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Chapter C:2

Corporate Formations and Capital Structure

Discussion Questions

C:2-1 Various. A new business can be conducted as a sole proprietorship, partnership, C corporation, S corporation, LLC, or LLP. Each form has tax and nontax advantages and disadvantages. See pages C:2-2 through C:2-8 for a listing of the tax advantages and disadvantages of each form. A comparison of the C corporation, S corporation, and partnership alternative business forms appears in Appendix F. pp. C:2-2 through C:2-8.

C:2-2 Alice and Bill should consider forming a corporation and making an S corporation election. An S corporation election will permit the losses incurred during the first few years to be passed through to Alice and Bill and be used to offset income from other sources. The corporate form affords them limited liability. As an alternative to incorporating, Alice and Bill might consider setting up a limited liability company that is taxed as a partnership and also has limited liability. pp. C:2-6 through C:2-8.

C:2-3 Yes, several alternative classifications. The only default tax classification for the LLC is a partnership. Because the LLC has two owners, it cannot be taxed as a sole proprietorship. The entity can elect to be taxed as a C corporation or an S corporation. If the entity makes such an election, Sec. 351 applies to the deemed corporate formation. The entity would have to make a separate election to be treated as an S corporation. pp. C:2-8 and C:2-9.

C:2-4 The default tax classification for White Corporation is a C corporation. However, White can be treated as an S corporation if it makes the necessary election. Following an S corporation election, the entity's income will be taxed to its owners, thereby avoiding double taxation. The S corporation election is made by filing Form 2553 within the first 2½ months of the corporation's existence (see Chapter C:11). pp. C:2-6 and C:2-7.

C:2-5 The only default tax classification for the LLC is a sole proprietorship. Because the LLC has only a single owner, it cannot be treated as a partnership. Thus, the default classification is a "disregarded entity" taxed as a sole proprietorship. The entity can elect to be taxed as a C corporation or an S corporation. If the entity makes such an election, Sec. 351 applies to the deemed corporate formation. pp. C:2-8 and C:2-9.

C:2-6 Possible arguments include:

PRO (Corporate formations should be taxable events):

1. A corporate formation is an exchange transaction; therefore, parties to the exchange should recognize gains and losses.
2. Making a corporate formation a taxable event increases tax revenues.
3. Simplification is achieved by eliminating one of the two options - whether a transaction is taxable or not. This change will make administration of the tax laws easier.

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4. This change eliminates the need for taxpayers to structure transactions to avoid Sec. 351 to recognize gains and/or losses.

CON (No change should occur to current law):

1. A change in current law would hurt start-up corporations by reducing their capital through the income tax paid by transferors on an asset transfer.
2. No economic gains or losses are realized. Just a change in the form of ownership (direct vs. indirect) has occurred. Therefore, it is not appropriate to recognize gains and losses at this time.
3. With taxation, corporations will have to raise more capital because transferors of noncash property will have less capital to invest and because money must be diverted to pay taxes.
4. Taxpayers are prevented from recognizing losses under the current system, thereby increasing revenues to the government.
5. With taxation, businesses would be deterred from incorporating because of the tax consequences, and therefore economic growth in the U.S. would be adversely affected. pp. C:2-9 and C:2-10.

C:2-7 The following tax consequences, if Sec. 351 applies: Neither the transferor nor the transferee corporation recognizes gain or loss when property is exchanged for stock. Unless boot property (i.e., property other than qualified stock) is received, the transferor's realized gain or loss is deferred until he or she sells or exchanges the stock received. If boot property is received, the recognized gain is the lesser of (1) the amount of money plus the FMV of the nonmoney boot property received or (2) the realized gain. The transferor recognizes no losses even if boot property is received. The transferor's basis in the stock received references his or her basis in the property transferred and is increased by any gain recognized and is reduced by the amount of money plus the FMV of the nonmoney boot property received and the amount of any liabilities assumed by the transferee corporation. The basis of the boot property is its FMV. The transferee corporation recognizes no gain on the transfer. The transferee corporation's basis in the property received is the same basis that the transferor had in the property transferred increased by any gain recognized by the transferor. pp. C:2-12, C:2-16, and C:2-17.

C:2-8 For purposes of Sec. 351, the following items are considered to be property: Money and almost any other kind of tangible or intangible property, including installment obligations, accounts receivable, inventory, equipment, patents, trademarks, trade names, and computer software. Property does not include services, an indebtedness of the transferee corporation that is not evidenced by a security, or interest on an indebtedness that accrued on or after the beginning of the transferor's holding period for the debt. pp. C:2-12 and C:2-13.

C:2-9 "Control" is defined as follows: Transferrers as a group must own at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. The nonvoting stock ownership is tested on a class-by-class basis. pp. C:2-13 through C:2-16.

C:2-10 The IRS has interpreted the phrase as follows: Sec. 351 requires the transferors to control the transferee corporation immediately after the exchange but does not specify how long this control must be maintained. The transferors, however, must not have a prearranged plan to dispose of their

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stock outside the control group. If they have such a plan, the IRS may not treat the transferors as in control immediately after the exchange. p. C:2-16.

C:2-11 No. The Sec. 351 requirements are not met because Peter is not considered a transferor of property. Even though he transferred $1,000 of money, this property is of nominal value--less than 10% of the value of the stock he received for services ($49,000). Therefore, only John and Mary are deemed to have transferred property and, since they own only 66-2/3% of the stock of New Corporation, they are not in control. The 10% minimum is specified in Rev. Proc. 77-37 and applies only for advance ruling purposes. The shareholders may choose to engage in the transaction without an advance ruling, report it as nontaxable, and run the risk of being audited, with the result that the IRS treats the transaction as taxable. Alternatively, they might restructure the transaction by having Peter provide a larger amount of cash to the corporation and take more shares of stock. Another option would be for Peter to provide fewer services with the increased amount of cash and still receive 100 shares of stock. pp. C:2-14 and C:2-15.

C:2-12 No. Section 351 does not require that the shareholders receive stock equal in value to the property transferred. Section 351 would apply to the transfer by Susan and Fred if all other requirements are met. However, Fred probably will be deemed to have made a gift of 25 shares of stock, paid compensation of $25,000, or repaid a $25,000 debt to Susan by transferring the Spade stock. pp. C:2-15 and C:2-16.

C:2-13 Yes. Section 351 applies to property transfers to an existing corporation. For the exchange to be tax-free, the transferors must be in control of the corporation immediately after the exchange. In this example, Carl is <u>not</u> in control since he owns only 75 out of 125 shares, or 60% of the North stock. Therefore, the Sec. 351 requirements are not met. To qualify under Sec. 351, Carl can transfer enough property to acquire a total of 200 shares out of 250 (200 shares held by Carl and 50 shares held by Lynn) outstanding shares. In this situation, Carl would own exactly 80% of North stock (250 shares x 0.80 = 200 shares). A less expensive alternative would be for Lynn to transfer property equal to or exceeding $10,000 (50 shares owned x $2,000 per share x 10% minimum) to be considered a transferor. pp. C:2-14 and C:2-15.

C:2-14 The transferor's basis in stock received in a Sec. 351 exchange is determined as follows (Sec. 358(a)):

	Adjusted basis of property transferred to the corporation
Plus:	Any gain recognized by the transferor
Minus:	FMV of boot received from the corporation
	Money received from the corporation
	The amount of any liabilities assumed by the transferee corporation
	<u>Adjusted basis of stock received</u>

For purposes of calculating stock basis, liabilities assumed by the transferee corporation are considered money and reduce the shareholder's basis in any stock received (Sec. 358(d)).

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The shareholder's holding period for the stock includes the holding period of any capital assets or Sec. 1231 assets transferred. If the shareholder transfers any other property (e.g., inventory), the holding period for any stock received begins on the day after the exchange date. This rule can cause some shares of transferee corporation stock to have two different holding periods. The shareholder's basis for any boot property is its FMV, and the holding period begins on the day after the exchange date (Sec. 358(a)(2)). pp. C:2-18 and C:2-19.

C:2-15 Two sets of circumstances may require recognition of gain when liabilities are transferred.

- First, all liabilities assumed by a controlled corporation are considered boot if the principal purpose of the transfer of any portion of such liabilities is tax avoidance or if no bona fide business purpose exists for the transfer (Sec. 357(b)).
- Second, if the total amount of liabilities transferred to a controlled corporation exceeds the total adjusted basis of all property transferred by the transferor, the excess liability amount is treated as a gain taxable to the transferor without regard to whether the transferor had actually realized gain or loss (Sec. 357(c)).

Under the second set of circumstances, the transferor recognizes gain, but the excess liabilities are not considered to be boot. Section 357(c)(3) provides special rules for cash basis transferors who transfer excess liabilities to a corporation. pp. C:2-22 through C:2-25.

C:2-16 The IRS likely would consider the following two factors: (1) The transferor's reason for incurring the liability (e.g., did the liability relate to the transferor's trade or business). (2) The length of time from when the liability was incurred to the transfer date. If the transferor incurred the liability in connection with his or her trade or business, a Sec. 357(b) "problem" probably would not exist even if the transferor incurred the liability shortly before the transfer date. pp. C:2-12 through C:2-27.

C:2-17 If Mark receives no boot, depreciation is not recaptured (Secs. 1245(b)(3) and 1250(d)(3)). The recapture potential is transferred to Utah Corporation along with the property. If Mark <u>does</u> receive boot and must recognize gain, the recognized gain is treated as ordinary income but not in an amount exceeding the recapture potential. Any remaining recapture potential is transferred to Utah. If Utah sells the property at a gain, it must recapture depreciation deducted by Mark and not recaptured at the time of the transfer, as well as depreciation that it has claimed. Depreciation in the year of transfer must be allocated between the transferor and transferee according to the number of months each party has held the property. The transferee is considered to have held the property for the entire month in which the property was transferred. pp. C:2-25 through C:2-27.

C:2-18 The assignment of income doctrine could apply to a transfer of unearned income. However, the assignment of income doctrine does not apply to a transfer of accounts receivable by a cash method transferor in a Sec. 351 exchange if (1) the transferor transfers substantially all the assets and liabilities of a business and (2) a business purpose exists for the transfer. (See Rev. Rul. 80-198, 1980-2 C.B. 113.) p. C:2-27.

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C:2-19 In enacting Sec. 385, Congress mandated that the following factors be taken into account in determining whether an amount advanced to a corporation should be characterized as debt or equity capital:

- Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
- Whether the debt is subordinate to or preferred over other indebtedness of the corporation,
- The ratio of debt to equity of the corporation,
- Whether the debt is convertible into the stock of the corporation, and
- The relationship between holdings of stock in the corporation and holdings of the interest in question.

Although Congress enacted Sec. 385 in an attempt to provide statutory guidelines for the debt/equity question, the lack of a subsequent set of interpretative regulations has required taxpayers, the IRS, and the courts to continue to use these statutory factors and other factors identified by the courts in ascertaining whether an instrument is debt or equity. Amendment of Sec. 385 in 1989 to permit part-debt and part-equity corporate instruments has lead to the issuance of administrative pronouncements (e.g., Notice 94-97, 1947-1 C.B. 357) that interpret the Sec. 385 statutory guidelines. See also O.H. Kruse Grain & Milling v. CIR, 5 AFTR 2d 1544, 60-2 USTC ¶9490 (9th Cir., 1960) cited in footnote 47 of the text, which lists additional factors the courts might consider. pp. C:2-27 and C:2-28.

C:2-20 Advantages of using debt include: Interest is deductible (subject to limitations) by the payor while a dividend payment is not deductible, and the repayment of an indebtedness generally is treated as a return of capital while a stock redemption often is treated as a dividend. Disadvantages of using debt include that dividend payments are eligible for a dividends-received deduction when received by a corporate shareholder; stock can be received tax-free as part of a corporate formation and/or reorganization while the receipt of debt usually is treated as boot; a distribution of stock to shareholders can be a nontaxable stock dividend while a distribution of a debt usually results in dividend income; and worthless stock results in an ordinary loss under Sec. 1244 while a worthless debt instrument generally results in a capital loss. Pp. C:2-29 and C:2-30.

C:2-21 Ordinary loss treatment. The principal advantage of satisfying the Sec. 1244 small business stock requirements is the ordinary loss treatment available for individual shareholders and certain partnerships reporting up to $50,000 (or $100,000 if married and filing jointly) of losses incurred on a sale or exchange of the stock. Ordinary loss treatment is available only if the loss is incurred by a qualifying shareholder who acquired the stock from the small business corporation; the corporation was a small business corporation at the time it issued the stock (i.e., a corporation whose aggregate money and other property received for stock is less than $1 million); the corporation issued the stock for money or property (other than stock or securities); and the issuing corporation derived more than 50% of its aggregate gross receipts from active sources during the most recent five tax years ending before the date when the stock was sold or exchanged. Pp. C:2-32 and C:2-33.

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C:2-22 The two advantages of business bad debt treatment are (1) a business bad debt deduction can be claimed for partial worthlessness and (2) a business bad debt can be deducted as an ordinary loss. A nonbusiness bad debt can be deducted only in the year in which total worthlessness occurs. No partial write-offs of nonbusiness bad debts are permitted. A nonbusiness bad debt can be deducted only as a short-term capital loss. These losses can offset capital gains or be deducted by individuals up to $3,000 in a tax year. No limit exists on business bad debt deductions and, if such losses exceed income, they can be carried back as part of a net operating loss. To claim a business bad debt deduction, the holder must show that the dominant motivation for the loan was related to the taxpayer's business and was not related to the taxpayer's investment activities. Pp. C:2-33 and C:2-34.

C:2-23 To recognize gain or loss. Shareholders might avoid Sec. 351 treatment if, in transferring property, they realize a gain or loss that they want to recognize. They may be able to avoid Sec. 351 treatment by violating one or more of its requirements, for example, by selling the property to the corporation for cash, by selling the property to a third party who contributes it to the corporation, or by receiving sufficient boot to recognize the gain. Pp. C:2-34 through C:2-36.

C:2-24 The reporting requirements are as follows: Every person who receives stock, securities, or other property in a Sec. 351 exchange must attach a statement to his or her tax return for the period that includes the date of the exchange. The statement must include all the facts pertinent to the exchange (see Reg. Sec. 1.351-3(a)). Similarly, the transferee corporation must attach a statement to its tax return for the year in which the exchange took place (see Reg. Sec. 1.351-3(b)). The transferee's statement requires a description of the property and liabilities received from the transferors and the stock and property transferred to the transferors in exchange for the property. P. C:2-36.

Issue Identification Questions

C:2-25 Mary and Peter should consider the following tax issues:

- Does the property transfer meet the Sec. 351 requirements?
  - Have Peter and Mary transferred property? Does Peter's controlling Trenton Corporation prior to the transfer change the tax result?
  - Are the transferors in control of the corporation immediately after the transfer?
  - Do the transferors receive transferee corporation stock?
- What is each shareholder's recognized gain?
- What is each shareholder's basis in his or her stock?
- What is each shareholder's holding period for his or her stock?
- Does Trenton recognize gain when it issues its stock?
- What is Trenton's basis in the property received from Mary?
- What is Trenton's holding period for the property received from Mary?

The property transfer meets all the Sec. 351 requirements. Peter and Mary are considered to own all 195 of the Trenton shares immediately after the exchange. Peter's contribution of cash for stock is not considered to be a nominal amount according to IRS rules relating to the issuance of private letter rulings (i.e., it equals or exceeds 10% of the value of Peter's prior stock holdings). Thus, his stock is counted towards the 80% minimum stock ownership for control. Mary recognizes no gain on the asset transfer and takes a $50,000 basis in the Trenton shares she receives. The

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holding period for the Trenton shares includes her holding period for the property transferred. Trenton recognizes no gain when it issues its stock and takes a $50,000 basis in the property. pp. C:2-12 through C:2-30.

C:2-26 Carl and his son should consider the following tax issues:

- Does the property transfer meet the Sec. 351 requirements?
  - Have Carl and his son transferred property?
  - Are the transferors in control of the corporation immediately after the transfer?
  - Do the transferors receive transferee corporation stock?
- Does the property contribution/receipt of stock as described in the facts reflect the true nature of the transaction? Or, has a deemed gift or other event occurred?
- What is each shareholder's recognized gain?
- What is each shareholder's basis in his stock?
- What is each shareholder's holding period in his stock?
- If a deemed gift has been made, is it a taxable gift from Carl to his son? (This question could be rewritten for events other than a gift (e.g., repayment of a loan.))
- What is Cook Corporation's basis in the property received from Carl?
- What is Cook's holding period for the property received from Carl?

The contribution is nontaxable because it meets all the Sec. 351 requirements, and Carl and Carl, Jr. own all the Cook stock. Carl, Jr. receives a disproportionate amount of stock relative to his $20,000 capital contribution. It appears that the transaction should be recast so that Carl is deemed to receive 80 shares of stock, each valued at $1,000. He then gifts 30 shares to Carl, Jr. The deemed gift leaves each shareholder with 50 shares of stock. Neither shareholder recognizes any gain, and Carl takes a $50,000 adjusted basis in the 80 shares he receives. He recognizes no gain on the transfer of 30 shares to Carl, Jr., and $18,750 [(30/80) x $50,000] of his basis accompanies the deemed gifted shares. Carl's basis in his remaining 50 shares is $31,250 ($50,000 - $18,750). Carl, Jr's basis in his 50 shares is $38,750 ($20,000 + $18,750). Pp. C:2-9 through C:2-27.

C:2-27 Bill should consider the following tax issues:

- Was the stock sold to a related party (Sam), as defined by Sec. 267(b)? If so, Bill cannot recognize the loss, and the remaining issues need not be examined. If not, then…
- Is the stock a capital asset?
- Is Bold a qualifying small business corporation?
- If so, does the stock qualify for Sec. 1244 stock treatment?
- If Sec. 1244 stock, what is Bill's marital and filing status?
- Has Bill's basis in the stock changed relative to its initial acquisition cost?
- What is the amount and character of Bill's recognized loss?

Bill's stock sale results in the realization of a $65,000 ($100,000 - $35,000) long-term capital loss. If the purchaser is a related party, Sec. 267(a) precludes Bill from recognizing the loss. Because Bill is the original holder of the stock, the loss may be characterized as ordinary under Sec. 1244, assuming the various requirements of that provision are satisfied. Pp. C:2-32 and C:2-33.

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Problems

C:2-28 With the given facts, the C corporation option with the salary payment results in the lowest total tax, as determined in the following analysis:

	Sole Proprietorship	C Corporation With Salary	C Corporation With Dividend	S Corporation With Salary	S Corporation With Distribution
Entity Level:					
Income before salary	$50,000	$50,000	$50,000	$50,000	$50,000
Salary deduction	-0-	(20,000)	-0-	(20,000)	-0-
Taxable income	$50,000	$30,000	$50,000	$30,000	$50,000
Entity level tax	$ -0-	$ 6,300	$10,500	$ -0-	$ -0-
Lucia:					
Pass-through income	$50,000	$ -0-	$ -0-	$30,000	$50,000
QBI deduction	(10,000)			(6,000)	(10,000)
Salary income	-0-	20,000	-0-	20,000	-0-
Dividend income	-0-	-0-	20,000	-0-	-0-
Total income to Lucia	$40,000	$20,000	$20,000	$44,000	$40,000
Lucia's tax	$ 8,800[a]	$ 4,400[b]	$ 3,000[c]	$ 9,680[d]	$ 8,800[e]
Total Tax	$ 8,800	$10,700	$13,500	$ 9,680	$ 8,800

[a]$40,000 x 0.22 = $8,800
[b]$20,000 x 0.22 = $4,400
[c]$20,000 x 0.15 = $3,000
[d]$44,000 x 0.22 = $9,680
[e]$40,000 x 0.22 = $8,800

With the given facts, the sole proprietorship and the S corporation with distributions provide the best options. These forms allow for the qualified business income (QBI) deduction. Also, the corporate tax rate (21%) is close to the individual's tax rate (22%), so the C corporation form along with the double taxation of distributed income in the form of a dividend causes that form to be disadvantageous. The C corporation with salary, while reducing double taxation, does not provide a QBI deduction or a reduced tax rate on salary, so this option also has disadvantages. The S corporation with salary has the disadvantage of reducing the amount of income subject to the QBI deduction. Given different facts, such as a higher individual tax rate, the outcomes of this analysis could change. pp. C:2-2 through C:2-8.

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C:2-29 a. None. Dick does not recognize his $10,000 realized loss.

b. $60,000 basis in Triton shares received. Dick's holding period is deemed to begin three years ago when Dick originally purchased the land.

c. None. Evan does not recognize his $15,000 realized loss.

d. $45,000 basis in Triton shares received. Evan's holding period is deemed to begin four years ago when Evan originally purchased the machinery.

e. Fran recognizes $20,000 of ordinary income.

f. $20,000 basis in Triton shares received. Fran's holding period begins the day after the exchange date in the current year.

g. Triton takes a $50,000 basis in the land and a $30,000 basis in the machinery. Because of the loss property limitation rule, the bases of these assets are reduced to their respective FMVs, assuming the parties do not elect to reduce stock basis. Thus, both assets have a holding period that begins the day after the transfer in the current year. The services, if capitalized, would have a $20,000 basis and a holding period starting in the current year. pp. C:2-9 through C:2-22.

C:2-30 a. $20,000 gain. The Sec. 351 requirements have not been met because 30% of the stock is issued for services. Therefore, Ed recognizes $20,000 ($35,000 - $15,000) of capital gain.

b. $35,000 basis in Jet shares received. Ed's holding period begins on the day after the exchange date.

c. Fran recognizes a $10,000 ($35,000 - $45,000) Sec. 1231 loss.

d. $35,000 basis in Jet shares received. Fran's holding period begins on the day after the exchange date.

e. George recognizes $30,000 of ordinary income.

f. $30,000 basis in Jet shares received. George's holding period begins the day after the exchange date.

g. Jet Corporation takes a $35,000 basis in the land and a $35,000 basis in the machinery. Its holding period for each asset begins the day after the exchange date. The services, if capitalized, would have a $30,000 basis.

h. Because the Sec. 351 requirements would now have been met, the answers change as follows:

a. Ed recognizes no gain or loss.

b. $15,000 basis in the Jet shares received. Ed's holding period is deemed to begin four years ago when he originally purchased the land.

c. Fran recognizes no loss.

d. $45,000 basis in the Jet shares received. Fran's holding period is deemed to begin four years ago when she originally purchased the machinery.

e. George recognizes $25,000 of ordinary income.

f. $30,000 ($5,000 cash + $25,000 FMV of services) basis in the Jet shares received. George's holding period begins the day after the exchange date.

g. Jet's basis in the land and machinery are $15,000 and $35,000, respectively. The loss property limitation rule limits the corporation's basis in the machinery to its FMV. Jet's holding period for the land is deemed to begin four years ago when Dick originally purchased the land. The holding period for the machinery begins the day after the exchange date because, by having its basis reduced to FMV, it no longer has a basis that references the

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transferor's basis before the exchange. The services, if capitalized, would have a $25,000 basis. pp. C:2-12 through C:2-22.

C:2-31 a. The control requirement is not met. Transferors of property receive only 75% and thus do not have 80% control.

b. The control requirement is met. Robert transferred more than a nominal amount of property. The 80% control requirement has been met since all of Robert's stock is counted for this purpose.

c. The control requirement is not met. Sam owns only 33-1/3% of the Vast stock immediately after the exchange. No stock ownership is attributed from Sam's parents to Sam.

d. The control requirement is met. Charles and Ruth own 100% of the Tiny stock. The transfers do not have to be simultaneous.

e. The control requirement is not met. Charles had a prearranged plan to sell a sufficient amount of shares to fail the control test. Only if Sam were considered to be a transferor (i.e., the sale took place as part of a public offering) would the transaction meet the requirements of Sec. 351. pp. C:2-13 through C:2-16.

C:2-32 a. The control requirement is met. The property transferred by Fred is not considered to be nominal relative to the value of stock received for services. Therefore, Fred and Greta are considered to own 100% of the New stock.

b. The control requirement is not met. For advance ruling purposes, Maureen's shares are not counted towards determining whether the control requirement has been met because the property she contributed was nominal (i.e., does not meet the 10% property minimum of Rev. Proc. 77-37) compared to the value of the stock received for services. The taxpayer may choose to enter into the transaction without an advance ruling, report it as nontaxable, and run the risk of being audited, with the result that the IRS treats the transaction as taxable. Alternatively, Maureen can contribute additional property so that the amount of property equals or exceeds the 10% minimum. The minimum property contribution is $4,545 [$4,545 = 0.1 x ($50,000 - $4,545)]. The $4,545 amount is found by solving the following equation for Property: Property = 0.1 x ($50,000 - Property), which solves to Property = (0.1 x $50,000)/1.1. pp. C:2-13 and C:2-14.

C:2-33 Veronica needs to receive 1,000 additional shares in exchange for $25,000 worth of silver bullion. The 200 shares currently held by Veronica equal 40% of the 500 shares outstanding. To avoid recognizing a gain, Veronica must be "in control" of Poly-Electron immediately after the exchange. Control implies ownership of at least 80% of the total number of Poly-Electron shares outstanding.

The number of additional shares that Veronica must acquire to achieve control can be calculated as follows, where A = additional shares needed:

$$(200 + A) / (500 + A) = 0.80$$
$$200 + A = 0.80 \text{ x } (500 + A)$$
$$200 + A = 400 + 0 .80 A$$
$$0.20 A = 200$$
$$A = 1{,}000 \text{ additional shares}$$

Thus, with the additional 1,000 shares, Veronica will have 80% control after the exchange (i.e., 1,200 / 1,500 = 80%.) If each share is worth $25, the value of silver bullion that Veronica must

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contribute is $25,000 (1,000 shares x $25). Having achieved control, Veronica's exchange will qualify for nontaxable treatment under Sec. 351. pp. C:2-13 through C:2-15.

C:2-34 a. No. The exchange does not qualify as nontaxable under Sec. 351 because Al and Bob do not control West Corporation. (Al owns only 1,000/1,300 = 76.9% of the voting common stock while Bob owns 100% of the nonvoting preferred stock). Al recognizes $25,000 of gain on the transfer of the patent. His basis in his West stock is $25,000. Bob recognizes no gain or loss because he contributed cash. His basis in the preferred stock is $25,000. Carl recognizes $7,500 of ordinary income. His basis in his West stock is $7,500. West recognizes no gain or loss on the exchange. Its basis for the assets is: cash, $25,000; patent, $25,000; and services, $7,500.

b. Nontaxable. The exchange now qualifies as nontaxable under Sec. 351 because Al and Bob together own 1,200/1,500 = 80% of the voting common stock and 100% of the nonvoting preferred stock. Al recognizes no gain or loss, and his basis in his West stock is zero. Bob recognizes no gain or loss, and his basis in his West stock is $25,000. Carl recognizes $7,500 of ordinary income, and his basis in his West stock is $7,500. The consequences to West are the same as in Part a, except the basis for the patent is zero instead of $25,000.

c. Nontaxable. The exchange apparently would qualify under Sec. 351. Assuming the $800 of cash contributed is acceptable under Rev. Proc. 77-37 because it meets the 10% property minimum for advance ruling purposes, Al and Bob would recognize no gain or loss. Carl would recognize $6,700 of ordinary income. The consequences to West are the same as in Part b except the cash contributed by Carl takes an $800 basis and the services generate $6,700 of taxable income. pp. C:2-13 through C:2-16.

C:2-35

	Cash	Equipment	Building	Land	Total
FMV of assets	$ 5,000	$90,000	$40,000	$30,000	$165,000
Fraction of total value	0.030303	0.545455	0.242424	0.181818	1.0000
FMV of stock received	$ 3,788	$68,182	$30,303	$22,727	$125,000
Plus: Boot property	1,212	21,818	9,697	7,273	40,000
Total proceeds	$ 5,000	$90,000	$40,000	$30,000	$165,000
Minus: Adj. basis of assets	(5,000)	(60,000)	(51,000)	(24,000)	(140,000)
Gain (loss) realized	$ -0-	$30,000	($11,000)	$ 6,000	$ 25,000
Allocation of boot	$ 1,212	$21,818	$ 9,697	$ 7,273	$ 40,000
Gain recognized	$ -0-	$21,818	$ -0-	$ 6,000	$ 27,818

a. $27,818 gain recognized:

Gain on equipment, ordinary income (recapture on Sec. 1245 property)	$21,818
Gain on land, Sec. 1231 gain	6,000
Total gain recognized	$27,818

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b. $40,000 basis in stock:

Adj. basis of property transferred	$140,000
Minus: FMV of boot received	(40,000)
Plus: Gain recognized by transferor	27,818
Basis in stock	$127,818
Basis in interest-bearing notes ($10,000 each):	$ 40,000

c. $165,000 total basis in the property received:

	Tom's Basis	Recog. Gain	Reduction*	Total
Cash	$ 5,000	$ -0-	$ -0-	$ 5,000
Equipment	60,000	21,818	-0-	81,818
Building	51,000	-0-	(2,818)	48,182
Land	24,000	6,000	-0-	30,000
Total	$140,000	$27,818	$(2,818)	$165,000

*Total adjusted basis = $167,818 ($140,000 + $27,818); total FMV = $165,000. Thus, the reduction under Sec. 362(e)(2) = $2,818 ($167,818 - $165,000). Reg. Sec. 1.362-4(g)(2)(ii), adjusted basis includes the increase for gain recognized by the shareholder.

pp. C:2-16 through C:2-22.

C:2-36 $15,000. Ann must recognize $15,000 ($25,000 - $10,000) of gain on the exchange. To comply with the advance ruling requirements of Rev. Proc. 77-37, Fred must receive more than a nominal amount of stock in exchange for his property. If Fred obtained additional stock worth at least 10% of the value of the stock he already owned (i.e., at least five shares of stock in exchange for $5,000), his stock likely would be counted for control purposes, and the Sec. 351 requirements would be met. Ann may choose to enter into the transaction without increasing her property contribution so as to acquire at least 80% of Zero's stock or without having Fred increase his contribution to at least $5,000, proceed without an advance ruling, and report the transaction as being nontaxable. Ann and Fred then run the risk of being audited and the IRS's arguing the transaction is taxable. pp. C:2-14 and C:2-15.

C:2-37 $4,000. Lucy recognizes $4,000 ($12,000 - $8,000) gain on the exchange because she owns less than 80% of the stock immediately after the exchange [(50+10)/110=54.5%]. To qualify under Sec. 351:
(1) Lucy could contribute additional property for enough additional stock to obtain 80% control. To meet the 80% control requirement, she would have to purchase an additional 150 shares to own 200 shares (of the 250 shares outstanding).
(2) Marvin could exchange enough property as part of the same transaction to qualify as a transferor under Sec. 351. For advance ruling purposes under Rev. Proc. 77-37, Marvin would have to contribute at least $6,000 for an additional five shares of stock to be considered a transferor of property. The taxpayers may choose to engage in the transaction without Lucy's and Marvin's increasing their property contributions, proceed without an advance ruling, and report it as being

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nontaxable. However, they would run the risk of being audited and the IRS's arguing the transaction is taxable. pp. C:2-14 and C:2-15.

C:2-38 a. None. Neither Jerry nor Frank recognizes any gain or loss on the exchange because the Sec. 351 requirements have been met.

b. $44,000. Because the exchange is disproportionate, Frank probably could be deemed to have made a gift of 25 shares of Texas stock to Jerry. Jerry's basis in his 75 shares is $44,000 ($28,000 basis in property transferred by Jerry + $16,000 basis in the 25 shares received from Frank). This calculation presumes that no gift taxes are paid on the transfer. If gift taxes are paid, a second basis adjustment may be needed for the portion of the gift tax attributable to the appreciation.

c. $16,000. Frank's basis in his 25 Texas shares is $16,000 [$32,000 basis in property transferred x (25/50)]. pp. C:2-15 and C:2-16.

C:2-39 a. $20,000 capital gain:

Amount realized	$170,000
Minus: Basis in land	(30,000)
Realized gain	$140,000
Boot received (note)	$ 20,000
Gain recognized (capital in character)	$ 20,000

b. $30,000. Basis of common stock and preferred stock: $30,000 + $20,000 - $20,000 = $30,000. This basis must be allocated to the common and preferred stock based on their relative fair market values.

Basis of common stock: $\frac{\$100,000}{\$150,000}$ x $30,000 = $20,000

Basis of preferred stock: $\frac{\$50,000}{\$150,000}$ x $30,000 = $10,000

Basis of short-term note: $20,000 (FMV).

c. Basis of land to Temple Corporation: $50,000 = $30,000 + $20,000

pp. C:2-16 through C:2-22.

C:2-40 a. None for Karen and Larry; $7,000 capital gain to Joe. Karen and Larry recognize no gain or loss under Sec. 351 because they receive only stock. Joe recognizes a $7,000 ($15,000 - $8,000) capital gain because he receives only notes and therefore does not qualify for Sec. 351 treatment.

b. Joe's basis in the notes is $15,000. Karen's basis in the stock is $18,000. Larry's basis in the stock is $25,000.

c. Gray Corporation's basis in the land is $15,000. Gray's basis in the equipment is $18,000. The $10,000 of depreciation recapture potential is inherited by Gray because Karen does not recognize a gain on the asset transfer. pp. C:2-16 through C:2-19.

C:2-41 a. $4,000 gain. Nora realizes a $7,000 gain [($18,000 + $4,000) - $15,000] and must recognize a gain of $4,000, the amount of the boot (note) received. Of the $4,000 gain, $3,000 is ordinary income recaptured under Sec. 1245. The remaining $1,000 is a Sec. 1231 gain.

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b. $4,000 and $15,000. Nora's basis in the note is $4,000, its FMV. Nora's basis in the stock is $15,000 ($15,000 + $4,000 gain - $4,000 FMV of note).

c. $19,000. Needle Corporation's basis in the machinery is $19,000 ($15,000 + $4,000 gain recognized). pp. C:2-16 through C:2-22 and C:2-25 through C:2-27.

C:2-42a. $3,000 of ordinary income: Jim realizes a $3,500 [($5,000 + $1,000 + $2,000) - $4,500] gain and recognizes a $3,000 gain. Because the $2,000 education loan assumed by Gold Corporation has no apparent business purpose, all liabilities transferred to Gold are treated as boot under Sec. 357(b). All of Jim's gain is ordinary income recaptured under Sec. 1245.

b. $4,500. Jim's basis in his stock is $4,500 ($4,500 + $3,000 - $3,000).

c. Jim's holding period for the additional shares includes his holding period for the automobile.

d. $7,500. Gold's basis in the automobile is $7,500 ($4,500 + $3,000). pp. C:2-22 and C:2-23.

C:2-43 a. $3,000 of ordinary income, determined as follows:

Stock (FMV) received		$17,000
Release from liability		28,000
Amount realized		$45,000
Minus: Basis of property transferred		
Machinery	$15,000	
Money	10,000	(25,000)
Realized gain		$20,000
Liability assumed		$28,000
Minus: Basis of all property transferred		(25,000)
Recognized gain (Sec. 357(c))		$ 3,000

The gain is treated as ordinary income under Sec. 1245 recapture rules.

b. Zero basis:

Property transferred	$25,000
Minus: Boot received (including liability)	(28,000)
Plus: Gain recognized	3,000
Basis in Moore stock	$ -0-

c. $18,000 basis:

Barbara's basis in the machine	$15,000
Plus: Barbara's recognized gain	3,000
Moore corporation's total basis in machinery	$18,000

d. Sam recognizes no gain or loss.

e. $17,000 basis, the amount of money he contributed to Moore for the stock.

f. Barbara's holding period for her stock includes her holding period for the machinery. Sam's holding period starts on the day after the exchange date.

g. Sec. 351 would not apply, so the answers would change as follows:

a. $20,000 ordinary income. Barbara would recognize $20,000 of ordinary income recaptured under Sec. 1245.

b. $17,000 basis. Barbara's basis in the stock would be $17,000, its FMV.

c. $35,000 basis. Moore's basis in the machinery would be $35,000, its FMV.

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d. $17,000 ordinary income. Sam would recognize $17,000 of ordinary income from compensation.

e. $17,000 basis. Sam's basis in the Moore stock would be $17,000, its FMV.

f. Sam's holding period for his stock would start on the day after the exchange date. Barbara's stock would have a split holding period because she contributed both Sec. 1231 property and cash.

pp. C:2-24 and C:2-25.

C:2-44 a. $3,000 gain recognized. Jerry realizes an $18,000 [($15,000 + $35,000) - $32,000] gain and recognizes a $3,000 ($35,000 - $32,000) gain because the liabilities exceed the property's basis (Sec. 357(c)).

b. Zero basis. Jerry's basis in his Emerald stock is zero ($32,000 + $3,000 - $35,000).

c. $35,000 basis. Emerald's basis in the property is $35,000 ($32,000 + $3,000).

d. a. No gain or loss. Jerry recognizes no gain or loss because the liabilities are not considered boot and do not exceed the basis of property contributed.

b. $17,000 basis. Jerry's basis in his Emerald stock is $17,000 ($32,000 - $15,000).

c. $32,000 basis. Emerald's basis in the property is $32,000.

pp. C:2-22 through C:2-25.

C:2-45 a. No gain or loss recognized. Ted realizes a $70,000 ([$60,000 + $35,000 + $15,000] - [$5,000 + $35,000]) gain, but Ted recognizes no gain or loss. Section 357(c)(3) precludes Ted from recognizing a gain because of his "excess" liability situation (i.e., liabilities that total $50,000 exceeding the $40,000 total bases of the assets).

b. $25,000 basis. Ted's basis in the stock received is $25,000 ($40,000 - $15,000). No reduction in basis is required for liabilities assumed by the transferee corporation under Sec. 357(c)(3) or under Sec. 358(d)(2).

c. $40,000 basis. The corporation's basis in the assets is the same $40,000 basis that Ted had ($5,000 in the cash, zero in the accounts receivable, and $35,000 in the equipment).

d. The corporation. The corporation must recognize the income from the receivables when it collects on them. The corporation also can deduct the current liabilities when it pays them (Rev. Rul. 80-198, 1980-2 C.B. 13). pp. C:2-24 and C:2-25.

C:2-46 a. $10,000 of ordinary income. Mary realizes a $50,000 ($110,000 - $60,000) gain but recognizes a $10,000 gain (amount of boot received). The gain is treated as ordinary income under the Sec. 1245 recapture rules.

b. $60,000 basis. Mary's basis in the Green stock is $60,000 ($60,000 + $10,000 - $10,000). Her holding period for the stock is deemed to begin three years ago when she purchased the machine. Mary's basis in the two-year note (boot) is $10,000, its FMV. Her holding period for the note begins on the day after the exchange date.

c. Green recognizes no gain or loss.

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d. $70,000 basis. Green's basis in the machine is $70,000 ($60,000 basis to Mary + $10,000 gain recognized by Mary). Green's holding period is deemed to begin three years ago when Mary purchased the machine. pp. C:2-17 through C:2-21, C:2-25, and C:2-26.

C:2-47 a. Since this transfer occurred after December 22, 2017, Ace Corporation recognizes $500,000 of ordinary income because the City of Omaha is a governmental entity.

b. Ace Corporation takes a $500,000 basis in the land.

c. Ace reports $600,000 of ordinary income. When it purchases the equipment, Ace takes a $250,000 basis in the equipment, its cost.

d. Alternative facts:

a. Because the nonshareholder contributor is not a customer, potential customer, governmental entity or civic organization, Ace Corporation recognizes no income.

b. Ace Corporation takes a zero basis in the land.

c. Ace recognizes no income when it receives the cash. The basis of the equipment purchased with the $100,000 contribution is its $250,000 purchase price minus the $100,000 of contributed cash, or $150,000. pp. C:2-31 and C:2-32.

C:2-48 a. Kobe recognizes a $70,000 dividend, which is taxed at the applicable capital gains tax rate, and Bryant Corporation reports taxable income of $120,000. Bryant may not deduct the dividend paid to Kobe.

b. Kobe recognizes interest income of $20,000, which is taxed at his ordinary tax rate. The principal repayment is not taxable to Kobe. Bryant reports taxable income of $100,000 because it gets a $20,000 deduction for the interest paid to Kobe. pp. C:2-27 through C:2-30.

C:2-49 a. $75,000 capital loss to each shareholder. The $75,000 loss with respect to the stock investments is capital in character for both Tom and Vicki because they did not purchase the stock from the corporation. Because the $25,000 debts are secured by bonds, the worthless security rules of Sec. 165(g)(1) apply and their losses will be capital in character.

b. STCL to Vicki; ordinary loss to Tom. If the liability were not secured by bonds, Vicki's loan would be related solely to her stock investment and should be treated as a nonbusiness bad debt that is deductible as a short-term capital loss (up to $3,000 a year after netting capital losses against capital gains). An argument can be made that Tom's loss would relate to an attempt to maintain his employment with Guest Corporation and, therefore, has a substantial business purpose. Such a loss would be deductible as an ordinary loss if the dominant motive for making the loan were related to his employment activities.

c. Limited ordinary loss on stock; capital loss on bonds. The loss with respect to the stock investment would be ordinary in character under Sec. 1244 for both Tom and Vicki up to the $100,000 annual limit for the couple because they purchased the stock directly from Guest. The $50,000 loss exceeding the $100,000 Sec. 1244 limit would be capital in character. The worthless security rules of Sec. 165(g)(1) still would apply to the $25,000 losses on the bond investments. These losses would be capital in character. pp. C:2-32 through C:2-34.

C:2-50 Harry: Ordinary loss of $50,000 under Sec. 1244 and LTCL of $75,000.

Susan: LTCL of $175,000.

Big Corporation: $125,000 LTCL. pp. C:2-32 through C:2-34.

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C:2-51 a. $50,000 ordinary loss and $2,000 LTCL. Lois's loss is $52,000 ($28,000 - $80,000 basis), of which $50,000 (the limit for a single taxpayer) is ordinary under Sec. 1244. The remaining $2,000 is a long-term capital loss.

b. $42,000 ordinary loss and $10,000 LTCL. Lois's loss still would be $52,000 ($28,000 - $80,000 basis). However, for purposes of computing the Sec. 1244 loss, Lois's basis in the stock would be $70,000. Therefore, the ordinary loss under Sec. 1244 would be $42,000 ($28,000 - $70,000). The remaining $10,000 would be a long-term capital loss. pp. C:2-32 through C:2-34.

C:2-52 $52,000 LTCL. The entire loss is capital in character because Sue was not the original owner of the stock; therefore, the stock is no longer Sec. 1244 stock. pp. C:2-32 through C:2-34.

C:2-53 a. Donna recognizes no gain when she transfers the land to Development Corporation. Development's basis in the land will be $150,000. All gain on the subsequent sale will be ordinary income to Development. This alternative results in the pre-contribution gain that accrued prior to Donna's transfer and the post-contribution profit earned from subdividing the land being taxed at a 21% tax rate.

b. Donna could transfer the land to Development in exchange for stock and $330,000 of debt instruments. In this case, Donna would recognize $330,000 of long-term capital gain and Development's basis in the land would be $480,000. The $330,000 of pre-contribution capital gain (net of any capital losses that Donna has recognized) is taxed at the applicable capital gains tax rate (in this case, 23.8%, including the 3.8% net investment tax). The step-up in basis permits Development to use the additional basis to offset income earned from subdividing the land that otherwise would be taxed at a 21% tax rate. Author's Note: The basic scenario apparently would permit Donna's gain to be reported using the installment method. However, sale of the land by a related person (a corporation controlled by Donna) within two years of the transfer date precludes deferral of the installment gain (Sec. 453(e)). pp. C:2-34 through C:2-36.

Comprehensive Problems

C:2-54 a. Yes. The transaction meets the requirements of Sec. 351. Transferors of property (Alice, Bob, and Carla) own 88.2% (750/850 = 0.882) of the Bear stock.

b. Alice recognizes a $10,000 gain, the amount by which the $60,000 mortgage assumed by Bear Corporation exceeds the $50,000 basis ($12,000 + $38,000) of all the assets transferred by Alice. The character is Sec. 1231 gain, of which some would be Sec. 1250 gain because of depreciation claimed on the building. Bob recognizes $10,000 of gain (the lesser of his realized gain of $15,000 or the boot received of $10,000). The gain is treated as ordinary income recaptured under Sec. 1245. Carla recognizes no gain or loss even though she received cash because she realized a $5,000 loss. Dick recognizes $10,000 of ordinary income as compensation for his services. Bear recognizes no gain or loss on issuing its stock or the note.

c. Alice's basis in her stock is zero ($12,000 + $38,000 - $60,000 liabilities + $10,000 gain). Her holding period for the stock includes her holding period for the land and building. Each share of stock, therefore, has a split holding period. Bob's stock basis is $25,000 ($25,000 + $10,000 gain - $10,000 boot). His holding period for his stock includes his holding period for the equipment. Carla's basis for her stock is $10,000 ($15,000 - $5,000 boot). Her holding period for the stock includes her holding period for the van. Dick's basis in his stock is $10,000. His holding period begins on the day after the exchange date.

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d. Bear's basis in the assets received is: land $15,000 [$12,000 + (0.30 x $10,000)] and building $45,000 [$38,000 + (0.70 x $10,000)]. (The gain is allocated between the land and building according to the two assets' relative FMVs as prescribed by the Sec. 357 Treasury Regulations.) The holding period for the land and building includes the time Alice held these properties. Equipment basis is $35,000 ($25,000 + $10,000). Holding period includes the time that Bob owned the properties. Van basis is $10,000, limited to the van's FMV. If Bear and Carla elect, Bear can take a $15,000 basis in the van, but Carla's basis in her stock would be limited to $5,000, its FMV. Holding period begins the day after the exchange date because the van takes a FMV basis. The accounting services are deductible by Bear if incurred after operations have begun. If the expenses are pre-operating expenses, they should be amortizable under Sec. 248. pp. C:2-12 through C:2-27.

C:2-55

Transferor shareholders	**----Ed----**	**----------Fay----------**	
	For Property	**For Inventory**	**For Land**
FMV common stock received	$40,000	$22,000	$ 11,000
FMV qualified preferred stock received	9,000		
FMV nonqualified preferred stock received	6,000		
Cash received	-0-	16,000	8,000
Liability assumed	-0-	2,000	1,000
Total amount realized	$55,000	$40,000	$ 20,000
Adjusted basis of property transferred	(36,000)	(14,000)	(50,000)
Gain (loss) realized	$19,000	$26,000	$(30,000)
Gain (loss) recognized	$ 6,000	$16,000	$ -0-

Ed's $6,000 gain recognized is ordinary income because of depreciation recapture, and Fay's $16,000 gain recognized is ordinary income because she transferred inventory.

Basis of nonqualified preferred stock:

Ed's basis in the nonqualified preferred stock received is its $6,000 FMV. The holding period of the stock begins the day after the exchange.

Basis of qualified stock:	**Ed**	**Fay**
Basis of property transferred	$36,000	$64,000
Plus: Gain recognized	6,000	16,000
Minus: Boot received:		
Nonqualified preferred stock	(6,000)	
Cash	-0-	(24,000)
Liability assumed	-0-	(3,000)
Total basis of qualified stock	$36,000	$53,000

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Check:

FMV qualified stock received	$49,000	$33,000
Minus: Gain deferred	(13,000)	(10,000)
Plus: Loss deferred	-0-	30,000
Total basis of qualified stock	$36,000	$53,000

Allocation of Ed's qualified stock basis (by relative FMV):

Common stock: $40,000/$49,000 x $36,000 = $29,388
Qualified preferred stock: $9,000/$49,000 x $36,000 = $6,612
The basis of each class of qualified stock includes Ed's holding period for the equipment transferred.

Fay's stock:

Each share has a split holding period, with two-thirds considered beginning the day after the exchange, and one-third including Fay's holding period for the land. See Rev. Rul. 85-164, 1985-2 C.B. 117.

Corporation

No gain (loss) recognized

Basis of property received:	**Equipment**	**Inventory**	**Land**
Transferred (carryover) basis	$36,000	$14,000	$50,000
Gain recognized by shareholder	6,000	16,000	-0-
Basis reduction under §362(e)(2)	-0-	-0-	(20,000)*
Total	$42,000	$30,000	$30,000

Holding period: Includes the transferor's holding period for each property.

*Total FMV of property transferred by Fay ($40,000 + $20,000)	$ 60,000
Total adjusted basis of property transferred by Fay ($14,000 + $16,000 + $50,000)**	(80,000)
Reduction under §362(e)(2) [all to loss property, the land]	$(20,000)

**Under Reg. §1.362-4(g)(2)(ii), the transferee corporation's basis for this calculation takes into account all applicable provisions of the tax law and, therefore, includes any gain recognized by the shareholder. Also see Reg. §1.362-4(h) Ex. (6). Thus, the inventory basis for this purpose is $30,000 ($14,000 + $16,000). If the corporation and Fay make a §362(e)(2)(C) election, Fay reduces her stock basis by $20,000 to $33,000, and the corporation takes a $50,000 carryover basis in the land. See Reg. §1.362-4(d)(2). pp. C:2-12 through C:2-27.

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Tax Strategy Problems

C:2-56 a. The circumstances vary for the shareholders, who may or may not be pleased with this result. They have avoided the requirements of Sec. 351, which allows Eric to recognize a $150,000 capital loss. Although Florence has to recognize $25,000 of ordinary income, Wildcat can depreciate the machinery's FMV of $25,000. If Eric can use the $150,000 loss to offset capital gains from other sources, he may be happy with this result. If Florence is in a low tax bracket, she might not mind that she has to recognize $25,000 of ordinary income. However, if Eric has no capital gains and cannot use the $150,000 capital loss, avoiding Sec. 351 may not be a desirable result. This is especially true if Wildcat plans to subdivide the land and sell it, thereby generating ordinary income in the near future. If Sec. 351 applied, Wildcat's basis in the land would be limited under the Sec. 362(e)(2) reduction rules to $50,000, its FMV. However, Eric and Wildcat Corporation could make an election under Sec. 362(e)(2)(C) so that the land would have a $200,000 carryover basis to Wildcat and, therefore, much less income for Wildcat to report in future years. In such case, Eric's basis would be limited to his stock's FMV of $50,000 rather than the $200,000 basis in the property contributed. If he is not planning to sell his stock anytime soon, this reduction might not matter. Also Florence could avoid recognizing $25,000 of ordinary income on the machinery. On the other hand, the machinery would have a zero basis to Wildcat, and therefore Wildcat would not be allowed any depreciation on the machinery. As far as George is concerned, it makes no difference to him whether Sec. 351 applies or not. The result to him is the same either way. pp. C:2-21 and C:2-22.

b. If the shareholders decide that meeting the Sec. 351 requirements would produce a greater tax benefit, they can proceed in several ways. For example:

1. The corporation could give George 150 shares of stock worth $15,000 and $10,000 of bonds. In such case Eric and Florence would own more than 80% (750/900 = 0.83) of the stock.
2. Florence and Eric each could contribute an additional $15,000 for 150 shares of stock. In such case, Eric and Florence would own more than 80% (1,050/1,300 = 0.808) of the stock.
3. George could contribute $2,500 of cash in addition to his services for 25 more shares. Thus, he would be a property contributor allowing <u>all</u> his shares to count in the 80% test. In such case, Eric, Florence, and George would own 100% of the stock.

C:2-57 a. Advantages of Alternative a:

1. Simplicity. Each person gets stock equal to her contribution to capital and will share in any appreciation in value in proportion to her contribution.
2. Paula recognizes no gain on the transaction because she received no boot.
3. The stock will be Sec. 1244 stock so, if Paula or Mary sells the stock at a loss or the business becomes bankrupt, at least some of the loss will be an ordinary loss.
4. The corporation, with the shareholders' consent, can elect S corporation status for the first two years, so the losses flow through to the shareholders to offset income from other sources. Later, the corporation, with the shareholders' consent, can revoke the S corporation election to become a regular C corporation.

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Disadvantages of Alternative a:

1. All distributions to Paula and Mary (above reasonable salaries) will be taxed as dividends to the shareholders and are not deductible by the corporation, although the dividends are subject to preferential tax rates.
2. Mary may want additional assurance that she will have preference in getting her investment back before the corporation pays any dividends. Since Paula has a majority ownership, she can decide when and if the corporation pays any dividends.
3. Paula may not want to share ownership with Mary. She might prefer that Mary's investment be treated as a loan so that all future appreciation accrues to her (Paula).

b. Advantages of Alternative b:

1. Paula recognizes no gain on the transaction.
2. Mary is assured of a return of her investment on whatever terms are specified in the debt instrument, plus a return of 8% for ten years (provided the corporation does not go bankrupt).
3. Even if the corporation becomes bankrupt, Mary will have first call on any assets before Paula since Mary is a creditor.
4. Paula owns all the stock and benefits from the company's appreciation in value.
5. Paula's stock is Sec. 1244 stock.
6. The corporation, with Paula's consent, can elect S corporation status for the first two years, which allows Paula to use losses to offset income from other sources.
7. The corporation gets a deduction for the interest paid to Mary, subject to limitations.
8. Mary's income is limited to the note interest. She is not taxed on the return of her principal.

Disadvantages of Alternative b:

1. Mary may want to participate in the anticipated growth of the company. She might prefer some stock in addition to some notes.
2. All distributions to Paula (above salary) are taxed as dividends and are not deductible by the corporation, although the dividends are subject to a preferential tax rate.
3. In the event of bankruptcy, Mary's loss is capital in character.

c. Advantages of Alternative c:

1. Both Paula and Mary share in any stock appreciation.
2. The interest paid to Paula and Mary is deductible by the corporation, subject to limitations. Their income does not include any principal payments.
3. The stock is Sec. 1244 stock, so Mary and Paula each would have an ordinary loss for at least part of their investment.
4. The corporation, with the shareholders' consent, can elect S corporation status and pass through losses during the first two years. Later, the corporation, with the shareholders' consent, can revoke the S corporation election.

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Disadvantages of Alternative c:

1. For Paula, receipt of the note would be considered the receipt of boot, and she would have to recognize gain to the extent of $100,000 FMV of the note received, possibly over the ten-year period under the installment method.
2. Paula might not want to share ownership with Mary.
3. Mary might prefer a more secure return of her investment as in Alternative b even if she cannot participate in future growth of the corporation.
4. The IRS might try to reclassify the debt as equity, thereby changing its tax characteristics and possibly jeopardizing the S corporation election, if one has been made.

d. Advantages of Alternative d:

1. Paula recognizes no gain on the exchange.
2. All stock is Sec. 1244 stock.
3. Paula owns all the common stock and is entitled to the company's appreciation in value. If she is willing to share some of this appreciation, the preferred stock could be made participating preferred stock.

Disadvantages of Alternative d:

1. Mary has no assured return because the corporation might not pay dividends. However, she is more assured of payment than with common stock since the stock is cumulative.
2. Mary does not participate in the growth of the corporation. However, if they agree, the preferred stock can be participating.
3. The corporation cannot elect S corporation status because it has issued more than one class of stock.
4. All distributions to Paula and Mary (above any salaries) are taxable to them as dividends and not deductible by the corporation, although the dividends are subject to a preferential tax rate.

In general, no one plan is ideal. Paula and Mary must take into consideration the following factors:

1. How much of the future appreciation in growth is Paula willing to share with Mary?
2. How much assurance does Mary want that she will have first claim on assets to repay her investment? How willing is she to be a minority shareholder or would she rather be a creditor?
3. How large a risk exists that the corporation will go bankrupt so that Paula and Mary want their ownership stakes to be Sec. 1244 stock?
4. How willing is Paula to recognize gain on the corporate formation?

C:2-58 a. A pass-through entity. In light of the nursery's projected losses over the next two years, Paula and Mary might consider organizing the business as an S corporation, a general partnership, a limited partnership, or a limited liability company. With respect to all these forms, losses generated at the entity level would pass through to Paula's and Mary's separate returns. As a result, Paula and Mary could use a pro rata share of the entity's loss to offset income they earn over the next two years. In the case of a C corporation, losses generated at the entity level would carry

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over to offset the corporation's income in other years. Paula and Mary could not use C corporation losses to offset income they earn individually over the next two years. In either case, any NOL carryover would be subject to the 80% of taxable income limitation in the carryover years. Regarding the pass-through entity, this form would have the added advantage of providing the owners a qualified business income deduction should the entity become profitable in the future.

b. As a type of partnership. To achieve their various business and investment objectives, and in light of their proposed use of debt and equity, Paula and Mary might structure the partnership as either a limited partnership or as a general partnership that makes a special allocation. A limited partnership would give either investor the opportunity to trade her general partnership right to manage the business (analogous to common stock ownership) for a limited partnership right to a fixed rate of return (analogous to preferred stock ownership). A limited partnership also would give either investor the opportunity to become a general creditor of the partnership (analogous to a corporate bondholder).

In the case of a general partnership, so long as the special allocation has substantial economic effect (see Chapter C:9) this business form would give either investor the opportunity to trade her general partnership right to residual profits (analogous to common stock ownership) for a more limited right to a fixed rate of return (analogous to preferred stock ownership). It also would give either investor the opportunity to become a general creditor of the partnership (analogous to a corporate bondholder).

Although the general partner in either partnership form would have unlimited liability, a limited liability company taxed by default as a general partnership would afford all its members limited liability.

Case Study Problems

C:2-59 Listed below are the major points that should be covered in the memorandum to Bob. The student should incorporate those points into a properly structured memorandum using good form with proper grammar and punctuation.

In the client memorandum, before discussing the tax advantages and disadvantages of incorporating, the student might discuss the nontax advantages of incorporating (e.g., limited liability, ease of transferring ownership interest, etc.).

With the popularity of limited liability companies (LLCs), some consideration should be given to this business form. All states have adopted LLC legislation. Because most of Bob's business will be done within a single state, interstate activities and the lack of a common body of LLC rules among states will not be an issue.

The adoption of the final check-the-box regulations means that C corporation tax treatment is not limited to incorporated entities. Some discussion of the tax implications of the check-the-box regulations for an existing entity (a proprietorship) should be mentioned in the memorandum.

<u>Incorporation</u>

1. A corporate formation in which Bob receives only stock is nontaxable. Bob will recognize no gain or loss on the asset transfer. The transfer of property by either of the new investors should be properly timed since nontaxable transfers to existing corporations are difficult to accomplish because of the 80% control requirement. Timing is less important if the new

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investors are contributing cash and their contributions are to be made after Bob's contribution.

2. Bob likely will desire to continue to use the calendar year as the corporation's tax year because there appears to be little advantage of changing to a fiscal year.

3. Bob likely will desire to continue the cash method of accounting as the corporation's overall method of accounting because of its simplicity, assuming the small business exception under Sec. 448 applies if he operates the business as a C corporation.

4. Bob will continue to use the same depreciation method and convention once he transfers the building and equipment to the corporation. The depreciation recapture potential carries over from the proprietorship to the corporation. Depreciation for the year of transfer should be divided between Bob and the corporation.

5. The income from collecting the accounts receivable and accounts payable items that represent deductible expenses are reported by the corporation. The income is recognized when the corporation collects the receivables. The expenses are deducted when the corporation pays the liability.

6. Consideration should be given to an S corporation election. A C corporation may trigger double taxation if the earnings are distributed as a dividend, although the dividends will be taxed at the applicable capital gains rate. The S corporation election will permit all the earnings to be taxed at the individual tax rates and avoid the possibility of double taxation. The qualified business income deduction also may apply.

7. By retaining C corporation status, Bob would be permitted to exclude 100% of the gain recognized on the sale or exchange of qualified small business corporation stock that has been held for more than five years. Even if the stock were held less than five years, but more than one year, Bob's gain would be taxed at the applicable capital gains rate. This advantage is not available to an S corporation whose shareholders instead increase the basis of their stock by the amount of any earnings retained in the business.

8. The salary paid to Bob should be reviewed to make sure it is reasonable. The employment taxes paid on the salary are about the same as the self-employment tax liability incurred with the sole proprietorship.

9. Consideration should be given to the availability of fringe benefits for Bob from either the C or S corporation business form. In general, the treatment of these fringe benefits—accident and health benefit premiums, etc.—are treated like guaranteed payments or salary for partners and 2%-or-more-shareholders of an S corporation. (See Chapter C:11.)

10. Consideration should be given to a retirement plan for Bob. He can make deductible contributions to an IRA, or perhaps establish a qualified plan if he makes the S corporation election.

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Capital Structure

1. The simplest capital structure is to have solely common stock issued to Bob and/or either of the other individuals who are interested in investing in the business. Common stock may be attractive to the individual who desires to be active in the business. Bob may prefer to issue preferred stock or debt to the individual who is interested only in investing in the business. The preferred stock could provide a guaranteed dividend payment for the investor. Preferred stock, however, may prevent an S corporation election.

2. The preferred or common stock should qualify for Sec. 1244 treatment. Section 1244 permits an ordinary loss to be claimed on the sale, exchange, or worthlessness of the stock.

3. The use of debt will permit the payment of a deductible interest payment to the debt holder, subject to limitations. The receipt of debt as part of the incorporation transaction will trigger the recognition of part or all of the transferor's realized gain.

4. The use of debt will permit the repayment to be partially or totally nontaxable. Unlike stock, which need not be retired, debt usually is retired at a designated maturity date.

5. Bob should consider whether he should transfer the building and equipment to the corporation as part of the incorporation transaction. Some tax advantages may exist with Bob retaining title to the property and leasing it to the corporation. Keeping the property outside the business and leasing it to the corporation also prevents the possible taking of the property by the corporation's creditors if financial difficulties arise.

Although the above discussion has been couched in terms of using a corporation or an LLC primarily to obtain tax advantages, one probably also should explain that LLCs and partnerships can be taxed as a C corporation under the check-the-box regulations. This change will provide greater flexibility for selecting the business entity form.

Depending on the length of the assignment, the student might compare the partnership, corporation, and LLC forms of doing business because it is not entirely obvious from the facts that the corporate form is superior to the partnership form.

C:2-60 Among the information that the transferor must provide the IRS are statements about the property transferred and its adjusted basis to the transferor. In addition, a statement about the liabilities transferred to the corporation including the nature of the liabilities, when and why they were created, and the corporate business reason for the transfer must be attached to the transferor's return for the year of the transfer (see Reg. Sec. 1.351-3(a). Similar information must be attached to the transferee corporation's tax return for the year of transfer (see Reg. Sec. 1.351-3(b).

From the facts of the problem, the funds obtained from placing the mortgage on the building and land apparently has been used for personal purposes. Withdrawals from a sole proprietorship, however, are not a taxable event for Eric Wright. The transfer of the mortgage to the corporation, however, may be a taxable event if the IRS can prove that the acquisition or assumption of the liability by the corporation had a tax avoidance motive or lacked the necessary business purpose. In such a situation, all the liabilities assumed and acquired by the corporation would be boot property. On the

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other hand, a factor in favor of the taxpayer not being subject to Sec. 357(b) is that one year has passed between the time the mortgage was taken out and the time it was transferred to the corporation.

The tax practitioner should thoroughly research the issue before reaching a conclusion. Should he or she find Sec. 357(b) is applicable, he or she should not agree to the client's position since the AICPA's Statements on Standards for Tax Services (SSTS) No. 1, Tax Return Positions, Para. 5a (reproduced in Appendix E) holds that a CPA should not recommend to a client that a position be taken with respect to the tax treatment of any item on a return unless the CPA has a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged. Eric's situation may lie in a gray area but, if sufficient authority exists for saying the necessary business purpose is present, the CPA may prepare Eric's return and not report any gain under Sec. 357(b). If the position does not have a reasonable basis, SSTS No. 1, Paragraph 5b, also would prevent the CPA from signing either Eric's personal return or the corporate return unless the liability is appropriately disclosed on the two returns. Thus, even if the position is disclosed, the CPA may not sign the return if the position does not have a reasonable basis.

Tax Research Problems

C:2-61 The memorandum should explain why the transaction meets the requirements of Sec. 351. Under Reg. Sec. 1.351-1(a)(3), stock underwriters may be disregarded for purposes of Sec. 351 if the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory. If a person acquires stock from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the stock is treated as transferring cash directly to the corporation in exchange for the stock and the underwriter is disregarded.

C:2-62 The memorandum should point out that the transfers of property to a controlled corporation are nontaxable only if the transferors control the transferee corporation immediately after the exchange (Sec. 351(a)). Section 368(c) defines control in terms of two 80% tests. Regulation Sec. 1.351-1(a) outlines some of the requirements of the control test but does not directly address the question of a prearranged binding agreement whereby one transferor sells one-half of his stock to someone who is not a transferor. Example (1) of Reg. Sec. 1.351-1(b) permits a transfer to qualify under Sec. 351 where transferee corporation stock is transferred by gift from a controlling transferor to his son, who also is a transferor, immediately after the exchange. Regulation Sec. 1.351-1(a)(1)(ii) permits a shareholder to be ignored as a transferor when the amount of stock issued directly for property is of relatively small value in comparison to the value of the stock already owned or to be received by the person who transferred the property.

Under Rev. Rul. 79-194, 1979-1 C.B. 145, the control requirement of Sec. 351(a) is to be determined after any sales or transfers occur. In Situation 1 of this ruling, the control requirement is satisfied when part of the 80% stock interest in a newly created corporation that was acquired by a transferor corporation was sold to a group of investors who had acquired the other 20% stock interest in the original transaction. In this situation, the shift in ownership occurred among individuals who were transferors, and the recipients owned a substantial amount of the corporation's stock.

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In a second situation, described in Rev. Rul. 79-194, the control requirement was not met upon completion of a sale under a similar agreement, whereby a transferor who originally had acquired 99% of the stock sold one-half the stock of the new corporation to a second transferor who had originally acquired only 1% of the stock. The IRS held that the control requirement was not met because the 1% shareholder received stock of small value in the original transfer relative to the amount received in total and, therefore, was not considered to be a transferor.

In the current case, it must be determined whether Bob has received a substantial part of the Stone Corporation stock or not. Revenue Procedure 77-37, 1977-2 C.B. 568, Sec. 3.07, indicates that ownership of 10% of the stock to be owned is not "of small value" and therefore should be considered a substantial part of the stock. Under this authority, the control requirement should be met and the transaction should be permitted to qualify under Sec. 351.

C:2-63 The memorandum should explain that, as long as the additional 25 shares to be received by Greta do not have any other rights attaching to them, they are considered to be stock for purposes of Sec. 351. Thus, Greta will not have to recognize any income when she receives her contingent shares.

Revenue Ruling 57-586, 1957-2 C.B. 249, addressed negotiable certificates issued to a shareholder in connection with a nontaxable reorganization representing a contingent interest in additional shares of the acquiring corporation's stock that would be issued along with cash dividends if certain occurrences took place. The ruling held that the certificates were "other" property and fell under the boot rules.

Two later court cases and several revenue rulings have changed this position substantially. First, in June M. Carlberg v. U.S., 6 AFTR 2d 5316, 60-2 USTC ¶9647 (8th Cir., 1960), the Eighth Circuit Court of Appeals held that certificates of contingent interest issued to the taxpayer-stockholder in a corporate reorganization permitting her to obtain reserved shares, which were not to be issued pending the determination of liabilities of one of the merging corporations, were stock rather than other property.

In James C. Hamrick, 43 T.C. 21 (1964), the Tax Court held that a taxpayer's contractual right to receive additional stock, contingent upon the earnings of the corporation exceeding a specified amount, is the equivalent of stock within the meaning of Sec. 351. The receipt of additional shares in later years pursuant to the original incorporation agreement was held not to result in the recognition of gain by the transferor.

The IRS held in Rev. Rul. 66-112, 1966-2 C.B. 68, that, because the contingent contractual rights were not specifically marketable and could give rise only to the receipt of additional stock by a transferor, both the stock and the control tests of Sec. 351 were satisfied. The IRS has acquiesced to the Hamrick decision (1966-2 C.B. 2). Revenue Ruling 66-112 also distinguished the facts at hand from those in Rev. Rul. 57-586.

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Revenue Ruling 67-90, 1967-1 C.B. 79, provides that a contingent contractual right to receive only additional voting stock provided for in a plan of reorganization satisfies the "solely for voting stock" requirement for a Type B reorganization where the number of additional shares of stock to be issued is determined by a formula based upon the future market price of the shares of the acquiring corporation.

Revenue Procedure 77-37, 1977-2 C.B. 568, places certain restrictions on contingent stock that will be issued as part of a reorganization when a taxpayer is requesting a private letter ruling on the transaction. These restrictions do not apply to a Sec. 351 transaction. Revenue Procedure 83-59, 1983-2 C.B. 575, as modified by Rev. Proc. 2013-32, 2013-28 I.R.B. 55, requires a representation be made about contingent shares that are to be issued as part of a request for a private letter ruling on a Sec. 351 transaction, but it does not place any limit on the portion of the stock that can be considered to be contingent.

C:2-64 Yes. John can avoid recognizing the $175,000 gain according to Ninth Circuit and Second Circuit holdings. In Peracchi v. CIR, 81 AFTR 2d 98-1754, 98-1 USTC ¶50, 150 (9th Cir., 1998), the Ninth Circuit reversed the decision of the Tax Court and held that an unsecured promissory note contributed to a corporation by its sole shareholder had a basis equal to its face amount. A similar result was reached in Lessinger v. CIR, 63 AFTR 2d 89-1055, 89-1 USTC ¶9254 (2nd Cir., 1989).

Therefore, if John contributes a $175,000 promissory note to Newco in addition to the assets, the basis of assets contributed includes the face value of the note and is $475,000 ($250,000 + $175,000). Because the liabilities do not exceed the basis of assets contributed, John recognizes no gain.

C:2-65 The client letter should address two questions. First, if Leticia, Monica, and Nathaniel advance funds to Lemona Corporation, will the advance be recharacterized as equity instead of debt? Second, will the unavailability of alternative financing at "reasonable rates" be significant in any decision to recharacterize?

If the IRS and/or the courts recharacterize the advance as equity, the IRS and/or the courts would treat any "interest" paid to the three investors as "dividends," nondeductible by Lemona. Furthermore, the IRS and/or the courts might treat the advance as nonbusiness related, i.e., as intended to safeguard the investors' initial equity investment. In the latter event, if Lemona later became insolvent, and the three investors were unable to recoup the full amount of the advance, their loss would be treated as nonbusiness bad debt. Because the loss would be capital in character, it would be deductible only to the extent of $3,000 (per year) in excess of any capital gains. No relief for partial losses would be afforded the investors.

The key statutory authority that governs the characterization of an investor advance to a corporation is Sec. 385. Under Sec. 385, the Treasury Secretary is authorized to issue regulations for determining whether an interest in a corporation should be treated as equity or indebtedness. Factors to be considered in the determination include,

- Whether there is a written, unconditional promise to pay a sum certain in money
- Whether the interest is subordinate to any corporate indebtedness
- The corporation's debt to equity ratio
- Convertibility of the interest into corporate stock
- The relationship between stockholdings and the interest in question

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Based on Factors 2, 3, and 5, the three investors' interest in Lemona resembles equity more than debt. The interest is subordinate to other Lemona obligations; the corporation's debt to equity ratio is extraordinarily high (25:1 before the note issuance); and the relationship between the interest in question and the investors' pre-existing stockholdings is proportionate.

On the other hand, based on Factors 1 and 4, the three investors' interest resembles debt more than equity. The interest is evidenced by a note (i.e., a written, unconditional promise to pay a sum certain in money), and it is not convertible into Lemona stock.

Under the authority granted by Sec. 385, the Treasury Secretary issued regulations in 1980 but withdrew them in 1983. In the absence of regulatory authority, court cases provided guidance.

In Rudolph A. Hardman, 60AFTR 2d 87-5651, 82-7 USTC ¶9523 (9th Cir., 1987), the Ninth Circuit Court of Appeals cited 11 factors for distinguishing debt from equity for purposes of Sec. 385:

- The names given to certificates evidencing indebtedness
- The presence or absence of a maturity date
- The source of repayments
- The right to enforce payment of principal and interest
- Participation in management
- The investor's status relative to corporate creditors
- The intent of the parties
- Thin capitalization
- Identity of interest between creditor and stockholder
- Payment of interest out of "dividend" funds
- The ability of the corporation to obtain funds from outside lenders

In the client letter, and to the extent possible, the student should evaluate the three investors' corporate interest in terms of each of these factors.

In Tomlinson v. The 1661 Corporation, 19 AFTR 2d 1413, 67-1 USTC ¶9438 (5th Cir., 1967), a closely held corporation attempted to procure financing from outside lenders, but because of prohibitive interest rates, instead issued 7%, 15-year notes to its existing shareholders in exchange for cash advances of $138,400. The debt was subordinate to other corporate obligations. The corporation was not entitled to pay dividends on its stock until it had paid all past accrued interest on the notes. The corporation issued the notes on a pro rata basis and was thinly capitalized. On its tax return, the corporation deducted "interest" payments on the notes, but the IRS disputed this tax treatment. The IRS argued that based on all the facts and circumstances, the capital advanced by the shareholders was equity, not debt. Therefore, payments on the securities were dividends and nondeductible.

In the client letter, the student should draw an analogy between the facts and issues of the Tomlinson case and those of the case in question. The student also should cite factual dissimilarities that might undermine application of the Tomlinson holding to the present case. From the analysis, he or she should derive a cogent conclusion that addresses the two central issues.

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"What Would You Do In This Situation?" Solution

Ch. C:2, p. C:2-31. The Case of the 100-Year Bonds.

The IRS is likely to carefully scrutinize any issuance of debt to determine whether it should be treated as debt or equity or some combination of each.

The Treasury Department has been given the authority under Sec. 385 to write regulations to distinguish between debt and equity, and also to allow an issue to be treated partly as debt and partly as equity. Thus far, the Treasury Department has not issued final Sec. 385 regulations. As a result, taxpayers must rely on judicial decisions as an indication of how a particular issue will be treated.

Section 385 suggests factors that should be considered in determining whether amount advanced to a corporation should be treated as debt or equity. In addition, O.H. Kruse Grain and Milling v. CIR, 5 AFTR 2d 1544, 60-2 USTC ¶9490 (9th Cir., 1960), lists additional factors the courts might consider. The Treasury Department indicated in Notice 94-47, 1994-1 C.B. 357, that it will carefully scrutinize instruments that combine tax treatment for debt with significant equity characteristics. Eight factors were listed that may be considered.

As a CPA, you should inform your client of the risk that the proposed debt issue may be challenged by the IRS and partly or totally reclassified as equity. The fact that many large corporations already have issued debt instruments with extremely long maturities is a point in your client's favor. If the corporation decides to go ahead with the issue, you would be justified in recommending the interest deductions if there exists a realistic possibility of the deductions being sustained upon examination. You also may recommend the deductions if a reasonable basis exists, and the taxpayer makes adequate disclosures. See Statement on Standards for Tax Services No. 1, Tax Return Positions in Appendix E.

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Chapter I:2

Determination of Tax

Discussion Questions

I:2-1 a. Gross income is income from taxable sources. Form 1040 combines the results of computations made on several separate schedules. For example, income from a proprietorship is reported on Schedule C, where gross income from the business is reduced by related expenses. Only the net income or loss computed on Schedule C is carried to Form 1040. This is procedurally convenient but means gross income is not shown on Form 1040.

b. Gross income is relevant to certain tax determinations. For example, whether a person is required to file a tax return is based on the amount of the individual's gross income. As the amount does not necessarily appear on any tax return, it may be necessary to separately make the computation in order to determine whether a dependent is a qualifying relative. pp. I:2-3.

I:2-2 The term "income" includes all income from whatever source derived, based on principles of economics and/or accounting. Gross income refers only to income from taxable sources; it does not include tax-exempt income. p. I:2-3.

I:2-3 a. A deduction is an amount that is subtracted from gross income (or adjusted gross income), while a credit is an amount that is subtracted from the tax itself.

b. In general, a $10 credit is worth more than a $10 deduction because the credit results in a $10 tax savings. The savings from a deduction is less than 100% of $10, depending on the tax bracket that applies to the taxpayer.

c. If a refundable credit exceeds the taxpayer's tax liability, the taxpayer will receive a refund equal to the excess. In the case of nonrefundable credits, the taxpayer will not receive a refund, but may be entitled to a carryover or carryback. pp. I:2-4 through I:2-6.

I:2-4 A dependent must be a qualifying child or a qualifying relative:

- A qualifying child must (1) be the taxpayer's child or sibling, (2) be under 19, a full-time student under 24, or disabled, (3) live with the taxpayer, and (4) not provide more than half of his or her own support.
- A qualifying relative must (1) be related to the taxpayer (or reside in the taxpayer's home for the entire year), (2) have gross income less than $4,150 (2018), and (3) receive over one-half of his or her support from the taxpayer.

Both types of dependents also must meet several requirements: (1) have a social security number reported on the taxpayer's return, (2) meet a citizenship test, (3) cannot normally file a joint return, and (4) cannot claim others as dependents. pp. I:2-12 through I:2-16.

I:2-5 a. Support includes amounts spent for food, clothing, shelter, medical and dental care, education, and the like. Support does not include the value of services rendered by the taxpayer for the dependent nor does it include a scholarship received by a son or daughter of the taxpayer.

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b. Yes. When several individuals contribute to the support of another, it is possible for members of the group to sign a multiple support agreement that enables one member of the group to claim the supported person as a dependent. Also, in the case of divorced couples, the parent with custody for over half of the year may claim their child as a dependent even if that parent did not provide more than 50% of the child's support. Similarly, in the case of a written agreement, the noncustodial parent may claim their child as a dependent even if that parent provided 50% or less of the child's support.

c. The value of an automobile given to an individual may represent support for that individual. The automobile must be given to the individual and must be used exclusively by the individual. pp. I:2-15.

I:2-6 A taxpayer will use a rate schedule instead of a tax table if taxable income exceeds the maximum in the tax table (currently $100,000) or if the taxpayer is using a special tax computation method such as short-year computation. p. I:2-19.

I:2-7 a. In general, it is the taxpayer's gross income that determines whether the individual must file a return. The specific dollar amounts are listed in the text. Certain individuals must file even if they have less than the specified gross income amounts. These include taxpayers who receive advance payments of the earned income credit and taxpayers with $400 or more of self-employment income. Dependent individuals must file if they have either (1) unearned income over $1,050 or (2) total gross income in excess of the standard deduction.

b. Taxpayers who owe no tax because of deductions or other reasons must still file a return if they have gross income in excess of the filing requirement amounts. p. I:2-33 and I:2-34.

I:2-8 Home mortgage interest and real property taxes are itemized deductions. As a result those expenses alone often exceed the standard deduction, enabling a homeowner to itemize. Renters typically do not have these deductions, so the standard deduction may be greater than itemized deductions. p. I:2-11.

I:2-9 If the support test for a qualifying relative were "50% or more" and two individuals provided equal amounts of support for another person, that person would be a qualifying relative of both individuals (assuming the other requirements for a qualifying relative were met). By specifying that the individual provides "more than 50%" of the person's support, that person cannot be a qualifying relative of more than one individual. If two individuals each provide exactly 50% of another person's support, that person would not be a qualifying relative of anyone because no one provided more than half of his or her support, but the two individuals may be able to use a multiple support agreement to allow one of them to claim that other person as a dependent.

In practice, it is unlikely that an individual provides exactly 50% of another person's support. The distinction between "50% or more" and "more than 50%" is important, however, in other areas of the tax law. For example, consider an individual who owns exactly 50% of a corporation's stock, and that individual sells all of his or her stock to the person who owns the other 50% of the corporation's stock. As Chapter C:7 discusses, the deductibility of a corporation's net operating loss is limited if the corporation's ownership changes by more than

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50 percentage points. In this case, that limitation would not be triggered because the corporation's ownership changes by exactly 50 percentage points, not more than 50 percentage points. p. I:2-15.

I:2-10 The normal due date for calendar-year individuals and C corporations is April 15. The normal due date for calendar-year partnerships and S corporations is March 15. If the normal due date is a Saturday, Sunday, or holiday, the normal due date is delayed to the next day that is not a Saturday, Sunday or holiday. p. I:2-34.

I:2-11 Automatic extensions of six months generally are available. For a C corporation, the extension is six or seven months, depending on fiscal year-end. Any tax that may be owed must be paid with the application for an extension. p. I:2-34.

I:2-12 Yes. In general, the source of income is not important. It is the use that is important. An exception does exist for a child's scholarship. Parents do not have to consider a child's scholarship when determining whether they provide over half of the child's support. p. I:2-15.

I:2-13 It can be, but as was noted in the preceding answer, parents may ignore a child's scholarship in deciding whether they provide over half of the child's support. p.I:2-15.

I:2-14 The purpose of the multiple support agreement is to allow one member of a group to claim a supported person as a dependent when the members together contribute more than 50% of the support of that person and each member of the group contributes over 10%. The multiple support agreement results in an exception to the requirement that the taxpayer alone must provide over one-half of the dependent's support. pp. I:2-16 and I:2-17.

I:2-15 In general, the parent with custody for the greater part of the year may claim the children as dependents. The noncustodial parent may claim them as dependents only if required documentation provides for it. p. I:2-18.

I:2-16 In general, a couple must be married on the last day of the tax year in order to file a joint return. In addition, the spouses must have the same tax year. Also, if one spouse is a nonresident alien, then that spouse must agree to include all of his or her gross income on the return. p. I:2-20.

I:2-17 The phrase "maintain a household" means to pay over one-half of the costs of the household. These costs include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance and food consumed on the premises. Such costs do not include clothing, education, medical treatment, vacations, life insurance and transportation. p. I:2-22.

I:2-18 A married person, if otherwise qualified, can claim head-of-household status if he or she is married to a nonresident alien or if he or she qualifies as an abandoned spouse. To be an abandoned spouse, the taxpayer must have lived apart from his or her spouse for the last six months of the year and maintain a household for a qualifying child in which they both live. p. I:2-23.

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I:2-19 a. A C Corporation is taxed on its income. In other words, it is taxed as a separate entity. An S Corporation is normally not taxed on its income. Instead, its income flows through and is reported by the shareholders. Each shareholder reports his or her share of the income even if it is not actually distributed.

b. Some corporations are ineligible for making an S corporation election. Others may choose the C corporation because the 21% corporate tax rate is less than the rate for the higher individual tax brackets (e.g., 32%, 35%, and 37%). Other considerations not discussed in Chapter 2 include fringe benefits, the need to retain earnings in the business and dividend policy. pp. I:2-27 and I:2-28.

I:2-20 The 21% tax rate that applies for C corporations. If an individual with a significant amount of other income operates a new business as a proprietorship, that income is taxed at the owner's marginal tax rate, which may be higher than 21%. Thus, the current tax can be reduced if the corporate form is used and income is retained in the corporation. This advantage may be lost if the corporation distributes the income. New businesses often need to retain income for expansion. p. I:2-27.

I:2-21 a. The major categories of property excluded from capital asset status are:

- Inventory
- Trade receivables
- Certain properties created by the efforts of the taxpayer
- Depreciable business property and business land
- Certain government publications.

b. Yes. An individual's net long-term capital gain generally is taxed at 0%, 15%, or 20%, depending on the taxable income and filing status. These tax rates are less than the rates that otherwise would apply. Short-term capital gains are taxed much like other income.

c. The availability of favorable tax rates for long-term gains is one implication of capital asset classification. Another is the limitation on the amount of capital loss that can be deducted from other income. At the present time, only $3,000 of net capital loss can be deducted from other income by an individual taxpayer in any year.

d. Individual taxpayers first deduct (or offset) capital losses from capital gains. If a net capital loss results, only $3,000 of the net capital loss can be deducted from other income. Net capital losses in excess of $3,000 are carried over to future years. p. I:2-30.

I:2-22 Yes. By waiting the taxpayer can convert the short-term gain to a long-term gain taxed at a maximum rate of 20%. The long-term rate will be available if the taxpayer holds the property over 12 months. The taxpayer should, however, take into consideration other nontax factors such as whether the value of the asset may decline during the extended holding period. p. I:2-30.

I:2-23 a. Shifting income means moving income from one tax return to another. Splitting income means creating additional taxable entities (such as corporations) so as to spread income between more taxpayers.

b. Different taxpayers are in different tax brackets. As a result, taxes can be saved by shifting income from a taxpayer who is in a high tax bracket to a taxpayer who is in a lower tax bracket.

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c. The tax on the unearned income of children (i.e., the kiddie tax) was created to reduce the opportunity to reduce taxes by shifting income from parents who are in high tax brackets to children who have little or no other income and would, therefore, normally be in a low tax bracket. pp. I:2-30 and I:2-31.

I:2-24 a. Both spouses are liable for additional taxes on a joint return. An exception exists for a so-called innocent spouse. To utilize the innocent spouse provision, the tax must be attributable to erroneous items of the other spouse. In addition, the innocent spouse cannot have known or had reason to know of the error, and must elect relief within two years after the IRS begins collection activities. Further, it must be inequitable to hold the innocent spouse liable for the understatement.

b. In the event of underpayment of taxes on a joint return, the IRS can collect the unpaid tax from either spouse. pp. I:2-32 and I:2-33.

I:2-25 Couples may change from joint returns to separate returns only prior to the due date for the return. Couples may change from separate returns to a joint return within three years of the due date including extensions. p. I:2-33.

Issue Identification Questions

I:2-26 The main issue is whether Yung can claim his nephew as a dependent. The nephew must be a U.S. resident in order to qualify. Normally, this requires that a person have a visa as a permanent resident, but dependency has been permitted when special circumstances were present. For example, the Tax Court allowed a foreigner to be claimed as a dependent when it considered the length of the dependent's stay, the individual's intent, and the presence of substantial assets in the U.S. [Carmen R. Escobar, 68 TC 304 (1977)]. The nephew's desire to stay and the desire of other members of the family to move here could all be factors that are considered in determining whether the nephew is a resident. p. I:2-13.

I:2-27 The primary tax issue is whether they should file a joint return. Filing jointly could produce a tax savings because more income will be taxed at the low 10% and 12% rates. Carmen, however, should carefully consider whether Carlos is disclosing all of his income. If not, she may be liable for additional taxes, interest, and penalties resulting from the unreported income. The innocent spouse rules may not protect her. She is not required to know with certainty Carlos' income in order to be liable. The fact that Carmen is "surprised" that Carlos' income is so low suggests that she has reason to know that there is unreported income. pp. I:2-32 and I:2-33.

I:2-28 The primary tax issue is the filing status for both Bill and Jane. Both can file as unmarried taxpayers because they were divorced prior to the end of the tax year. To file as a head of household, a taxpayer must pay more than one-half of the costs of maintaining a household (as one's home) in which a dependent relative lives for more than one-half of the year. In the case of divorce, the child need not be a dependent of the custodial spouse. The facts in this question are similar to W.E. Grace v. CIR, 25 AFTR 2d 70-328, 70-1 USTC ¶ 9149 (5th Cir., 1970) and Levon P. Biolchin v. CIR, 26 AFTR 2d 70-5727, 70-2 USTC ¶ 9674 (7th Cir., 1970) where the courts disregarded the fact that the taxpayer owned the house and denied head

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of household status. Jane should also fail to qualify for head of household status because she did not pay more than one-half of the costs of maintaining the household. Secondary issues concern the treatment of child support payments and whether the furnishing of home expenses can be treated as alimony. p. I:2-22.

Problems

I:2-29

	Smiths	Millers
Salary	$30,000	$95,000
Taxable interest income	20	1,000
Gross Income	$30,020	$96,000
Minus: IRA Contribution	0	(5,500)
Adjusted gross income	$30,020	$90,500
Minus: Greater of standard deduction or itemized deductions	(24,000)	(24,000)
Taxable Income	$ 6,020	$66,500
Gross tax (using Rate Schedule)	$ 602*	$ 7,599*
Minus: Withholding	(1,750)	(8,500)
Tax due (refund)	($ 1,148)	($ 901)

* This answer is based on the 2018 rate schedule. The 2018 tax table was unavailable at the time this solution was prepared. The actual answer using the tax table would be very close to the above answer. pp. I:2-6 and I:2-7.

I:2-30	a.	Salary	$ 1,800
		Taxable interest income	1,600
		Adjusted gross income	$ 3,400
		Minus: Standard deduction	(12,000)
		Taxable income	-0-
	b.	Salary	$ 1,800
		Taxable interest income	1,600
		Adjusted gross income	$ 3,400
		Minus: Standard deduction ($1,800 + $350)	(2,150)
		Taxable income	$ 1,250

p. I:2-12.

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I:2-31 a.

	Carl	Carol
Adjusted gross income	$60,000	$90,000
Minus: Itemized deductions	(11,000)	(16,200)
Taxable income	$49,000	$73,800

Note: Because Carol claimed itemized deductions on her return, Carl must also itemize. Their total itemized deductions are $27,200 ($11,000 + $16,200). Both could have claimed a standard deduction of $12,000 (total of $24,000), so they gained $3,200 ($27,200 - $24,000) of deductions by itemizing.

b.

Adjusted gross income ($60,000 + $90,000)	$150,000
Minus: Itemized deductions ($11,000 + $16,200)	(27,200)
Taxable income	$122,800

p. I:2-11.

I:2-32 a. Brian may not be claimed as a dependent because his gross income exceeds $4,150 (2018). Brian is not a qualifying child because he is over age 23. He is not a qualifying relative because he fails the gross income test.

b. No effect. Brian's student status is irrelevant because he is over age 23. Thus, Wes and Tina may not claim Brian as a dependent in this case.

c. Sherry may be claimed as a dependent by Wes and Tina as she is considered a qualifying child. She meets the four tests of relationship, age, abode, and support. Her gross income is not relevant.

d. Under these facts, Sherry would not be eligible to be claimed as a dependent because she isn't a qualifying child. Under the other dependent test, the gross income test may not be waived, as she is not a full-time student and is over age 18.

e. Granny may not be claimed as a dependent as she fails the gross income test. Her interest from the U.S. bonds exceeds $4,150 and no exception applies. If Granny's interest had been less than $4,150, she would have qualified, as Social Security is not included in her gross income.

pp. I:2-12 through I:2-16.

I:2-33 a. Carole and John can claim David and Kristen as dependents this year. Jack is not a qualifying child (over age 18 and not a full-time student) and is not a qualifying relative because his gross income exceeds $4,150. David can be claimed as a dependent because he is a qualifying child. He meets the four tests of relationship, age, abode, and support. Gross income is not considered for the qualifying child test. Kristen also is a qualifying child and can be claimed as a dependent.

b. Assuming Jack is a full-time student in medical school for at least five months this year, he would be a qualifying child as he now meets the age test (under age 24 and a full-time student). Carole and John can claim Jack as a dependent.

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c. In this case, Jack would not be a qualifying child because he fails the age test. However, he is a qualifying relative as he meets the relationship, gross income, and support tests. His gross income is less than $4,150 in 2018.

d. If David were a part-time student, he would not be either a qualifying child or qualifying relative. With respect to the qualifying child test, David fails the age test as he is a part-time student. As to the qualifying relative test, David fails the gross income test.

e. David would not be a dependent as he fails the support test for both the qualifying child and qualifying relative tests. pp. I:2-12 through I:2-16.

I:2-34 a. Robert cannot claim Jane as a dependent. Jane is not his qualifying child as she fails the age, abode, and presumably the support test. The facts in the problem do not specify how the $26,000 ($11,000 + $15,000) of support is allocated between Jane and her two children. But this is irrelevant as she fails the age and abode tests. Jane also fails the qualifying relative test because she has too much gross income.

b. Jane can claim her children as dependents. Robert apparently provides over one-half of their support, but that is irrelevant as they are Jane's "qualifying children." The support requirement for qualifying children only says that the children cannot be self-supporting.

c. Jane is entitled to the child credit for each of her two children. Even if Robert were eligible to claim the children as dependents, he would not benefit from the child credit because of his AGI. Robert's $350,000 of AGI exceeds $200,000 by $150,000, so his credit would be reduced, but not below zero, by $7,500 [$50 x (($350,000 - $200,000)/$1,000)]. pp. I:2-12 through I:2-16.

I:2-35 Based on the facts given, Juan cannot claim either Maria or Norma as dependents. He can claim Jose only if written documentation exists.

Maria cannot be claimed as a dependent as she provides over one-half of her own support.

Although Juan provides more than one-half of Jose's support, Jose lives with Linda. Absent required documentation, Linda is entitled to claim Jose as a dependent. If Linda signs a completed Form 8332, Juan can do so.

Norma is not a "qualifying child" for either her father or Jose as she lives with neither. Further, she is a part-time student. She does not qualify as a "qualifying relative" because she has too much gross income. pp. I:2-12 through I:2-16.

I:2-36 a. Either Mario or Elaine. Caroline cannot because she is unrelated to Anna, and Doug cannot because he provides less than 10% of Anna's support.

b. Elaine must agree in writing to the arrangement.

c. No. Head-of-household status cannot be based on dependency obtained as the result of a multiple support agreement.

d. No. Old-age allowances are not available for dependents. Old-age allowances increase the amount of the elderly person's standard deduction. pp. I:2-16 and I:2-17.

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I:2-37 a. Joan, the custodial spouse, claims the children as dependents and receives the child credit for them.

b. No. p. I:2-18.

I:2-38

Form		Filing Status	Child Credit
a.	1040EZ	Single	0
b.	1040A	Single	0
c.	1040	Head-of-Household	0
d.	1040A	Single	0
e.	1040A	Head-of-Household	1

In part a, Arnie could file a Form 1040 or Form 1040A instead of a Form 1040EZ, but he is not required to do so. In parts b, d, and e, the taxpayer could file a Form 1040 instead of a Form 1040A but is not required to do so. pp. I:2-23 and I:2-35.

I:2-39 a. Not a dependent and no child credit. A cousin must live with the taxpayer in order to qualify as a dependent as a cousin does not automatically meet the relationship test.

b. One dependent and $500 child credit. Because the social security benefits are excluded from gross income, the father meets the gross income test. The father is not required to live with Bob to meet the relationship test. Although the father is not Bob's child, Bob and Ann are allowed a $500 child credit for him because the father is a dependent who is not a qualifying child under age 17.

c. One dependent and one $500 child credit. The daughter is a qualifying child and, because she is a full-time student under age 24, the gross income test is not relevant. Because she is over 16, she does not qualify for the $2,000 child credit.

d. Not a dependent and no child credit. The mother cannot be claimed as a dependent by anyone because she provided over half of her own support. pp. I:2-12 through I:2-17.

I:2-40 a. Juan's AGI exceeds $200,000, but Maria's AGI does not. The child credit thus would be reduced if Juan claims it, but there would be no reduction if Maria claims it. Overall, the tax savings are larger if Maria claims the child credit, so it would be better not to have a written agreement allowing Juan to claim the children as dependents. However, Juan may not be willing to pay as much child support if he foregoes any child credit.

b. As the custodial parent, Maria is entitled to file as a head-of-household. This is true even if she does not claim the children as dependents. Juan will file as a single taxpayer. pp. I:2-18 and I:2-19.

I:2-41 a.

Adjusted gross income ($105,000 + $86,000)	$191,000
Minus: Itemized deductions ($19,000 + $8,100)	(27,100)
Taxable income	$163,900
Gross tax	$ 27,937

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b. Mary's tax filing as a single taxpayer:

Adjusted gross income	$86,000
Minus: Standard deduction	(12,000)
Taxable income	$74,000
Gross tax	$12,220*

Bill's tax filing as a single taxpayer:

Adjusted gross income	$105,000
Minus: Itemized deductions	(19,000)
Taxable income	$ 86,000
Gross tax	$ 14,930*

Their income taxes total $27,150 ($12,220 + $14,930).

*These amounts are based upon the 2018 tax rate schedule because the 2018 tax table was unavailable when the solution was prepared.

c. Their tax will be $787 ($27,937 - $27,150) higher if they marry before year-end. This is attributable to the fact that their $27,100 of itemized deductions is $3,900 less than the $31,000 ($12,000 + $19,000) of total deductions they would claim if they were not married. The increased taxes due to this is partially offset by the fact that $3,500 ($86,000 - $82,500) of Bill's taxable income is taxed at 22% if they are married rather than 24% if they are not. pp. I:2-20 through I:2-22.

I:2-42 a. Amy need not file because her gross income is less than the threshold of $12,000 and her self-employment income is less than $400.

b. Betty need not file, as her gross income ($9,100) is less than $13,600 ($12,000 + $1,600).

c. Chris must file, as his gross income of $2,300 exceeds his standard deduction of $2,250 ($1,900 + $350). Chris' standard deduction is limited to the amount of earned income plus $350.

d. Dawn must file because her unearned income is over $1,050 and her total gross income exceeds her standard deduction.

e. Doug must file because his gross income is over $0 and he is married and not living with his spouse. p. I:2-23 and I:2-24.

I:2-43 a. Yes.

b. No. The aunt would have to live with the taxpayer.

c. No. Because she qualifies for the more favorable surviving spouse status, she cannot file as head-of-household.

d. Yes. Because he qualifies as an abandoned spouse he can file as a head-of-household. pp. I:2-22 and I:2-23.

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I:2-44 a. 2016: Celia files a joint return even though Wayne died in October.

2017: Celia must file as a single taxpayer. As a part-time student, Wally is not a qualifying child.

2018: Same as 2017.

2019: Same as 2017.

b. Single. Juanita does not qualify for head-of-household status because Josh is not a "qualifying child." He is over 18 and is not a full-time student.

c. Gertrude may use the head-of-household filing status. Even though she is still legally married, she meets the tests for an abandoned spouse. She lived apart from her spouse for the last six months of the taxable year and paid over one-half the cost of maintaining a household for her dependent son. pp. I:2-21 through I:2-23.

Note to Instructor: A good exercise is to ask the class how the solution for part a would change if Wally were a full-time student rather than part-time. Celia would qualify as a surviving spouse in 2017 and 2018 and a single taxpayer in 2019.

I:2-45 a. $190,000 ($92,000 + $98,000).

b.	Gross income	$190,000
	Minus: Business expenses	(48,000)
	IRA contributions	(11,000)
	Adjusted gross income	$131,000
c.	Adjusted gross income	$131,000
	Minus: Itemized deductions	(26,000)
	Taxable income	$105,000
	Gross tax	$14,979*
	Child credit	(2,000)
	Net tax	$12,979

*$8,907 + (22% x ($105,000 - $77,400))

pp. I:2-6 and I:2-7.

I:2-46 Jan should take the standard deduction. Jan cannot deduct any medical expenses as they are less than 7.5% of AGI. She is left with $5,000 of itemized deductions (mortgage interest of $3,000 and property taxes of $2,000) which are less than the $12,000 standard deduction. p. I:2-10.

I:2-47 a.

Earnings	$4,200
Interest	2,200
Adjusted gross income	$6,400
Standard deduction ($4,200 + $350)	(4,550)
Taxable income	$1,850

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Debbie is subject to the kiddie tax, assuming her earned income is less than or equal to one-half of her support. Her tax thus is calculated as follows:

Net unearned income = $2,200 - $1,050 - $1,050 = $100

Earned taxable income = $1,850 - $100 = $1,750

A 10% tax rate applies to the first $4,300 ($1,750 + $2,550) of Debbie's taxable income. Her taxable income is only $1,850, so her tax is $185 (10% x $1,850).

b. The answer would not change. If Debbie were age 16, she would be subject to the kiddie tax regardless of her student status and her earned income if her unearned income exceeds $2,100.

pp. I:2-24 through I:2-26.

I:2-48 a. Adjusted gross income:

Salaries	$130,000
Allowable capital loss	(3,000)
Adjusted gross income	$127,000

b. Itemized deductions:

Home mortgage interest	$ 10,000
State income taxes	4,000
Charitable contributions	5,000
Itemized deductions	$ 19,000

c. Taxable income:

Adjusted gross income	$127,000
Standard deduction	(24,000)
Taxable income	$103,000

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I:2-49

Karen
Karen's gross tax is $245. At age 21, Karen is subject to the kiddie tax because she is a full-time student whose earned income is less than one-half of her own support and who has unearned income in excess of $2,100.

Taxable income:	
Wages	$3,000
Interest	2,800
Adjusted gross income	$5,800
Standard deduction ($3,000 + $350)	(3,350)
Taxable income	$2,450

Net unearned income = $2,800 - $1,050 - $1,050 = $700

Earned taxable income = $2,450 - $700 = $1,750

A 10% tax rate applies to the first $4,300 ($1,750 + $2,550) of Kim's taxable income. Because her $2,450 taxable income is less than $4,300, Kim's tax is $245 (10% x $2,450).

Susan
Susan's gross tax is $205. She is not subject to the kiddie tax as she is age 18 and her earned income is greater than one-half of her support.

Wages	$11,000
Interest	2,400
Adjusted gross income	$13,400
Standard deduction ($11,000 + $350)	(11,350)
Taxable income	$2,050
Gross tax	$ 205

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Amelie
Amelie's gross tax is $185. Amelie is subject to the kiddie tax as she is under age 18 and her unearned income is greater than $2,100.

Taxable income:	
Wages	$5,900
Interest	2,200
Adjusted gross income	$8,100
Standard deduction ($5,900 + $350)	(6,250)
Taxable income	$1,850

Net unearned income = $2,200 - $1,050 - $1,050 = $100

Earned taxable income = $1,850 - $100 = $1,750

A 10% tax rate applies to the first $4,300 ($1,750 + $2,550) of Amelie's taxable income. Because her $1,850 taxable income is less than $4,300, Amelie's tax is $185 (10% x $1,850).

I:2-50 a.

Salary	$ 70,000
S corporation income	30,000
Adjusted gross income	$100,000
Itemized deductions	(18,000)
Taxable income	$ 82,000
Gross tax	$ 13,980

b.

Corporation:	
Taxable income	$ 30,000
Gross tax (0.21 x $30,000)	$ 6,300
Individual:	
Salary	$ 70,000
Dividend ($30,000 - $6,300)	23,700
Adjusted gross income	$ 93,700
Itemized deductions	(18,000)
Taxable income	$ 75,700
Gross tax	$ 10,935*
Total tax ($6,300 + $10,935)	$ 17,235

*The individual's gross tax is the total of the tax on the dividend income and the tax on the remaining income. The tax on the dividend income of $23,700 is $3,555 (0.15 x $23,700). The tax on the remaining income of $52,000 ($75,700 - $23,700) is $7,380 computed using the rate schedule for single taxpayers.

c. The answer to part a is unchanged as the shareholder is taxed on the S corporation's income regardless of whether it is distributed. In part b, the corporation's tax is the same, $6,300, but the shareholder is only taxed on the salary of $70,000.

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Adjusted gross income	$ 70,000
Itemized deductions	(18,000)
Taxable income	$ 52,000
Gross tax	$ 7,380
Total tax ($6,300 + $7,380)	$ 13,680

The shareholder will be taxed on the corporation's undistributed income if it is paid out as a dividend in a future year.

pp. I:2-27 through I:2-29.

I:2-51 Lana's child credit is $5,750 [(3 x $2,000) - ($50 x 5)]. pp. I:2-18 and I:2-19.

I:2-52 a. They will save $1,110 ($3,000 x 0.37). Only $3,000 of loss can be offset against other income. The remaining $12,000 of loss can be carried over and offset against future income.

b. The additional tax is $2,000 ($10,000 x 0.20).

c. They will save $1,110 as in part a. The net loss is $5,000 but as in part a, only $3,000 can be offset against other income. The carryover, however, is only $2,000 ($15,000 - $10,000 - $3,000). p. I:2-30.

I:2-53

		2018	**2019**
a.	Salary	$90,000	$90,000
	Minus: Itemized or standard deduction	(12,000)	(15,600)
	Taxable income	$78,000	$74,400
	Gross Tax	$13,100	$12,308
b.	Salary	$90,000	$90,000
	Minus: Itemized or standard deduction	(12,000)	(12,000)
	Taxable income	$78,000	$78,000
	Gross tax	$13,100	$13,100
c.	Salary	$90,000	$90,000
	Minus: Itemized or standard deduction	(12,000)	(19,600)
	Taxable income	$78,000	$70,400
	Gross tax	$13,100	$11,428

d. By contributing the $8,000 in 2019, Virginia is able to deduct the entire amount. If $4,000 is contributed in each year, only the $4,000 contributed in 2019 is deductible. No tax benefit is received in 2018 because the contribution is less than the standard deduction. If $8,000 is contributed in 2018, then no tax benefit is received. pp. I:2-31 and I:2-32.

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I:2-54 a. 1040A
b. 1040
c. 1040A
d. 1040A

In parts a, c, and d, the taxpayer could file a Form 1040 instead of a Form 1040A but is not required to do so. p. I:2-35.

I:2-55 a. Maria's adjusted gross income is $48,000.

Salary	$51,000
Capital loss allowable	(3,000)
Adjusted gross income	$48,000

b. Maria's taxable income is $36,000.

Adjusted gross income	$48,000
Standard deduction	(12,000)
Taxable income	$36,000

c. Maria's tax liability is $4,130.

I:2-56 a. As no special rules apply and taxable income is $83,000, the gross tax is $10,139.
b. Ralph and Tina are entitled to a child credit for Tina equal to $2,000.
c. Pam's gross tax is computed as follows:

Adjusted gross income (interest)	$3,500
Minus: Standard deduction	(1,050)
Taxable income	$2,450

Net unearned income = $3,500 - $1,050 - $1,050 = $1,400

Earned taxable income = $2,450 - $1,400 = $1,050

A 10% tax rate applies to the first $3,600 ($1,050 + $2,550) of Pam's taxable income. Because her $2,450 taxable income is less than $3,600, Pam's tax is $245 (10% x $2,450).

d. If Pam were age 25, her tax would be computed using the tax rate schedule for a single individual. As her $2,450 taxable income is less than $9,525, Pam's tax is $245 (10% x $2,450). In this case, the kiddie tax does not affect the amount of tax Pam pays.

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I-2:57 a. Gail qualifies as a surviving spouse. She is eligible to use the joint return rate schedule.

b. Her taxable income and gross income tax are computed as follows:

Adjusted gross income	$245,000
Minus: Itemized deductions	(30,000)
Taxable income	$215,000
Gross income tax	$ 40,179

Gail's $245,000 AGI exceeds the $200,000 threshold for reducing the child tax credit for taxpayers who are not married filing jointly, so her credit is reduced (but not below zero) by $2,250 [$50 x (($245,000 – $200,000)/$1,000)]. This reduces Gail's credit to zero. (It is reduced from $2,000 to zero if the daughter is under age 17, and it is reduced from $500 to zero if she is age 17 or older.)

c. Because having a dependent child is required to qualify as a surviving spouse, Gail must file as a single taxpayer. The tax on her $215,000 of taxable income is $50,940.

pp. I:2-18 and I:2-21.

Tax Strategy Problems

I:2-58 The tax liability under the three alternatives is computed as below:

Business income:	**Proprietorship**	**S Corporation**	**C Corporation**
Operating income	$150,000	$150,000	$150,000
Compensation paid to Jack		(100,000)	(100,000)
Net	$150,000	$ 50,000	$ 50,000
Corporate income tax			$ 10,500
Jack's income:			
Business income	$150,000	$ 50,000	
Compensation		100,000	$100,000
Dividends			5,000
Other income	1,000	1,000	1,000
Adjusted Gross Income	$151,000	$151,000	$106,000
Itemized deductions	(14,000)	(14,000)	(14,000)
Taxable income	$137,000	$137,000	$ 92,000
Individual income tax	$ 27,170	$ 27,170	$ 15,920
Total tax	$ 27,170	$ 27,170	$ 26,420

The total tax paid when Jack operates the business as a C corporation is less than the tax paid with the other organizational forms. He does, however, face a potential future individual income tax on the remaining $34,500 ($50,000 - $10,500 - $5,000) of corporate income when the corporation distributes that income. The reason the tax is less now is because higher rates apply to the additional income reported on his personal return when he operates as a proprietor or

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makes an S election. Dividends are taxed at 15% when received by single individuals whose taxable income is greater than $38,600 but not greater than $425,800.

I:2-59 a. Andrea will save $740 (37% x $2,000) if she makes the contribution.

b. Andrea's taxes will not change because the contribution is not deductible.

c. Andrea will save $222 (37% x $600) if she makes the gift. Given the amount of her income, the daughter will owe no tax.

d. Andrea will save $222. She however will not be as well off because the exempt interest of $300 is less than the after tax interest of $378 ($600 - $222) from the taxable bonds.

Tax Form/Return Preparation Problems

I:2-60 (See Instructor's Resource Manual)

I:2-61 (See Instructor's Resource Manual)

Case Study Problems

I:2-62 This question has some interesting implications. One problem relates to the sale of the loss property. Bala and Ann can only deduct $3,000 of the capital loss from ordinary income each year. As a result, it would take ten years to use up the loss unless they realize a capital gain against which to offset the loss. Although a $3,000 capital loss offsets income that would otherwise be taxed at 37%, it takes a long time to use up the loss. If Bala and Ann sell both of the parcels they own they will realize a net loss of $8,000, which will be used up in the current and next two years even if they realize no additional gains. Further, the $8,000 net loss will offset income that would otherwise be taxed at 37%.

Kim is a dependent of her parents and has no other income, so her taxable income if the land were sold would be $17,950 ($19,000 - $1,050 standard deduction). Because she is age 16, Kim is subject to the kiddie tax. Her net unearned income would be $16,900 ($19,000 - $1,050 - $1,050), and her earned taxable income would be $1,050 ($17,950 - $16,900). Her $17,950 taxable income is comprised entirely of long-term capital gain, so $3,650 ($1,050 + $2,600) would be taxed at 0%, $10,100 (($1,050 + $12,700) - $3,650) would be taxed at 15%, and the remaining $4,200 ($17,950 - $3,650 - $10,100) would be taxed at 20%. The total tax would be $2,355 ((15% x $10,100) + (20% x 4,200)). By waiting to sell her land when she is no longer subject to the kiddie tax, more of the gain may be taxed at 0% or 15%, depending on her income at that time. p. I:2-30.

I:2-63 As Larry and Sue were married at the end of the year, they can file either a joint income tax return or two separate returns. On the surface, there is not much difference between the tax liability on a joint return versus separate returns. The important issue here is the fact that Sue believes that Larry may be under-reporting tip income. If they file a joint return, Sue may be liable for the joint tax liability including penalties that may result from under-reporting. There is an innocent spouse provision, but one condition for claiming innocent spouse status is that the taxpayer did not know and had no reason to know that there was under-reporting. As Sue is suspicious of her husband, she should file a separate return to protect herself from possible tax liability associated with unreported income. pp. I:2-32 and I:2-33.

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Tax Research Problems

I:2-64 Since the stepdaughter and her family do not live with Ed, they must be related to him in order to qualify as his dependents. Children meet the relationship tests for a qualifying child (Sec. 152(c)(2)(A)) and for a qualifying relative (Sec. 152(d)(2)(A)), and a child for these purposes includes a stepchild (Sec. 152(f)(1)(A)(i)). Further, Reg. Sec. 1.152-2(d) states that a relationship "once existing will not terminate by divorce or death of a spouse."

On the other hand, Ed is not related to the stepdaughter's husband. Stepson-in-laws are not listed in Sec. 152. The Tax Court in Desio Barbetti [9 T.C. 1097 (1947)] held that the term "grandchildren" does not include step-grandchildren, and that neither stepchild nor son-in-law covers stepson-in-laws. Current law refers to children and their descendants, which suggests that the step-grandchild is eligible to be claimed as a dependent.

I:2-65 The baby can be claimed as a dependent even though he or she lived for only a day. In Rev. Rul. 73-156, 1973-1 C.B. 58, the IRS ruled that dependency may be claimed if state or local law treats the child as having been born alive, and this is evidenced by an official document such as a birth or death certificate. If the child had no social security number the IRS instructs taxpayers to enter "Died" in place of the social security number on Form 1040.

I:2-66 Although Larry may not meet the technical definition of "blind" when he wears the new contact lens, the fact that he can only wear the lens for brief times means that he cannot depend on having the advantage of improved sight. Therefore, the Tax Court in Emanuel Hollman, 38 T.C. 251 (1963) granted an extra personal exemption for blindness permitted under prior law. It seems likely that the same rule would be available to taxpayers today claiming the additional standard deduction amount available to blind taxpayers under current law.

"What Would You Do In This Situation?" Solution

Ch. I:2, p. I:2-29.

A married person has the option of filing a joint return or as a married person filing separately. Whether a person is married depends on the laws of the state of residence. The abandoned spouse rules provide an exception, but the rules only apply if the taxpayer maintains a household for a dependent child. This case does not indicate that Jane has a child.

State laws establish conditions that must be met for a missing person to be declared legally dead. Typically, a missing person cannot be declared legally dead for seven years. During the interim, a guardian can be appointed to handle the affairs of the missing person. This all taken together indicates that Jane is still classified as a married person for tax purposes.

The IRS has ruled that a spouse who is appointed guardian may elect to file a joint return with his or her missing spouse (Rev. Rul. 55-387, 1955-1 CB 131). The joint return would enable Jane to take advantage of the lower rate schedule and utilize a larger standard deduction. Before she could file a joint return, Jane would have to be appointed as Jim's guardian.

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Choosing to file a joint return does have some risks. Jane does not know how much income Jim has or whether he is even alive. Should she file a joint return, the innocent spouse provision probably would protect Jane from tax on any income that Jim may be earning.

One unusual aspect of the situation is that the IRS may know of her husband's status. This is because the IRS would have any return that Jim is filing and have information on any income that is being reported under his social security number on 1099's and W-2's. The IRS is prohibited from giving out information on taxpayers including where they live. As a result, it is unclear what the IRS would do with the information should Jane file a joint return.

Jane could file for a divorce. If the divorce were granted before year end, Jane would file as a single taxpayer. Also, if Jim is declared legally dead Jane will file as a single taxpayer.

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Chapter I:2

Determination of Tax

Learning Objectives

After studying this chapter, the student should be able to:

1. Use the tax formula to compute an individual's taxable income.
2. Determine the amount of deductions from Adjusted Gross Income.
3. Calculate the income tax for individuals.
4. Explain the basic income tax rules relating to business entities.
5. Explain the basic income tax rules of capital gains and losses.
6. Describe tax planning considerations for various tax matters.
7. Describe compliance and procedural matters for filing tax returns.

Areas of Greater Significance

It is absolutely vital that students understand the individual formula for calculating the tax or refund due (including standard deduction and filing status). This formula is necessary throughout the balance of the text to work out the problems. Any deficiencies in understanding at this point would be carried over to subsequent materials.

Areas of Lesser Significance

In the interest of time, the instructor may determine that the following area is best covered by student reading, rather than class discussion:

1. Business income and business entities.

Problem Areas for Students

The following areas may prove especially difficult for students:

1. Whether a taxpayer qualifies for head of household filing status.

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2. The relationship between the standard deduction and itemized deductions.

3. Whether the qualification (or non-qualification) of a person as a dependent affects the head of household filing status (i.e., the rules for head of household and qualifying dependents overlap, but are not totally consistent).

Highlights of Recent Tax Law Changes

The following items of tax law have changed since the 2018 edition of this chapter:

1. The TCJA changes the treatment of alimony for any divorce or legal separation agreements executed after 2018. Alimony payments will be excluded from the gross income of the recipient and not be deductible by the paying ex-spouse.

2. The TCJA allows flow-through entities to deduct 20% of qualified business income.

3. The TCJA eliminates personal and dependency exemptions.

4. The TCJA provides for new marginal tax rates: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. (See inside front cover for income limits.)

5. The TCJA returns the AGI floor for medical expenses to 7.5% for all taxpayers regardless of age.

6. The TCJA sets a cap of $10,000 ($5,000 if married filing separately) on the deduction of state and local taxes.

7. The TCJA reduces the maximum amount of indebtedness for the home mortgage interest deduction to $750,000 on debt incurred after December 16, 2017 and eliminates mortgage interest deduction for home equity loans.

8. The TCJA increases the maximum amount of the cash charitable contribution deduction to 60% of AGI.

9. The TCJA eliminates deductions for personal casualty and theft losses, except those attributable to a federally declared disaster.

10. The TCJA suspends miscellaneous deductions subject to a 2% of AGI floor.

11. The TCJA significantly increases the standard deduction amount for each filing status.

12. The TCJA separates the "kiddie tax" from the parents' marginal tax rate. (See Instructor Aid I:2-2.)

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13. The TCJA sets a flat tax rate of 21% for ordinary income and capital gains for corporations.

14. The TCJA eliminates the reduction of itemized deductions for high income taxpayers.

15. The floor for filing a tax return for each filing status, except for married filing separately, has increased to match the new standard deduction amounts.

Teaching Tips

1. Due to the annual changes in many of the rules covered in this chapter (e.g., standard deduction), you may wish to inform the students that examinations and/or quizzes will be held on an open-book basis or that you will provide any required statutory amounts for testing purposes. Using this approach allows the students to concentrate on the concepts rather than memorizing numbers.

2. This introductory chapter is a good place to begin emphasizing the difference between deductions for AGI and deductions from AGI. This distinction will increase in importance in subsequent chapters.

Lecture Outline

I. Formula for Individual Income Tax

1. Basic Formula (Table I:2-1, Example I:2-1; Figure I:2-1; Question I:2-1; Problem I:2-29)

    a. The basic formula for calculating individual income tax is:

        i. Gross income – Exclusions - Deductions for AGI = Adjusted gross income

        ii. Adjusted gross income - Deductions from AGI = Taxable income

        iii. Taxable income × Tax rate(s) = Gross tax

        iv. Gross tax - (Credits + Prepayments) = Net tax

2. Definitions (Tables I:2-2 through I:2-5)

    a. Brief definitions of income, exclusions, gross income, deductions for adjusted gross income, adjusted gross income, deductions from adjusted

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gross income, itemized deductions, standard deduction, taxable income, tax rates, gross tax, and tax credits are presented with references to detailed coverage later in the text.

II. Deductions from Adjusted Gross Income

1. Itemized Deductions (Table I:2-6; Example I:2-2)

   a. The total of qualifying medical expenses, taxes, investment and residential interest, and charitable contributions are claimed only if the total of such items exceeds the standard deduction.

   b. Deductions for medical expenses and charitable contributions are limited by varying percentages of adjusted gross income. Deductions for taxes and residential interest are also capped (generally $10,000 for taxes and interest on $750,000 of indebtedness).

2. Standard Deduction (Examples I:2-3, I:2-4)

   a. The full amount of the standard deduction (which varies with filing status, age, and vision) may be claimed when it exceeds the taxpayer's itemized deductions.

      i. EXAMPLE: A single taxpayer in 2018 has $10,000 of allowable itemized deductions. Since the applicable standard deduction for this taxpayer ($12,000) is greater than his itemized deductions, the taxpayer deducts $12,000 in determining his taxable income.

Filing Status	**Standard Deduction**	
	2017	**2018**
Married couple filing jointly	$12,700	$24,000
Surviving spouse	12,700	24,000
Head of household	9,350	18,000
Single (unmarried individual other than surviving spouse or head of household)	6,350	12,000
Married individual filing separately	6,350	12,000

   b. Additions to the standard deduction are available for taxpayers who are 65 or older and/or blind. The 2018 additions are $1,300 for married taxpayers and $1,600 for single taxpayers.

      i. EXAMPLE: A single taxpayer in 2018 who is 65 and blind would have a standard deduction of $13,600 [$12,000 + $1,600 (age) + $1,600 (blindness)].

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3. Dependency Requirements (Examples I:2-8, I:2-12, I:2-16, I:2-17; Topic Review I:2-1; Problem I:2-32)

    a. Qualification of dependents can affect a taxpayer's filing status and access to deductions and credits. Dependents must meet the following requirements:

        i. Have a Social Security number reported on return;

        ii. Be a U.S. Citizen, U.S. Resident, or reside in Canada or Mexico; and

        iii. Not have filed a joint return (unless filed for the sole purpose of obtaining a refund).

    b. Additional requirements for "qualifying children"

        i. Be a natural, adopted, foster child, or stepchild of the taxpayer, a sibling of the taxpayer, or descendants of any of the previous;

        ii. Be under 19, a full-time student under age 24, or a permanently and totally disabled child;

        iii. Have the same principal abode as taxpayer, and

        iv. Dependent may not provide more than one half of his or her own support.

    c. Additional requirements for "qualifying relatives"

        i. Be related to the taxpayer or reside in the taxpayer's household for the entire year;

        ii. Have gross income less than $4,150; and

        iii. The taxpayer must normally provide more than one half of the dependent's support. (Receipts of the potential dependent are counted as support only if the receipts are spent for support, i.e., if the dependent puts all his social security payments in a savings account, the payments do not count in the support test.)

        iv. Exceptions may exist under multiple support agreements and parental releases.

4. Child Credit (Example I:2-21; Problem I:2-51)

    a. Individual taxpayers may claim a $2,000 credit for each qualifying child (U.S. citizen/national/resident under 17 who qualifies as the taxpayer's

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dependent descendent, stepchild, or foster child) under age 17 plus a $500 credit for each other dependent.

b. The total credit for all children is reduced by $50 for each $1,000 (or fraction thereof) of AGI over $200,000 ($400,000 for married filing jointly).

c. Under certain circumstances, the credit is refundable.

III. Determining the Amount of Tax (Examples I:2-26, I:2-27; Topic Review I:2-2; Problem I:2-48; Instructor Aid I:2-1)

Gross tax is determined by applying the tax table (Appendix A) or tax rate schedule inside the front cover to the taxpayer's taxable income.

In 2018, tax brackets of 10%, 12%, 22%, 24%, 32%, 35%, and 37% are applicable to individual taxpayers. The income level covered by the six brackets varies with filing status.

1. Joint Return

   a. A joint return may be filed by a man and woman if they are considered married for tax purposes on the last day of the tax year. Common law marriages and same-sex marriages are recognized. Annulled marriages are viewed as having never occurred.

   b. Taxpayers legally divorced at the end of the year may be treated as married for tax purposes, if the divorce is considered a sham.

      i. EXAMPLE: Taxpayers obtain a foreign divorce effective 12-30-2016 and remarry 1-2-2017. The only reason for the procedure was to improve tax filing status. The taxpayers will be treated as married for the tax year ending 12-31-2016.

2. Surviving Spouse (Example I:2-28)

   a. A widow or widower may file as a surviving spouse in the two years after the year the decedent spouse died if the surviving spouse:

      i. Has not remarried;

      ii. Is a U.S. citizen or resident;

      iii. Was qualified to file a joint return in the year of death; and

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iv. Paid over half the costs of maintaining a household in which a dependent child, adopted child, or stepchild lives during the entire tax year.

b. The widow or widower may file jointly in the year of the spouse's death with the cooperation of the executor of the estate. Both the surviving spouse and the executor must sign any joint return. If either party does not agree to file a joint return, then they must file as married filing separately.

c. The widow or widower may qualify as head of household in the years after the expiration of the surviving spouse status, assuming the surviving spouse meets the qualifications outlined below.

3. Head of Household (Example I:2-29)

a. An individual may file as head of household if the individual:

i. Is considered single for tax purposes (see abandoned spouse, below);

ii. Is not a surviving spouse;

iii. Is a U.S. citizen or resident; and

iv. Pays over half the costs of maintaining a household in which a qualifying child or dependent relative lives for more than half of the tax year. Dependent parents may reside in a separate household, and children do not have to be tax dependents to qualify.

4. Single Taxpayer

a. A taxpayer who does not qualify for any other filing status must file under the single status.

5. Married Filing Separately

a. Married individuals may choose to file separate returns rather than one joint return. Separate returns will seldom provide the best overall tax results due to the higher rates. However, every married couple's tax should be computed using both the joint return rules and the separate return rules to insure the lowest overall tax.

6. Abandoned Spouse (Examples I:2-32, I:2-33; Question I:2-18)

a. A legally married individual may file as head-of-household if the individual:

i. Lived apart from the spouse for the last 6 months of the year;

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ii. Pays over half of the cost of maintaining a household in which the taxpayer and a dependent child lived for over half the year; and

iii. Is a U.S. citizen or resident.

b. Without the abandoned spouse rule, the only alternative for the taxpayer would be to file married-separately (due to the unavailability of the absent spouse to prepare and sign a joint return). Head-of-household tax rates are significantly better than married-filing separately rates.

7. Children with Unearned Income (Example I:2-37; Problem I:2-56; Instructor Aid I:2-2)

a. A dependent's standard deduction is the greater of $1,050 or the dependent's earned income plus $350.

b. For children under 18, unearned income in excess of $2,100 is taxed in a special way. Between the ages of 18 and 23, this "kiddie tax" only applies under certain circumstances (e.g., the child's earned income represents less than half of his or her support).

IV. Business Income and Business Entities

Unlike for individuals, the tax rate schedule for C corporations is not progressive. Instead, a flat 21% tax rate applies.

V. Treatment of Capital Gains and Losses (Question I:2-21; Instructor Aid I:2-3)

1. Definition of Capital Assets

a. Capital assets are assets other than inventory; depreciable property used in a trade or business; real property used in a trade or business; patents; copyrights or literary, musical, or artistic compositions in the hands of the creator or a donee of the creator; letters or memoranda; accounts or notes receivable from the ordinary course of a trade or business; or certain U.S. Government publications.

b. The tax definition of capital assets is significantly different from the financial accounting definition of capital assets (i.e., property, plant, & equipment).

2. Tax Treatment of Gains and Losses

a. Net long-term capital gains (with a holding period greater than one year) are generally taxed at 0% if taxable income is not over $38,600, 15% if taxable income is between $38,600 and $425,800, and 20% if taxable income is over

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$425,800. Different thresholds apply to other filings statuses ($77,200 and $479,000 for married filing jointly; $51,700 and $425,400 for head of household). Net short-term capital gains are taxed at ordinary income. Net capital losses offset a maximum of $3,000 of other income, with an unlimited carryforward for individuals.

b. A net investment income tax of 3.8% applies to certain high-income taxpayers.

VI. Tax Planning Considerations

1. Shifting Income Between Family Members (Examples I:2-42 through I:2-44)

   a. Shifting taxable income to family members to lower tax brackets will reduce the overall family tax burden.

   b. Restrictions apply to transactions that only involve assignment, and not shifting, of income, as well as transactions that trigger the kiddie tax.

2. Splitting Income (Example I:2-45)

   a. Creating additional taxpayers can reduce the overall tax burden, but administrative costs, especially of additional corporations, reduce the overall savings.

3. Maximizing Itemized Deductions (Examples I:2-46, I:2-47)

   a. Itemized deductions only provide value to the extent that they exceed the standard deduction. Timing expenses and charitable contributions so that they fall in a single tax year can increase the value of the resulting deductions.

4. Filing Joint or Separate Returns (Example I:2-50)

   a. Both tax and non-tax issues determine whether married couples should file jointly or separately.

   b. Spouses who file jointly are jointly liable for income tax, including the tax on disallowed deductions or unreported income. The innocent spouse provision protects spouses who were not aware of the magnitude of the understated tax liability, and the separate liability election allows spouses or former spouses to elect to be separately liable for the tax.

VII. Compliance and Procedural Considerations

1. Who Must File (Example I:2-51)

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a. Generally, the income limitation for filing is the standard deduction for a particular status. The limitation is zero for married filing separately. (See page I:2-35 for the gross income filing levels.)

i. EXAMPLE: For 2018, a single taxpayer (under 65, not blind, not a dependent on another return) must file a return when gross income exceeds $12,000.

2. Due Dates and Extensions

a. Tax returns for calendar-year individual taxpayers (Forms 1040, 1040EZ, 1040A) are due April 15 (or first business day thereafter if April 15 is not a business day) following the end of the taxable year, with an automatic six-month extension if Form 4868 is filed by the due date for the return.

b. Forms 1040EZ and 1040A are used for taxpayers that have few complications in the tax year. Taxpayers with only salary, wages, and no more than $1,500 of interest may file using Form 1040EZ. Taxpayers with only salary, wages, dividends, interest, pensions and annuities, and unemployment income can file using Form 1040A. Both forms also have restrictions on deductions and credits allowed. All taxpayers may file using Form 1040.

c. Partnerships must file Form 1065 and S corporations must file Form 1120S by the fifteenth day of the third month following year end (i.e., March 15 for calendar-year-end taxpayers). C corporations must file Form 1120 and have the same due date as individual taxpayers. Any of these organizations can file Form 7004 to obtain a six-month extension.

d. An extension to file is not an extension on paying taxes. Interest and penalties apply for underpayment even when filing an extension.

3. Systems for Reporting Income

a. Payments made by certain entities are reported to the IRS for computer cross-checking that all income has been reported.

b. Items reported include pensions, annuities, wages, dividends, interest, sales of securities, unemployment compensation, rents, royalties, and lump-sum distributions from retirement plans.

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Court Case Briefs

Kenneth Royce Boykin v. CIR, 1984 PH T.C. Memo & 84,297, 48 TCM 267.

The taxpayer and his wife were divorced in February of 1979, but he continued to live with his former wife and their children after the divorce in 1979 and 1980. IRC Sec.143 provides that the "determination of whether an individual is married shall be made as of the close of his taxable year." IRC Sec.143 further provides that an individual legally separated by divorce or a separate maintenance decree is not considered married. The taxpayer was denied the filing status of married, filing jointly because he was not married at the close of the tax years at issue. Texas (state of residence) recognizes common law marriages that have the elements of mutual agreement, cohabitation, and the holding out of themselves as married to the public. Their cohabitation did not qualify because they had not mutually agreed to be remarried. However, he was permitted "head of household" filing status because he met the requirements of Sec. 2(b). He was not married at the close of the tax year and he maintained a household for over half of the tax year for his dependent children.

Haynes, 119 AFTR 2d 2017-865.

Mr. and Mrs. Haynes hired Mr. Dunbar, a CPA, to prepare and file their 2010 individual tax return. In 2011, Dunbar filed for an extension to submit the Haynes's 2010 income tax return, which was granted by IRS. On Oct. 17, 2011, Dunbar attempted to use the Lacerte software program to electronically file the Haynes's 2010 tax return. The IRS rejected the filing because the return listed Mrs. Haynes's social security number on the line designated for the employer identification number. Dunbar advised Mr. Haynes that the return had been filed, but eleven months later, the IRS notified the Haynes that it had not received their 2010 return. In December 2012, Dunbar filed the Haynes's 2010 tax return on paper. IRS assessed a late-filing penalty, which the Haynes paid. They subsequently filed a refund suit in district court, but the court rejected their claim. The court stated that relying on a CPA's erroneous word that the return had been filed was not reasonable cause for failing to file a tax return in a timely fashion.

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Instructor Aid I:2-1

Relative Tax by Filing Status*

Lowest	Married Filing Jointly/Surviving Spouse
↓	Head of Household
	Single
Highest	Married Filing Separately**

*Assuming the same amount of taxable income.

**In the few cases where the married couple both has income and only one has substantial amounts of itemized deductions, the result may vary.

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Instructor Aid I:2-2

Kiddie Tax

1. Compute the child's taxable income in the normal fashion for dependents.

2. Compute the child's net unearned income (investment income, including dividends, taxable interest, capital gains, rents, and royalties):

   Unearned income

   Less: Statutory deduction of $1,050

   Less: Greater of

   a. $1,050 of standard deduction, or

   b. Itemized deductions directly connected with the production of the unearned income

   Equals:Net unearned income (not less than zero)

3. Compute the child's earned taxable income (ETI) by subtracting net unearned income (Step 2) from taxable income (Step 1). ETI is not less than zero.

4. Determine tax rate:

   10%: Portion of taxable income not over ETI + $2,550

   24%: Portion of taxable income over ETI + $2,550

   35%: Portion of taxable income over ETI + $9,150

   37%: Portion of taxable income over ETI + $12,500

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Instructor Aid I:2-3

Capital Assets

Capital assets are defined in a negative manner under the Internal Revenue Code. Capital assets are assets that are not:

- Inventory
- Depreciable property used in a trade or business
- Real Property used in a trade or business
- Patents
- Copyrights
- Literary, musical, or artistic compositions

} In the hands of the creator or a donee of the creator

- Letters or memorandums
- Accounts or notes receivable from the ordinary course of a trade or business
- Certain U.S. Government publications

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Form **1040A** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** (99) **2017** IRS Use Only—Do not write or staple in this space.

OMB No. 1545-0074

Your first name and initial	Last name	Your social security number
Zachary L.	Mao	123 45 6789
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Cici K.	Mao	987 65 4321

Home address (number and street). If you have a P.O. box, see instructions. 520 Chestnut St. Apt. no.

▲ Make sure the SSN(s) above and on line 6c are correct.

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Philadelphia, PA 19106

Foreign country name | Foreign province/state/county | Foreign postal code

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Filing status Check only one box.

1 ☐ Single
2 ☒ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) (see instructions)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a.
b ☒ **Spouse**

Boxes checked on 6a and 6b: 2

c **Dependents:** If more than six dependents, see instructions.

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
Oliver	Mao	111-22-3333	Son	✓

No. of children on 6c who:
• lived with you: 1
• did not live with you due to divorce or separation (see instructions):
Dependents on 6c not entered above:

d Total number of exemptions claimed. Add numbers on lines above ▶ 3

Income

Attach Form(s) W-2 here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2.		7	85,000
8a	**Taxable** interest. Attach Schedule B if required.		8a	200
b	**Tax-exempt** interest. **Do not** include on line 8a.	8b		
9a	Ordinary dividends. Attach Schedule B if required.		9a	
b	Qualified dividends (see instructions).	9b		
10	Capital gain distributions (see instructions).		10	
11a	IRA distributions.	11a	11b Taxable amount (see instructions).	11b
12a	Pensions and annuities.	12a	12b Taxable amount (see instructions).	12b
13	Unemployment compensation and Alaska Permanent Fund dividends.		13	
14a	Social security benefits.	14a	14b Taxable amount (see instructions).	14b
15	Add lines 7 through 14b (far right column). This is your **total income.** ▶		15	85,200

Adjusted gross income

16	Educator expenses (see instructions).	16		
17	IRA deduction (see instructions).	17		
18	Student loan interest deduction (see instructions).	18		
19	Tuition and fees. Attach Form 8917.	19		
20	Add lines 16 through 19. These are your **total adjustments.**		20	
21	Subtract line 20 from line 15. This is your **adjusted gross income.** ▶		21	85,200

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Form 1040A (2017) Page **2**

Tax, credits, and payments	**22**	Enter the amount from line 21 (adjusted gross income).		22	85,200
	23a	Check if: ☐ **You** were born before January 2, 1953, ☐ Blind; ☐ **Spouse** was born before January 2, 1953, ☐ Blind. **Total boxes checked** ▶ 23a			
	b	If you are married filing separately and your spouse itemizes deductions, check here ▶ 23b ☐			
Standard Deduction for— • People who check any box on line 23a or 23b **or** who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, $6,350 Married filing jointly or Qualifying widow(er), $12,700 Head of household, $9,350	**24**	Enter your **standard deduction.**		24	12,700
	25	Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-.		25	72,500
	26	**Exemptions.** Multiply $4,050 by the number on line 6d.		26	12,150
	27	Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your **taxable income.** ▶		27	60,350
	28	**Tax,** including any alternative minimum tax (see instructions).	28 8,124 *		
	29	Excess advance premium tax credit repayment. Attach Form 8962.	29		
	30	Add lines 28 and 29.		30	8,124
	31	Credit for child and dependent care expenses. Attach Form 2441.	31		
	32	Credit for the elderly or the disabled. Attach Schedule R.	32		
	33	Education credits from Form 8863, line 19.	33		
	34	Retirement savings contributions credit. Attach Form 8880.	34		
	35	Child tax credit. Attach Schedule 8812, if required.	35 1,000		
	36	Add lines 31 through 35. These are your **total credits.**		36	1,000
	37	Subtract line 36 from line 30. If line 36 is more than line 30, enter -0-.		37	7,124
	38	Health care: individual responsibility (see instructions). Full-year coverage ☒		38	
	39	Add line 37 and line 38. This is your **total tax.**		39	7,124
	40	Federal income tax withheld from Forms W-2 and 1099.	40 8,000		
If you have a qualifying child, attach Schedule EIC.	**41**	2017 estimated tax payments and amount applied from 2016 return.	41		
	42a	**Earned income credit (EIC).**	42a		
	b	Nontaxable combat pay election. 42b			
	43	Additional child tax credit. Attach Schedule 8812.	43		
	44	American opportunity credit from Form 8863, line 8.	44		
	45	Net premium tax credit. Attach Form 8962.	45		
	46	Add lines 40, 41, 42a, 43, 44, and 45. These are your **total payments.** ▶		46	8,000
Refund	**47**	If line 46 is more than line 39, subtract line 39 from line 46. This is the amount you **overpaid.**		47	876
Direct deposit? See instructions and fill in 48b, 48c, and 48d or Form 8888.	**48a**	Amount of line 47 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		48a	876
	▶ **b**	Routing number ☐☐☐☐☐☐☐☐☐ ▶ **c** Type: ☐ Checking ☐ Savings			
	▶ **d**	Account number ☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐			
	49	Amount of line 47 you want **applied to your 2018 estimated tax.**	49		
Amount you owe	**50**	**Amount you owe.** Subtract line 46 from line 39. For details on how to pay, see instructions. ▶		50	
	51	Estimated tax penalty (see instructions).	51		

Third party designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete the following. ☒ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶ ☐☐☐☐☐

Sign here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
		Manager	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
		Teacher	

Paid preparer use only

Print/type preparer's name	Preparer's signature	Date	Check ▶ ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Go to *www.irs.gov/Form1040A* for instructions and the latest information. Form **1040A** (2016)

*From 2017 Tax Table.

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Note to Instructor: Updating for TCJA 2017 Reform

The problem asks for the taxpayers' Form 1040A for 2017, which was the most recent Form 1040A when this edition was published. The solution thus does not reflect the changes made by the Tax Cuts and Jobs Act of 2017. If those changes had applied to this problem's facts, the key changes include the increase in the standard deduction amount, the elimination of the personal exemptions, the reduced tax rates, and the increased child tax credit. More specifically, the following amounts would be different:

Line 24: The standard deduction would be $24,000.

Line 25: $61,200 ($85,200 – $24,000).

Line 26: Personal and dependency exemptions are no longer allowed.

Line 27: Taxable income is $61,200 (see revised line 25 above).

Line 28: The tax is $6,963 [$1,905 + (0.12 × ($61,200 – $19,050))]. The 2018 tax table was not available when this edition was published. This also is the amount on line 30.

Line 35: The child credit is $2,000. This also is the amount on line 36.

Line 37: $4,963 ($6,963 – $2,000). This also is the amount on line 39.

Line 47: The amount overpaid is $3,037 ($8,000 – $4,963). This also is the amount on line 48a.

On June 29, 2018, the IRS announced plans to replace the current Forms 1040, 1040A, and 1040EZ with a streamlined Form 1040 (IR-2018-146). The line numbers above thus will likely not correspond to the line numbers on the form the taxpayers would use for 2018.

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Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return 2017 OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2017, or other tax year beginning , 2017, ending , 20 See separate instructions.

Your first name and initial	Last name	Your social security number
John R.	Lane	111 44 6666
If a joint return, spouse's first name and initial	Last name	Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. Apt. no.
1010 Ipsen Street

▲ Make sure the SSN(s) above and on line 6c are correct.

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).
Yorba Linda, CA 90102

Foreign country name | Foreign province/state/county | Foreign postal code

Presidential Election Campaign
Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☑ You ☐ Spouse

Filing Status

Check only one box.

1 ☑ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) (see instructions)

Exemptions

6a ☑ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**

Boxes checked on 6a and 6b: 1

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see instructions)
Dependents on 6c not entered above

d Total number of exemptions claimed — Add numbers on lines above ▶ 1

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	20,000
8a	**Taxable** interest. Attach Schedule B if required		8a	300
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	
b	Qualified dividends	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions 15a	b Taxable amount	15b	
16a	Pensions and annuities 16a 31,000	b Taxable amount	16b	31,000
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits 20a	b Taxable amount	20b	
21	Other income. List type and amount		21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	51,300

Adjusted Gross Income

23	Educator expenses	23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
25	Health savings account deduction. Attach Form 8889	25		
26	Moving expenses. Attach Form 3903	26		
27	Deductible part of self-employment tax. Attach Schedule SE	27		
28	Self-employed SEP, SIMPLE, and qualified plans	28		
29	Self-employed health insurance deduction	29		
30	Penalty on early withdrawal of savings	30		
31a	Alimony paid b Recipient's SSN ▶	31a		
32	IRA deduction	32	5,500	
33	Student loan interest deduction	33		
34	Reserved for future use	34		
35	Domestic production activities deduction. Attach Form 8903	35		
36	Add lines 23 through 35		36	5,500
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37	45,800

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2017)

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Form 1040 (2017) Page 2

Tax and Credits	38	Amount from line 37 (adjusted gross income)	38	45,800
	39a	Check if: [X] **You** were born before January 2, 1953, [ ] Blind. [ ] **Spouse** was born before January 2, 1953, [ ] Blind. **Total boxes checked** ▶ 39a 1		
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b [ ]		
Standard Deduction for— • People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, $6,350 Married filing jointly or Qualifying widow(er), $12,700 Head of household, $9,350	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40	8,000
	41	Subtract line 40 from line 38	41	37,800
	42	**Exemptions.** If line 38 is $156,900 or less, multiply $4,050 by the number on line 6d. Otherwise, see instructions	42	4,050*
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	33,750
	44	**Tax** (see instructions). Check if any from: **a** [ ] Form(s) 8814 **b** [ ] Form 4972 **c** [ ]	44	4,600**
	45	**Alternative minimum tax** (see instructions). Attach Form 6251	45	
	46	Excess advance premium tax credit repayment. Attach Form 8962	46	
	47	Add lines 44, 45, and 46 ▶	47	4,600
	48	Foreign tax credit. Attach Form 1116 if required — 48		
	49	Credit for child and dependent care expenses. Attach Form 2441 — 49		
	50	Education credits from Form 8863, line 19 — 50		
	51	Retirement savings contributions credit. Attach Form 8880 — 51		
	52	Child tax credit. Attach Schedule 8812, if required — 52		
	53	Residential energy credit. Attach Form 5695 — 53		
	54	Other credits from Form: **a** [ ] 3800 **b** [ ] 8801 **c** [ ] — 54		
	55	Add lines 48 through 54. These are your **total credits**	55	
	56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0- ▶	56	4,600
Other Taxes	57	Self-employment tax. Attach Schedule SE	57	
	58	Unreported social security and Medicare tax from Form: **a** [ ] 4137 **b** [ ] 8919	58	
	59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
	60a	Household employment taxes from Schedule H	60a	
	b	First-time homebuyer credit repayment. Attach Form 5405 if required	60b	
	61	Health care: individual responsibility (see instructions) Full-year coverage [X]	61	
	62	Taxes from: **a** [ ] Form 8959 **b** [ ] Form 8960 **c** [ ] Instructions; enter code(s)	62	
	63	Add lines 56 through 62. This is your **total tax** ▶	63	4,600
Payments	64	Federal income tax withheld from Forms W-2 and 1099 — 64 6,000		
If you have a qualifying child, attach Schedule EIC.	65	2017 estimated tax payments and amount applied from 2016 return — 65		
	66a	**Earned income credit (EIC)** — 66a		
	b	Nontaxable combat pay election — 66b		
	67	Additional child tax credit. Attach Schedule 8812 — 67		
	68	American opportunity credit from Form 8863, line 8 — 68		
	69	Net premium tax credit. Attach Form 8962 — 69		
	70	Amount paid with request for extension to file — 70		
	71	Excess social security and tier 1 RRTA tax withheld — 71		
	72	Credit for federal tax on fuels. Attach Form 4136 — 72		
	73	Credits from Form: **a** [ ] 2439 **b** [ ] Reserved **c** [ ] 8885 **d** [ ] — 73		
	74	Add lines 64, 65, 66a, and 67 through 73. These are your **total payments** ▶	74	6,000
Refund	75	If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you **overpaid**	75	1,400
	76a	Amount of line 75 you want **refunded to you.** If Form 8888 is attached, check here ▶ [ ]	76a	1,400
Direct deposit? See instructions.	▶ b	Routing number ▶ **c** Type: [ ] Checking [ ] Savings		
	▶ d	Account number		
	77	Amount of line 75 you want **applied to your 2018 estimated tax** ▶ — 77		
Amount You Owe	78	**Amount you owe.** Subtract line 74 from line 63. For details on how to pay, see instructions ▶	78	
	79	Estimated tax penalty (see instructions) — 79		

Third Party Designee Do you want to allow another person to discuss this return with the IRS (see instructions)? [ ] **Yes.** Complete below. [X] **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation Accountant	Daytime phone number
Spouse's signature If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check [ ] if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Go to *www.irs.gov/Form1040* for instructions and the latest information. Form **1040** (2017)

*A cousin is not a qualifying relative if he or she does not live with the taxpayer.

**From 2017 Tax Table.

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Note to Instructor: Updating for TCJA 2017 Reform

The problem asks for the taxpayer's Form 1040 for 2017, which was the most recent Form 1040 when this edition was published. The solution thus does not reflect the changes made by the Tax Cuts and Jobs Act of 2017. If those changes had applied to this problem's facts, the key changes would be the use of the standard deduction due to the increased amount, the elimination of personal exemptions and the reduced tax rates. More specifically, the following amounts would be different:

Line 40: Single individuals are allowed a $12,000 standard deduction, so John would deduct that rather than $8,000 of itemized deductions.

Line 41: $33,800 ($45,800 – $12,000).

Line 42: Personal and dependency exemptions are no longer allowed.

Line 43: Taxable income is $33,800 (see revised line 41 above).

Line 44: The tax is $3,866 [$952.50 + (0.12 × ($33,800 – $9,525))]. The 2018 tax table was not available when this edition was published. This also is the amount on lines 47, 56, and 63.

Line 75: The amount overpaid is $2,134 ($6,000 – $3,866). This also is the amount on line 76a.

On June 29, 2018, the IRS announced plans to replace the current Forms 1040, 1040A, and 1040EZ with a streamlined Form 1040 (IR-2018-146). The line numbers above thus will likely not correspond to the line numbers on the form the taxpayers would use for 2018.

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Chapter C:2

Corporate Formations and Capital Structure

Learning Objectives

After studying this chapter, the student should be able to:

1. Discuss the tax advantages and disadvantages of alternative business forms.

2. Apply the check-the-box regulations to partnerships, corporations, and trusts.

3. Recognize the legal requirements and tax considerations related to forming a corporation.

4. Discuss the requirements for deferring gain or loss upon incorporation.

5. Explain the tax implications of alternative capital structures.

6. Determine the tax consequences of worthless stock or debt obligations.

7. Identify tax planning opportunities in corporate formations.

8. Comply with procedural rules for corporate formations.

Areas of Greater Significance

It is important for the student to understand the tax consequences of forming a corporation, including the impact on both corporation and shareholder. The tax advantages and disadvantages of alternative forms of doing business should also be stressed.

Areas of Lesser Significance

In the interest of time, the instructor may determine that the following areas are best covered by student reading, rather than by class discussion:

1. Capital contributions.

2. Compliance and procedural considerations (Reporting requirements under Sec. 351).

3. Choice of capital structure.

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Problem Areas for Students

The following areas may prove especially difficult for students:

1. Allocating basis in a partially tax-free incorporation.

2. Characterization of an instrument as debt or equity.

3. Understanding that the tax basis for property contributed to a corporation is different from the basis that is used for financial accounting purposes.

Highlights of Recent Tax Law Changes

The Tax Cuts and Jobs Act of 2017 has significantly changed tax rates. These changed rates alter many traditional decisions often made by individuals when selecting a business entity. Changes often make the C Corporation more useful versus the S Corporation and increases the complexity of the decision-making process. The deduction for qualified business income is a significant change that needs to be addressed as part of the decision-making process.

Teaching Tips

Limited liability companies (LLCs) and limited liability partnerships (LLPs) have become more prevalent forms of doing business. Some discussion of LLCs and LLPs should take place here with particular emphasis on (1) the treatment of LLCs in the state where your school is located; and (2) the use of LLPs by the Big 4 accounting firms. More discussion on LLCs and LLPs takes place in Chapters C:9 and C:10.

Use Examples C:2-11 and C:2-12 to illustrate the rationale behind treating a Sec. 351 transaction as a nontaxable exchange. pp. C:2-12 and C:2-13. Some discussion might be incorporated about the fact that a corporate liquidation is not a tax-free transaction. As a result, it is inexpensive to create a corporation, but may be expensive to liquidate a corporation.

Table C:2-1 may be used as a format for presenting the tax consequences of a Sec. 351 transaction. p. C:2-11.

Use Example C:2-23 as an illustration of a prearranged disposition of stock that disqualifies a Sec. 351 transaction. p. C:2-16.

Tables C:2-2 and C:2-3 can be used as a format for presenting the advantages and disadvantages of issuing equity vs. debt. Point out that cash flow consideration may make equity more attractive than debt. pp. C:2-29 and C:2-30.

Lecture Outline

I. Organization Forms Available.

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Businesses can be conducted in one of several forms. A brief summary of these forms will provide the students with an overview of some of the factors that enter into the business form decision.

A. **Sole Proprietorships.** A sole proprietorship is a business owned by one individual and often is selected by individuals who are beginning a new business. The income and expenses are reported on a Schedule C of Form 1040 since a sole proprietorship is not a separate tax entity. All of the business assets are owned by the proprietor. Examples C:2-1 and C:2-2 illustrate the effect this will have on the amount of tax that will be paid on business income. A completed Schedule C and the related facts are included in Appendix B. These facts are used (with minor modifications) to illustrate the similarities and differences in the tax reporting process for a sole proprietorship, C corporation, partnership, and S corporation.

1. **Tax Advantages.** The tax advantages of doing business as a sole proprietorship are listed beginning on p. C:2-3.

   Profits may qualify for the 20% qualified business income deduction, which is the most significant change under the TCJA of 2017 to be emphasized.

2. **Tax Disadvantages.** The tax disadvantages of operating as a sole proprietorship are listed beginning on p. C:2-3.

B. **Partnerships.** A partnership is an unincorporated business carried on by two or more individuals or other entities. A partnership is a tax reporting, non-taxpaying entity, which acts as a conduit. All items of income, expense, gain, loss, and credit flow through to the partners' tax returns. A partnership must file a Form 1065 annually. Each partner receives a Schedule K-1 (Form 1065), which provides the information that must be reported on the partner's tax return. Examples C:2-3 and C:2-4, p. C:2-4, illustrate the effect of partnership income and loss on an individual partner's tax liability. Only those partnerships maintaining a fiscal year under the Sec. 444 reporting period rules must make tax payments based on the amount of income deferral. A completed Form 1065 and the related facts are included in Appendix B.

A partnership can be either a general partnership or a limited partnership. In a general partnership, each partner has unlimited liability for partnership debts. In a limited partnership, at least one partner must be a general partner, and at least one partner must be a limited partner. Limited partners are liable only to the extent of their investment plus any amount that they commit to contribute to the partnership if called upon.

1. **Tax Advantages.** A partnership is exempt from taxation. Marginal tax rates of the individual partners may be lower than the marginal corporate tax rate on the same income historically, but this may not be the case as of the TCJA of 2017. p. C: 2-4.

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Pass through income may qualify for 20% of qualified business income deductions.

No double taxation is inherent in the use of the partnership form. Profits are taxed only when earned. Generally, additional taxes are not imposed on withdrawals.

Losses generally can be used to offset income from other sources. A positive basis adjustment is made when income is earned by the partnership and taxed to the partners. This reduces the gain recognized when a sale or exchange of the partnership interest occurs. No such basis adjustment occurs with a C corporation.

2. **Tax Disadvantages.** All profits are taxed when earned even though reinvested in the business. Marginal tax rates of the partners may be greater than the applicable marginal tax rate if the income is taxed to a corporation.

   A partner is not an employee. Employment taxes must be paid on a partner's self-employment income from the partnership.

   Some tax-exempt fringe benefits are not available to partners.

   The partnership's taxable year generally must conform to that of its partners or be a calendar year unless a special election is made to use a fiscal year. pp. C: 2-4 and C: 2-5.

C. **C Corporations.** A C corporation is a separate entity that for tax years beginning after December 31, 2017 is taxed at 21% on taxable income. A C corporation must report all its income and expenses and compute its tax liability on Form 1120 (U.S. Corporation Income tax Return). A completed Form 1120 appears in Appendix B. Shareholders are not taxed on the corporation's earnings unless these earnings are distributed as dividends, and qualified dividends are taxed at the shareholder's tax rate for long-term capital gains, which, after 2017, can be 0%, 15%, or 20%, depending on the individual's tax status and level of taxable income. In addition, an incremental 3.8% tax rate applies to net investment income for taxpayers whose modified AGI exceeds $200,000 ($250,000 for married filing jointly). Net investment income includes, among other things, interest, dividends, annuities, royalties, rents, and net gains from the disposition of property not used in trade or business, all reduced by deductions allocable to such income or gains. In contrast, a C Corporation's capital gains are taxed at the same 21% tax rate as its other income.

1. **Tax Advantages.**

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Shareholders employed by the corporation are treated as employees for fringe benefit purposes. As employees they are eligible to receive deductible salary payments. This allows them to adjust their compensation (within limits) to cause the income to be taxed partly on the corporate return and partly on the shareholders' returns, to minimize their overall tax liability.

A C corporation is allowed to use a fiscal year. There are restrictions on using a fiscal year that apply to personal service corporations unless a special election is made under Sec. 444 by the corporation. p. C: 2-6.

2. **Tax Disadvantages.** Double taxation occurs when dividends are paid or the corporation's stock is sold or exchanged.

Shareholders can generally not withdraw money from the corporation without tax consequences. Distributions are taxable as dividends to the extent of earnings and profits.

Net operating losses can only be carried back or forward to offset income from other taxable years. Losses cannot be used to offset the shareholder's personal income.

Capital losses provide no benefit in the year that they are incurred. They can only be used to offset capital gains. p. C: 2-6.

D. **S Corporations**. S corporations are corporations that elect to be taxed as a partnership. Generally no tax is paid by the corporation. Instead, all items of income, deduction, gain, loss, and credit flow through to the individual shareholders. Corporate rules apply unless overridden by the Subchapter S provisions. A completed Form 1120S (U.S. Income Tax Return for an S Corporation) is included in Appendix B.

1. **Tax Advantages.** S corporations are generally exempt from taxation. The shareholders pay tax at their marginal tax rates, which are generally lower than the C corporation's marginal tax rate. See the **Tax Strategy Tip** on p. C:2-7.

Pass through income may qualify for the 20% qualified business income deduction.

Losses flow through to shareholders and generally can be used to offset income earned from other sources. Passive loss rules may limit loss deductions to shareholders. (See Chapter C:11.)

Capital gains are taxed to individual shareholders as though they were earned by the individual. An individual may be able to offset these gains

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with capital losses from other sources or have them taxed at their own capital gains rates.

Capital losses flow through separately to the shareholders and can be used to offset other capital gains and to a limited extent ordinary income. Shareholders can contribute or withdraw money from the S corporation without adverse tax consequence. Profits are taxed as earned. The earnings are generally not taxed a second time when distributed as dividends.

A positive basis adjustment is made when income is earned by the S corporation and taxed to the shareholders. This reduces the gain recognized when a sale or exchange of the S corporation stock occurs. No such basis adjustment occurs with a C corporation.

2. **Tax Disadvantages.** All the corporation's profits are taxed when earned, whether distributed or not. Distributions generally are made to at least cover the taxes paid by the shareholders on their share of the corporation's earnings.

If the shareholders' marginal tax rates exceed those for a C corporation, the capital that remains for reinvestment may be reduced.

Tax-free fringe benefits are generally not available to shareholders. When provided, they are deductible by the corporation and taxable to the shareholder as compensation. Shareholders are treated as employees for purposes of social security taxes.

An S corporation generally must select a calendar year as its tax year unless a special election is made under Sec. 444 to use a fiscal year.

E. **Limited Liability Company.** A limited liability company (LLC) combines the best features of a partnership and corporation even though it is neither. It is taxed like a partnership while providing the limited liability of a corporation.

F. **Limited Liability Partnership.** Many states also have statutes that allow a business to operate as a limited liability partnership (LLP). This partnership form is particularly attractive to professional service partnerships, such as public accounting firms. Under state LLP laws, partners are liable for their own acts and the acts of individuals under their direction. LLP partners are not liable for the negligence or misconduct of other partners. p. C: 2-8.

G. A side-by-side comparison of the tax and nontax attributes of C corporations, partnerships, and S corporations is presented in Appendix F. It might be helpful to periodically refer to this comparison throughout Chapters C:2 through C:11.

II. Check-the-Box Regulations.

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Unincorporated businesses are able to choose whether to be taxed as a partnership or corporation. The rules are commonly referred to as "check-the-box" regulations. Treasury Regulations provide that an unincorporated business with two or more owners is taxed as a partnership unless it elects to be taxed as a corporation. An unincorporated business with one owner may elect to be taxed as a corporation or be disregarded as a separate entity and be taxed directly to the owner on a Schedule C. This election is not available to corporations, trusts, or certain special entities such as Real Estate Investment Trusts, Real Estate Mortgage Investment Conduits, or Publicly Traded Partnerships.
An eligible entity may affirmatively elect its classification on Form 8832 [Entity Classification Election]. Examples C:2-8 and C:2-9, p. C:2-8, illustrate the default rules. If an entity makes an election to change its classification, it cannot again change its classification by election during the 60 months following the effective date of the election. There are tax consequences to the changing of classifications. When applying check-the-box regulations, taxpayers must also check whether or not their state will treat an entity in a consistent manner for state tax purposes. p. C:2-8.

III. Legal Requirements and Tax Considerations Related to Forming a Corporation.

The legal requirements for forming a corporation depend on the laws of the state in which the corporation is incorporated. These laws provide for legal capital minimums, incorporation fee, franchise tax, and corporate tax rules. Most corporations are incorporated in the state in which they commence business. Articles of incorporation must be filed. A fee is charged for incorporation and an annual franchise tax is collected. It is important to note that these fees and taxes can be substantial, and should be a consideration prior to formation.

IV. Tax Considerations in Forming a Corporation.

Property, money, or services are transferred to the corporation in exchange for a debt or equity interest. Tax consequences may occur for both the shareholder, debtholder, and the corporation. Example C:2-10 on p. C:2-10 illustrates these tax consequences for the corporation and its shareholders.

At this point you may wish to use Table C:2-1, Overview of Corporate Formation Rules. This summary is found on p. C:2-11 of the text and is a good tool to be used to explain each of the parts of the incorporation transaction. Book-tax accounting issues are discussed later in this chapter.

V. Section 351: Deferring Gain or Loss upon Incorporation.

No gain or loss is recognized when property is transferred to a corporation solely in exchange for stock provided that immediately after the exchange, the transferors are in control. Recognition of gain or loss is deferred through adjustment of the shareholder's basis in the stock. (See Example C:2-11 on p. C:2-12.) The requirements for nonrecognition treatment are discussed below.

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A. **The Property Requirement.** Property must be transferred to the corporation in an exchange transaction. Property includes money, and almost any other kind of property including installment obligations, accounts receivable, inventory, equipment, patents, and other intangibles representing "know-how," trademarks, trade names, and computer software.

Excluded from the property definition are services received in exchange for stock in a corporation, indebtedness of the transferee corporation that is not evidenced by a security, and interest on an indebtedness of the transferee corporation that accrued on or after the beginning of the transferor's holding period for the debt.

B. **The Control Requirement.** The transferors as a group must be in control immediately after the exchange. Control is ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. Only stock received for property is counted when determining if control has been received. Stock received for services does not count for purposes of determining control unless property is also contributed.

A transfer of property to an existing corporation will be tax-free only if an 80% interest in the corporation is acquired, or existing shareholders also transfer enough additional property to the corporation to permit the 80% requirement to be satisfied by the transferors as a group.

Transferors must be in control of the corporation immediately after the exchange. The exchanges do not need to be simultaneous, but must be agreed to beforehand and executed in an expeditious and orderly manner.

C. **The Stock Requirement.** No gain or loss is recognized by transferors who exchange property solely for transferee corporation stock. Voting or nonvoting stock may be received by the transferors. Nonqualified preferred stock is preferred stock that has one of the following characteristics: 1. The shareholder can require the corporation to redeem the stock. 2. The corporation is required to redeem the stock. 3. The corporation has the right to redeem the stock, and is more likely than not to do so, or 4. The dividend rate on the stock varies in relation to interest rates or other such indices. However, nonqualified preferred stock is treated as boot. Stock rights or stock warrants are not considered stock for purposes of Sec. 351. p. C: 2-16.

At this point, you may wish to review with the students by referencing Topic Review C:2-1, which provides a concise overview of the requirements of Sec. 351. This review is found on p. C:2-17 in the text.

D. **Effect of Sec. 351 on the Transferors.** If all the requirements of Sec. 351 are met, the transferors do not recognize any gain or loss on contribution of their

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property to the corporation. The receipt of property other than stock does not completely disqualify the transaction from coming under Sec. 351. However the receipt of property other than stock may cause the exchange to be partly taxable.

Property other than stock that is received is considered **boot**. Gain is recognized to the extent of the lesser of (1) the transferor's realized gain or (2) the amount of money plus FMV of the nonmoney boot property received. A loss is never recognized. The character of the gain depends upon the type of the property transferred. (See Example C:2-24.) Where several properties are transferred, a "separate properties approach" is used. (See Example C:2-25.)

E. **Basis of Stock Received.** The basis of the stock received in a Sec. 351 exchange is the adjusted basis of the property transferred plus any gain recognized by the transferor minus (1) any money received (including liabilities transferred to the corporation that are treated like money) and (2) the FMV of any nonmoney boot property that is received. (See Example C:2-26.)

F. **Tax Consequences to Transferee Corporation.** The transferee corporation needs to determine the amount of gain or loss (if any) it must recognize and the basis of property or services acquired. No gain or loss is recognized by a transferee corporation exchanging stock or debt instruments for property. A transferee corporation must **recognize** gain (but not loss) if it transfers appreciated property to a transferor as part of a Sec. 351 exchange. (See Example C:2-30.)

If the transaction is taxable to the transferor, the basis of the property acquired is its acquisition cost. If the transaction falls under Sec. 351, the basis of the property to the transferee corporation is the transferor's basis plus gain recognized by the transferor. The corporation's holding period includes the transferor's period in the case of a Sec. 351 transaction. (See Example C:2-31.)

Topic Review C:2-2 presents a summary of the tax consequences of a tax-free asset transfer to the transferor and the transferee corporation and may be referred to at this point to summarize the more important material relating to partially tax-free in corporations. This review is presented on p. C:2-20.

G. **Assumption of the Transferor's Liabilities.** The assumption of liabilities does not cause the transferor to recognize part or all of his realized gain unless (1) the transfer is made for a tax avoidance purpose or there is no bona fide business purpose for the acquisition and/or assumption of the debt, or (2) the liabilities assumed are in excess of the basis of the properties transferred.

The most important factor in determining whether a tax avoidance purpose is present is the length of time between the incurrence of the liability and the transfer of the liability to the corporation. Liabilities are considered to have a business purpose if the liabilities are incurred in the normal course of business or

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in the course of acquiring business property. If no business purpose is found, all of the liabilities assumed or acquired are considered boot.

If the total amount of liabilities transferred to a controlled corporation by a transferor exceeds the total adjusted basis of all properties transferred by the transferor, the excess liability is a gain that is taxable to the transferor. (See Example C:2-37.)

The term liabilities for a cash or hybrid method of accounting transferor does not include (1) any amount that would give rise to a deduction when paid or (2) any amount that is payable to a retired partner or to liquidate a deceased partner's interest. (See Example C:2-38.)

Topic Review C:2-3 presents a summary of the liability assumption and acquisition rules of Sec. 357 and may now be used to review this material with the students. This review is presented on p. C:2-25.

H. **Other Considerations in a Sec. 351 Exchange.**

1. **Recapture of Depreciation.** If a Sec. 351 exchange is nontaxable, no depreciation recapture is required. The transferor's recapture potential is transferred to the transferee corporation. (See Example C:2-39.)

2. **Computing Depreciation.** When a shareholder transfers depreciable property to a corporation in a Sec. 351 transaction, the corporation must continue to use the same depreciation method and recovery period with respect to the shareholder's basis in the property. An allocation of the depreciation for the year that includes the transfer date must be made between the transferor and transferee. If a basis adjustment occurs because the transferor recognizes a gain, a second depreciable asset is created which is generally depreciated as a new asset under the MACRS rules. (See Example C:2-40.)

3. **Assignment of Income Doctrine.** This doctrine is a judicial requirement that income be taxed to the person who earns it. This doctrine does not apply to a Sec. 351 exchange if the transferor transfers substantially all the business assets and liabilities to the corporation and a business purpose exists for the transfer. Accounts receivable take a zero basis in the corporation's hands and are included in income when collected. (See Example C:2-42.)

VI. Choice of Capital Structure.

A. **Characterization of Obligations as Debt or Equity Capital.** The tax laws provide an incentive for closely held corporations to maximize the amount of allowable interest deductions. Where debt financing resembles equity obligations,

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the form of the transaction will be ignored and debt will be reclassified as common or preferred stock. No single factor is controlling in determining when reclassification will occur.

B. **Debt Capital.**

1. **Issuance of Debt.** For years beginning after December 31, 2017, C Corporations with average gross receipts for the previous three years exceeding $25 million are limited in the interest deduction to the sum of (1) businesses interest income; (2) 30% of adjusted taxable income; and (3) floor plan financing interest for corporate tax payers who sell motor vehicles. Interest expense greater than the sum of these three items carries over to the next tax year, subject to the limitation in that year. The carry over period is indefinite. To arrive at adjustable taxable income, a C Corporation calculates taxable income without regard to (1) any item of income, gain, deduction, or loss not properly allocable to a trade or business; (2) any business interest or business interest income; (3) any net operating loss deduction; and (4) any deduction allowable for depreciation, amortization, or depletion taken in years before 2022. C Corporations with average gross receipts of $25 million or less are not limited in their business interest deduction. In contrast to business interest expenses, the corporation cannot deduct dividends paid on equity security.

2. **When Interest Is Paid.** Interest paid on debt is deductible by the payor. Dividends paid on stock are not deductible by the corporation. Noncorporate investors who borrow funds in order to make an investment in a C corporation will find that the interest expense incurred to carry such an investment is generally subject to the investment interest limitation; unless the investment is a passive activity and the interest expense comes under the passive activity limitation rules.

3. **When an Indebtedness Is Satisfied.** Repayment of an indebtedness is not considered an exchange transaction. An obligation that is repaid by a corporation does not result in a gain or loss being recognized by the creditor. The satisfaction of a debt instrument (e.g., note, bond, or a debenture) is an exchange for the holder of a debt instrument and gain or loss will be recognized if the amount received is different from the asset's basis.

   Table C:2-2 presents the tax advantages and disadvantages of using debt in the capital structure. This table may be found on p. C:2-29. You may want to discuss the case presented in the box on p. C:2-31 concerning extremely long-term debt issued to raise capital by a corporation.

C. **Equity Capital.** The reasons for use of multiple classes of stock are found on p. C:2-29. Because of the many different types of equity issues that are possible, all

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tax and nontax advantages of each type cannot be listed. Table C:2-3, Tax Advantages and Disadvantages of Using Stock in the Capital Structure, is found on p. C:2-30.

D. **Capital Contributions by Shareholders.** A corporation does not recognize any income when it receives money or property as a capital contribution from a shareholder. If additional contributions are made without additional stock being issued, the payments are regarded as an additional price paid for the existing stock. (See Example C:2-44.)

E. **Capital Contributions by Nonshareholders.** Nonshareholders sometimes contribute capital to a corporation in the form of cash or other property. For example, a city government might make a "contribution to capital" to a corporation in the form of undeveloped land to induce a corporation to locate within the city and provide jobs for citizens of the municipality. For transfers before December 23, 2017, such "contributions to capital" were excluded from the corporation's gross income if the money or property contributed was neither a payment for goods or services nor a subsidy to induce the corporation to limit production. However, for transfers after December 22, 2017, the term "contribution of capital" no longer includes contributions to the corporation by nonshareholders who are customers, potential customers, governmental entities, or civic groups. In these cases, the transfers will continue to be nontaxable. In this case, the corporation will continue to take a zero basis in the property received, which precludes the corporation from claiming depreciation deductions or other capital recovery offsets with respect to the contributed property.

If a nonshareholder, who is not a customer, potential customer, governmental entity or civic group, contributes cash, the basis of any property acquired with the cash during a 12-month period beginning on the day the corporation received the contribution is reduced by the cash amount used to acquire the property. This basis reduction applies to the corporation's other property in the following order:

1. Depreciable Property
2. Amortizable Property
3. Depletable Property
4. All other property

In the sequence of these downward adjustments, however, a property's basis may not be reduced below zero.

VII. Worthlessness of Stock or Debt Obligations.

A. **Securities.** A debt or equity investment that is evidenced by a security and that becomes worthless results in a capital loss for the investor on the last day of the tax year in which the worthlessness occurs.

Ordinary loss can be reported in some situations. An example of this would be securities that are held by dealers as inventory. A domestic corporation is also

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permitted to claim an ordinary loss in connection with the worthlessness of a security of an affiliated corporation.

The Sec. 1244 rules permit an ordinary loss to be claimed for qualifying stock issued by a small business corporation that is sold, exchanged, or becomes worthless. Ordinary loss treatment is only allowed an individual who was originally issued the stock, or by a partner in a partnership that was originally issued the stock, and whose distributive share includes the losses for the corporate stock. If a shareholder contributes additional money or property to a corporation after acquiring Sec. 1244 stock, the amount of ordinary loss recognized upon the sale, exchange, or worthlessness of the Sec. 1244 stock is limited to the shareholder's capital contribution at the time the shares were issued. The ordinary loss is limited to $50,000 (or $100,000 if the taxpayer is married and files jointly). Losses in excess of the dollar ceiling are capital losses.

The ordinary loss can be carried back or forward as part of a net operating loss. (See Example C:2-47.)

B. **Unsecured Debt Obligations.** Shareholders may make loans to corporations. The type of loss that can be claimed on these advances depends on the nature of the loan. If the advance is treated as paid-in capital, the amount of the loan increases the worthless securities loss on the stock.

A loan made to a corporation that is not evidenced by a security can be deducted under either the business or nonbusiness bad debt rules. Most unsecured advances are considered to be made outside the shareholder's trade or business. If a noncorporate shareholder makes the loan, it will generally be considered a nonbusiness bad debt that is a short-term capital loss, and is limited to a $3,000 deduction per year.

VIII. Tax Planning Considerations.

Sec. 351 treatment is mandatory, not elective, if the provisions are met. In some cases shareholders may wish to recognize gains or losses. In order to accomplish this, one of the provisions necessary for the application of Sec. 351 must be violated. (See Example C:2-50.)

IX. Compliance and Procedural Requirements.

Every person who receives stock, securities, or other property in an exchange qualifying under Sec. 351 must attach a statement to his tax return for the period that includes the date of the exchange. A list of the required information for the transferor is found on p. C:2-36. The transferee corporation must attach a statement to its tax return for the year in which the exchange takes place. A list of the transferee corporation's required information is found on p. C:2-36.

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Court Case Briefs

Charles E. Wolfe v. U.S., 612 F. Supp 605 (DC Mont, 1985) aff'd. 798 F.2d 1241 (9th Cir., 1986).

The taxpayer, Charles E. Wolfe, was the sole shareholder and president of Wolfe & Company, a corporation which leased tractor-trailers. Mr. Wolfe also operated an "over-the-road" trucking business as a sole proprietorship. The corporation incurred a large federal tax bill which was paid by Mr. Wolfe personally when the corporation was unable to pay. Mr. Wolfe contended that he should not be held personally liable for the tax liability of the corporation.

The main issue was whether the corporation was the alter ego of Mr. Wolfe. If so, then the Internal Revenue Service could "pierce the corporate veil" and look to Mr. Wolfe's personal assets for satisfaction of the corporate tax liability. The court considered eleven factors, including level of ownership and control of the corporation, commingling of personal and corporate funds, common books and records, distribution of earnings and profits, and representation of corporate-personal relationship. In this case, the facts represented a classic case of a shareholder so dominating corporate affairs such that the corporation and the shareholder did not appear to have separate identities.

Therefore, the Service could pierce the corporate veil and look to the personal assets of the sole shareholder for payment of the taxes. Further, neither economic difficulties nor employee's illness constituted reasonable cause for failure to file or pay tax.

American Bantam Car Company v. CIR, 11 T.C. 397 (1948), aff'd. per curiam 177 F.2d 513 (3rd Cir., 1949).

This is a leading case in the determination of whether a transfer to a corporation is a tax-free transfer to a controlled corporation under the Code Sec. 351. This case is based on Section 112(b)(5) of the Revenue Act of 1936, the precursor of Code Sec. 351.

In this case, property was transferred to the newly formed American Bantam Car Company in exchange for stock of the corporation by three individuals, who immediately after the transfer owned greater than an 80% interest in the corporation. Subsequent to this transfer, the corporation entered into agreements with underwriters for the public offering of stock of the corporation, which if such offering had resulted in sufficient sales, would have reduced the interests of these three initial shareholders, based on the voting rights endowed upon the stock in the articles of incorporation.

The issue before the court was whether these transactions were all part of an integrated plan, thereby eliminating tax-free exchange treatment under Section 112(b)(5) or whether they were actually separate transactions. The court looked at four factors in making their decision: 1) intent of the parties, 2) mutual interdependence of steps, 3) time element, and 4) ultimate result. There is a detailed analysis of each factor and a summary of prior court cases in this case. The court held that the transactions were indeed separate and that the transfer of assets to the corporation

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should be treated as a tax-free exchange. Therefore, the basis of the assets for the corporation was their basis in the hands of the transferors on the date of the exchange.

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Melodic Musical Sales, Inc.
XX-2019017 2017 Form 1120

Notes to Instructor:

Instructors may want to simplify the tax return project by giving students some or all of the following information rather than having them calculate the items:

Current year depreciation on property placed in service before 2017:

Building ($1,000,000 x 0.02564)	$ 25,640
Equipment 1 ($200,000 x 0.1249 x 0.5)	12,490
Equipment 2 ($400,000 x 0.1249)	49,960
Trucks ($100,000 x 0.192)	19,200
Total	$107,290

Current year depreciation on equipment placed in service in 2017:

Sec. 179 expensing	$500,000

Total current-year depreciation	$607,290

Capital gains and losses for 2017:

Short-term capital gain on sale of PDQ stock	$ 30,000
Long-term capital loss on sale of JSB stock	(7,000)

Sale of Equipment 1:

Selling price		$230,000
Cost	$200,000	
Minus: Accumulated depreciation	(125,030)	
Adjusted basis		(74,970)
Gain recognized		$155,030
Sec. 1245 recapture		$125,030
Sec. 1231 gain		$ 30,000

Underpayment penalty:

Omit Form 2220 and just insert $4,087 penalty on Form 1120, Page 1, Line 33.

Schedule M-3:

Omit this schedule.

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

U.S. Corporation Income Tax Return

For calendar year 2017 or tax year beginning _____, 2017, ending _____, 20 ____

▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123

2017

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

TYPE OR PRINT

Name: Melodic Musical Sales, Inc.

Number, street, and room or suite no. If a P.O. box, see instructions.: 5500 Fourth Avenue

City or town, state, or province, country, and ZIP or foreign postal code: City, ST 98765

B Employer identification number: XX-2019017

C Date incorporated: 12/31/2013

D Total assets (see instructions): $ 6,507,398

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

Income	1a	Gross receipts or sales	1a	8,500,000		
	b	Returns and allowances	1b	212,500		
	c	Balance. Subtract line 1b from line 1a			1c	8,287,500
	2	Cost of goods sold (attach Form 1125-A)			2	3,825,000
	3	Gross profit. Subtract line 2 from line 1c			3	4,462,500
	4	Dividends (Schedule C, line 19)			4	10,200
	5	Interest			5	
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	43,000
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	125,030
	10	Other income (see instructions—attach statement)			10	
	11	**Total income.** Add lines 3 through 10 ▶			11	4,640,730
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ▶			12	552,500
	13	Salaries and wages (less employment credits)			13	340,000
	14	Repairs and maintenance			14	17,680
	15	Bad debts			15	34,000
	16	Rents			16	
	17	Taxes and licenses			17	116,450
	18	Interest			18	178,500
	19	Charitable contributions			19	25,500
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	607,290
	21	Depletion			21	
	22	Advertising			22	40,800
	23	Pension, profit-sharing, etc., plans			23	
	24	Employee benefit programs			24	
	25	Domestic production activities deduction (attach Form 8903)			25	
	26	Other deductions (attach statement)			26	150,450
	27	**Total deductions.** Add lines 12 through 26 ▶			27	2,063,170
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	2,577,560
	29a	Net operating loss deduction (see instructions)	29a			
	b	Special deductions (Schedule C, line 20)	29b	7,140		
	c	Add lines 29a and 29b			29c	7,140
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28. See instructions			30	2,570,420
	31	Total tax (Schedule J, Part I, line 11)			31	873,943
	32	Total payments and refundable credits (Schedule J, Part II, line 21)			32	770,000
	33	Estimated tax penalty. See instructions. Check if Form 2220 is attached ▶ ☑			33	4,087
	34	**Amount owed.** If line 32 is smaller than the total of lines 31 and 33, enter amount owed			34	108,030
	35	**Overpayment.** If line 32 is larger than the total of lines 31 and 33, enter amount overpaid			35	
	36	Enter amount from line 35 you want: **Credited to 2018 estimated tax** ▶ **Refunded** ▶			36	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Mary Travis — Signature of officer | 4/14/18 — Date | ▶ President — Title

May the IRS discuss this return with the preparer shown below? See instructions. ☐ Yes ☐ No

Paid Preparer Use Only

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

Firm's name ▶ | Firm's EIN ▶

Firm's address ▶ | Phone no.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2017)

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Form 1120 (2017) Page **2**

Schedule C	**Dividends and Special Deductions** (see instructions)	(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)	10,200	70	7,140
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Total.** Add lines 1 through 8. See instructions for limitation			7,140
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Dividends from foreign corporations not included on line 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on line 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on page 1, line 4 ▶	10,200		
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			7,140

Form **1120** (2017)

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Schedule J Tax Computation and Payment (see instructions)

Part I–Tax Computation

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)). See instructions ▶ ☐				
2	Income tax. Check if a qualified personal service corporation. See instructions ▶ ☐			2	873,943
3	Alternative minimum tax (attach Form 4626)			3	
4	Add lines 2 and 3			4	873,943
5a	Foreign tax credit (attach Form 1118)	5a			
b	Credit from Form 8834 (see instructions)	5b			
c	General business credit (attach Form 3800)	5c			
d	Credit for prior year minimum tax (attach Form 8827)	5d			
e	Bond credits from Form 8912	5e			
6	**Total credits.** Add lines 5a through 5e			6	
7	Subtract line 6 from line 4			7	873,943
8	Personal holding company tax (attach Schedule PH (Form 1120))			8	
9a	Recapture of investment credit (attach Form 4255)	9a			
b	Recapture of low-income housing credit (attach Form 8611)	9b			
c	Interest due under the look-back method—completed long-term contracts (attach Form 8697)	9c			
d	Interest due under the look-back method—income forecast method (attach Form 8866)	9d			
e	Alternative tax on qualifying shipping activities (attach Form 8902)	9e			
f	Other (see instructions—attach statement)	9f			
10	**Total.** Add lines 9a through 9f			10	
11	**Total tax.** Add lines 7, 8, and 10. Enter here and on page 1, line 31			11	873,943

Part II–Payments and Refundable Credits

12	2016 overpayment credited to 2017			12	
13	2017 estimated tax payments			13	770,000
14	2017 refund applied for on Form 4466			14	( )
15	Combine lines 12, 13, and 14			15	770,000
16	Tax deposited with Form 7004			16	
17	Withholding (see instructions)			17	
18	**Total payments.** Add lines 15, 16, and 17			18	770,000
19	Refundable credits from:				
a	Form 2439	19a			
b	Form 4136	19b			
c	Form 8827, line 8c	19c			
d	Other (attach statement—see instructions)	19d			
20	**Total credits.** Add lines 19a through 19d			20	
21	**Total payments and credits.** Add lines 18 and 20. Enter here and on page 1, line 32			21	770,000

Schedule K Other Information (see instructions)

		Yes	No
1	Check accounting method: a ☐ Cash b ☑ Accrual c ☐ Other (specify) ▶		
2	See the instructions and enter the:		
a	Business activity code no. ▶ 451140		
b	Business activity ▶ Retail sales		
c	Product or service ▶ Musical instruments		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? If "Yes," enter name and EIN of the parent corporation ▶		✓
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		✓
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G)*	✓	

*Schedule G is not attached. If attached, it would show the same information as shown on Form 1125-E.

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Schedule K **Other Information** *(continued from page 3)*

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

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

b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below.		✓

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

6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? See sections 301 and 316		✓
	If "Yes," file **Form 5452,** Corporate Report of Nondividend Distributions. See the instructions for Form 5452. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.		
7	At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of the total voting power of all classes of the corporation's stock entitled to vote or at least 25% of the total value of all classes of the corporation's stock?		✓
	For rules of attribution, see section 318. If "Yes," enter: **(a)** Percentage owned ► _____ and **(b)** Owner's country ► _____ **(c)** The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ► _____		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount ► ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
9	Enter the amount of tax-exempt interest received or accrued during the tax year ► $ 4,250		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ► 3		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here ► ☐ If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.		
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction reported on page 1, line 29a.) ► $ N/A		
13	Are the corporation's total receipts (page 1, line 1a, plus lines 4 through 10) for the tax year **and** its total assets at the end of the tax year less than $250,000?		✓
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year ► $ _____		
14	Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement? See instructions		✓
	If "Yes," complete and attach Schedule UTP.		
15a	Did the corporation make any payments in 2017 that would require it to file Form(s) 1099?		✓
b	If "Yes," did or will the corporation file required Forms 1099?		
16	During this tax year, did the corporation have an 80% or more change in ownership, including a change due to redemption of its own stock?		✓
17	During or subsequent to this tax year, but before the filing of this return, did the corporation dispose of more than 65% (by value) of its assets in a taxable, non-taxable, or tax deferred transaction?		✓
18	Did the corporation receive assets in a section 351 transfer in which any of the transferred assets had a fair market basis or fair market value of more than $1 million?		✓
19	During the corporation's tax year, did the corporation make any payments that would require it to file Forms 1042 and 1042-S under chapter 3 (sections 1441 through 1464) or chapter 4 (sections 1471 through 1474) of the Code?		✓

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Schedule L Balance Sheets per Books

		Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
	Assets				
1	Cash		469,491		953,648
2a	Trade notes and accounts receivable	340,000		425,000	
b	Less allowance for bad debts	(17,000)	323,000	(21,250)	403,750
3	Inventories		2,125,000		2,975,000
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)		30,000		30,000
6	Other current assets (attach statement)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)		262,000		50,000
10a	Buildings and other depreciable assets	1,700,000		2,000,000	
b	Less accumulated depreciation	(230,000)	1,470,000	(285,000)	1,715,000
11a	Depletable assets				
b	Less accumulated depletion	( )		( )	
12	Land (net of any amortization)		300,000		300,000
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	( )		( )	
14	Other assets (attach statement)		60,000		80,000
15	Total assets		5,039,491		6,507,398
	Liabilities and Shareholders' Equity				
16	Accounts payable		300,000		270,000
17	Mortgages, notes, bonds payable in less than 1 year		700,000		560,000
18	Other current liabilities (attach statement)		18,598		126,128
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more		1,400,000		900,000
21	Other liabilities (attach statement)		70,893		134,719
22	Capital stock: a Preferred stock				
	b Common stock	850,000	850,000	850,000	850,000
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach statement)				
25	Retained earnings—Unappropriated		1,700,000		3,666,551
26	Adjustments to shareholders' equity (attach statement)				
27	Less cost of treasury stock		( )		( )
28	Total liabilities and shareholders' equity		5,039,491		6,507,398

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

Note: The corporation may be required to file Schedule M-3. See instructions.

1	Net income (loss) per books	2,051,551	7	Income recorded on books this year not included on this return (itemize): Tax-exempt interest $ 4,250	4,250
2	Federal income tax per books	937,769			
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize): Gain on equip. (155,030 – 90,000)	65,030	8	Deductions on this return not charged against book income this year (itemize): a Depreciation $ 492,290; b Charitable contributions $ Cap.loss C/O 10,000	502,290
5	Expenses recorded on books this year not deducted on this return (itemize): a Depreciation $; b Charitable contributions $; c Travel and entertainment $ See schedule	29,750	9	Add lines 7 and 8	506,540
6	Add lines 1 through 5	3,084,100	10	Income (page 1, line 28)—line 6 less line 9	2,577,560

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

1	Balance at beginning of year	1,700,000	5	Distributions: a Cash	85,000
2	Net income (loss) per books	2,051,551		b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	
			7	Add lines 5 and 6	85,000
4	Add lines 1, 2, and 3	3,751,551	8	Balance at end of year (line 4 less line 7)	3,666,551

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SCHEDULE D (Form 1120)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

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

▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123

2017

Name: Melodic Musical Sales, Inc.

Employer identification number: XX-2019017

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

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked	125,000	95,000		30,000

4 Short-term capital gain from installment sales from Form 6252, line 26 or 37	4	
5 Short-term capital gain or (loss) from like-kind exchanges from Form 8824	5	
6 Unused capital loss carryover (attach computation)	6	(10,000)
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column h	7	20,000

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

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked	110,000	117,000		(7,000)

11 Enter gain from Form 4797, line 7 or 9	11	30,000
12 Long-term capital gain from installment sales from Form 6252, line 26 or 37	12	
13 Long-term capital gain or (loss) from like-kind exchanges from Form 8824	13	
14 Capital gain distributions (see instructions)	14	
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column h	15	23,000

Part III Summary of Parts I and II

16 Enter excess of net short-term capital gain (line 7) over net long-term capital loss (line 15)	16	20,000
17 Net capital gain. Enter excess of net long-term capital gain (line 15) over net short-term capital loss (line 7)	17	23,000
18 Add lines 16 and 17. Enter here and on Form 1120, page 1, line 8, or the proper line on other returns. If the corporation has qualified timber gain, also complete Part IV	18	43,000

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

For Paperwork Reduction Act Notice, see the Instructions for Form 1120. Cat. No. 11460M **Schedule D (Form 1120) 2017**

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Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ Go to *www.irs.gov/Form8949* for instructions and the latest information.

▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074

2017

Attachment Sequence No. **12A**

Name(s) shown on return: Melodic Musical Sales, Inc.

Social security number or taxpayer identification number: XX-2019017

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either may show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are short term. For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)

☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS

☑ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss).** Subtract column (e) from column (d) and combine the result with column (g)
100 shares PDQ Corp.	12/15/16	10/7/17	125,000	95,000			30,000
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 1b** (if **Box A** above is checked), **line 2** (if **Box B** above is checked), or **line 3** (if **Box C** above is checked) ▶			125,000	95,000			30,000

Note: If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37768Z Form **8949** (2017)

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Form 8949 (2017) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side	Social security number or taxpayer identification number
Melodic Musical Sales, Inc.	XX-2019017

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are long term. For short-term transactions, see page 1.

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☐ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- ☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
- ☑ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss).** Subtract column (e) from column (d) and combine the result with column (g)
75 shares JSB Corp.	9/18/15	6/17/17	110,000	117,000			(7,000)
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) ▶			110,000	117,000			(7,000)

Note: If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2017)

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SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

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

▶ Attach to Form 1120 or 1120-C.
▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123

2017

Name of corporation (common parent, if consolidated return): Melodic Musical Sales, Inc.

Employer identification number: XX-2019017

Check applicable box(es): (1) ☑ Non-consolidated return (2) ☐ Consolidated return (Form 1120 only)
(3) ☐ Mixed 1120/L/PC group (4) ☐ Dormant subsidiaries schedule attached

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

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

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

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

2a Enter the income statement period: Beginning 01/01/2017 Ending 12/31/2017

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

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

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

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

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

4a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4a	2,051,551
b	Indicate accounting standard used for line 4a (see instructions): (1) ☑ GAAP (2) ☐ IFRS (3) ☐ Statutory (4) ☐ Tax-basis (5) ☐ Other (specify)		
5a	Net income from nonincludible foreign entities (attach statement)	5a	( )
b	Net loss from nonincludible foreign entities (attach statement and enter as a positive amount)	5b	
6a	Net income from nonincludible U.S. entities (attach statement)	6a	( )
b	Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	6b	
7a	Net income (loss) of other includible foreign disregarded entities (attach statement)	7a	
b	Net income (loss) of other includible U.S. disregarded entities (attach statement)	7b	
c	Net income (loss) of other includible entities (attach statement)	7c	
8	Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	8	
9	Adjustment to reconcile income statement period to tax year (attach statement)	9	
10a	Intercompany dividend adjustments to reconcile to line 11 (attach statement)	10a	
b	Other statutory accounting adjustments to reconcile to line 11 (attach statement)	10b	
c	Other adjustments to reconcile to amount on line 11 (attach statement)	10c	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10	11	2,051,551

Note: Part I, line 11, must equal Part II, line 30, column (a) or Schedule M-1, line 1 (see instructions).

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

		Total Assets	Total Liabilities
a	Included on Part I, line 4 ▶	6,507,398	1,990,847
b	Removed on Part I, line 5 ▶		
c	Removed on Part I, line 6 ▶		
d	Included on Part I, line 7 ▶		

For Paperwork Reduction Act Notice, see the Instructions for Form 1120. Cat. No. 37961C **Schedule M-3 (Form 1120) 2017**

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Schedule M-3 (Form 1120) 2017 Page **2**

Name of corporation (common parent, if consolidated return): Melodic Musical Sales, Inc.

Employer identification number: XX-2019017

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

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

Name of subsidiary (if consolidated return):

Employer identification number:

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

Income (Loss) Items (Attach statements for lines 1 through 12)	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1 Income (loss) from equity method foreign corporations				
2 Gross foreign dividends not previously taxed				
3 Subpart F, QEF, and similar income inclusions				
4 Section 78 gross-up				
5 Gross foreign distributions previously taxed				
6 Income (loss) from equity method U.S. corporations				
7 U.S. dividends not eliminated in tax consolidation	10,200			10,200
8 Minority interest for includible corporations				
9 Income (loss) from U.S. partnerships				
10 Income (loss) from foreign partnerships				
11 Income (loss) from other pass-through entities				
12 Items relating to reportable transactions				
13 Interest income (see instructions)[a]	4,250		(4,250)	
14 Total accrual to cash adjustment				
15 Hedging transactions				
16 Mark-to-market income (loss)				
17 Cost of goods sold (see instructions)	(3,825,000)			(3,825,000)
18 Sale versus lease (for sellers and/or lessors)				
19 Section 481(a) adjustments				
20 Unearned/deferred revenue				
21 Income recognition from long-term contracts				
22 Original issue discount and other imputed interest				
23a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities[b]	113,000	(113,000)		
b Gross capital gains from Schedule D, excluding amounts from pass-through entities		60,000		60,000
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses		(7,000)		(7,000)
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses		125,030		125,030
e Abandonment losses				
f Worthless stock losses (attach statement)				
g Other gain/loss on disposition of assets other than inventory				
24 Capital loss limitation and carryforward used		(10,000)		(10,000)
25 Other income (loss) items with differences (attach statement)				
26 **Total income (loss) items.** Combine lines 1 through 25	(3,697,550)	55,030	(4,250)	(3,646,770)
27 **Total expense/deduction items** (from Part III, line 38)	(1,384,269)	(488,040)	963,269	(909,040)
28 Other items with no differences	7,133,370			7,133,370
29a Mixed groups, see instructions. All others, combine lines 26 through 28	2,051,551	(433,010)	959,019	2,577,560
b PC insurance subgroup reconciliation totals				
c Life insurance subgroup reconciliation totals				
30 **Reconciliation totals.** Combine lines 29a through 29c	2,051,551	(433,010)	959,019	2,577,560

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

[a]Tax-exempt interest.

[b]$90,000 equipment gain + $23,000 net stock gain.

Schedule M-3 (Form 1120) 2017

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Schedule M-3 (Form 1120) 2017 Page 3

Name of corporation (common parent, if consolidated return): Melodic Musical Sales, Inc.

Employer identification number: XX-2019017

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

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

Name of subsidiary (if consolidated return):

Employer identification number:

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

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense	873,943		(873,943)	
2 U.S. deferred income tax expense*	63,826		(63,826)	
3 State and local current income tax expense	63,750			63,750
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Foreign withholding taxes				
8 Interest expense (see instructions)	178,500			178,500
9 Stock option expense				
10 Other equity-based compensation				
11 Meals and entertainment				
12 Fines and penalties				
13 Judgments, damages, awards, and similar costs				
14 Parachute payments				
15 Compensation with section 162(m) limitation				
16 Pension and profit-sharing				
17 Other post-retirement benefits				
18 Deferred compensation				
19 Charitable contribution of cash and tangible property	25,500			25,500
20 Charitable contribution of intangible property				
21 Charitable contribution limitation/carryforward				
22 Domestic production activities deduction				
23 Current year acquisition or reorganization investment banking fees				
24 Current year acquisition or reorganization legal and accounting fees				
25 Current year acquisition/reorganization other costs				
26 Amortization/impairment of goodwill				
27 Amortization of acquisition, reorganization, and start-up costs				
28 Other amortization or impairment write-offs				
29 Reserved				
30 Depletion				
31 Depreciation	115,000	492,290		607,290
32 Bad debt expense	38,250	(4,250)		34,000
33 Corporate owned life insurance premiums	25,500		(25,500)	
34 Purchase versus lease (for purchasers and/or lessees)				
35 Research and development costs				
36 Section 118 exclusion (attach statement)				
37 Other expense/deduction items with differences (attach statement)				
38 **Total expense/deduction items.** Combine lines 1 through 37. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive	1,384,269	488,040	(963,269)	909,040

Schedule M-3 (Form 1120) 2017

* $937,769 FIT expense per books – $873,943 total tax liability (ignoring penalty).

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Form **1125-A**

(Rev. October 2016)

Department of the Treasury
Internal Revenue Service

Cost of Goods Sold

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

OMB No. 1545-0123

Name: Melodic Musical Sales, Inc.

Employer identification number: XX-2019017

1	Inventory at beginning of year	1	2,125,000	
2	Purchases	2	4,675,000	
3	Cost of labor	3		
4	Additional section 263A costs (attach schedule)	4		
5	Other costs (attach schedule)	5		
6	**Total.** Add lines 1 through 5	6	6,800,000	
7	Inventory at end of year	7	2,975,000	
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return. See instructions	8	3,825,000	

9a Check all methods used for valuing closing inventory:

(i) ☐ Cost

(ii) ☑ Lower of cost or market

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

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

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

d If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO **9d**

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

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

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Purpose of Form

Use Form 1125-A to calculate and deduct cost of goods sold for certain entities.

Who Must File

Filers of Form 1120, 1120-C, 1120-F, 1120S, 1065, or 1065-B, must complete and attach Form 1125-A if the applicable entity reports a deduction for cost of goods sold.

Inventories

Generally, inventories are required at the beginning and end of each tax year if the production, purchase, or sale of merchandise is an income-producing factor. See Regulations section 1.471-1. If inventories are required, you generally must use an accrual method of accounting for sales and purchases of inventory items.

Exception for certain taxpayers. If you are a qualifying taxpayer or a qualifying small business taxpayer (defined below), you can adopt or change your accounting method to account for inventoriable items in the same manner as materials and supplies that are not incidental.

Under this accounting method, inventory costs for raw materials purchased for use in producing finished goods and merchandise purchased for resale are deductible in the year the finished goods or merchandise are sold (but not before the year you paid for the raw materials or merchandise, if you are also using the cash method).

If you account for inventoriable items in the same manner as materials and supplies that are not incidental, you can currently deduct expenditures for direct labor and all indirect costs that would otherwise be included in inventory costs. See the instructions for lines 2 and 7.

For additional guidance on this method of accounting, see Pub. 538, Accounting Periods and Methods. For guidance on adopting or changing to this method of accounting, see Form 3115, Application for Change in Accounting Method, and its instructions.

Qualifying taxpayer. A qualifying taxpayer is a taxpayer that, (a) for each prior tax year ending after December 16, 1998, has average annual gross receipts of $1 million or less for the 3 prior tax years and (b) its business is not a tax shelter (as defined in section 448(d)(3)). See Rev. Proc. 2001-10, 2001-2 I.R.B. 272.

Qualifying small business taxpayer. A qualifying small business taxpayer is a taxpayer that, (a) for each prior tax year ending on or after December 31, 2000, has average annual gross receipts of $10 million or less for the 3 prior tax years, (b) whose principal business activity is not an ineligible activity, and (c) whose business is not a tax shelter (as defined in section 448 (d)(3)). See Rev. Proc. 2002-28, 2002-18 I.R.B. 815.

Uniform capitalization rules. The uniform capitalization rules of section 263A generally require you to capitalize, or include in inventory, certain costs incurred in connection with the following.

- The production of real property and tangible personal property held in inventory or held for sale in the ordinary course of business.
- Real property or personal property (tangible and intangible) acquired for resale.
- The production of real property and tangible personal property by a corporation for use in its trade or business or in an activity engaged in for profit.

See the discussion on section 263A uniform capitalization rules in the instructions for your tax return before completing Form 1125-A. Also see Regulations sections 1.263A-1 through 1.263A-3. See Regulations section 1.263A-4 for rules for property produced in a farming business.

For Paperwork Reduction Act Notice, see instructions. Cat. No. 55988R Form **1125-A** (Rev. 10-2016)

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Form **1125-E**
(Rev. October 2016)
Department of the Treasury
Internal Revenue Service

Compensation of Officers

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

OMB No. 1545-0123

Name: Melodic Musical Sales, Inc.

Employer identification number: XX-2019017

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

(a) Name of officer	(b) Social security number (see instructions)	(c) Percent of time devoted to business	Percent of stock owned (d) Common	Percent of stock owned (e) Preferred	(f) Amount of compensation
1 Mary Travis	XXX-XX-XXXX	100 %	50 %	%	246,500
John Willis	XXX-XX-XXXX	100 %	25 %	%	153,000
Chris Parker	XXX-XX-XXXX	100 %	25 %	%	153,000
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
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		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	

2	Total compensation of officers	2	552,500
3	Compensation of officers claimed on Form 1125-A or elsewhere on return	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1120, page 1, line 12 or the appropriate line of your tax return	4	552,500

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 55989C Form **1125-E** (Rev. 10-2016)

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Form **2220**

Department of the Treasury
Internal Revenue Service

Underpayment of Estimated Tax by Corporations

▶ Attach to the corporation's tax return.
▶ Go to *www.irs.gov/Form2220* for instructions and the latest information.

OMB No. 1545-0123

2017

Name: Melodic Musical Sales, Inc.

Employer identification number: XX-2019017

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

Part I Required Annual Payment

1	Total tax (see instructions)			1	873,943
2a	Personal holding company tax (Schedule PH (Form 1120), line 26) included on line 1	2a			
b	Look-back interest included on line 1 under section 460(b)(2) for completed long-term contracts or section 167(g) for depreciation under the income forecast method	2b			
c	Credit for federal tax paid on fuels (see instructions)	2c			
d	**Total.** Add lines 2a through 2c			2d	
3	Subtract line 2d from line 1. If the result is less than $500, **do not** complete or file this form. The corporation doesn't owe the penalty			3	873,943
4	Enter the tax shown on the corporation's 2016 income tax return. See instructions. **Caution: If the tax is zero or the tax year was for less than 12 months, skip this line and enter the amount from line 3 on line 5**			4	476,000
5	**Required annual payment.** Enter the **smaller** of line 3 or line 4. If the corporation is required to skip line 4, enter the amount from line 3			5	476,000

Part II Reasons for Filing—Check the boxes below that apply. If any boxes are checked, the corporation **must** file Form 2220 even if it doesn't owe a penalty. See instructions.

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

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

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

Part III Figuring the Underpayment

			(a)	(b)	(c)	(d)
9	**Installment due dates.** Enter in columns (a) through (d) the 15th day of the 4th (***Form 990-PF filers:*** Use 5th month), 6th, 9th, and 12th months of the corporation's tax year	9	4/15/17	6/15/17	9/15/17	12/15/17
10	**Required installments.** If the box on line 6 and/or line 7 above is checked, enter the amounts from Schedule A, line 38. If the box on line 8 (but not 6 or 7) is checked, see instructions for the amounts to enter. If none of these boxes are checked, enter 25% (0.25) of line 5 above in each column	10	119,000	317,971	218,486	218,486
11	Estimated tax paid or credited for each period. For column (a) only, enter the amount from line 11 on line 15. See instructions.	11	100,000	200,000	235,000	235,000
	Complete lines 12 through 18 of one column before going to the next column.					
12	Enter amount, if any, from line 18 of the preceding column	12				
13	Add lines 11 and 12	13		200,000	235,000	235,000
14	Add amounts on lines 16 and 17 of the preceding column	14		19,000	136,971	120,457
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	100,000	181,000	98,029	114,543
16	If the amount on line 15 is zero, subtract line 13 from line 14. Otherwise, enter -0-	16		0	0	
17	**Underpayment.** If line 15 is less than or equal to line 10, subtract line 15 from line 10. Then go to line 12 of the next column. Otherwise, go to line 18	17	19,000	136,971	120,457	103,943
18	**Overpayment.** If line 10 is less than line 15, subtract line 10 from line 15. Then go to line 12 of the next column	18				

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

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11746L Form **2220** (2017)

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Part IV Figuring the Penalty

			(a)	(b)	(c)	(d)
19	Enter the date of payment or the 15th day of the 4th month after the close of the tax year, whichever is earlier. ***(C Corporations with tax years ending June 30 and S corporations:*** Use 3rd month instead of 4th month. ***Form 990-PF and Form 990-T filers:*** Use 5th month instead of 4th month.) See instructions	19	6/15/17	9/15/17	12/15/17	3/15/18
20	Number of days from due date of installment on line 9 to the date shown on line 19	20	61	92	91	121
21	Number of days on line 20 after 4/15/2017 and before 7/1/2017	21	61	15		
22	Underpayment on line 17 × Number of days on line 21 / 365 × 4% (0.04)	22	$ 127	$ 225	$	$
23	Number of days on line 20 after 6/30/2017 and before 10/1/2017	23		77	15	
24	Underpayment on line 17 × Number of days on line 23 / 365 × 4% (0.04)	24	$	$ 1,156	$ 198	$
25	Number of days on line 20 after 9/30/2017 and before 1/1/2018	25			76	16
26	Underpayment on line 17 × Number of days on line 25 / 365 × 4% (0.04)	26	$	$	$ 1,003	$ 182
27	Number of days on line 20 after 12/31/2017 and before 4/1/2018	27				90
28	Underpayment on line 17 × Number of days on line 27 / 365 × 4% (0.04)	28	$	$	$	$ 1,025
29	Number of days on line 20 after 3/31/2018 and before 7/1/2018	29				15
30	Underpayment on line 17 × Number of days on line 29 / 365 × *%	30	$	$	$	$ 171
31	Number of days on line 20 after 6/30/2018 and before 10/1/2018	31				
32	Underpayment on line 17 × Number of days on line 31 / 365 × *%	32	$	$	$	$
33	Number of days on line 20 after 9/30/2018 and before 1/1/2019	33				
34	Underpayment on line 17 × Number of days on line 33 / 365 × *%	34	$	$	$	$
35	Number of days on line 20 after 12/31/2018 and before 3/16/2019	35				
36	Underpayment on line 17 × Number of days on line 35 / 365 × *%	36	$	$	$	$
37	Add lines 22, 24, 26, 28, 30, 32, 34, and 36	37	$ 127	$ 1,381	$ 1,201	$ 1,378
38	**Penalty.** Add columns (a) through (d) of line 37. Enter the total here and on Form 1120, line 33; or the comparable line for other income tax returns	38	$ 4,087			

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

*The rate for the first quarter of 2018 is 4%.

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Form **4562**

Department of the Treasury
Internal Revenue Service (99)

Depreciation and Amortization

(Including Information on Listed Property)

▶ Attach to your tax return.

▶ Go to *www.irs.gov/Form4562* for instructions and the latest information.

OMB No. 1545-0172

2017

Attachment Sequence No. **179**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Melodic Musical Sales, Inc.	Retail Sales	XX-2019017

Part I **Election To Expense Certain Property Under Section 179**

Note: If you have any listed property, complete Part V before you complete Part I.

1	Maximum amount (see instructions)	1	510,000
2	Total cost of section 179 property placed in service (see instructions)	2	500,000
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	2,030,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	510,000

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
	Equipment	500,000	500,000

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	500,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	500,000
10	Carryover of disallowed deduction from line 13 of your 2016 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	510,000
12	Section 179 expense deduction. Add lines 9 and 10, but don't enter more than line 11	12	500,000
13	Carryover of disallowed deduction to 2018. Add lines 9 and 10, less line 12 ▶	13	

Note: Don't use Part II or Part III below for listed property. Instead, use Part V.

Part II **Special Depreciation Allowance and Other Depreciation (Don't** include listed property.**)** (See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III **MACRS Depreciation (Don't** include listed property.**)** (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2017	17	107,290
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2017 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property						
h Residential rental property						
i Nonresidential real property						

Section C—Assets Placed in Service During 2017 Tax Year Using the Alternative Depreciation System

20a Class life						
b 12-year						
c 40-year						

Part IV **Summary** (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	607,290
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2017)

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Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ **Attach to your tax return.**
▶ **Go to *www.irs.gov/Form4797* for instructions and the latest information.**

OMB No. 1545-0184

2017

Attachment Sequence No. **27**

Name(s) shown on return: Melodic Musical Sales, Inc.

Identifying number: XX-2019017

1	Enter the gross proceeds from sales or exchanges reported to you for 2017 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft.	6	30,000
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	30,000
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. **Individuals, partners, S corporation shareholders, and all others.** If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	125,030
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824.	16	
17	Combine lines 10 through 16	17	125,030
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	

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Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Equipment 1	1/2/14	10/16/17
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	230,000			
21 Cost or other basis plus expense of sale	21	200,000			
22 Depreciation (or depletion) allowed or allowable	22	125,030			
23 Adjusted basis. Subtract line 22 from line 21	23	74,970			
24 Total gain. Subtract line 23 from line 20	24	155,030			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	125,030			
b Enter the **smaller** of line 24 or 25a	25b	125,030			
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975. See instructions	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage. See instructions	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	155,030
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	125,030
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	30,000

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

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Melodic Musical Sales, Inc.
XX-2019017 2017 Form 1120

Page 1, Line 17 - Taxes and licenses:

Payroll tax	$ 52,700
State income tax	63,750
Total	$116,450

Page 1, Line 26 - Other deductions:

General insurance	$ 46,750
Utilities	61,200
Legal and accounting fees	42,500
Total	$150,450

Schedule L, Line 14 - Other assets:	**Beginning**	**Ending**
Cash surrender value	$60,000	$80,000

Schedule L, Line 18 - Other current liabilities:	**Beginning**	**Ending**
Accrued payroll taxes	$12,648	$ 15,810
Accrued state income taxes	3,825	6,375
Accrued federal income taxes	2,125	103,943
Total	$18,598	$126,128

Schedule L, Line 21 - Other liabilities:	**Beginning**	**Ending**
Net deferred tax liability	$70,893	$134,719

Schedule M-1, Line 5 - Expenses recorded on books, not deducted:

Premiums - Officers' life insurance	$25,500
Bad debt expense ($38,250 – $34,000)	4,250
Total	$29,750

Form 4562, Part III, Line 17 - MACRS deductions for property placed in service before 2017:

Building ($1,000,000 x 0.02564)	$ 25,640
Equipment 1 ($200,000 x 0.1249 x 0.5)	12,490
Equipment 2 ($400,000 x 0.1249)	49,960
Trucks ($100,000 x 0.192)	19,200
Total	$107,290

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

U.S. Corporation Income Tax Return

For calendar year 2016 or tax year beginning _____, 2016, ending _____, 20 ____

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

OMB No. 1545-0123

2016

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

TYPE OR PRINT

Name: Permtemp Corporation

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state, or province, country and ZIP or foreign postal code

B Employer identification number

C Date incorporated: 2016

D Total assets (see instructions): $ 16,716,750

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

Income	1a	Gross receipts or sales	1a 20,000,000		
	b	Returns and allowances	1b		
	c	Balance. Subtract line 1b from line 1a		1c	20,000,000
	2	Cost of goods sold (attach Form 1125-A)		2	15,000,000
	3	Gross profit. Subtract line 2 from line 1c		3	5,000,000
	4	Dividends (Schedule C, line 19)		4	50,000
	5	Interest		5	
	6	Gross rents		6	
	7	Gross royalties		7	
	8	Capital gain net income (attach Schedule D (Form 1120))		8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)		9	
	10	Other income (see instructions—attach statement)		10	
	11	**Total income.** Add lines 3 through 10 ▶		11	5,050,000
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ▶		12	
	13	Salaries and wages (less employment credits)		13	
	14	Repairs and maintenance		14	
	15	Bad debts		15	150,000
	16	Rents		16	
	17	Taxes and licenses		17	
	18	Interest		18	475,000
	19	Charitable contributions		19	
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)		20	1,400,000
	21	Depletion		21	
	22	Advertising		22	
	23	Pension, profit-sharing, etc., plans		23	
	24	Employee benefit programs		24	
	25	Domestic production activities deduction (attach Form 8903)		25	
	26	Other deductions (attach statement) Other $3,855,000 + M&E $22,500		26	3,877,500
	27	**Total deductions.** Add lines 12 through 26 ▶		27	5,902,500
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11		28	(852,500)
	29a	Net operating loss deduction (see instructions)	29a		
	b	Special deductions (Schedule C, line 20)	29b 35,000		
	c	Add lines 29a and 29b		29c	35,000
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28. See instructions		30	(887,500)
	31	Total tax (Schedule J, Part I, line 11)		31	0
	32	Total payments and refundable credits (Schedule J, Part II, line 21)		32	
	33	Estimated tax penalty. See instructions. Check if Form 2220 is attached ▶ ☐		33	
	34	**Amount owed.** If line 32 is smaller than the total of lines 31 and 33, enter amount owed		34	
	35	**Overpayment.** If line 32 is larger than the total of lines 31 and 33, enter amount overpaid		35	
	36	Enter amount from line 35 you want: **Credited to 2017 estimated tax** ▶	**Refunded** ▶	36	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer _____ Date _____ ▶ Title _____

May the IRS discuss this return with the preparer shown below? See instructions. ☐ Yes ☐ No

Paid Preparer Use Only

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

Firm's name ▶ | Firm's EIN ▶

Firm's address ▶ | Phone no.

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Schedule L Balance Sheets per Books	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
Assets				
1 Cash				500,000
2a Trade notes and accounts receivable			2,000,000	
b Less allowance for bad debts	( )		(250,000)	1,750,000
3 Inventories				4,000,000
4 U.S. government obligations				
5 Tax-exempt securities (see instructions)				50,000
6 Other current assets (attach statement) Net DTA*				216,750
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach statement)				1,000,000
10a Buildings and other depreciable assets			10,000,000	
b Less accumulated depreciation	( )		(800,000)	9,200,000
11a Depletable assets				
b Less accumulated depletion	( )		( )	
12 Land (net of any amortization)				
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (attach statement)				
15 Total assets				16,716,750
Liabilities and Shareholders' Equity				
16 Accounts payable				2,610,000
17 Mortgages, notes, bonds payable in less than 1 year				
18 Other current liabilities (attach statement)				
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more				8,500,000
21 Other liabilities (attach statement)				
22 Capital stock: a Preferred stock				
b Common stock			6,000,000	6,000,000
23 Additional paid-in capital				
24 Retained earnings—Appropriated (attach statement)				
25 Retained earnings—Unappropriated				(393,250)
26 Adjustments to shareholders' equity (attach statement)				
27 Less cost of treasury stock		( )		( )
28 Total liabilities and shareholders' equity				16,716,750

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

Note: The corporation may be required to file Schedule M-3 (see instructions).

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

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

1	Balance at beginning of year	0	5	Distributions: a Cash	
2	Net income (loss) per books	(393,250)		b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	
			7	Add lines 5 and 6	0
4	Add lines 1, 2, and 3	(393,350)	8	Balance at end of year (line 4 less line 7)	(393,250)

* $420,750 DTA – $204,000 DTL.

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SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

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

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

OMB No. 1545-0123

2016

Name of corporation (common parent, if consolidated return): Permtemp Corporation

Employer identification number:

Check applicable box(es): (1) ☑ Non-consolidated return (2) ☐ Consolidated return (Form 1120 only) (3) ☐ Mixed 1120/L/PC group (4) ☐ Dormant subsidiaries schedule attached

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

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

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

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

2a Enter the income statement period: Beginning 1/1/2016 Ending 12/31/2016

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

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

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

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

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

4a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4a	(393,250)
b	Indicate accounting standard used for line 4a (see instructions): (1) ☑ GAAP (2) ☐ IFRS (3) ☐ Statutory (4) ☐ Tax-basis (5) ☐ Other (specify)		
5a	Net income from nonincludible foreign entities (attach statement)	5a	( )
b	Net loss from nonincludible foreign entities (attach statement and enter as a positive amount)	5b	
6a	Net income from nonincludible U.S. entities (attach statement)	6a	( )
b	Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	6b	
7a	Net income (loss) of other includible foreign disregarded entities (attach statement)	7a	
b	Net income (loss) of other includible U.S. disregarded entities (attach statement)	7b	
c	Net income (loss) of other includible entities (attach statement)	7c	
8	Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	8	
9	Adjustment to reconcile income statement period to tax year (attach statement)	9	
10a	Intercompany dividend adjustments to reconcile to line 11 (attach statement)	10a	
b	Other statutory accounting adjustments to reconcile to line 11 (attach statement)	10b	
c	Other adjustments to reconcile to amount on line 11 (attach statement)	10c	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10	11	(393,250)

Note: Part I, line 11, must equal Part II, line 30, column (a) or Schedule M-1, line 1 (see instructions).

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

		Total Assets	Total Liabilities
a	Included on Part I, line 4 ▶	16,716,750	11,110,000
b	Removed on Part I, line 5 ▶		
c	Removed on Part I, line 6 ▶		
d	Included on Part I, line 7 ▶		

For Paperwork Reduction Act Notice, see the Instructions for Form 1120. Cat. No. 37961C **Schedule M-3 (Form 1120) 2016**

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Schedule M-3 (Form 1120) 2016 Page 2

Name of corporation (common parent, if consolidated return): Permtemp Corporation

Employer identification number:

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

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

Name of subsidiary (if consolidated return)

Employer identification number

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

Income (Loss) Items (Attach statements for lines 1 through 12)	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1 Income (loss) from equity method foreign corporations				
2 Gross foreign dividends not previously taxed				
3 Subpart F, QEF, and similar income inclusions				
4 Section 78 gross-up				
5 Gross foreign distributions previously taxed				
6 Income (loss) from equity method U.S. corporations				
7 U.S. dividends not eliminated in tax consolidation	50,000			50,000
8 Minority interest for includible corporations				
9 Income (loss) from U.S. partnerships				
10 Income (loss) from foreign partnerships				
11 Income (loss) from other pass-through entities				
12 Items relating to reportable transactions				
13 Interest income (see instructions) T-E interest	15,000		(15,000)	
14 Total accrual to cash adjustment				
15 Hedging transactions				
16 Mark-to-market income (loss)				
17 Cost of goods sold (see instructions)	(15,000,000)			(15,000,000)
18 Sale versus lease (for sellers and/or lessors)				
19 Section 481(a) adjustments				
20 Unearned/deferred revenue				
21 Income recognition from long-term contracts				
22 Original issue discount and other imputed interest				
23a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e Abandonment losses				
f Worthless stock losses (attach statement)				
g Other gain/loss on disposition of assets other than inventory				
24 Capital loss limitation and carryforward used				
25 Other income (loss) items with differences (attach statement)				
26 **Total income (loss) items.** Combine lines 1 through 25	(14,935,000)		(15,000)	(14,950,000)
27 **Total expense/deduction items** (from Part III, line 38)	(1,603,250)	(250,000)	(194,250)	(2,047,500)
28 Other items with no differences *	16,145,000			16,145,000
29a Mixed groups, see instructions. All others, combine lines 26 through 28	(393,250)	(250,000)	(209,250)	(852,500)
b PC insurance subgroup reconciliation totals				
c Life insurance subgroup reconciliation totals				
30 **Reconciliation totals.** Combine lines 29a through 29c	(393,250)	(250,000)	(209,250)	(852,500)

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

*Sales $20,000,000 - Other expenses $3,855,000

Schedule M-3 (Form 1120) 2016

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Name of corporation (common parent, if consolidated return): Permtemp Corporation

Employer identification number:

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

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

Name of subsidiary (if consolidated return):

Employer identification number:

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

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense				
2 U.S. deferred income tax expense	(216,750)		216,750	
3 State and local current income tax expense				
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Foreign withholding taxes				
8 Interest expense (see instructions)	475,000			475,000
9 Stock option expense				
10 Other equity-based compensation				
11 Meals and entertainment	45,000		(22,500)	22,500
12 Fines and penalties				
13 Judgments, damages, awards, and similar costs				
14 Parachute payments				
15 Compensation with section 162(m) limitation				
16 Pension and profit-sharing				
17 Other post-retirement benefits				
18 Deferred compensation				
19 Charitable contribution of cash and tangible property	100,000	(100,000)		
20 Charitable contribution of intangible property				
21 Charitable contribution limitation/carryforward				
22 Domestic production activities deduction				
23 Current year acquisition or reorganization investment banking fees				
24 Current year acquisition or reorganization legal and accounting fees				
25 Current year acquisition/reorganization other costs				
26 Amortization/impairment of goodwill				
27 Amortization of acquisition, reorganization, and start-up costs				
28 Other amortization or impairment write-offs				
29 Reserved				
30 Depletion				
31 Depreciation	800,000	600,000		1,400,000
32 Bad debt expense	400,000	(250,000)		150,000
33 Corporate owned life insurance premiums				
34 Purchase versus lease (for purchasers and/or lessees)				
35 Research and development costs				
36 Section 118 exclusion (attach statement)				
37 Other expense/deduction items with differences (attach statement)				
38 **Total expense/deduction items.** Combine lines 1 through 37. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive	1,603,250	250,000	194,250	2,047,500

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Permtemp Corporation
Deferred Tax Accounting 2016

Deferred Tax Asset:	End of 2016
Net operating loss	$ 887,500
Charitable contributions carryover	100,000
Net accounts receivable ($2,000,000 tax basis − $1,750,000 book basis)	250,000
Total	$1,237,500
Times: Tax rate	0.34
Deferred tax asset	$ 420,750

Deferred Tax Liability:	
Depreciation ($9,200,000 book basis − $8,600,000 tax basis)	$ 600,000
Times: Tax rate	0.34
Deferred tax liability	$ 204,000

Journal Entry:

Deferred tax asset	420,750	
Deferred tax liability		204,000
Federal income tax benefit		216,750

Adjusted Income Statement (Partial):

Net income before federal income taxes	$ (610,000)
Plus: Federal income tax benefit	216,750
Net loss per books	$ (393,250)
Effective tax rate [$(216,750)/$(610,000)]	35.53%

Tax Rate Reconciliation:

Statutory tax rate	34.00%
Nondeductible M&E expense [$22,500/($(610,000) x 34%)]	(1.25)%
Tax-exempt income [$(15,000)/$(610,000) x 34%]	0.83%
Dividends-received ded. [$(35,000)/$(610,000) x 34%]	1.95%
Effective tax rate	35.53%

Note: If this were the 2017 tax provision, the DTA, DTL, and tax rate reconciliation would be calculated using a 21% tax rate.

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Permtemp Corporation
Deferred Tax Accounting 2016

Provision Reconciliation:

Net income before federal income taxes	$ (610,000)
Permanent differences:	
Nondeductible M&E expense	22,500
Tax-exempt income	(15,000)
Dividends-received deduction	(35,000)
Net income after permanent differences	$ (637,500)
Temporary differences:	
Charitable contribution deduction	100,000
Bad debt expense	250,000
Depreciation	(600,000)
Net operating loss	$ (887,500)

Adjusted Book Balance Sheet:

Cash		$ 500,000
Accounts receivable	$ 2,000,000	
Allowance for doubtful accounts	(250,000)	1,750,000
Inventory		4,000,000
Net deferred tax asset ($420,750 - $204,000)		216,750
Fixed assets	$10,000,000	
Accumulated depreciation	(800,000)	9,200,000
Investment in corporate stock		1,000,000
Investment in tax-exempt bonds		50,000
Total assets		$16,716,750
Accounts payable		$ 2,610,000
Long-term debt		8,500,000
Common stock		6,000,000
Retained earnings		(393,250)
Total liabilities and equity		$16,716,750

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

U.S. Corporation Income Tax Return

For calendar year 2017 or tax year beginning _____, 2017, ending _____, 20 ____

▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123

2017

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

TYPE OR PRINT

Name: Permtemp Corporation

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state, or province, country, and ZIP or foreign postal code

B Employer identification number

C Date incorporated: 2016

D Total assets (see instructions): $ 20,425,000

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

Income	1a	Gross receipts or sales	1a	33,000,000		
	b	Returns and allowances	1b			
	c	Balance. Subtract line 1b from line 1a			1c	33,000,000
	2	Cost of goods sold (attach Form 1125-A)			2	22,000,000
	3	Gross profit. Subtract line 2 from line 1c			3	11,000,000
	4	Dividends (Schedule C, line 19)			4	55,000
	5	Interest			5	
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	
	10	Other income (see instructions—attach statement)			10	
	11	**Total income.** Add lines 3 through 10 ▶			11	11,055,000
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ▶			12	
	13	Salaries and wages (less employment credits)			13	
	14	Repairs and maintenance			14	
	15	Bad debts			15	425,000
	16	Rents			16	
	17	Taxes and licenses			17	
	18	Interest			18	455,000
	19	Charitable contributions			19	140,000
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	2,450,000
	21	Depletion			21	
	22	Advertising			22	
	23	Pension, profit-sharing, etc., plans			23	
	24	Employee benefit programs			24	
	25	Domestic production activities deduction (attach Form 8903)			25	
	26	Other deductions (attach statement) Other $4,675,500 + M&E $30,000			26	4,705,000
	27	**Total deductions.** Add lines 12 through 26 ▶			27	8,175,000
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	2,880,000
	29a	Net operating loss deduction (see instructions)	29a	887,500		
	b	Special deductions (Schedule C, line 20)	29b	38,500		
	c	Add lines 29a and 29b			29c	926,000
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28. See instructions			30	1,954,000
	31	Total tax (Schedule J, Part I, line 11)			31	664,360*
	32	Total payments and refundable credits (Schedule J, Part II, line 21)			32	
	33	Estimated tax penalty. See instructions. Check if Form 2220 is attached ▶ ☐			33	
	34	**Amount owed.** If line 32 is smaller than the total of lines 31 and 33, enter amount owed			34	
	35	**Overpayment.** If line 32 is larger than the total of lines 31 and 33, enter amount overpaid			35	
	36	Enter amount from line 35 you want: **Credited to 2018 estimated tax** ▶		**Refunded** ▶	36	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer _____ Date _____ ▶ Title _____

May the IRS discuss this return with the preparer shown below? See instructions. ☐ **Yes** ☐ **No**

Paid Preparer Use Only

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

Firm's name ▶ | Firm's EIN ▶

Firm's address ▶ | Phone no.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2017)

*In 2018, the tax rate will be 21% instead of 34%.

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Schedule L Balance Sheets per Books

		Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
	Assets				
1	Cash		500,000		2,125,000
2a	Trade notes and accounts receivable	2,000,000		3,300,000	
b	Less allowance for bad debts	(250,000)	1,750,000	(450,000)	2,850,000
3	Inventories		4,000,000		6,000,000
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)		50,000		50,000
6	Other current assets (attach statement) Net DTA[a]		216,750		
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)		1,000,000		1,000,000
10a	Buildings and other depreciable assets	10,000,000		10,000,000	
b	Less accumulated depreciation	(800,000)	9,200,000	(1,600,000)	8,400,000
11a	Depletable assets				
b	Less accumulated depletion	( )		( )	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	( )		( )	
14	Other assets (attach statement)				
15	Total assets		16,716,750		20,425,000
	Liabilities and Shareholders' Equity				
16	Accounts payable		2,610,000		2,120,000
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach statement) Taxes payable				664,360
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more		8,500,000		8,500,000
21	Other liabilities (attach statement) Net DTL[b]				378,000
22	Capital stock: a Preferred stock				
	b Common stock	6,000,000	6,000,000	6,000,000	6,000,000
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach statement)				
25	Retained earnings—Unappropriated		(393,250)		2,762,640
26	Adjustments to shareholders' equity (attach statement)				
27	Less cost of treasury stock		( )		( )
28	Total liabilities and shareholders' equity		16,716,750		20,425,000

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

Note: The corporation may be required to file Schedule M-3. See instructions.

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

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

1	Balance at beginning of year	(393,250)	5	Distributions: a Cash	
2	Net income (loss) per books	3,155,890		b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	
			7	Add lines 5 and 6	0
4	Add lines 1, 2, and 3	2,762,640	8	Balance at end of year (line 4 less line 7)	2,762,640

[a] $420,750 DTA - $204,000 DTL.
[b] $472,500 DTL - $94,500 DTA.

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SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

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

▶ Attach to Form 1120 or 1120-C.
▶ Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123

2017

Name of corporation (common parent, if consolidated return): Permtemp Corporation

Employer identification number:

Check applicable box(es): (1) ☑ Non-consolidated return (2) ☐ Consolidated return (Form 1120 only)
(3) ☐ Mixed 1120/L/PC group (4) ☐ Dormant subsidiaries schedule attached

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

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

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

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

2a Enter the income statement period: Beginning 01/01/2017 Ending 12/31/2017

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

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

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

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

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

4a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1 .	**4a**	3,155,890
b	Indicate accounting standard used for line 4a (see instructions): (1) ☑ GAAP (2) ☐ IFRS (3) ☐ Statutory (4) ☐ Tax-basis (5) ☐ Other (specify)		
5a	Net income from nonincludible foreign entities (attach statement)	**5a**	( )
b	Net loss from nonincludible foreign entities (attach statement and enter as a positive amount) . . .	**5b**	
6a	Net income from nonincludible U.S. entities (attach statement)	**6a**	( )
b	Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	**6b**	
7a	Net income (loss) of other includible foreign disregarded entities (attach statement)	**7a**	
b	Net income (loss) of other includible U.S. disregarded entities (attach statement)	**7b**	
c	Net income (loss) of other includible entities (attach statement)	**7c**	
8	Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	**8**	
9	Adjustment to reconcile income statement period to tax year (attach statement)	**9**	
10a	Intercompany dividend adjustments to reconcile to line 11 (attach statement)	**10a**	
b	Other statutory accounting adjustments to reconcile to line 11 (attach statement)	**10b**	
c	Other adjustments to reconcile to amount on line 11 (attach statement)	**10c**	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10 .	**11**	3,155,890

Note: Part I, line 11, must equal Part II, line 30, column (a) or Schedule M-1, line 1 (see instructions).

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

		Total Assets	Total Liabilities
a	Included on Part I, line 4 . . . . . ▶	20,425,000	11,662,360
b	Removed on Part I, line 5 . . . . . ▶		
c	Removed on Part I, line 6 . . . . . ▶		
d	Included on Part I, line 7 . . . . . ▶		

For Paperwork Reduction Act Notice, see the Instructions for Form 1120. Cat. No. 37961C **Schedule M-3 (Form 1120) 2017**

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Schedule M-3 (Form 1120) 2017 Page 2

Name of corporation (common parent, if consolidated return): Permtemp Corporation

Employer identification number:

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

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

Name of subsidiary (if consolidated return):

Employer identification number:

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

Income (Loss) Items (Attach statements for lines 1 through 11)	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1 Income (loss) from equity method foreign corporations				
2 Gross foreign dividends not previously taxed				
3 Subpart F, QEF, and similar income inclusions				
4 Section 78 gross-up				
5 Gross foreign distributions previously taxed				
6 Income (loss) from equity method U.S. corporations				
7 U.S. dividends not eliminated in tax consolidation	55,000			55,000
8 Minority interest for includible corporations				
9 Income (loss) from U.S. partnerships				
10 Income (loss) from foreign partnerships				
11 Income (loss) from other pass-through entities				
12 Items relating to reportable transactions				
13 Interest income				
14 Total accrual to cash adjustment . T-E interest	15,000		15,000	
15 Hedging transactions				
16 Mark-to-market income (loss)				
17 Cost of goods sold	( )			( )
18 Sale versus lease (for sellers and/or lessors)	22,000,000			22,000,000
19 Section 481(a) adjustments				
20 Unearned/deferred revenue				
21 Income recognition from long-term contracts				
22 Original issue discount and other imputed interest				
23a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e Abandonment losses				
f Worthless stock losses (attach statement)				
g Other gain/loss on disposition of assets other than inventory				
24 Capital loss limitation and carryforward used				
25 Other income (loss) items with differences (attach statement)				
26 **Total income (loss) items.** Combine lines 1 through 25	(21,930,000)	0	(15,000)	(21,945,000)
27 **Total expense/deduction items** (from Part III, line 38)	(3,239,110)	(1,550,000)	1,289,110	(3,500,000)
28 Other items with no differences*	28,325,000			28,325,000
29a Mixed groups, see instructions. All others, combine lines 26 through 28	3,155,890	(1,550,000)	1,274,110	2,880,000
b PC insurance subgroup reconciliation totals				
c Life insurance subgroup reconciliation totals				
30 **Reconciliation totals.** Combine lines 29a through 29c	3,155,890	(1,550,000)	1,274,110	2,880,000

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

*$33,000,000 sales - $4,675,000 other expenses.

Schedule M-3 (Form 1120) 2017

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Schedule M-3 (Form 1120) 2017 Page 3

Name of corporation (common parent, if consolidated return): Permtemp Corporation

Employer identification number

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

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

Name of subsidiary (if consolidated return)

Employer identification number

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

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense	664,360		(664,360)	
2 U.S. deferred income tax expense	594,750		(594,750)	
3 State and local current income tax expense				
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Foreign withholding taxes				
8 Interest expense (see instructions)	455,000			455,000
9 Stock option expense				
10 Other equity-based compensation				
11 Meals and entertainment	60,000		(30,000)	30,000
12 Fines and penalties				
13 Judgments, damages, awards, and similar costs				
14 Parachute payments				
15 Compensation with section 162(m) limitation				
16 Pension and profit-sharing				
17 Other post-retirement benefits				
18 Deferred compensation				
19 Charitable contribution of cash and tangible property	40,000			40,000
20 Charitable contribution of intangible property				
21 Charitable contribution limitation/carryforward		100,000		100,000
22 Domestic production activities deduction				
23 Current year acquisition or reorganization investment banking fees				
24 Current year acquisition or reorganization legal and accounting fees				
25 Current year acquisition/reorganization other costs				
26 Amortization/impairment of goodwill				
27 Amortization of acquisition, reorganization, and start-up costs				
28 Other amortization or impairment write-offs				
29 Reserved				
30 Depletion				
31 Depreciation	800,000	1,650,000		2,450,000
32 Bad debt expense	625,000	(200,000)		425,000
33 Corporate owned life insurance premiums				
34 Purchase versus lease (for purchasers and/or lessees)				
35 Research and development costs				
36 Section 118 exclusion (attach statement)				
37 Other expense/deduction items with differences (attach statement)				
38 **Total expense/deduction items.** Combine lines 1 through 37. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive	3,239,110	1,289,110	(1,287,458)	3,500,000

Schedule M-3 (Form 1120) 2017

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Permtemp Corporation
Deferred Tax Accounting 2017

Deferred Tax Assets:

	Beg. Of 2017	End of 2017	Change
Net operating loss	$ 887,500	$ -0-	($887,500)
Charitable contributions carryover	100,000	-0-	(100,000)
Net accounts receivable	250,000	450,000*	200,000
Total	$1,237,500	$450,000	$(787,500)
Times: Tax rate	0.34	0.21	
Deferred tax asset	$ 420,750	$ 94,500	$ 326,250

*$3,300,000 tax basis – $2,850,000 book basis

Deferred Tax Liability:

	Beg. Of 2017	End of 2017	Change
Net operating loss	$ 600,000	$2,250,000*	$1,650,000
Times: Tax rate	0.34	0.21	
Deferred tax liability	$ 204,000	$ 472,500	$ 268,500

*$8,400,000 book basis – $6,150,000 tax basis

Journal Entry:

Current federal income tax expense	664,360	
Deferred federal income tax expense	594,750	
Deferred tax asset		326,250
Deferred tax liability		268,500
Federal income tax payable		664,360

Adjusted Income Statement (Partial):

Net income before federal income taxes	$4,415,000
Minus: Federal income tax expense ($664,360 + $594,750)	(1,259,110)
Net income per books	$3,155,890
Effective tax rate [$1,259,110/$4,415,000]	28.519%

Tax Rate Reconciliation:

Statutory tax rate	34.000%
Nondeductible M&E expense [$30,000/$4,415,000 × 34%]	0.231%
Tax-exempt income [$(15,000)/$4,415,000 × 34%]	(0.116)%
Dividends-received ded. [$(38,500)/$4,415,000 × 34%]	(0.296)%
Change in tax rate [$1,800,000*/$4,415,000 × (34% – 21%)]	(5.300)%
Effective tax rate	28.519%

*End of year: $2,250,000 total deductible temp. diff. – $450,000 net fixed assets.

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Permtemp Corporation
Deferred Tax Accounting 2017

Provision Reconciliation:

Net income before federal income taxes	$ 4,415,000
Permanent differences:	
Nondeductible M&E expense	30,000
Tax-exempt income	(15,000)
Dividends-received deduction	(38,500)
Net income after permanent differences	$ 4,391,500
Temporary differences:	
Bad debt expense	200,000
Charitable contribution deduction	(100,000)
Depreciation	(1,650,000)
Net operation loss deduction	(887,500)
Taxable income	$ 1,954,000

Adjusted Balance Sheet:

Cash		$ 2,125,000
Accounts receivable	$ 3,300,000	
Allowance for doubtful accounts	(450,000)	2,850,000
Inventory		6,000,000
Fixed assets	$10,000,000	
Accumulated depreciation	(1,600,000)	8,400,000
Investment in corporate stock		1,000,000
Investment in tax-exempt bonds		50,000
Total assets		$20,425,000
Accounts payable		$ 2,120,000
Federal income tax payable		664,360
Long-term debt		8,500,000
Net deferred tax liability ($472,500 – $94,500)		378,000
Common stock		6,000,000
Retained earnings		2,762,640
Total liabilities and equity		$20,425,000

Note: For 2018, all tax provision calculations, beginning and ending, will be made at the 21% corporate tax rate.

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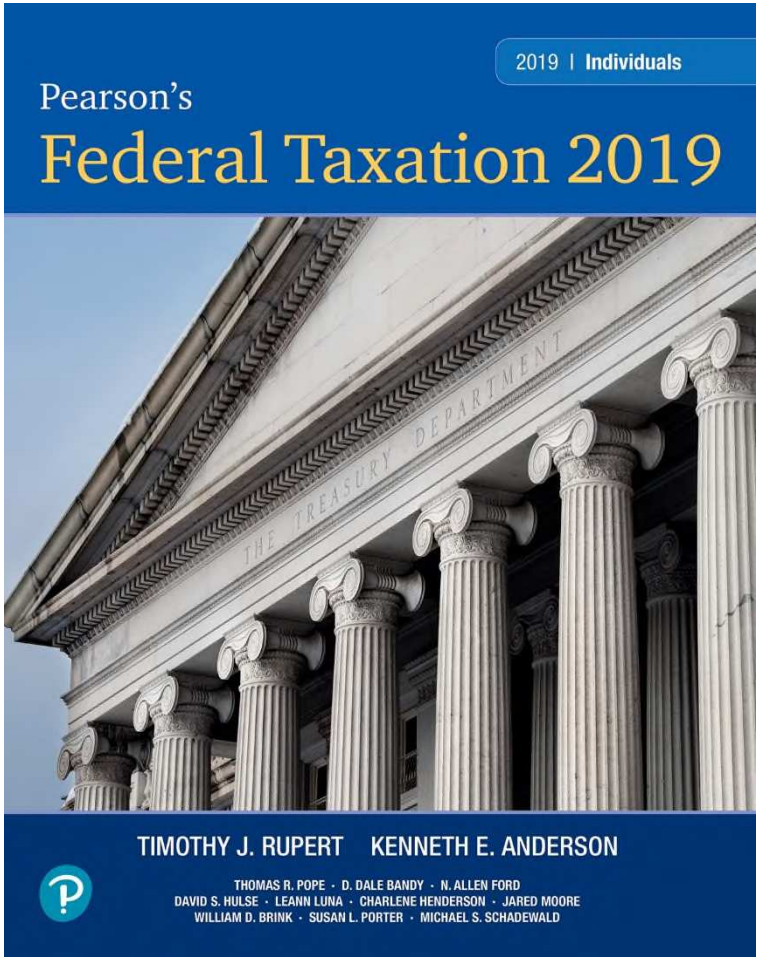
Pearson's Federal Taxation 2019: Individuals

Thirty-Second Edition



Chapter 2

Determination of Tax

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Learning Objectives (1 of 2)

2.1 Use the tax formula to compute an individual's taxable income

2.2 Determine the amount of deductions from Adjusted Gross Income

2.3 Calculate the income tax for individuals

2.4 Explain the basic income tax rules relating to business entities

Pearson

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Learning Objectives (2 of 2)

2.5 Explain the basic income tax rules of capital gains and losses

2.6 Describe tax planning considerations for various tax matters

2.7 Describe compliance and procedural matters for filing tax returns

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Basic Formula for Calculating Income Tax (1 of 3)

- Total Income
- Less: Exclusions
- Gross Income
- Less: Deductions for Adjusted Gross Income
- Adjusted Gross Income
- Less: Itemized Deductions/Standard Deductions
- Taxable income
- Tax liability calculated per table
- Less: Any credits or prepayments
- Equals: Net tax payable or refunds

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Basic Formula for Calculating Income Tax (2 of 3)

Form **1040** Department of the Treasury—Internal Revenue Service (99) **U.S. Individual Income Tax Return** **2017** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2017, or other tax year beginning , 2017, ending , 20 See separate instructions.

Your first name and initial: Larry S.	Last name: Lane	Your social security number: 123 | 45 | 6789
If a joint return, spouse's first name and initial: Jane V.	Last name: Lane	Spouse's social security number: 987 | 65 | 4321
Home address (number and street). If you have a P.O. box, see instructions.: 116 E. Edwards	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).: Lubbock, Texas 40401		Presidential Election Campaign: Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code

Filing Status Check only one box.

1 ☐ Single
2 ☒ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) (see instructions)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☒ **Spouse**

Boxes checked on 6a and 6b: 2

c **Dependents:**

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
Betty	Lane	111 22 3333	Daughter	☒
				☐
				☐
				☐

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who: • lived with you • did not live with you due to divorce or separation (see instructions): 1

Dependents on 6c not entered above:

d Total number of exemptions claimed — Add numbers on lines above ▶ 3

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	78,000
8a	**Taxable** interest. Attach Schedule B if required		8a	4,000
b	**Tax-exempt** interest. **Do not** include on line 8a	8b 500		
9a	Ordinary dividends. Attach Schedule B if required		9a	
b	Qualified dividends	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions 15a	b Taxable amount	15b	
16a	Pensions and annuities 16a	b Taxable amount	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits 20a	b Taxable amount	20b	
21	Other income. List type and amount		21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	82,000

Adjusted Gross Income

23	Educator expenses	23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
25	Health savings account deduction. Attach Form 8889	25		
26	Moving expenses. Attach Form 3903	26		
27	Deductible part of self-employment tax. Attach Schedule SE	27		
28	Self-employed SEP, SIMPLE, and qualified plans	28		
29	Self-employed health insurance deduction	29		
30	Penalty on early withdrawal of savings	30		
31a	Alimony paid b Recipient's SSN ▶	31a		
32	IRA deduction	32	5,500	
33	Student loan interest deduction	33		
34	Reserved for future use	34		
35	Domestic production activities deduction. Attach Form 8903	35		
36	Add lines 23 through 35		36	5,500
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37	76,500

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2017)

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Basic Formula for Calculating Income Tax (3 of 3)

Form 1040 (2017) Page 2

Tax and Credits	38	Amount from line 37 (adjusted gross income)		38	76,500
	39a	Check if: ☐ You were born before January 2, 1953, ☐ Blind. ☐ Spouse was born before January 2, 1953, ☐ Blind. Total boxes checked ▶ 39a			
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b ☐			
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, $6,350 Married filing jointly or Qualifying widow(er), $12,700 Head of household, $9,350	40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)		40	15,300
	41	Subtract line 40 from line 38		41	61,200
	42	Exemptions. If line 38 is $156,900 or less, multiply $4,050 by the number on line 6d. Otherwise, see instructions		42	12,150
	43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43	49,050
	44	Tax (see instructions). Check if any from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐		44	6,429
	45	Alternative minimum tax (see instructions). Attach Form 6251		45	
	46	Excess advance premium tax credit repayment. Attach Form 8962		46	
	47	Add lines 44, 45, and 46 ▶		47	6,429
	48	Foreign tax credit. Attach Form 1116 if required	48		
	49	Credit for child and dependent care expenses. Attach Form 2441	49		
	50	Education credits from Form 8863, line 19	50		
	51	Retirement savings contributions credit. Attach Form 8880	51		
	52	Child tax credit. Attach Schedule 8812, if required	52	1,000	
	53	Residential energy credits. Attach Form 5695	53		
	54	Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	54		54
	55	Add lines 48 through 54. These are your total credits		55	1,000
	56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0- ▶		56	5,429
Other Taxes	57	Self-employment tax. Attach Schedule SE		57	
	58	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919		58	
	59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required		59	
	60a	Household employment taxes from Schedule H		60a	
	b	First-time homebuyer credit repayment. Attach Form 5405 if required		60b	
	61	Health care: individual responsibility (see instructions) Full-year coverage ☑		61	
	62	Taxes from: a ☐ Form 8959 b ☐ Form 8960 c ☐ Instructions; enter code(s)		62	
	63	Add lines 56 through 62. This is your total tax ▶		63	5,429
Payments	64	Federal income tax withheld from Forms W-2 and 1099	64	6,000	
If you have a qualifying child, attach Schedule EIC.	65	2017 estimated tax payments and amount applied from 2016 return	65		
	66a	Earned income credit (EIC)	66a		
	b	Nontaxable combat pay election 66b			
	67	Additional child tax credit. Attach Schedule 8812	67		
	68	American opportunity credit from Form 8863, line 8	68		
	69	Net premium tax credit. Attach Form 8962	69		
	70	Amount paid with request for extension to file	70		
	71	Excess social security and tier 1 RRTA tax withheld	71		
	72	Credit for federal tax on fuels. Attach Form 4136	72		
	73	Credits from Form: a ☐ 2439 b ☐ Reserved c ☐ 8885 d ☐	73		
	74	Add lines 64, 65, 66a, and 67 through 73. These are your total payments ▶		74	6,000
Refund	75	If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid		75	571
	76a	Amount of line 75 you want refunded to you. If Form 8888 is attached, check here ▶ ☐		76a	571
Direct deposit? See instructions.	▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings			
	▶ d	Account number			
	77	Amount of line 75 you want applied to your 2018 estimated tax ▶	77		
Amount You Owe	78	Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions ▶		78	
	79	Estimated tax penalty (see instructions)	79		

Third Party Designee Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ Yes. Complete below. ☐ No
Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
Larry S. Lane	4/15/18	Attorney	555-555-1212
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Jane V. Lane	4/15/18	Student	

Paid Preparer Use Only Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN
Firm's name ▶ Firm's EIN ▶
Firm's address ▶ Phone no.

Go to www.irs.gov/Form1040 for instructions and the latest information. Form 1040 (2017)

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Total Income

- Any “income from whatever source derived.”
- Includes both taxable and non-taxable income.
- Does NOT include return of capital (basis) of property sold.
- Example: Bob sells a piece of property for $1,000. He has a cost basis of $700. Bob will include $300, not $1,000, in total income.

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Exclusions

- Gifts
- Life Insurance
- Welfare
- Certain Scholarships
- Certain Payments for Injury
- Certain Employee Benefits
- Certain Foreign Income
- Tax-Exempt Interest
- Series EE Bond Interest
- Medical Saving Account Distributions
- Meritorious Achievement Awards
- Certain Divorce Payments for agreements executed prior to 2019
- Gain from Sale of Home
- Roth IRA Distributions
- Social Security Benefits

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Gross Income Items per § 61

- Wages
- Business Gross Inc.
- Gains from Property Sales
- Interest
- Rents
- Royalties
- Dividends
- Alimony through 12/31/2018
- Annuities
- Life Insurance Proceeds
- Pensions
- COD Income
- Partnership Income
- IRD
- Trust/Estate Income

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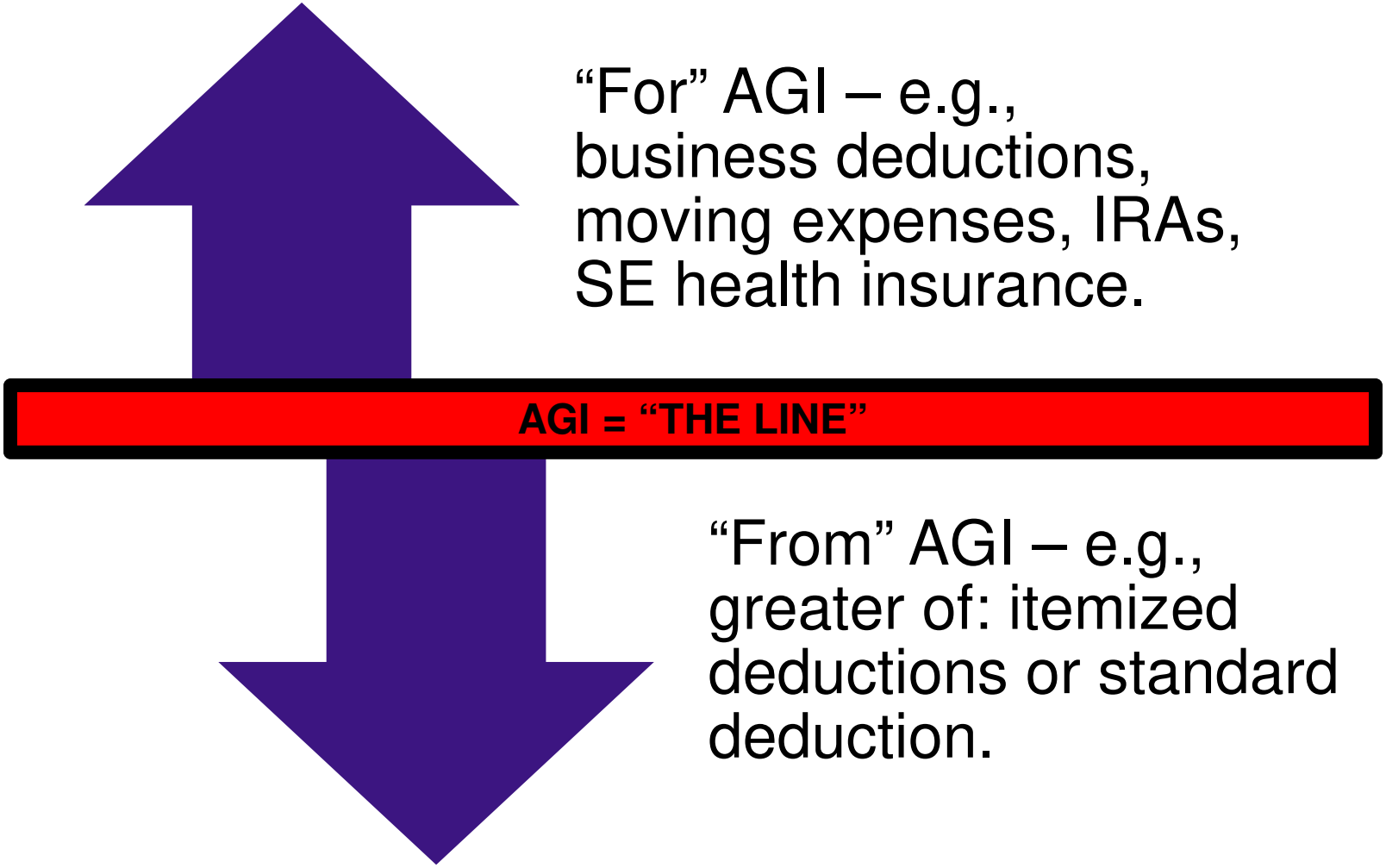
“For” vs. “From” AGI



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Deductions "For" AGI = § 62

- Trade and Business Deductions
- Reimbursed Employee Expenses
- Loss from Property Sales
- Rent/Royalty Deductions
- Retirement Plan Contributions
- Penalties from Savings Accounts
- One-half Self-Employment Taxes
- Self-employed Health Insurance Premiums
- Alimony for agreements executed prior to 2019
- Moving Expenses
- Repayments of Unemployment Compensation
- Certain Jury Duty Pay
- Interest on Student Loans
- Medical Savings Account Contributions

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Deductions “From” AGI

- Taxpayer can deduct greater of: Itemized Deductions OR Standard Deduction.

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Itemized Deduction (2018 Amounts)

- Medical Expenses
- Taxes – Property, Real Estate, and State
- Charitable Contributions
- Mortgage Interest

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Standard Deductions (2018 Amounts)

- Single = $12,000
- Head of Household = $18,000
- Married Filing Separately = $12,000
- Married Filing Jointly = $24,000
- Add $1,300 to the Standard Deduction ($2,600 if both elderly AND blind). Max increase of $5,200 for MFJ.

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Itemized Deductions – Not Subject to Thresholds (1 of 2)

- Mortgage Interest – limited to $750,000 mortgage incurred 12/16/2017 and later (limit is $1 million mortgage incurred before 12/16/2017).
- Charitable Contributions – limited to 60% AGI.
- Property, State, and Real Estate Taxes – limited to $10,000 ($5,000 MFS).
- Investment Interest – limited to net investment income.

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Itemized Deductions – Not Subject to Thresholds (2 of 2)

- Miscellaneous Deductions:
  - Estate taxes for Income in Respect of a Decedent.
  - Gambling losses to the extent of gambling income.
  - Amortization of bond premium.
  - Amounts restored under claim of right.

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Itemized Deductions – Subject to Floors

- Medical Expenses – Can only deduct amounts over 7.5% AGI.

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Disallowance of Standard Deduction

- Return < 12 months due to change in accounting period.
- Married filing separately where spouse itemizes.
- Nonresident Alien.

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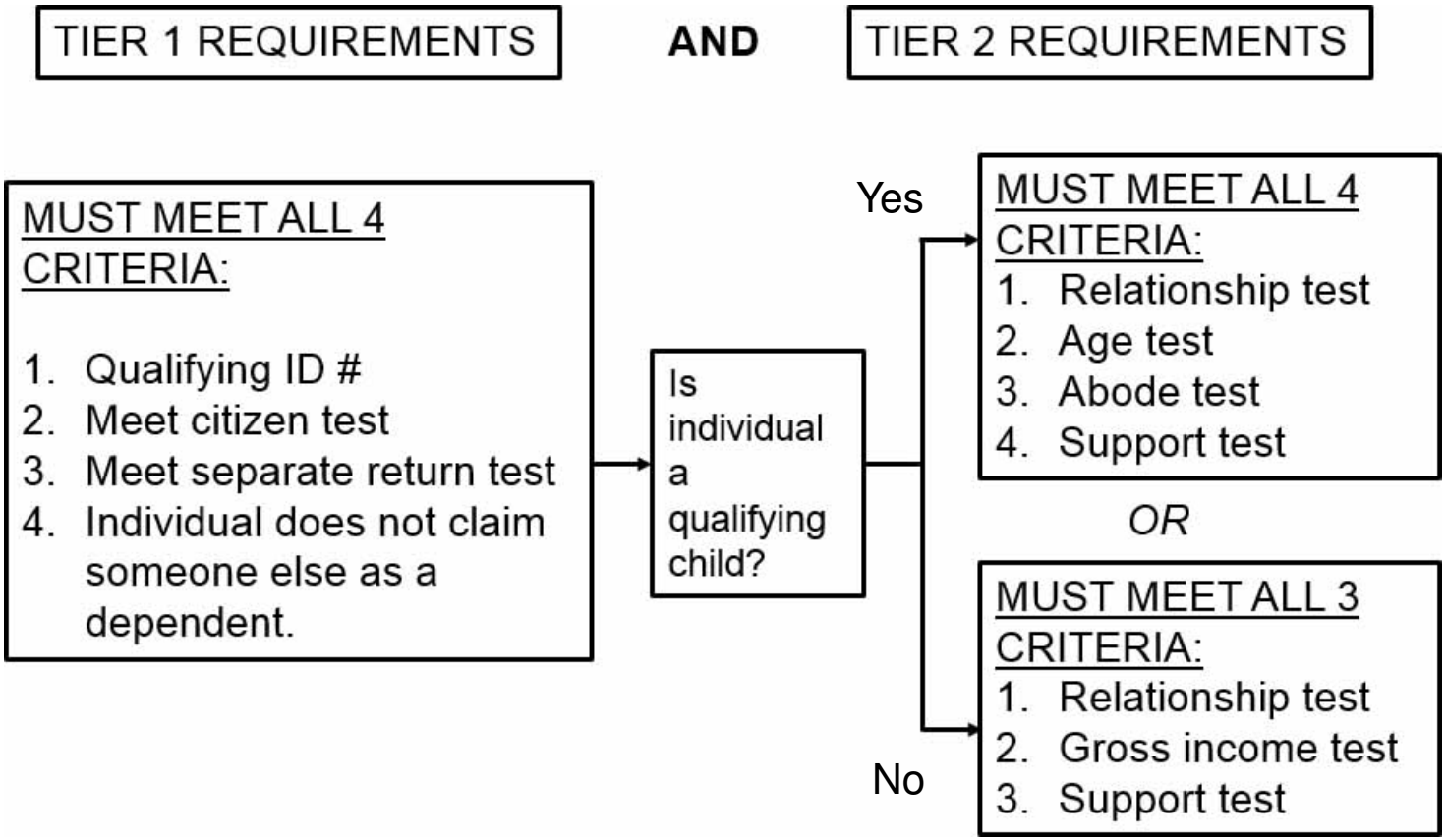
Dependency Exemptions – Qualification



Note: Individual must meet both Tier 1 and Tier 2 criteria to qualify as the taxpayer's dependent.

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Tier 1 Criteria for Dependency Exemption

- ID # – Each dependent must have a SSN.
- Citizenship – Must be US citizen, US national, or legal resident.
- Separate return test:
  - Generally, dependent cannot file joint return with spouse.
  - Exception: dependent files joint return only to obtain refund of tax withheld.

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Tier 2 Criteria – Dependent is a Qualifying Child (1 of 3)

- Relationship Test – Eligible individuals:
  - Taxpayer's natural, adopted, foster, and step-children.
  - Taxpayer's siblings, half-siblings, and step-siblings.
  - Any descendants of the above.
  - Adoption = legal adoptions or child being legally placed in home for adoption.

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Tier 2 Criteria – Dependent is a Qualifying Child (2 of 3)

- Age Test – Must fall within at least one category:
  - Under age 19; OR
  - Permanently and totally disabled (any age); OR
  - Full-time student under age 24.
    - Considered full-time student if dependent is enrolled at qualifying institution for at least 5 months and carries a full course load.

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Tier 2 Criteria – Dependent is a Qualifying Child (3 of 3)

- Abode Test – Must have same principal abode as the taxpayer for > ½ the year.
  - Non-custodial parent meets Abode test if custodial parent agrees in writing.
- Support Test – Dependent can't provide more than ½ of his/her support.

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Tier 2 Criteria – Other Qualifying Individuals (1 of 2)

Relationship Test – Must fall within at least one category:

1) Related to the taxpayer.
   - Does not have to live with taxpayer.
   - Can be a qualifying child, parents (including parents' ancestors and siblings), step-parents, or certain in-laws.
   - Taxpayer's cousins do not qualify under this category.
2) Resides in taxpayer's home the entire year.
   - Dependent needs only to be related to one spouse in a joint return. Relationship is not terminated by death or divorce once established.

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Tier 2 Criteria – Other Qualifying Individuals (2 of 2)

- Gross Income Test – Dependent's taxable gross income must be < $4,150 in 2018.
- Support Test – Taxpayer must provide more than ½ of dependent's financial support.
  - Include non-taxable amounts spent except scholarships.
  - Include FMV of items in support calculation including imputed rent.
  - Do not include FMV of personal services rendered by taxpayer to dependent.

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Tie-Breaker Rules for Dependency Exemption

- If more than one taxpayer can potentially claim an individual as a dependent, then the possible claimants are prioritized in order of greatest claim to least:
  1. Taxpayer who can claim under qualifying child rules vs. other relatives.
  2. Parents have greater claim over non-parents.
  3. If 1. and 2. don't apply, then exemption goes to taxpayer with highest AGI.

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Multiple Support Agreements (1 of 2)

- If group provides > 50% support but no one person provides > 50%, then the eligible members can designate one person.
- Eligible members must agree in writing.
- Claimant must complete a Multiple Support Declaration (Form 2120) ("MSD").
- MSD trumps tie-breaker rules.
- Taxpayer who can claim under qualifying child rules can't transfer to another taxpayer who can claim under the dependent's rules.

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Multiple Support Agreements (2 of 2)

Form **2120**
(Rev. October 2005)
Department of the Treasury
Internal Revenue Service

Multiple Support Declaration

▶ **Attach to Form 1040 or Form 1040A.**

OMB No. 1545-0074

Attachment Sequence No. **114**

Name(s) shown on return: Gabe I. Abel

Your social security number: 123 : 45 : 6789

During the calendar year 2017, the eligible persons listed below each paid over 10% of the support of:

John T. Abel

Name of your qualifying relative

I have a signed statement from each eligible person waiving his or her right to claim this person as a dependent for any tax year that began in the above calendar year.

Mable B. Abel — Eligible person's name — 222 : 11 : 0001 — Social security number

402 N. Lable Lane, Lawrence, NJ 08649 — Address (number, street, apt. no., city, state, and ZIP code)

Eligible person's name — Social security number

Address (number, street, apt. no., city, state, and ZIP code)

Eligible person's name — Social security number

Address (number, street, apt. no., city, state, and ZIP code)

Eligible person's name — Social security number

Address (number, street, apt. no., city, state, and ZIP code)

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Parental Release

- Generally, exemption is awarded to custodial parent.
- Exception – Non custodial parent can claim exemption if other parent signs Form 8332.

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Refundable Tax Credits

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Nonrefundable Credits

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Child Credits – § 24

- Can claim $2,000 credit for each qualifying child or $500 for each other dependent. Partially refundable.
- Qualifying child = same definition as for dependency exemption except < 17 years.
- Credit is reduced $50 for every $1,000 (or part thereof) over $200,000 ($400,000 MFJ).
- Partially refundable. Refund is limited to the lesser of: (1) 15% of the taxpayer's earned income in excess of $2,500 or (2) $1,400 (if the taxpayer has one or two qualifying children).

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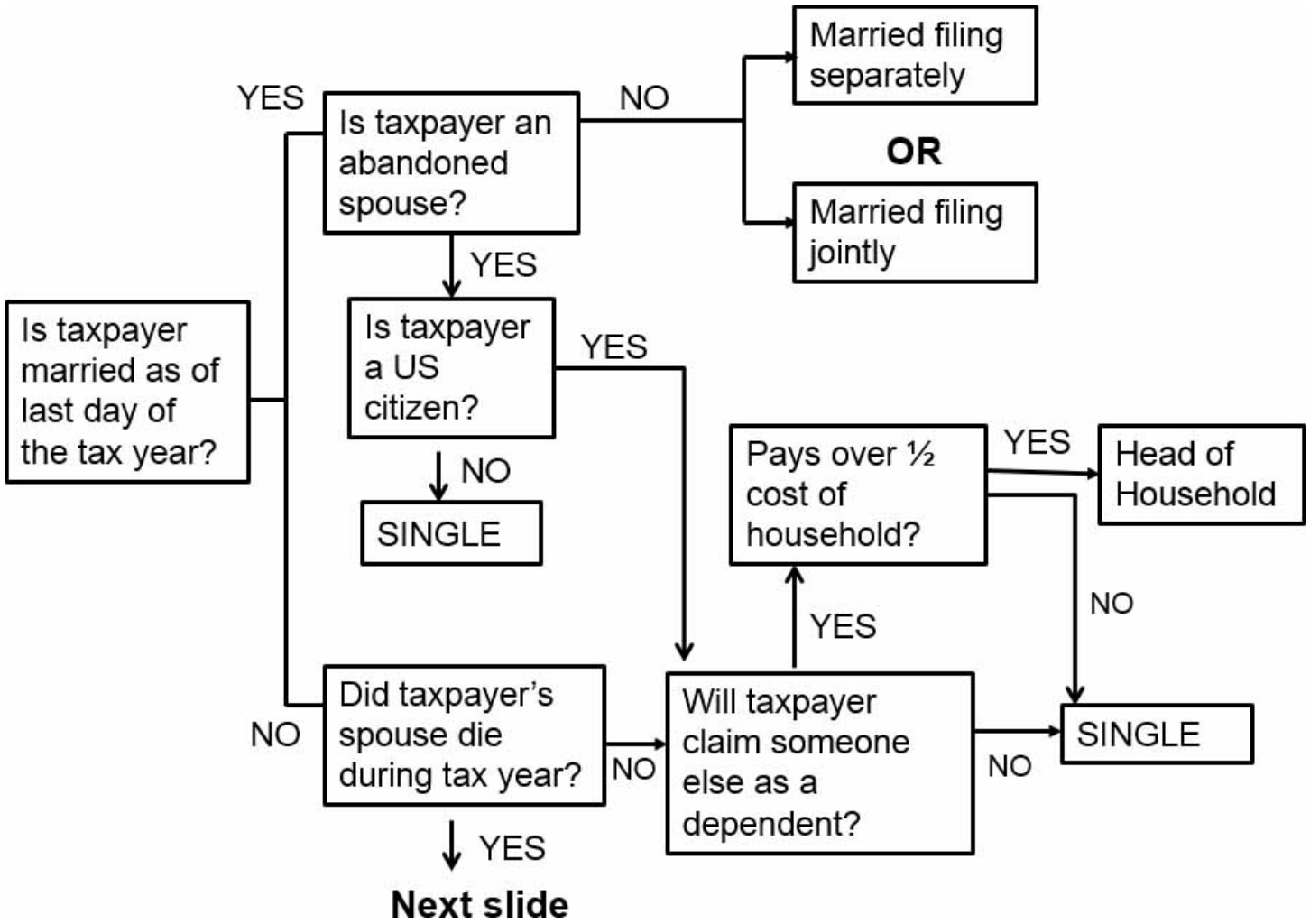
Determining Filing Status (1 of 2)



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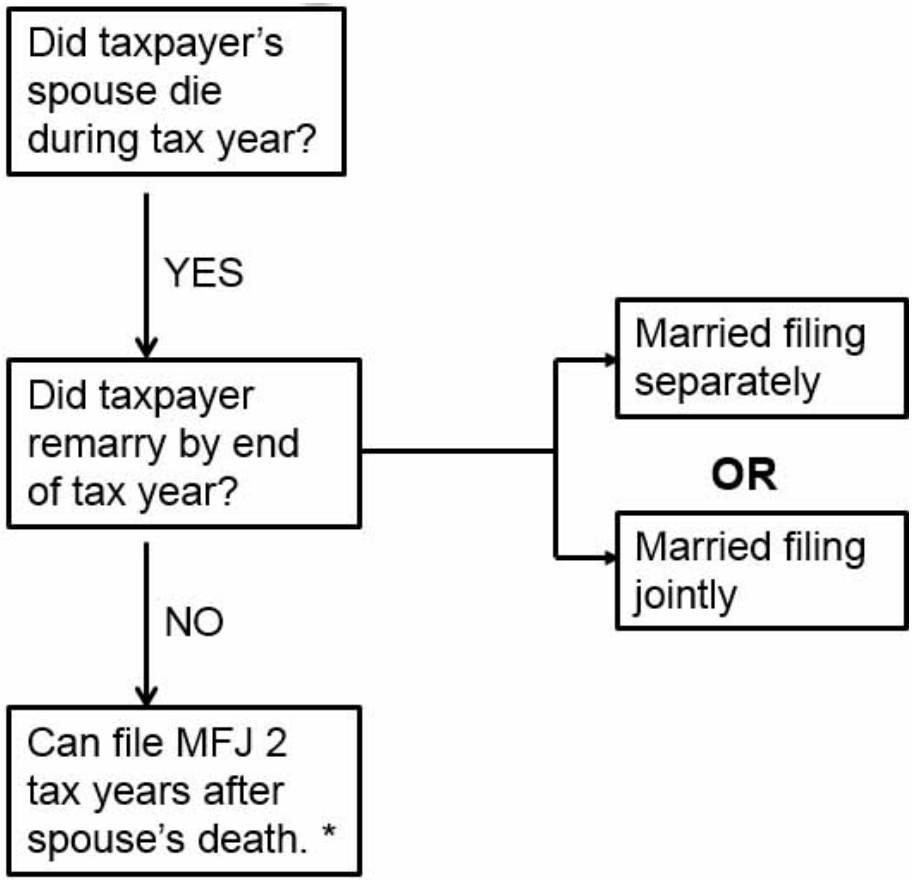
Determining Filing Status (2 of 2)



*** Additional requirements apply in Year 2.**

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Surviving Spouse Criteria

Year 1

- If not remarried, can claim MFJ.
- Can use MFJ tax schedule and MFJ standard deduction.

Year 2

- Cannot be remarried by end of Year 2.
- Must be a US citizen or resident.
- Must have a dependent living at home with taxpayer paying over ½ expenses of home.

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Children with Unearned Income (1 of 2)

- Children with earned or unearned income are required to file own tax return if otherwise over filing threshold.
- Standard deduction is limited to <u>greater of</u>:
  - $1,050; OR
  - Dependent's earned income + $350.

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Children with Unearned Income (2 of 2)

- "Kiddie Tax" – If child is under 18 (24 in some cases), some of child's unearned income is taxed at parent's marginal rate.
- If less than 18, "kiddie tax" applies to unearned income > $2,100.
- If 18, "kiddie tax" if:
  1. Earned income ≤ 1/2 support; AND
  2. Unearned income > $2,100.
- If 19 but less than 24, "kiddie tax" if:
  1. Full-time student; AND
  2. Earned income ≤ 1/2 support; AND
  3. Unearned income > $2,100.

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Treatment of Capital Gains/Losses (1 of 2)

- Capital gains and capital losses derive from sale or exchange of capital assets.
- Net long-term capital gains are taxed at a lower rate than ordinary income.
- Net short-term capital gains are taxed as ordinary income.

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Treatment of Capital Gains/Losses (2 of 2)

- Capital assets are general trade, business, or investment property that are not inventory.
- Net capital losses are deductible only up to $3,000. Excess capital losses can be carried forward.

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Maximum Net Capital Gain Rates

- Capital Gains can be taxed at the following maximum rates depending on the taxpayer's AGI:
- 0% for AGI < $38,601 – single ($77,201 – MFJ).
- 15% for AGI > $38,600, but < $425,801 – single ($77,200/479,001 – MFJ).
- 20% for AGI > $425,800 – single ($479,000 – MFJ).

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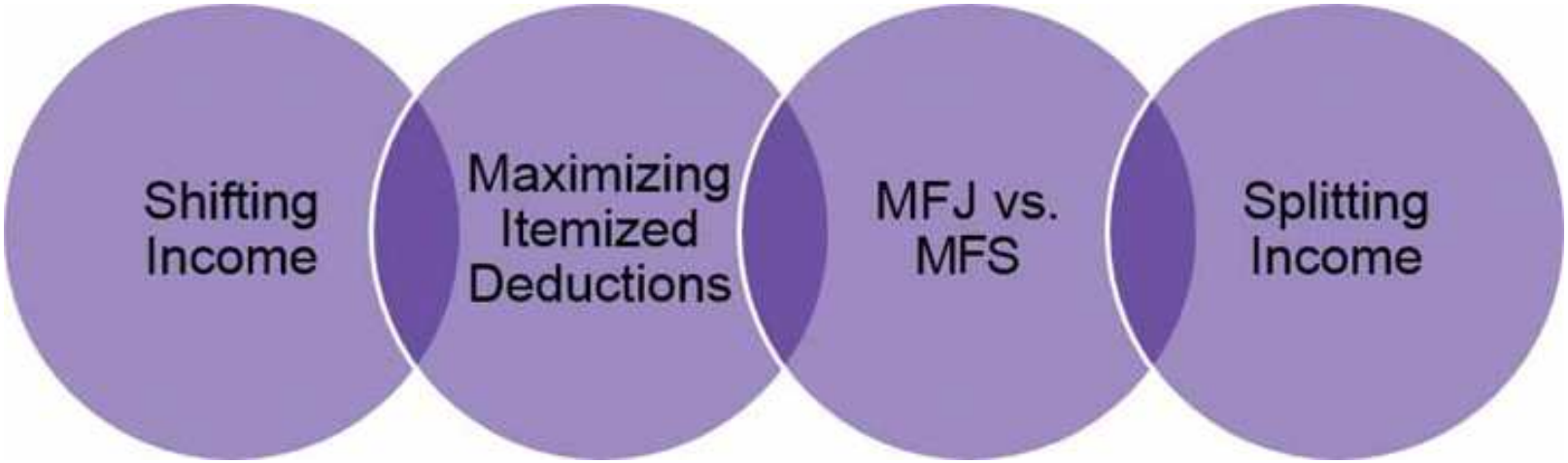
Tax Planning Considerations



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Who Must File? (1 of 2)

For taxpayers under 65, must file if gross income exceeds following levels even if no tax due (2018 thresholds):

Single	$12,000
MFJ	$24,000
Surviving Spouse	$24,000
MFS	$ 0
Married living separately	$ 0
Head of Household	$18,000

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Who Must File? (2 of 2)

Taxpayer must still file even if gross income below threshold if:

1. Taxpayer rec'd advance payments of EIC.
2. Taxpayer has self-employment income > $400.
3. Taxpayer who is claimed as a dependent by another AND unearned income > $1,050 or gross income > standard deduction.

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Due Dates

- Individuals – April 15
- C Corporations – 15th day of the 4th month after close of tax year.
- Partnership and S Corporations – 15th day of the 3rd month after close of tax year.
- If due date falls on weekend or national holiday, due date is moved to the first business day following.
- Extensions – 6 months for Individuals, Partnership, and S Corporations. 6, or 7 months for Corporations.

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Types of Individual Returns

- 1040
- 1040EZ
- 1040A

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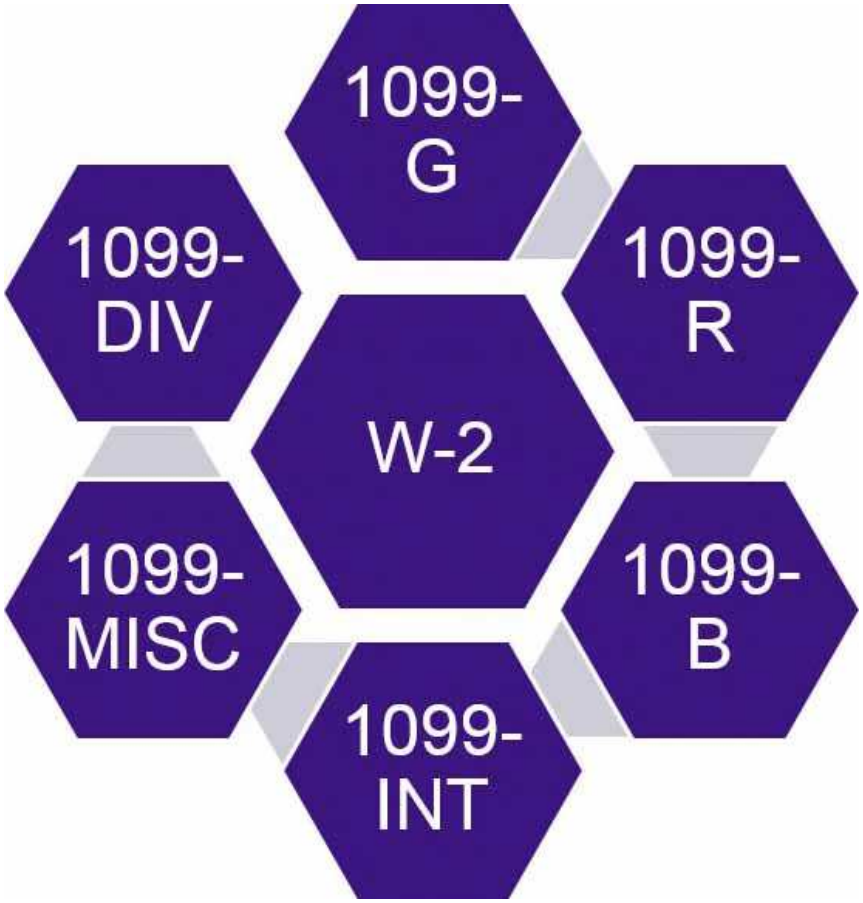
Reports Filed with IRS



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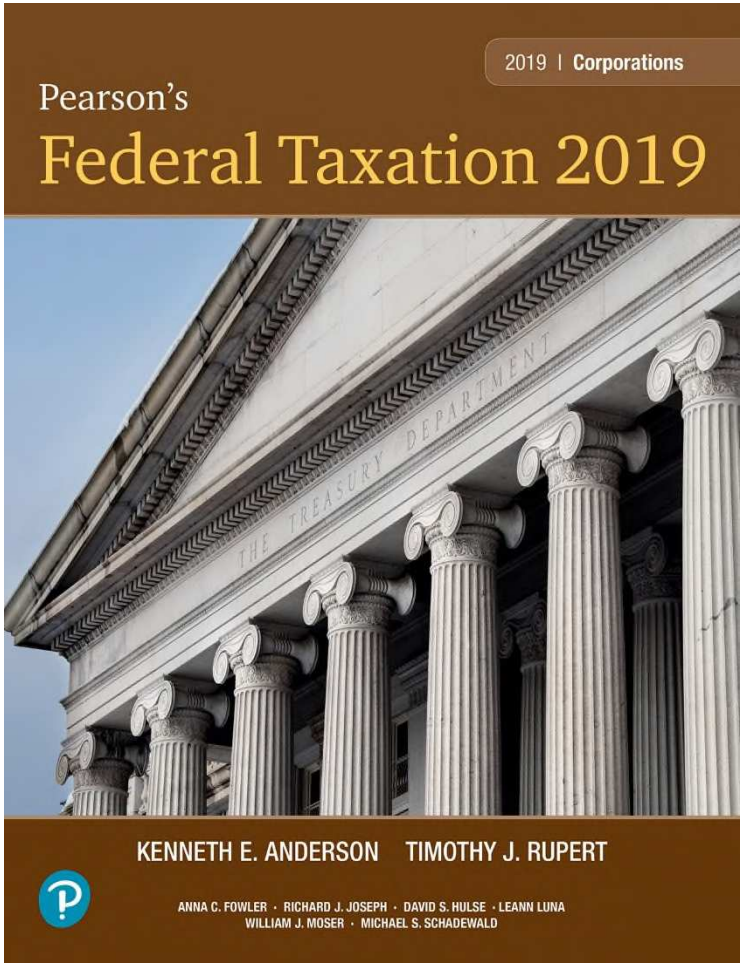
Pearson's Federal Taxation 2019: Corporations, Partnerships, Estates & Trusts

Thirty-Second Edition



Chapter 2

Corporate Formations and Capital Structure

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Learning Objectives (1 of 2)

2.1 Discuss the tax advantages and disadvantages of alternative business forms

2.2 Apply the check-the-box regulations to partnerships, corporations, and trusts

2.3 Recognize the legal requirements and tax considerations related to forming a corporation

2.4 Discuss the requirements for deferring gain or loss upon incorporation

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Learning Objectives (2 of 2)

2.5 Explain the tax implications of alternative capital structures

2.6 Determine the tax consequences of worthless stock or debt obligations

2.7 Identify tax planning opportunities in corporate formations

2.8 Comply with procedural rules for corporate formations

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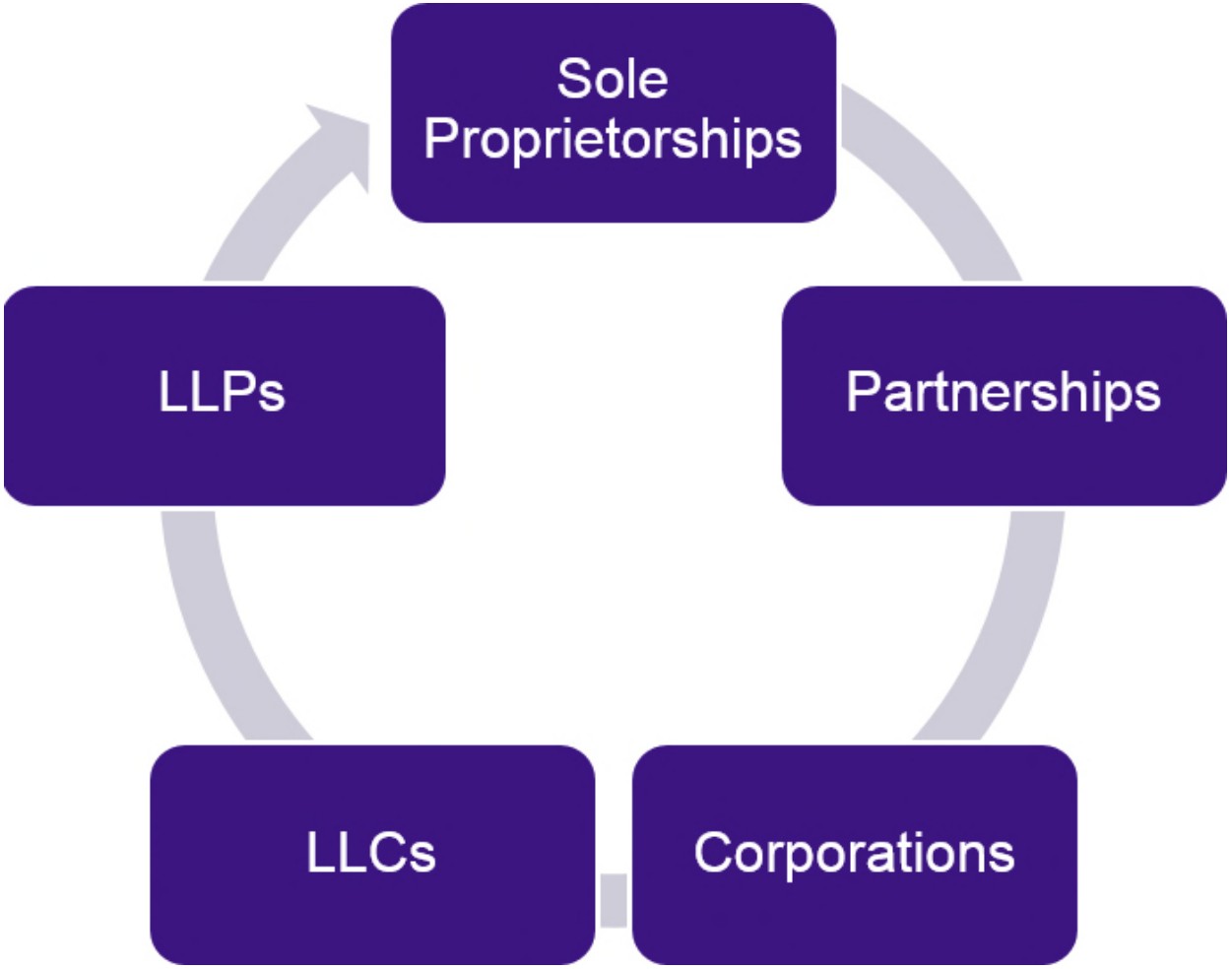
Organizational Forms



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Advantages of Sole Proprietorships

- Not subject to second layer of tax.
- Can withdraw cash w/o dividend treatment.
- Individual marginal rates < corporate rates.
- Business loss can offset owner's other non-passive income.
- Qualified Business Income Deduction allows exclusion from tax of 20% of profits.

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Disadvantages of Sole Proprietorships

- Profits are currently taxed even if not withdrawn.
- Certain fringe benefits may be taxable to owner.
- Must use calendar year tax year.

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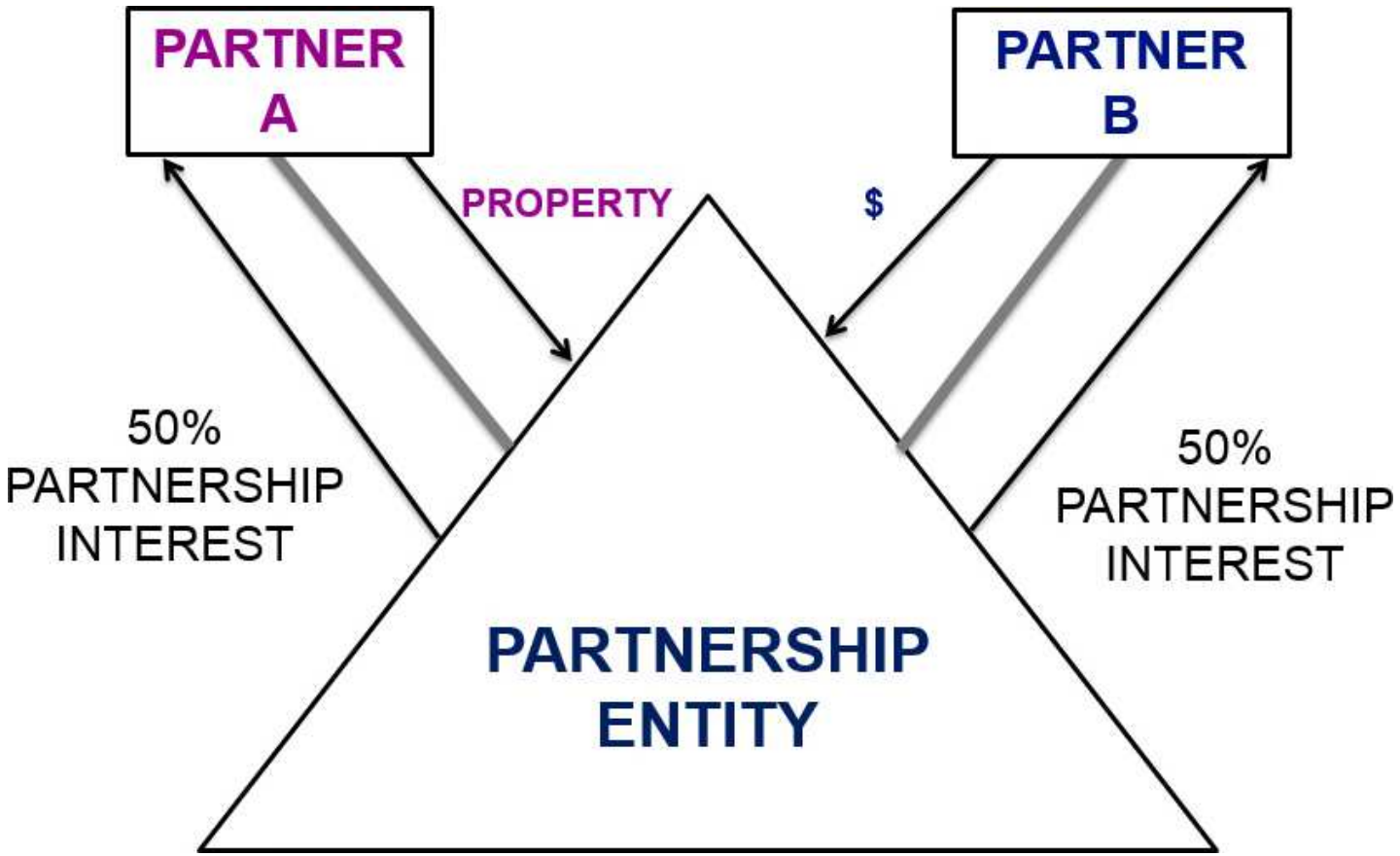
Forming a Partnership



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General vs. Limited Partnerships

General Partnerships

- GPs have unlimited liability for p'ship debts.
- Liability can be greater than capital invested.

Limited Partnerships

- LPs are liable only up to capital invested + agreed-upon amounts.
- Must have at least one GP and one LP.

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Advantages of Partnerships

- No entity level taxes – No double taxation.
- A partner's marginal rate may be < corporate rate.
- Contributions/distributions usually non-taxable.
- Pass-through income/losses can offset items on partner's Form 1040.
- Qualified Business Income Deduction allows exclusion from tax of 20% of profits.

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Disadvantages of Partnerships

- Profits currently taxed whether or not withdrawn.
- Partner's marginal rate could be > corporate marginal rate.
- No tax-free fringe benefits since not an employee.
- Must generally use calendar year tax year.

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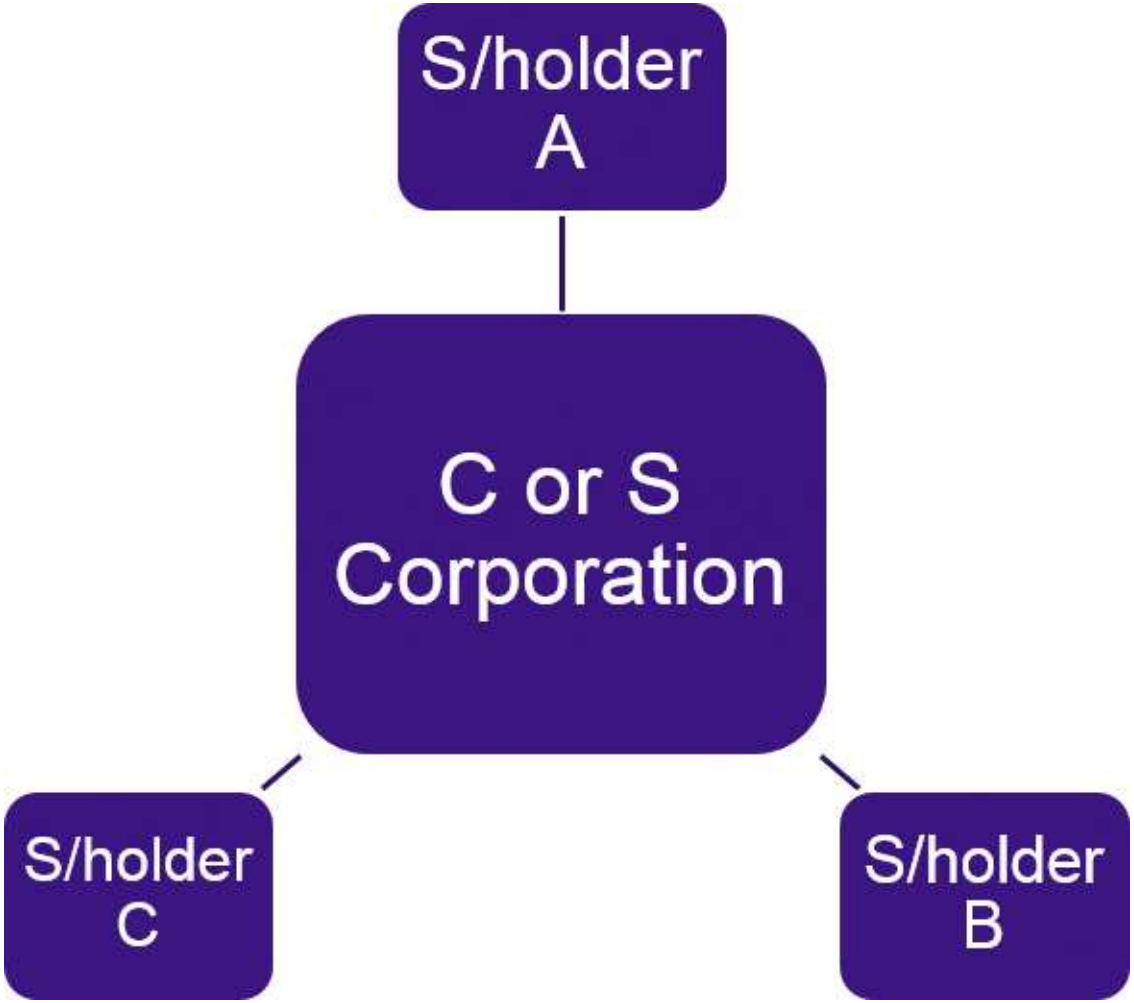
Corporate Structure



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Advantages of C Corporations

- Possible lower marginal rates on entity basis.
- Shareholder-employees can have tax-free fringe benefits.
- Corporation can use fiscal year tax year.
- Top corporate marginal rate is 21%.

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Disadvantages of C Corporations

- Double taxation due to entity-level tax.
- S/holder may have taxable dividend upon distribution of property.
- NOLs and capital losses stay at the entity level and don't pass through to s/holder.
- Cannot take the 20% Qualified Business Income Deduction.

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Advantages of S Corporations

- S Corps not subject to tax at an entity level. No double taxation.
- Shareholder may have a lower marginal rate than a C Corporation.
- Non-passive losses can offset any income on shareholder's Form 1040.
- Income/deduction items retain their character.
- Qualified Business Income Deduction allows exclusion from tax of 20% of profits.

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Disadvantages of S Corporations

- Shareholders taxed on all profits even if undistributed.
- Shareholders' marginal rate could be > if C Corp.
- No non-taxable fringe benefits for s/holder-owner.
- Must generally use calendar year accounting period.
- Limited number of shareholders.
- May have additional compliance requirements vs. sole proprietorship.

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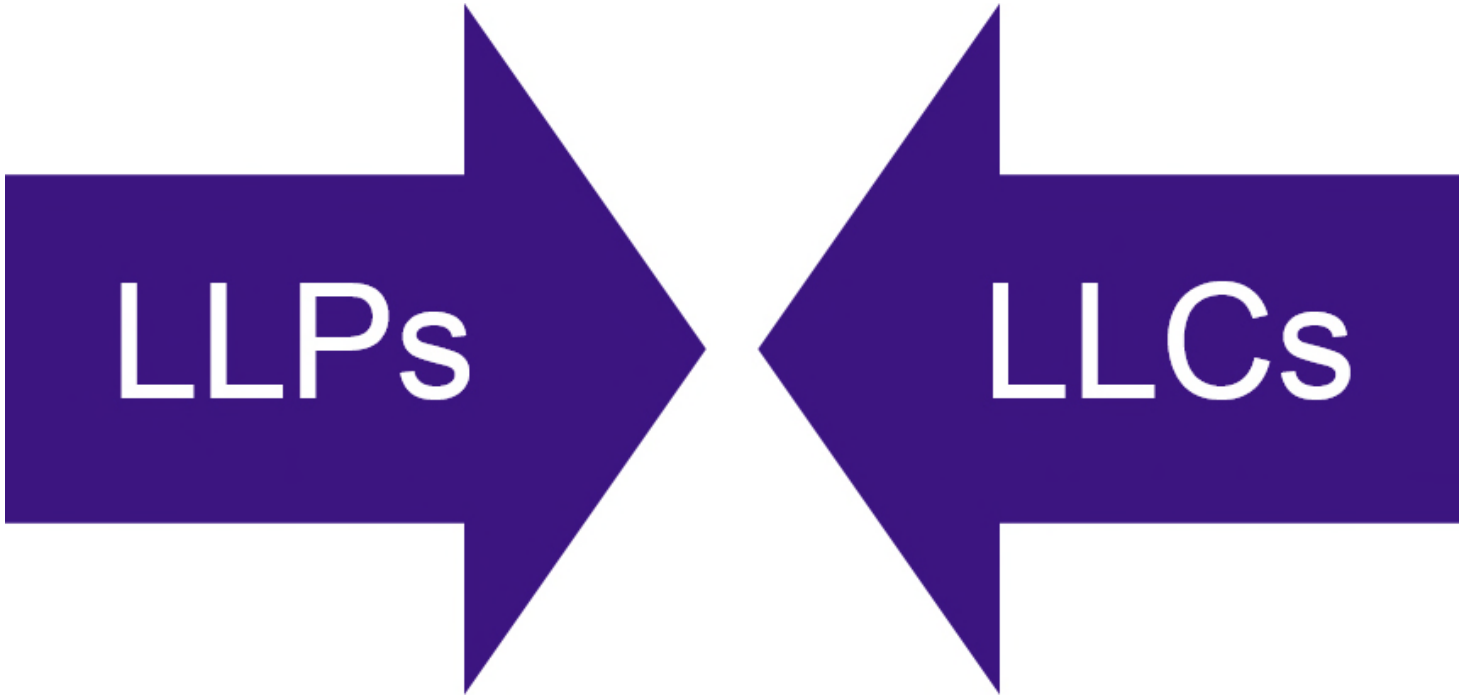
Advantages and Disadvantages



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Check the Box Regulations

- Available to unincorporated businesses.
- Can elect to be treated as a partnership or a corporation.
- If two or more owners, default is partnership unless election to be treated as a corporation.
- If one owner, default is a disregarded entity and treated as a sole proprietorship unless election to be treated as a corporation.

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Section 351 (1 of 2)

- No recognition of gain or loss (see also § 368(c)).
- Requirements:
  1. Transfer of property.
  2. Must be SOLELY in exchange for stock.
  3. Transferors must be in control of the corporation immediately after the exchange.
- Rationale is that the transferors have not changed their situation economically so should not be taxed (they owned the property before, and they own it afterwards).

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Section 351 (2 of 2)

- Shareholder takes a carryover basis from the property to the stock.
- Alternative calculation:

FMV of trans property

− deferred gain

or

+ deferred loss

Basis in new stock

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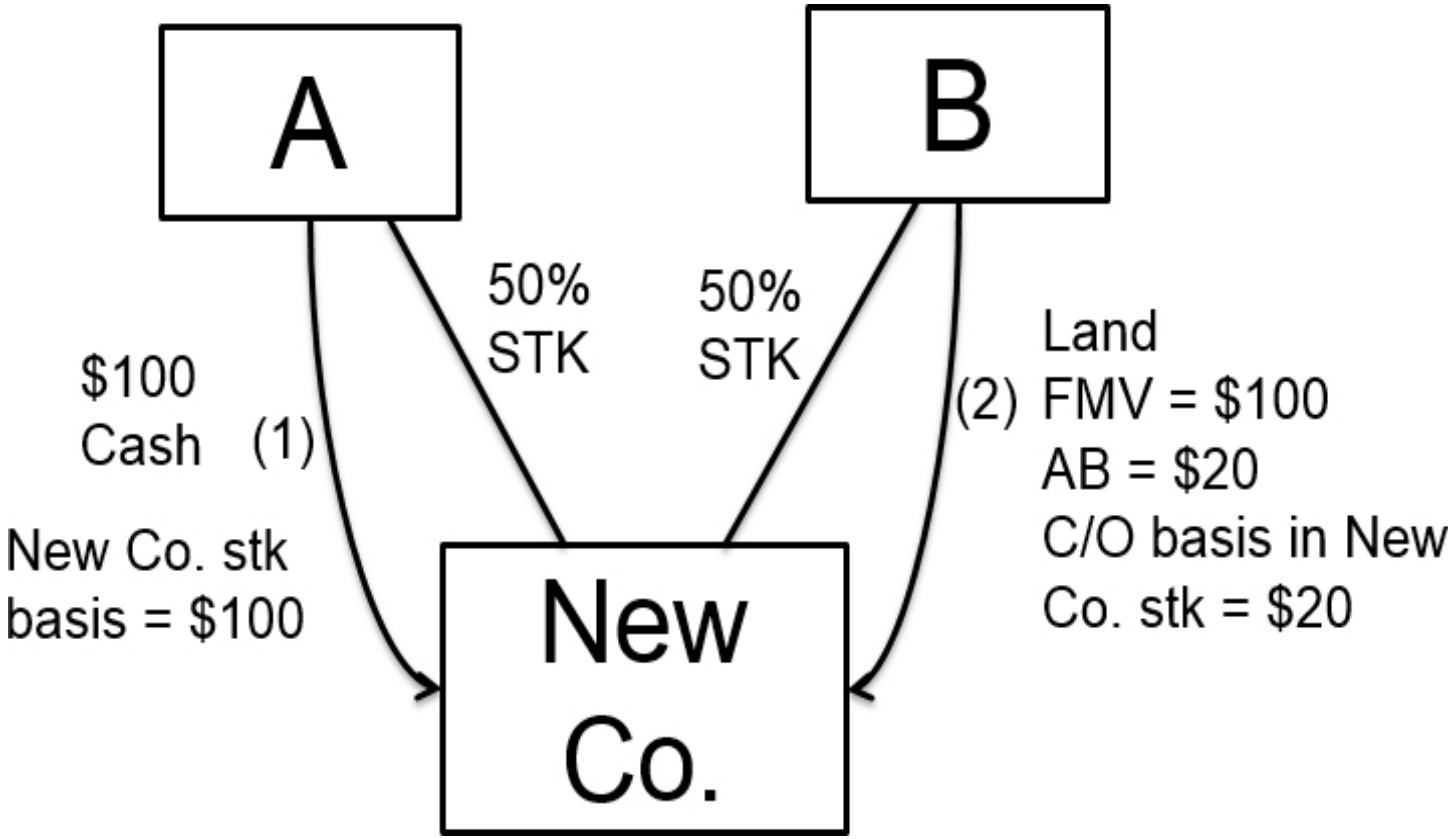
§ 351 Property Transaction



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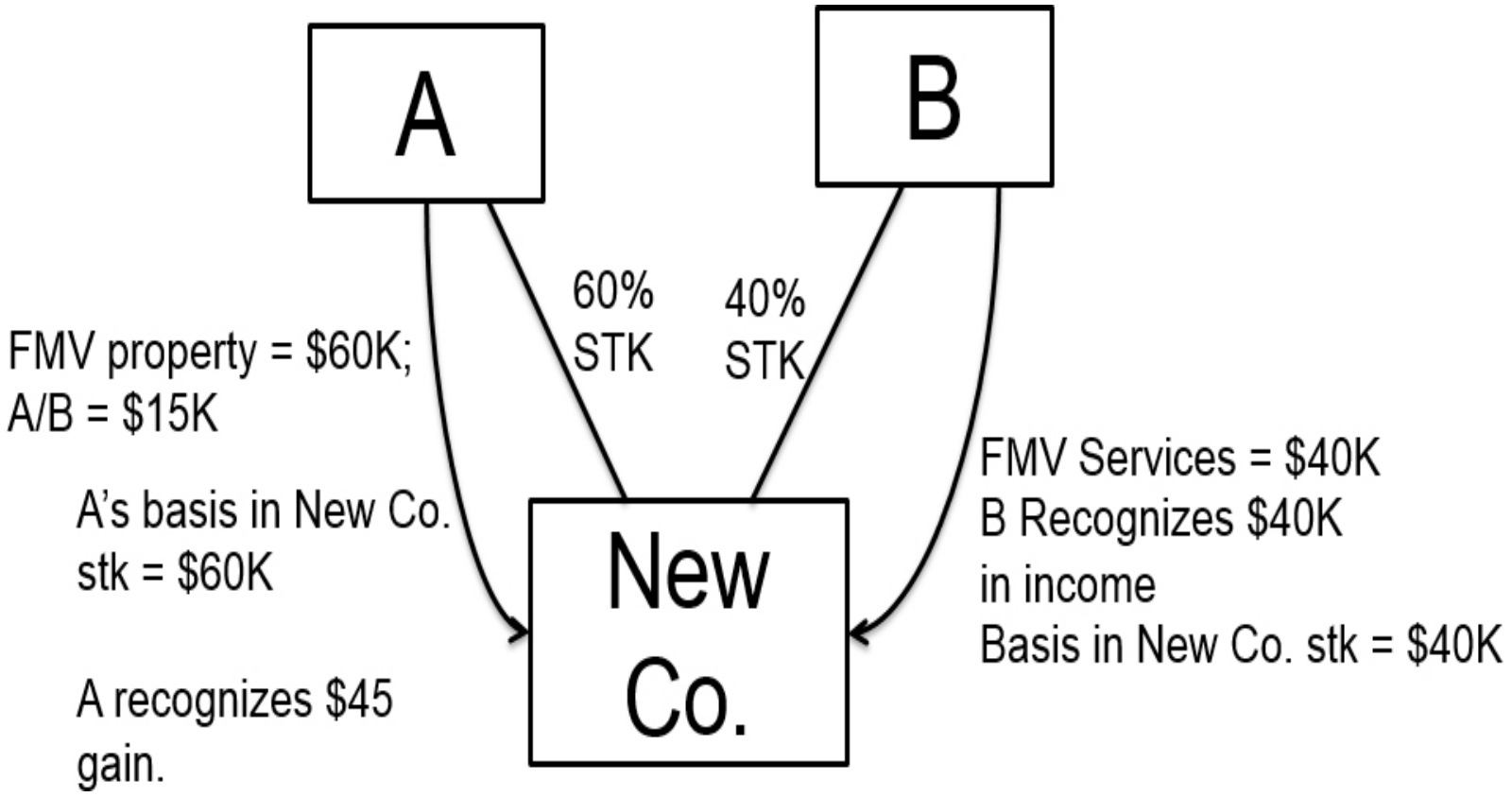
§ 351 Services Transaction



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§ 351 Control Requirement

- § 368(c) definition of “control”:
  1. 80% of total combined voting power of ALL classes of voting stock; AND
  2. 80% of the total number of shares of all other classes of stock, such as nonvoting preferred stock.

  NOTE: must meet 80% threshold for EACH class of stock, not just all nonvoting preferred as a whole.

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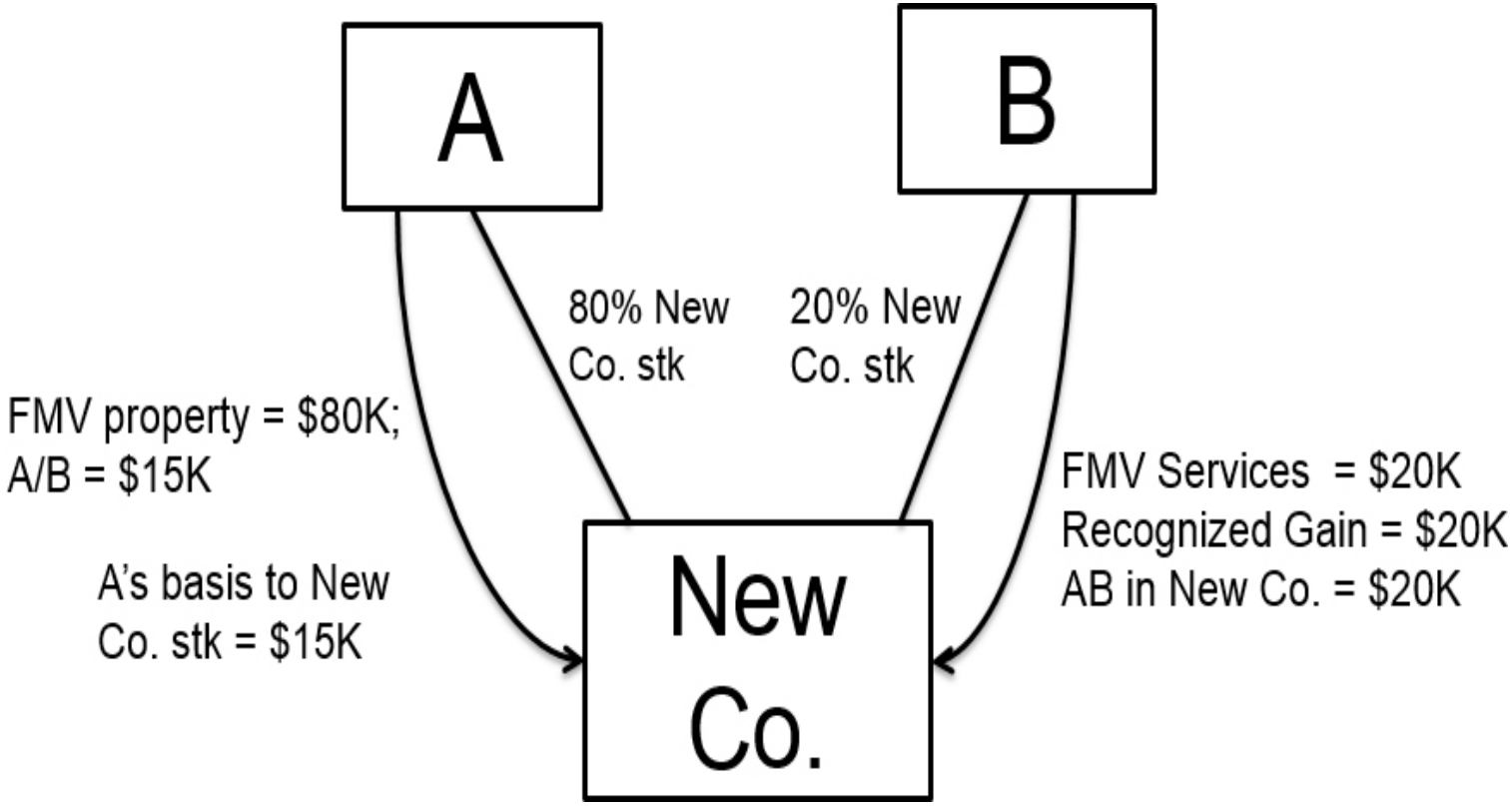
§ 351 Services Transaction (20%)



80% control requirement is met. A does not have to recognize $65K ($80K − $15K) in Built-In Gain ("BIG").

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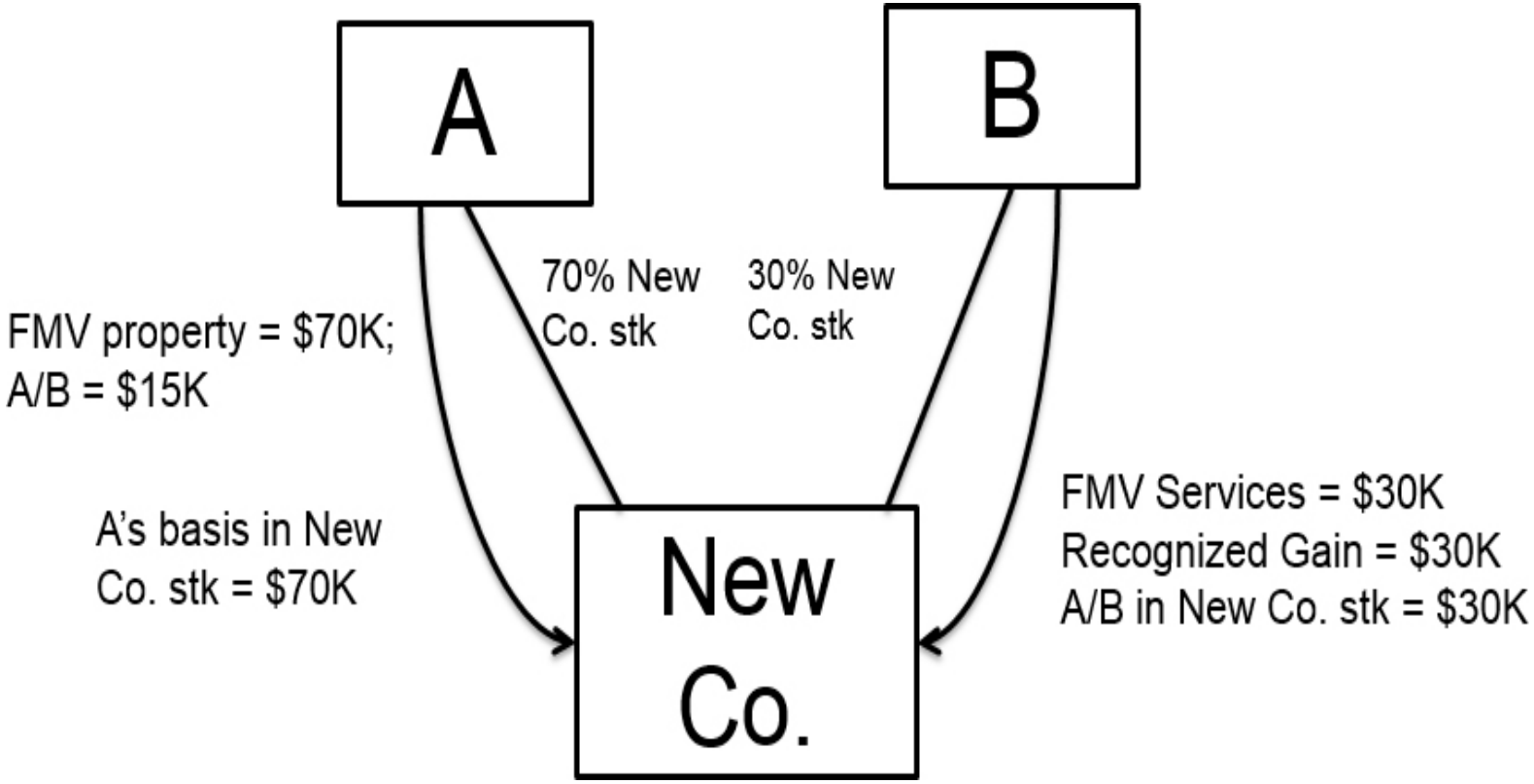
§ 351 Services Transaction (30%)



80% control requirement is not met.
A must recognize $55K ($70K − $15K) in BIG.

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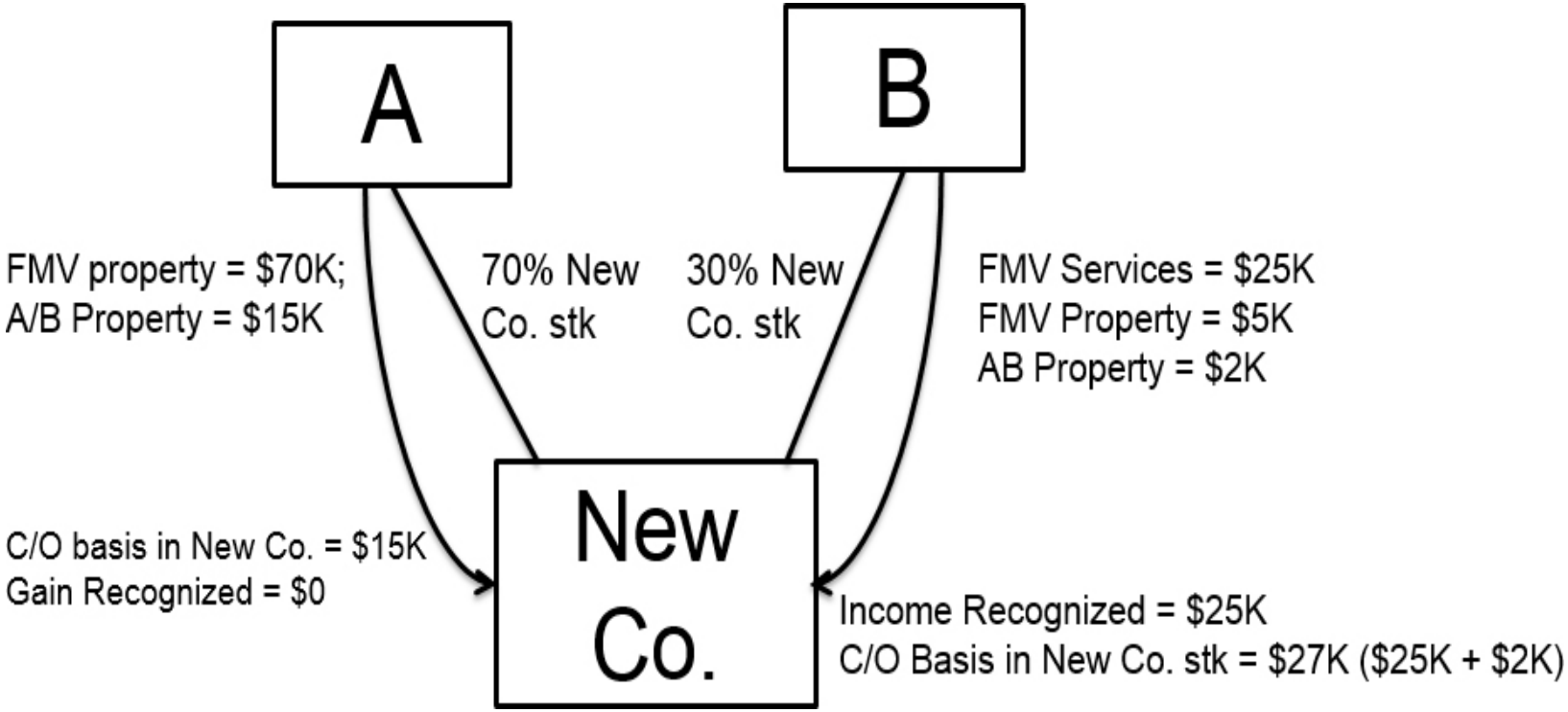
§ 351 Property/Services Transaction (1 of 2)



80% control requirement is met since FMV B's property contribution is over 10% the value of services ($25K x 10% = $2.5K; FMV property = $5K) Therefore, 10% threshold is met.

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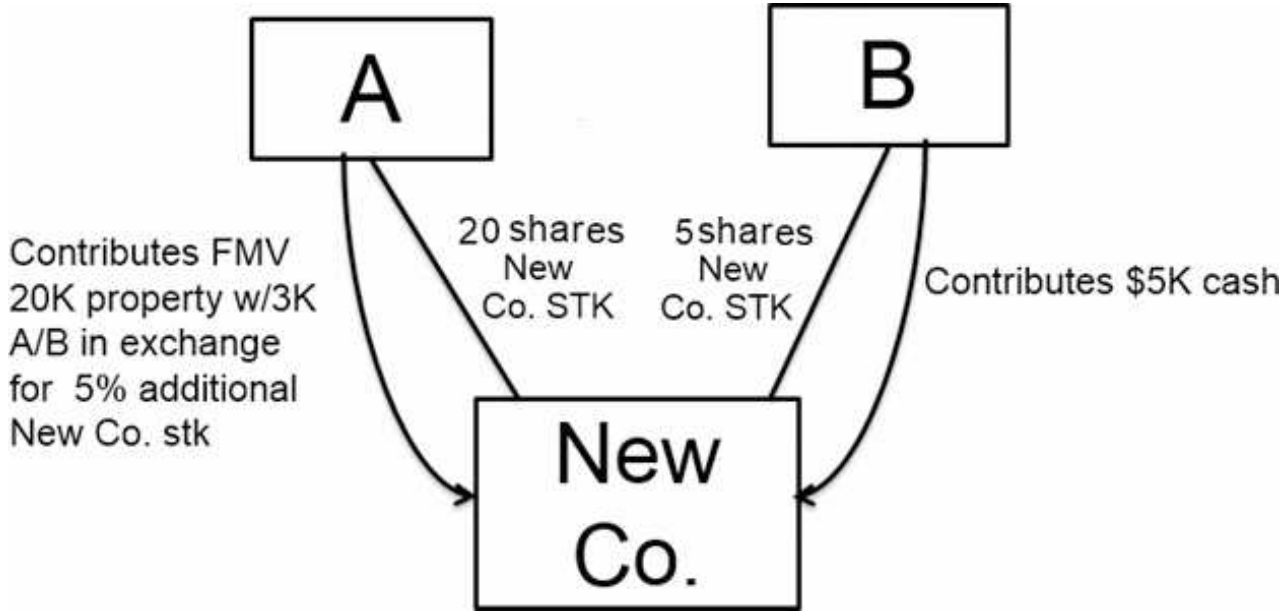
§ 351 Property/Services Transaction (2 of 2)

Prior to contribution, A & B's holdings in New Co. stock is worth $50K each, and they each own 50 shares of New Co. STK.



§351 is satisfied because B contributes additional property worth at least 10% (50K x 10% = 5K) of the current holdings. A can defer recognizing $17K (20K − 3K) of BIG.

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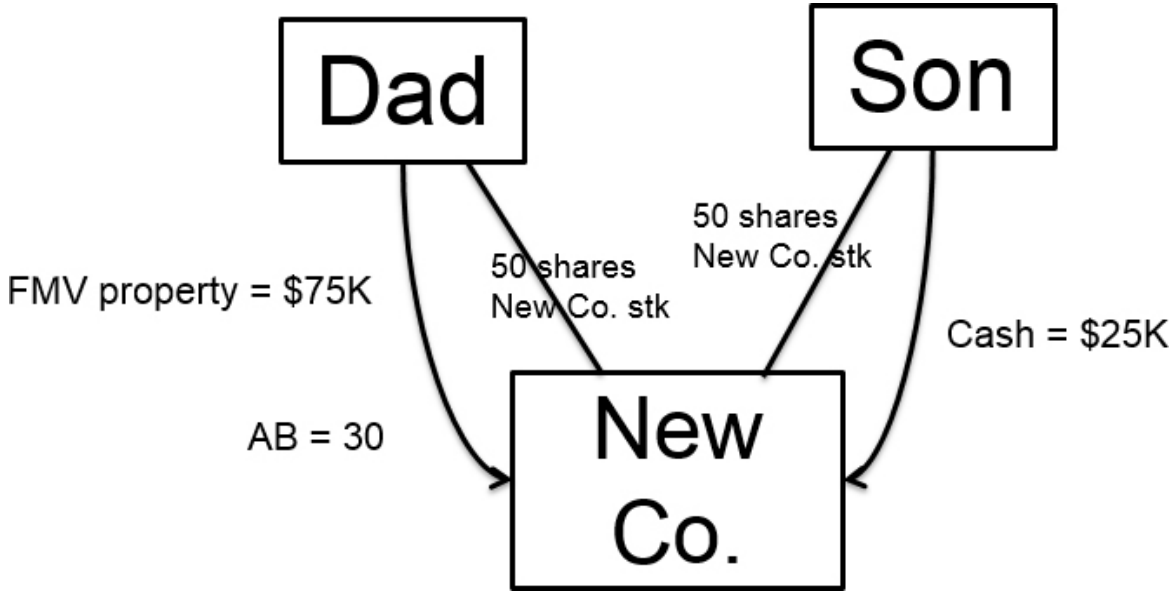
Disproportionate Exchanges



- Dad may owe gift taxes on extra 25 shares transferred to Son.
- §351 is met so Dad can defer $45K gain (75K − 30K)
- Dad deemed to have made gift of 25 shares to Son
- Dad's AB in his 50 shares is $20K ($\frac{50}{75} \times 30$)
- Son's AB is $35K ($25K cash + 10K basis from 25 shares gift by Dad)

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Effect of § 351 on Transferors

Issues:

1. Is there realized gain or loss?
2. Is there recognized gain or loss?
3. What is the character of the recognized gain or loss?
4. What is the carryover basis to the New Co. stock?
5. What is the holding period?

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What Is Boot?

- Cash
- Notes
- Property
- Securities
- Stock in another company
- Boot is NOT stock in transferee co.

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Computing Shareholder Basis

- Basis in Boot: Transferor's basis = FMV
- Basis in New Co. stock:

A/B Property transferred to New Co. + Gain Recognized

- FMV boot received
- Cash boot received
- Liabilities assumed by New Co.

A/B of Stock Received

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Example: Allocation of Gain

	Equip	Land
FMV	$30K	$70K
% of FMV	30%	70%
A / B	$20K	$20K
Realized Gain	$10K	$50K

Received: $50K, 50 share New Co. (100%)

Allocated Boot	$15K	$35K
Gain Recog.	$10K	$35K

C/O Basis in New Co. = $40K + $45 − $50 = $35

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Effect of § 351 to Transferees

Issues:

1. Is there realized gain or loss?
2. Is there recognized gain or loss?
3. What is the character of the recognized gain or loss?
4. What is the carryover basis to the assets received?
5. What is the holding period?

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Effect of § 351 to Transferees – Realized/Recognized Gain/Loss

- Transfer of New Co. stock or debt issued by New Co. in exchange for services, property, or cash = no realized or recognized gain or loss.
- New Co.'s transfer of property to new shareholder = gain is recognized as if it had been sold.
- Losses are not recognized. Sell it first!

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Effect of § 351 to Transferees – Basis in Property Received

Transferor's A/B in property being transferred to New Co.

+ Gain recognized by transferor

- Any reduction for loss property

New Co.'s basis in property received

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Example 1

Bob transfers to New Co. a piece of land with FMV of $20K and A/B of $2K in exchange for 100% of New Co. stock. Bob has owned the land for 2 years.

Since § 351 applies, then New Co. will take an A/B in the land of $2K and will have the same holding period as Bob.

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Example 2

Bob transfers to New Co. a piece of land with FMV of $20K and A/B of $2K in exchange for 50% of New Co. stock. Bob has owned the land for 2 years.

Since § 351 does NOT apply, then Bob recognizes $18K in gain. New Co. will take an A/B in the land of $20K and will start a new holding period.

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Effect of § 351 to Transferees – Receipt of Loss Property (1 of 2)

- If a shareholder transfers loss properties to a corporation, then the basis of the properties must be reduced to FMV.
- Prevents a "double deduction" – One at the shareholder level with a high basis, and a high basis at the corporate level if there were no reduction.
- Reduction in basis is allocated in proportion to the built-in losses on a shareholder by shareholder basis.

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Effect of § 351 to Transferees – Receipt of Loss Property (2 of 2)

- If A/B is not reduced to FMV, then holding period will tack.
- If total FMV of assets is > total A/B, then no reduction is required.
- If shareholders elect, the shareholders can take a reduction in basis instead of the corporation.

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Assumption of Transferor's Liabilities (1 of 2)

- For transfers NOT under like-kind exchange rules (§ 1031), the assumption of shareholder's indebtedness by New Co. is NOT the equivalent to receiving cash.
- Assumption of liability is in essence treated as a return of capital and reduces the transferor's A/B.

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Assumption of Transferor's Liabilities (2 of 2)

- Can use this treatment as long as:
  1. There was a proper business purpose for the debt; and
  2. Liabilities assumed not > total A/B of property transferred.
- If the liabilities > basis, § 357(c), then transferor must recognize excess liability as gain.
- Transferor has zero basis in his/her New Co. stock.

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Calculating Transferor's Basis

Assuming New Co. assumes Transferor's liabilities:

Basis in transferred asset

+ Cash transferred

+ Gain recognized (excess liabilities over basis)

+ Transferor's liabilities assumed by New Co.

Transferor's basis in New Co. stock

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§ 118 Example

Stonebriar, Inc., wants Robby's Sporting Goods to locate in its new mall that it is developing in Denton. It offers Robby's a tract of land on the mall site upon which the sporting goods store can be built. The FMV of the land = $1 million. Stonebriar's A/B is $100K. Robby's does not have to recognize the $1m in income, but it must take a basis of $0 in the land.

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Worthless Securities

- Examples of ordinary loss situations:
  - Securities that are non-capital.
  - Stock in affiliated corporations.
  - § 1244 stock.
- Worthless Unsecured debt
  - Non-business debts = short-term capital loss.
  - Business debts = ordinary losses.
- Ordinary losses = NOLs that can be carried forward indefinitely (limited to 80% of taxable income) starting in 2018.

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Tax Planning Considerations

- § 351 is automatic, not elective.
- Loss property – Should be disposed of before any § 351 transaction so any losses can be recognized.
- Can also avoid § 351 by busting 80% requirement. TP may have a reason for carrying a high basis in assets.
- However, § 267 may prevent loss recognition anyway if s/holder owns > 50%

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