
   c. What gain or loss is recognized by the corporation when it issues its shares to Sam? What is the basis to the corporation of the property it received from Sam?
   d. What is the gain or loss recognized by the corporation when it issues its shares to Bill? What is the basis to the corporation of the property it received from Bill?
53. Yager and Boggs formed Y&B Company in 2008. Yager contributed a building with a fair market value of $97,000, a mortgage of $75,000 and an adjusted basis of $50,000 in return for 22 shares of Y&B Company stock. (Y&B assumed the mortgage.) Boggs contributed land with a fair market value of $22,000 and an adjusted basis of $40,000 in return for 12 shares of Y&B Company stock and 10 $1,000 bonds. Lyle performed legal and accounting work during the incorporation process in return for six shares of stock. Determine the tax consequences of the transfers to all parties.

54. Mr. Hogan decided to incorporate his printing business and to give his manager, Mr. Temple, a share in the business. Mr. Hogan’s sole proprietorship transferred the following:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$0 $3,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>0 5,000</td>
</tr>
<tr>
<td>Printing press</td>
<td>4,000 6,000</td>
</tr>
<tr>
<td>Truck</td>
<td>12,300 8,000</td>
</tr>
<tr>
<td>Cash</td>
<td>2,000 2,000</td>
</tr>
</tbody>
</table>

Mr. Hogan received 70 shares of the stock, worth $14,000, in Express-Press Inc. Mr. Temple invested $2,000 in cash and received the remaining 30 shares of the stock. What are the tax consequences to Mr. Hogan, Mr. Temple, and Express-Press Inc.?

55. Susan Sweets is a 40 percent shareholder in Acclaim Inc., a theatrical supplies company. She transfers a fully depreciated car with a value of $2,000 to the corporation, but does not receive any consideration for it.

a. What are the tax consequences to Susan?
b. What are the tax consequences to the corporation?
c. What, if any, changes if Susan received another 10 percent stock interest for the car?

56. The municipality of Viewpoint, Kansas, wishes to attract local businesses. As part of a development program, it donated a building with a basis of $50,000 and a value of $200,000 plus $75,000 in cash to Sound & Fury Drums Inc. What are the tax consequences to Sound & Fury?

57. In each of the following situations, determine if there is any depreciation or general business credit recapture.

a. Joe incorporates his sole proprietorship and subsequently gifts the stock to his two children.
b. Joe and nine others put their businesses in one corporation in return for five to 15 percent of the stock. Joe’s share is 8 percent.
c. Joe incorporates his sole proprietorship. Soon thereafter, the corporation sells some of the assets.
d. Same as (c), but the corporation abandons some of the assets.
e. Joe gifts his car, used only for business, to his son, who transfers it to his 100 percent owned corporation.

58. Zebra Corporation received a gift of a tract of land from a nonshareholder to encourage Zebra Corporation to build a plant on the land. The value of the land was $20,000. Zebra Corporation also received cash of $25,000 from nonshareholders, which was used to buy machinery costing $25,000.

a. How much income does Zebra Corporation report as a result of these transactions?
b. What is the basis of the assets to Zebra Corporation?

59. Sylvester and Elvira Upjohn are married, filing joint returns. Sylvester is the sole shareholder of a Code Sec. 1244 corporation. He received the stock two years ago when he incorporated his sole proprietorship. The only assets transferred were cash of $10,000 and a truck with a basis of $11,000 and a value of $8,000 (current basis zero). The corporation is bankrupt with liabilities far exceeding the assets.

a. If the stock is worthless, what are the tax consequences to Sylvester?
b. Is Sylvester’s filing status relevant?

60. In 2006, Susan Christian transferred a machine with a fair market value of $30,000 and an adjusted basis of $40,000 to JPC Corporation in return for 60 shares of stock. The stock qualified as Code Sec. 1244 stock and the transfer qualified under Code Sec. 351. In 2008, JPC Corporation liquidated due to bankruptcy and Susan’s stock became worthless. What is Susan’s tax position in 2008?

61. Niffy Corporation, a domestic C corporation, issued 100 shares of Code Sec. 1202 stock on November 1, 2003, to Jennifer. This was the first time it issued such stock. Jennifer sold the shares on November 15, 2008. She had a $20,000 recognized gain on the sale. How much of the gain can Jennifer exclude, assuming Niffy Corporation always has been actively engaged in a trade or business and always has qualified as a small business corporation?
62. A corporation has income of $62,000 from operations and a net long-term capital loss of $5,000. What is the corporation’s taxable income for the year?

63. Baginski Corporation purchased a residential building and depreciated it using straight-line depreciation. Determine the amount of ordinary income and Code Sec. 1231 income to be recognized assuming:

- Selling price: $330,000
- Cost: $360,000
- Depreciation taken: $222,000

64. Cablephones Inc., which is not a member of an affiliated group, had gross income from operations of $390,000 and deductible expenses of $420,000. Dividends of $300,000 were received from more than 20 percent owned U.S. corporations.

a. What is the dividends-received deduction?
b. What would the dividends-received deduction be if the deductible expenses were $451,000?

65. What is the dividends-received deduction allowed a corporation that receives $100,000 in dividends from a 45 percent owned domestic corporation if 30 percent of the cost of the investment is borrowed to make the purchase?

66. McIntyre Corporation purchases 1,000 shares of a 10 percent owned domestic corporation at $100 per share. McIntyre receives a $25 per share dividend within the first year after the purchase. What is the amount by which McIntyre must reduce the basis of the acquired stock?

67. Tandem Cycles Inc. had the following results in the first five years of its existence:

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital Gain</th>
<th>Net Operating Loss</th>
<th>Ordinary Income</th>
<th>Capital Loss</th>
<th>Ordinary Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$11,000</td>
<td>(8,000)</td>
<td>4,000</td>
<td>(9,000)</td>
<td>20,000</td>
</tr>
</tbody>
</table>

a. What happens to the net operating loss from Year 2?
b. How should the capital loss of Year 4 be reported?

68. Sans Corporation reported the following results for 2008:

- Gross receipts from operations: $250,000
- Cost of goods sold: $50,000
- Operating expenses: $90,000
- Short-term capital gain: $10,000
- Short-term capital loss: $12,000
- Long-term capital gain: $40,000
- Long-term capital loss: $18,000

What is Sans Corporation’s taxable income and regular income tax liability before credits for 2008?

69. Capital Corporation had the following results in 2008:

- Gross receipts from operations: $200,000
- Net short-term capital gain: $50,000
- Net long-term capital loss: $75,000
- Cost of goods sold: $60,000
- Operating expenses: $40,000
- Dividends received from 30% owned domestic corporation: $80,000

a. What is Capital Corporation’s taxable income and regular income tax liability for 2008?
b. Assuming that Capital Corporation’s taxable income in 2007, its first year of existence, was $400,000, which included a net short-term capital gain of $50,000, what advice should be given to Capital with respect to its net capital asset position for 2008?

70. Caskets Inc. was incorporated on June 1, but did not start business until September 1. It adopted a fiscal year ending March 31, coinciding with the end of its natural business cycle. In connection with organizing the business, Caskets Inc. incurred the following expenses:

- Legal fees for incorporating: $8,000
- Accounting fees for opening corporate books: $400
- Tax planning advice: $300
- Printing and issuing stock certificates: $50
- Incorporation fee to state: $100
- Temporary directors’ fees: $2,000
- Legal fees for the transfer of assets to the corporation: $500

What is the amount of the organizational expenditures?

b. How much of the amount is deductible in the corporation’s first taxable year?

71. McKibbe Corporation has excess inventory that it no longer wants. In order to clear out its warehouse to make room for shipments of new inventory, it has decided to donate the inventory (bedding equipment) to several hospitals. The basis of the inventory is $100,000 and its fair market value is $120,000. The corporation made no other contributions this year. Determine its charitable contribution deduction assuming that its taxable in-
come before the dividends-received deduction and charitable contributions deduction is $700,000 and included in gross income is $100,000 in dividends received from a 35-percent-owned domestic corporation.

72. Donor Corporation had the following income and deductions for last year:
Sales ...................................................... $5,000,000
Cost of sales ...................................... 3,500,000
Other operating expenses ........... 800,000
Dividends (from 5 percent owned domestic corporations) ............... 100,000

Donor Corporation also made contributions (not included above) to qualifying charitable organizations of $175,000. Determine Donor Corporation’s taxable income for the year.

73. Barbara sells an asset to her wholly-owned corporation. The asset has a basis of $32,000 and a fair market value at the time of the sale of $27,000? What is the corporation’s recognized gain or loss if it sells the asset for $30,000 several years later?

74. Compute a corporation’s tax liability for 2008 if its taxable income equals:
   a. $100,000
   b. $150,000
   c. $400,000
   d. $11,000,000
   e. $16,000,000
   f. $19,000,000

75. Red Paint Corporation generated $40,000 of taxable income from operations last year, plus a $50,000 gain from the sale of land used as a parking lot for six years. What is the amount of federal income tax payable?

76. A & G Drug Store Inc. has been in operation for six years. The first four years it accumulated operating loss carryovers of $65,000. The fifth year it earned $25,000 in operating income and had $8,000 of dividend income. In its sixth year it had $54,000 in operating income and $11,000 of dividend income from X Corporation (A & G owns 10% of X Corporation, and did so in year 5). Compute A & G Drug’s tax liability for its sixth year.

77. Determine the amount of adjustments and tax preferences for the alternative minimum tax in each of the following situations:
   a. Equipment acquired in 2001 was depreciated under MACRS. Depreciation claimed for the year was $40,000; straight-line depreciation would have been $30,000 under the 150% declining balance method.
   b. An asset was sold for $180,000 using the installment method of accounting. Only $20,000 of the $60,000 gain on the sale was reported this year since the asset constituted nondealer property.
   c. The corporation owed some Leon County school bonds on which it received $15,000 of tax-exempt interest.
   d. The corporation purchased $100,000 of Section 1245 property during the year on which it used 200 percent declining-balance depreciation.

78. Determine the alternative minimum tax assuming a corporation has the following information:
   Taxable income......................... $600,000
   Adjustments to income.............. 300,000
   Tax preferences......................... 200,000
   General business credit............. 30,000

79. Assume the same information as in the previous problem, except that the adjustments to income are $100,000. What is the alternative minimum tax?

80. Presented below is Argo Company’s adjusted current earnings and preadjustment alternative minimum taxable income for 2008 through 2011:

<table>
<thead>
<tr>
<th>Year</th>
<th>Preadjustment AMTI</th>
<th>ACE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$400,000</td>
<td>$350,000</td>
</tr>
<tr>
<td>2009</td>
<td>$400,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>2010</td>
<td>$700,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2011</td>
<td>$650,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

Determine the ACE adjustment (positive or negative) for each of the years.

81. Determine the alternative minimum tax assuming a corporation has the following:
   Taxable income......................... $500,000
   Adjustments to income (other than the ACE adjustments) 200,000
   Tax preferences......................... 100,000
   Adjusted current earnings (ACE) 900,000

82. Windy Company had the following AMTI and ACE for 2008, 2009, and 2010. Indicate the ACE adjustment for each year.

<table>
<thead>
<tr>
<th>Year</th>
<th>AMTI</th>
<th>ACE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$500,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>2009</td>
<td>$500,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>2010</td>
<td>$500,000</td>
<td>$600,000</td>
</tr>
</tbody>
</table>

Indicate the ACE adjustment for each year.

83. The four Ames brothers own 25 percent each of two corporations, Unicycles Inc. and Tandem Inc. Last year, the two corporations generated $50,000 and $100,000 in taxable income, respectively. What is the total corporate tax liability?
84. The matrix below shows the stock ownership in four corporations by four unrelated individuals:

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10</td>
<td>5</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>2</td>
<td>30</td>
<td>40</td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>3</td>
<td>30</td>
<td>15</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>4</td>
<td>30</td>
<td>40</td>
<td>50</td>
<td>50</td>
</tr>
</tbody>
</table>

Which of the above corporations, if any, are members of a brother-sister controlled group? Explain why each corporation is included or not.

85. Tiller Corporation’s net income per books (after taxes) was $68,450. During the year, it had the following transactions:

- Federal income taxes: $13,750
- Net capital loss: 4,000
- Premiums paid on key person life insurance policy: 2,800
- Interest paid on a loan to acquire tax-exempt bonds: 2,000
- MACRS depreciation (for financial accounting purposes, Tiller claimed $4,000 of straight-line depreciation): 11,000
- Tax-exempt interest on municipal bonds: 9,000

Determine Tiller Corporation’s taxable income assuming it does not have an NOL deduction or special deductions. Reconcile the difference between book income and taxable income.

86. Crates Corporation’s financial income before income taxes for the year was $160,000. Organization costs of $72,000 are being written off over a 10-year period for financial statement purposes. For tax purposes, these costs are being written off over the minimum allowable period. For the year, Crates’ taxable income was:

a. $150,400
b. $157,600
c. $160,000
d. $162,400

87. A corporation with $300,000 in taxable income has a tax liability of:

a. 34 percent of $300,000
b. $22,250 + 34 percent of $200,000
c. $22,250 + 34 percent of $200,000 + 5 percent of $200,000
d. 15 percent of $50,000 + 25 percent of $25,000 + 34 percent of $225,000
e. None of the above

88. Cybele formed a corporation and transferred a building with a basis of $50,000, subject to a $70,000 mortgage, and cash of $15,000 to it for stock. Cybele’s stock and the corporation’s basis in the building are:

<table>
<thead>
<tr>
<th>Stock</th>
<th>Building</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Zero</td>
<td>$50,000</td>
</tr>
<tr>
<td>b. $15,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>c. Zero</td>
<td>$40,000</td>
</tr>
<tr>
<td>d. Zero</td>
<td>$55,000</td>
</tr>
</tbody>
</table>

89. The following statements about the dividends-received deduction are true, except:

a. The stock on which dividends are received must be held for at least 46 days.
b. The deduction is not available if the long position is offset by a similar short position.
c. The deduction is limited to a percentage of taxable income prior to charitable contribution, net operating loss, and capital loss deductions.
d. Even if a consolidated return is not filed, a 100 percent dividends-received deduction is available for payments between members of the same affiliated group.

90. Excluding extensions, which one of the following Form 1120 tax returns is filed late?

<table>
<thead>
<tr>
<th>Tax Year Ended</th>
<th>Date Filed</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. January 31, 2010</td>
<td>April 15, 2010</td>
</tr>
<tr>
<td>b. August 31, 2009</td>
<td>November 2, 2009</td>
</tr>
<tr>
<td>c. July 31, 2009</td>
<td>October 29, 2009</td>
</tr>
<tr>
<td>d. December 31, 2010</td>
<td>March 15, 2010</td>
</tr>
</tbody>
</table>

91. During 2008, Jones transferred $10,000 cash and a building with an adjusted basis of $50,000 and a fair market value of $90,000 to Malibu Gardens Corporation in return for 90 percent of its only class of stock. In addition, for a bona fide business purpose, Malibu Gardens assumed the $65,000 outstanding mortgage on the building. What is the amount of Jones’s recognized gain on the transfer?

a. $0  
b. $5,000  
c. $15,000  
d. $25,000  
e. None of the above
92. In 2008, Sally transferred a building with an adjusted basis of $40,000 and a fair market value of $45,000 to Sandy Corporation. In exchange, she received the following:

1. 80 percent of Sandy Corporation’s only class of stock, fair market value of $20,000
2. Equipment with a fair market value of $25,000 and an adjusted basis of $10,000

What is Sandy Corporation’s basis in the building received in the transfer?

a. $5,000
b. $25,000
c. $40,000
d. $45,000
e. None of the above

93. Indo Corporation was organized on January 4, 2008, and began active business on January 5, 2008. Indo incurred the following expenses in connection with creating its business.

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional fees for stock issuance</td>
<td>$400</td>
</tr>
<tr>
<td>State incorporation fees</td>
<td>200</td>
</tr>
<tr>
<td>Printing costs for stock certificates</td>
<td>150</td>
</tr>
<tr>
<td>Broker’s commissions on sale of stock</td>
<td>700</td>
</tr>
<tr>
<td>Legal fees for drafting the charter</td>
<td>600</td>
</tr>
<tr>
<td>Expenses for temporary directors</td>
<td>500</td>
</tr>
</tbody>
</table>

What is the maximum amount of organizational expenses which may be deducted by Indo on its 2008 tax return?

a. $1,300
b. $1,700
c. $1,850
d. $2,550
e. None of the above

94. Sinco Company had $300,000 of income from business operations and $700,000 of allowable expenses. It also received $20,000 in dividends from a domestic corporation in which it owns 22 percent of the stock. What is Sinco Company’s net operating loss?

a. $380,000
b. $396,000
c. $397,000
d. $400,000
e. None of the above

95. Jones is a sole proprietorship. He would like to be taxed as a corporation for federal tax purposes. Jones may become a corporation by:

a. Filing a corporate return for this year
b. Timely filing Form 7701 and attaching it to this year’s return
c. Timely filing Form 8832 and attaching it to this year’s return
d. He cannot be taxed as a corporation

96. XYZ is a corporation. It needs to raise some capital and is uncertain whether to issue debt or equity. Which of the following statements is true?

a. Both interest payments and dividend payments are deductible as expenses
b. Interest payments are deductible but dividend payments are not deductible as expenses
c. Principal repayment and stock retirement are deductible expenses
d. The shareholders (noncorporate and corporate) are indifferent as to whether they receive interest or dividends
e. All of the above are true
f. None of the above are true

97. In the year of formation, a corporation:

a. May elect a tax period other than those of its major shareholders
b. Must elect the same tax period as its major shareholders
c. Must use the cash basis for its accounting method
d. None of the above

98. Smith Co. sells a machine during the year for $100,000. Smith acquired the machine for $140,000. At the time of sale, the machine’s adjusted basis was $47,200. Smith Co.’s recognized gain on the sale is:

a. $52,800 Code Sec. 1231 gain
b. $52,800 Code Sec. 1245 gain
c. $10,560 Code Sec. 291 gain and $42,240 Code Sec. 1231 gain
d. $52,800 long-term capital gain
e. None of the above

99. Bevco incurred start-up expenditures while investigating the acquisition of a business. With respect to such expenditures, Bevco:

a. Can expense them in the year incurred
b. Must capitalize them and deduct them in the year of liquidation
c. Can expense the first $5,000 in the year incurred and elect to amortize the remaining costs over 180 months
d. Must capitalize them but may elect to amortize them over 50 months

e. None of the above

100. Which of the following corporate groups may file a consolidated tax return?

a. Brother-sister group
b. Parent-subsidiary group
c. Both brother-sister and parent-subsidiary groups
d. None of the above corporate groups may file a consolidated tax return.
101. Feld Corporation’s taxable income for 2008 before the domestic production activities deduction was $5,000,000. Its income from qualified production activities in 2008 was $6,000,000. Feld Corporation’s W-2 wages allocable to qualified production activities for 2008 were $2,000,000. What is Feld Corporation’s domestic production activities deduction?

102. A, B and V Corporations each have only one class of stock outstanding. The ownership of the stock is as follows:

| Shareholders | Corporations | Identical Owners-
|--------------|--------------|----------------
|              | A | J | V | ship |
| James        | 15%| 20%| 15%| 15% |
| Jennifer     | 15%| 20%| 20%| 15% |
| Kimberly     | 15%| 25%| 15%| 15% |
| Susan        | 15%| 10%| 20%| 10% |
| Tom Corporation | 40%| 25%| 30%| N/A |
|              | 100%| 100%| 100%| 55% |

Are any of the corporations part of a brother-sister controlled group for Code Sec. 1561 purposes?

103. **Comprehensive Problem.** Last year, Intrepid Corporation’s tax return revealed the following items:

- Dividends from 20 percent owned domestic corporations: $60,000
- Gross income from services rendered: $300,000
- Miscellaneous expenses: $250,000
- Long-term capital gains: $30,000
- Net operating loss carryforward: $15,000
- Charitable contributions: $20,000

**a.** What is Intrepid’s dividends-received deduction?

**b.** What is the charitable contribution deduction?

**c.** What is the taxable income for the year?

104. **Comprehensive Problem.** Mr. Trent transferred three apartment buildings to a new corporation in exchange for all its stock. The facts pertaining to the buildings were:

<table>
<thead>
<tr>
<th>Building</th>
<th>Basis</th>
<th>Value</th>
<th>Mortgage</th>
<th>Recapture Potential</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$10,000</td>
<td>$100,000</td>
<td>$60,000</td>
<td>$0</td>
</tr>
<tr>
<td>2</td>
<td>15,000</td>
<td>80,000</td>
<td>0</td>
<td>5,000</td>
</tr>
<tr>
<td>3</td>
<td>20,000</td>
<td>30,000</td>
<td>0</td>
<td>4,000</td>
</tr>
</tbody>
</table>

**a.** What gains are realized and recognized on each building? What is the character of the gains?

**b.** What is the corporation’s basis in each building?

**c.** What is Mr. Trent’s basis in his stock?

105. **Comprehensive Problem.** Jones, Able, and Smith want to form Shriver Corporation. They want to accomplish this in the most tax efficient (least costly) way possible. They have asked for advice. The counselor will receive $10,000 (in stocks and bonds). The relevant information follows:

<table>
<thead>
<tr>
<th>PARTY</th>
<th>GIVES</th>
<th>RECEIVES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jones</td>
<td></td>
<td>Machine</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Land</td>
</tr>
<tr>
<td>Building</td>
<td>65,000</td>
<td>45,000**</td>
</tr>
<tr>
<td></td>
<td>* Acquired for $85,000; straight-line depreciation taken.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>** Acquired for $70,000; straight-line depreciation taken; liability of $60,000 is assumed by Shriver Corporation.</td>
<td></td>
</tr>
<tr>
<td>Able</td>
<td></td>
<td>Machine</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Building</td>
</tr>
<tr>
<td></td>
<td>* Acquired for $95,000; straight-line depreciation taken.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>** Acquired for $75,000; straight-line depreciation taken; liability of $70,000 is on the property.</td>
<td></td>
</tr>
<tr>
<td>Smith</td>
<td></td>
<td>Machine</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Automobile</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Truck</td>
</tr>
<tr>
<td></td>
<td>* Acquired for $15,000; straight-line depreciation taken.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>** Acquired for $40,000; straight-line depreciation taken.</td>
<td></td>
</tr>
<tr>
<td>Counselor</td>
<td></td>
<td>Services</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Determine all tax consequences for Jones, Able, Smith, the counselor, and Shriver Corporation assuming the transfer occurred in 2008. Also assume that Jones, Able, and Smith are unrelated parties.

106. **Research Problem.** In 2006, Salt Lake Resorts Inc. generated a capital gain of $300,000 and no other taxable income or loss. In 2008, the corporation suffered a net operating loss of $50,000, which was carried back to 2006. Salt Lake Resorts Inc. did not make an election to carry forward only. The corporation has large
tax preferences. The IRS claims that (1) no tax benefit results from the carryback, and (2) the NOL is nevertheless used up. Salt Lake Resorts Inc. believes that either a tax benefit results or it can carry forward the $50,000 net operating loss to 2009. Is the IRS right? Why?

(See Foster Lumber Co., Inc., 76-2 USTC ¶9740, 429 U.S. 32, 97 S.Ct. 204 (1976).)

107. Research Problem. Cambo Corporation, a calendar-year taxpayer, was formed in 2004 and incurred $60,000 in organizational expenditures. Had the corporation made a proper election under Code Sec. 248, it would have been entitled to a $7,000 deduction in 2004. However, on its 2004 tax return it erroneously claimed a $60,000 current deduction (i.e., it expensed the full amount in the year it was organized). Upon audit in 2008, the IRS disallowed the $60,000 deduction and also did not allow Cambo a $7,000 deduction. Cambo Corporation seeks your advice on this issue.

(See Reg. §1.248-1(c); Bay Sound Transportation Co., 1967-2 USTC ¶9641 (DC Texas 1967), aff’d in part and rev’d in part on other issues, 1969-1 USTC ¶9371, 410 F.2d 505 (CA-5 1969).)