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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.

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 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)).

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.

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 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.

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 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.

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-	$ 4,500	$ 7,500	$ -0-	$ -0-
Lucia:					
Pass-through income	$50,000	$ -0-	$ -0-	$30,000	$50,000
Salary income	-0-	20,000	-0-	20,000	-0-
Dividend income	-0-	-0-	20,000	-0-	-0-
Total income to Lucia	$50,000	$20,000	$20,000	$50,000	$50,000
Lucia's tax	$12,500[a]	$ 5,000[b]	$ 3,000[c]	$12,500[d]	$12,500[e]
Total Tax	$12.500	$ 9,500	$10,500	$12.500	$12.500

[a]$50,000 x 0.25 = $12,500
[b]$20,000 x 0.25 = $5,000
[c]$20,000 x 0.15 = $3,000
[d]$50,000 x 0.25 = $12,500
[e]$50,000 x 0.25 = $12,500

Because corporate taxable income is low enough to be taxed at 15% and dividends are taxed at 15%, the C corporation options are better than the sole proprietor and S corporation options because, under the latter options, all income is taxed at Lucia's 25% ordinary tax rate. Within the C corporation options, the salary situation is better than the dividend situation because less income is subject to double taxation as a result of the salary deduction. These results apply only to the given factual circumstances. For example, if the corporation's income were taxed at higher marginal tax rates, such as 35% or 39%, the C corporation options would be less attractive than the sole proprietor and S corporation options. pp. C:2-2 through C:2-8.

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

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:

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

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 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

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

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.

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

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

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.

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:2-42 a. $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.

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.

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. None. Ace Corporation reports no income.

b. Ace takes a zero basis in the land.

c. Ace reports 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 funds, or $150,000. p. C:2-31.

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.

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 34% marginal 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 34% marginal 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.

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 a. No. The transaction does not meet the requirements of Sec. 351. Transferors of property, Eric and Florence, own only 75% (750/1,000 = .75) of the Wildcat stock, which fails the 80% test.

b. Eric recognizes a $150,000 capital loss on the land ($50,000 FMV - $200,000 basis). Florence recognizes a $25,000 gain ($25,000 FMV - $0 basis) on the equipment. The gain is treated as ordinary income under Sec. 1245 recapture rules. George recognizes $25,000 of ordinary income as compensation for his services. Wildcat Corporation recognizes no gain or loss on issuing its stock for property or services.

c. Eric's basis in his stock is $50,000, its FMV. Florence's basis in her stock is $25,000, its FMV. George's basis in his stock is $25,000, its FMV. They each have a holding period that begins the day after the exchange date.

d. Wildcat's bases in the assets received are as follows: land $50,000 (FMV) and equipment $25,000 (FMV). The holding period for the land and equipment begins the day after the exchange date. The legal services may be deductible by Wildcat if incurred after operations have begun. They might have to be amortized over a period of time depending on when they were incurred and for what they were incurred. Also, if George has not yet performed the services, deduction may be deferred until economic performance occurs. pp. C:2-12 through C:2-27.

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.

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.
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.
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.
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. 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.

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.

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 back or forward to offset the corporation's income in other years. Paula and Mary could not use such losses to offset income they earn over the next two years.

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 investors are contributing cash <u>and</u> 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 will permit a tax savings for the first $75,000 of corporate taxable income but 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 (which may be lower than the corporate tax rates) and avoid the possibility of double taxation.

7. By retaining C corporation status Bob would be permitted to exclude 50%, 75%, or 100% (depending on the acquisition date) of the gain recognized on the sale or exchange of qualified small business corporation stock that has been held for more than five years. The included gain is taxed at 28%, making the effective rate on the entire gain 14%, 7.84%, or 0%. 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.

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. 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 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.

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.

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 The memorandum should point out that, for tax purposes, Lisa and Matthew recognize no gain or loss (Sec. 351(a)). Lisa's basis in her stock is $50,000. Matthew's basis in his stock is $35,000 (Sec. 358(a)). Lima Corporation recognizes no gain on issuing the stock (Sec. 1032). Lima's basis in the land is $35,000 (Sec. 362(a)).

For financial accounting purposes, Lima records the land on its books at its $50,000 FMV and credits the capital account as follows: Common stock, $50,000 (ASC 845, formerly APB No. 29).

Lima's balance sheet immediately after the corporate information is as follows:

Assets		Capital	
Cash	$ 50,000	Common Stock	$100,000
Land	50,000		
Total	$100,000	Total	$100,000

For financial accounting purposes, the transferor will recognize gains and losses on the asset transfer. In this case, it is unlikely that either Lisa or Matthew would be maintaining GAAP financial accounting records.

C:2-65 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:2-66 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

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.

"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 (See page C:2-31). 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.

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 dependency exemption is available.

pp. I:2-3 through I:2-5.

I:2-2 The term "income" includes all income from whatever source derived based either on principles of economics or accounting. Gross income refers only to income from taxable sources. p. I:2-3.

I:2-3 a. A deduction is an amount that is subtracted from 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 direct dollar for dollar tax savings. The savings from a deduction depends 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 All dependents (1) must have social security numbers reported on the taxpayer's return, (2) must meet a citizenship test, (3) cannot normally file a joint return, and (4) cannot claim others as dependents. Qualifying children 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 be self-supporting. Other dependents must (1) be related to the taxpayer (or reside in the taxpayer's home for the entire year), (2) have gross income less than the amount of the personal exemption, and (3) receive over one-half of their support from the taxpayer. pp. I:2-12 through I:2-17.

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.

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 dependency exemption. Also, in the case of divorced couples, the parent with custody for over half of the year receives the dependency exemption even if that parent did not provide more than 50% of the child's support. Similarly, in the case of written agreement, the dependency exemption can be given to the noncustodial parent 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 through I:2-18.

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:2-20.

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:2-35.

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, and the standard deduction may be greater than itemized deductions. p. I:2-11.

I:2-9 If the threshold were "50% or more" two individuals who provided equal amounts of support for another person could both claim a dependency exemption for that individual. By specifying "over 50%" only one individual can meet the requirement. A multiple support agreement could be used by two individuals who provide equal amounts of support to allow one of the two to claim a dependency exemption. 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. The normal due date is delayed to the next day that is not a Saturday, Sunday or holiday. p. I:2-35.

I:2-11 Automatic extensions of six months generally are available. Any tax that may be owed must be paid with the application for an extension. p. I:2-36.

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.

I:2-14 The purpose of the multiple support agreement is to allow one member of a group to claim a dependency exemption when the members together contribute more than 50% of the support of another 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. p. I:2-17.

I:2-15 In general, the parent with custody for the greater part of the year receives the exemption. The noncustodial parent is entitled to the dependency exemption only if required documentation provides that the noncustodial parent is to receive the exemption. p. I:2-17.

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 his or her income on the return. p. I:2-21.

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:2-23.

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. pp. I:2-22 and I:2-23.

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 of lower corporate tax rates on taxable income up to $75,000. 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 Up to $50,000 of income earned by a C corporation is taxed at 15%. 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 will be higher than 15%. Thus, the current tax can be reduced if the corporate form is used and income is retained in the corporation. This advantage is 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. A net long-term capital gain is taxed at 15% (0% in the case of an individual taxpayer who is in the 10% or 15% tax bracket and 20% in the case of an individual in the 39.6% tax bracket). 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. p. I:2-30.

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 it 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.

c. The tax on the unearned income of a minor (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:2-32 and I:2-33.

I:2-24 a. Both the husband and wife are liable for additional taxes on a joint return. An exception exists for the 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 look to either spouse to collect the taxes. pp. I:2-33 and I:2-34.

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. pp. I:2-33 and I:2-34.

Issue Identification Questions

I:2-26 The main issue is whether Yung can claim a dependency exemption for his nephew. 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 a dependency exemption has been permitted when special circumstances were present. For example, the Tax Court allowed an exemption 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 15% 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. p. I:2-33.

I:2-28 The primary tax issue is the filing status for both Bill and Jane. Both can file as single 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 of household status. Jane should also fail to quality 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. pp. I:2-22 and I:2-23.

Problems

I:2-29

	Lanes	**Waynes**
Salary	$32,000	$115,000
Interest	1,000	10,000
Gross Income	$33,000	$125,000
Minus: IRA Contribution	(5,000)	-0-
Adjusted gross income	$28,000	$125,000
Minus: Itemized deductions	(15,000)	(15,000)
Exemptions	(8,100)	(8,100)
Taxable Income	$ 4,900	$101,900
Gross tax (using Rate Schedule)	$ 490*	$ 17,018
Minus: Withholding	(700)	(18,700)
Tax due (refund)	($ 210)	($ 1,682)

* This answer is based on the 2016 rate schedule. The 2016 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
	Interest		1,600
	Adjusted gross income		$ 3,400
	Minus: Standard deduction		(6,300)
		Exemption	(4,050)
	Taxable income		-0-
b.	Salary		$ 1,800
	Interest		1,600
	Adjusted gross income		$ 3,400
	Minus: Standard deduction ($1,800 + $350)		(2,150)
		Exemption	-0-
	Taxable income		$ 1,250

pp. I:2-11 and I:2-12.

I:2-31 a.

Adjusted gross income	$36,000
Minus: Standard deduction	(12,600)
Exemptions	(8,100)
Taxable income	$15,300

b.

Salary (Carl)	$14,000
Minus: Itemized deductions	-0-
Exemption	(4,050)
Taxable income	$9,950

Salary (Carol)	$22,000
Minus: Itemized deductions	(8,500)
Exemption	(4,050)
Taxable income	$ 9,450

Note: Because Carol claimed itemized deductions on her return, Carl must also itemize. Both could have claimed a standard deduction of $6,300 (total of $12,600), so combined they lost deductions of $4,100 ($12,600–$8,500) by itemizing.

p. I:2-32.

I:2-32 a.

Salary and interest	$20,800
Minus: Standard deduction	(12,600)
Exemptions	(8,100)
Taxable income	$ 100
Gross tax	$ 10

b.

Salary	$20,000
Minus: Standard deduction	(6,300)
Exemption	(4,050)
Taxable income	$ 9,650
Gross tax	$ 984

c. Julio and Jillian should not file a joint return. The parents will have to pay an additional $1,134 in taxes, while Julio and Jillian only save $974 ($984 - $10) by filing a joint return.

I:2-33 a. Brian may not be claimed as a dependent because his gross income exceeds $4,050 (2016). Brian is not a qualifying child because he is over age 23. He is not an other dependent 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 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 $4,050 and no exception applies. If Granny's interest had been less than $4,050, she would have qualified, as Social Security is not included in her gross income.

pp. I:2-14 through I:2-18.

I:2-34 a. Carole and John can claim David and Kristen this year. Jack is not a qualifying child (over age 18 and not a full-time student) and is not another relative because his gross income exceeds $4,050. David can be claimed as a dependent because he is considered 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. In this case, Jack would be considered 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.

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 $4,050 in 2016.

d. If David was 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:2-14 through I:2-18.

I:2-35 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 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 dependency exemptions for the children, he would not benefit from the child credit because of his income. pp. I:2-14 through I:2-18.

I:2-36 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 the dependency exemption. If Linda signs a completed Form 8332, Juan can claim the exemption.

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:2-14 through I:2-18.

I:2-37 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 a dependency exemption 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 standard deduction. pp. I:2-14 through I:2-18.

I:2-38 a. Joan, the custodial spouse, receives both the dependency exemption and child credit.

b. No. p. I:2-17.

I:2-39

	Form	Filing Status	Exemptions	Child Credit
a.	1040EZ	Single	1	0
b.	1040A	Single	1	0
c.	1040	Head-of-Household	1	0
d.	1040A	Single	1	0
e.	1040A	Head-of-Household	2	1

pp. I:2-14 through I:2-24.

I:2-40 a. No dependency exemption or child credit. A cousin must live with the taxpayers in order to qualify as a dependent as a cousin does not automatically meet the relationship test.

b. One dependency exemption. 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.

c. One dependency exemption, no child credit. The daughter is considered 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 child credit.

d. No dependency exemption or child credit. The mother cannot be claimed as a dependent by anyone because she provided over half of her own support. pp. I:2-14 through I:2-20.

I:2-41 a. The information provided suggests that Juan will be in a higher tax bracket than Maria. As a result, personal exemptions are worth more to Juan than to Maria.

b. The child credit is phased out for single taxpayers with AGI above $75,000. Because of his high income, Juan will not be entitled to any child credit. Accordingly, it is their combined tax advantage to allow Maria to take the child credit. The credit, however, is only available to taxpayers who claim dependency exemptions for children. Juan would not willingly agree to forego the dependency exemption without some consideration. The tax savings received by Maria from the dependency exemptions and the child credit should be considered when the amount of child support is being determined

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

I:2-42 a.

Salary ($32,000 + $39,000)	$71,000
Minus: Itemized deductions	(13,600)
Personal exemptions	(8,100)
Taxable income	$49,300
Gross tax	$ 6,468*

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

Salary	$39,000
Minus: Standard deduction	(6,300)
Personal exemption	(4,050)
Taxable income	$28,650
Gross tax	$ 3,834*

Bill's tax filing as a single taxpayer:

Salary	$32,000
Minus: Itemized deductions	(12,000)
Personal exemption	(4,050)
Taxable income	$15,950
Gross tax	$ 1,929*

Their income taxes total $5,763 ($3,834 + $1,929).

*These amounts are based upon the 2016 tax rate schedule because the 2016 tax table was unavailable when the solution was prepared.

c. Their tax will be $705 ($6,468 - $5,763) higher if they marry before year-end. This is attributable to the fact that the itemized deduction available to Bill and the standard deduction available to Mary if they are unmarried are greater than the itemized deductions available to them if they are married—$705 [0.15 x ($6,300 + $12,000 - $13,600)]. pp. I:2-20 through I:2-23.

I:2-43 a. Amy need not file because her gross income is less than the threshold of $10,350 and her self-employment income is less than $400.

b. Betty need not file, as her gross income ($9,100) is less than $11,900 ($6,300 + $1,550 + $4,050).

c. Chris must file, as his gross income of $2,300 exceeds his standard deduction $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 $4,050 and he is married and not living with his spouse. p. I:2-35.

I:2-44 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:2-20 through I:2-24.

I:2-45 a. 2014: Celia files a joint return even though Wayne died in October.

2015: Celia must file as a single taxpayer. As a part-time student, Wally is not a qualifying child.

2016: Same as 2015.

2017: Same as 2015.

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 2015 and 2016 and a single taxpayer in 2017.

I:2-46 a. $95,000 ($46,000 + $49,000).

b.	Gross income	95,000
	Minus: Business expenses	(24,000)
	IRA contributions	(10,000)
	Adjusted gross income	$61,000
c.	Adjusted gross income	$61,000
	Minus: Itemized deductions	(13,000)
	Exemptions ($4,050 x 3)	(12,150)
	Taxable income	$35,850

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

I:2-47 Jan should take the standard deduction. Jan cannot deduct any medical expenses or miscellaneous expenses as they are less than the applicable floors (10% AGI floor for medical and 2% of AGI floor for miscellaneous deductions). 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 $6,300 standard deduction. p. I:2-10.

I:2-48 $1,850 (salary $4,200 + interest $2,200 - standard deduction ($4,200 + $350)). The taxable income would be the same if she were 16 years of age. However, the tax rate applicable to $100 ($2,200 - $2,100) of the interest income would depend on the parents' tax bracket and not be based on Debbie's income (If she is 23 years old and a full-time student, the parents' tax bracket will be used if her earned income is less than half of her support). pp. I:2-24 through I:2-26.

I:2-49 a. Adjusted gross income:

Salary	$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. Personal exemptions ($4,050 x 4) $ 16,200

d. Taxable income

Adjusted gross income	$127,000
Itemized deductions	(19,000)
Personal exemptions	(16,200)
Taxable income	$ 91,800

I:2-50

Karen

Karen's gross tax is $371. At age 21, Karen is subject to the kiddie tax because she is a full-time student who earned 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:	
Unearned income	$2,800
Statutory deduction	(1,050)
Portion of standard deduction	(1,050)
Net unearned income	$ 700

Gross tax:	
Tax on net unearned income ($700 X 0.28)	$ 196
Tax on taxable income less net unearned income ($1,750 X 10%)	175
Gross tax	$ 371

Mike and Linda's taxable income of $180,000 is in the 28% tax bracket (see the tax rate schedule for married couples filing jointly). Karen's net unearned income thus is taxed at a 28% rate.

Susan

Susan's gross tax is $710. Susan does not owe 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	(6,300)
Taxable income	$7,100
Gross tax	$ 710

Amelie
Amelie's gross tax is $203. 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:	
Unearned income	$2,200
Statutory deduction	(1,050)
Portion of standard deduction	(1,050)
Net unearned income	$ 100

Gross tax:	
Tax on net unearned income ($100 X 0.28)	$ 28
Tax on taxable income less net unearned income ($1,750 X 0.10)	175
Gross tax	$ 203

I:2-51 a.

Salary	$ 60,000
S corporation income	40,000
Adjusted gross income	$100,000
Itemized deductions	(18,000)
Personal exemption	(4,050)
Taxable income	$ 77,950
Gross tax	$ 15,259

b.

Corporation:	
Taxable income	$ 40,000
Gross tax (0.15 x $40,000)	$ 6,000
Individual:	
Salary	$ 60,000
Dividend ($40,000 - $6,000)	34,000
Adjusted gross income	$ 94,000
Itemized deductions	(18,000)
Personal exemption	(4,050)
Taxable income	$ 71,950
Gross tax	$ 10,359*
Total tax ($6,000 + $10,359)	$ 16,359

*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 $34,000 is $5,100 (0.15 x $34,000). The tax on the remaining income of $37,950 ($71,950 - $34,000) is $5,259 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, $6,000, but the shareholder is only taxed on the salary of $60,000.

Adjusted gross income	$ 60,000
Itemized deductions	(18,000)
Personal exemption	(4,050)
Taxable income	$ 37,950
Gross tax	$ 5,259
Total tax ($6,000 + $5,259)	$ 11,259

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:2-30.

I:2-52 Lana's child credit is $2,450 [(3 x $1,000) - ($50 x 11)]. p. I:2-19.

I:2-53 a. They will save $1,188 ($3,000 x 0.396). 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 $1,188 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:2-54

		2016	2017
a.	Salary	$20,000	$20,000
	Minus: Itemized or standard deduction	(6,300)	(9,000)
	Exemption	(4,050)	(4,050)
	Taxable income	$ 9,650	$ 6,950
	Gross Tax	$ 984	$ 695
b.	Salary	$20,000	$20,000
	Minus: Itemized or standard deduction	(6,300)	(8,000)
	Exemption	(4,050)	(4,050)
	Taxable income	$ 9,650	$ 7,950
	Gross tax	$ 984	$ 795
c.	Salary	$20,000	$20,000
	Minus: Itemized or standard deduction	(6,300)	(10,000)
	Exemption	(4,050)	(4,050)
	Taxable income	$ 9,650	$ 5,950
	Gross tax	$ 984	$ 595

d. By contributing the $2,000 in 2017, Virginia is able to deduct the entire amount. If $1,000 is contributed in each year, only the $1,000 contributed in 2017 is deductible. No tax benefit is received in 2016 because the contribution is less than the standard deduction. If $2,000 is contributed in 2016, then no tax benefit is received. pp. I:2-32 and I:2-33.

I:2-55 a. 1040A
b. 1040
c. 1040A
d. 1040A

p. I:2-36.

I:2-56 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 $37,700.

Adjusted gross income	$48,000
Standard deduction	(6,300)
Personal exemption	(4,050)
Taxable income	$37,650

c. Maria's tax liability is $5,184.

I:2-57 a. As no special rules apply and taxable income is $83,000, the gross tax is $12,293.

b. Ralph and Tina are entitled to a child credit for Tina equal to $1,000.

c. Pam's gross tax is computed as follows:

Gross income (interest)	$3,500
Minus: Standard deduction	(1,050)
Taxable income	$2,450
Tax on first $1,050 (0.10 x $1,050)	$ 105
Tax on remaining $1,400 (0.25 x $1,400)	350
Gross tax	$ 455

d. If Pam were age 25, her tax would be computed without reference to the parents' tax rate. Thus, her tax would be $245 (0.10 x $2,450) assuming she is still a dependent.

I-2:58 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	$379,900
Minus: Itemized deductions	(17,942)*
Personal and dependency exemptions	(3,564)**
Taxable income	$358,394
Gross income tax	$ 93,683

*$20,000 - [0.03 x ($379,900 - $311,300)]
**($379,900 - $311,300)/$2,500 = 27.44, which rounds up to 28
28 x 0.02 = 0.56
($4,050 x 2) – (0.56 x $4,050 x 2) = $3,564

Because of her high income, Gail's child credit is fully phased-out and she also owes a 3.8% tax on her investment income over $250,000 or $4,936 (0.038 x [$379,900 - $250,000]).

c. Because having a dependent child is required to qualify as a surviving spouse, Gail must file as a single taxpayer.

pp. I:2-10, I:2-18, and I:2-31.

Tax Strategy Problems

I:2-59 The tax liability under the three alternatives is computed as below:

Business income	**Proprietorship**	**S Corporation**	**C Corporation**
Operating income	$60,000	$60,000	$60,000
Compensation paid to Jack		(40,000)	(40,000)
Net	$60,000	$20,000	$20,000
Corporate income tax			$ 3,000
Jack's income			
Business income	$60,000	$20,000	
Compensation		40,000	$40,000
Dividends			5,000
Other income	1,000	1,000	1,000
Adjusted Gross Income	$61,000	$61,000	$46,000
Other itemized deductions	(10,000)	(10,000)	(10,000)
Personal exemption	(4,050)	(4,050)	(4,050)
Taxable income	$46,950	$46,950	$31,950
Individual income tax	$ 7,509	$ 7,509	$ 3,579
Total tax	$ 7,509	$ 7,509	$ 6,579

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, however, does face a potential future individual income tax on the remaining $12,000 ($20,000 - $3,000 - $5,000) of corporate income in the year he 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 when he makes an S election. Dividends received by individuals in the 10% and 15% tax brackets are exempt from income tax. Jack's taxable income is $31,950 which is below the top-end of the 15% tax bracket. As a result, the current year's dividends do not result in a tax. Nevertheless, there may be a tax on future dividend distributions if Jack has more income. pp. I:2-27 through I:2-30.

I:2-60 a. Andrea will save $792 (39.6% 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 $238 (39.6% x $600) if she makes the gift. Given the amount of her income, the daughter will owe no tax.

d. Andrea will save $238. She however will not be as well off because the exempt interest of $300 is less than the after tax interest of $362 ($600 - $238) from the taxable bonds.

Tax Form/Return Preparation Problems

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

I:2-62 (See Instructor's Resource Manual)

I:2-63 (See Instructor's Resource Manual)

Case Study Problems

I:2-64 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 39.6%, 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 39.6%.

Because of her age, Kim is currently subject to the "kiddie tax", which means that most of her capital gain will be taxed at her parents' rate (20% for capital gains). By waiting to sell her land when she is no longer subject to the kiddie tax, she will be able to use her standard deduction to offset part of the gain and the remainder may be taxed at a low rate (perhaps zero). p. I:2-30.

I:2-65 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:2-33 and I:2-34.

Tax Research Problems

I:2-66 Since the stepdaughter and her family do not live with Ed, they must be related to him in order to qualify as his dependents. Clearly, the stepdaughter meets this test. Stepdaughters are specifically listed in Sec. 152(a)(2) as relatives. 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(a). 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 step-children and their descendants which suggests that the child is eligible to be claimed as a dependent.

I:2-67 The full exemption deduction for a dependent is available even though the dependent is born or dies during the year. In Rev. Rul. 73-156, 1973-1 C.B. 58, the IRS ruled that an exemption 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:2-68 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:2-28.

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, claim an additional personal exemption, and utilize a larger standard deduction. Before she could file a joint return, Jane would have to be appointed as Jim's guardian.

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.

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.

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

After 2012, the capital gains rate for noncorporate shareholders can be 0% for taxpayers in tax brackets of 15% and below, 15% for taxpayers in the 25% through 35% tax brackets, and 20% for taxpayers in the 39.6% tax bracket. An additional 3.8% capital gains rate applies for taxpayers whose modified AGI exceeds $200,000 ($250,000 for married filing jointly).

In 2011 and 2012, the employee's half of Social Security taxes was reduced from 6.2% to 4.2%. In 2013, the employee's share returned to 6.2% and continued at this rate in 2014 up to earnings of $117,000, and $118,500 in 2015 and 2016.

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.

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.

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. p. C: 2-4.

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 taxpaying entity that is taxed at rates ranging from 15% to 35%. A corporation must file a Form 1120 annually. Income may be taxed twice, once when earned by the corporation and either when it is paid out as a dividend or when the stock is sold or exchanged. Examples C:2-5 and C:2-6, p. C: 2-5, illustrate this point. A completed Form 1120 with related facts is included in Appendix B.

1. **Tax Advantages.** A corporation is taxed at marginal tax rates of 15% on the first $50,000 of taxable income and 25% on the next $25,000 of taxable income. These tax rates may be lower than the shareholder's marginal tax rate. As long as earnings are not distributed and taxed to both the shareholder and the corporation, a tax savings may result. Personal service corporations, personal holding companies and corporations accumulating earnings beyond the reasonable needs of the business have special taxing provisions. p. C: 2-5.

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.

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 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.

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. C2-8, 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.

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. However, nonqualified preferred stock is treated as boot. Preferred stock is nonqualified if: 1) the shareholder can require the corporation to redeem the stock; 2) the corporation is either required to redeem the stock or is likely to exercise a right to redeem the stock; or 3) the dividend rate on the stock varies with interest rates, commodity prices, or other similar indices. 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 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 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 use as much debt as possible. Where debt financing resembles equity obligations, 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.** If assets are exchanged for debt instruments, whether part of an otherwise tax-free transaction or not, the FMV of the debt received is treated as boot.

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 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.** The basis of property contributed by a nonshareholder is zero. If money is contributed, the basis of any property acquired with such money during a 12-month period beginning on the day the contribution was received is reduced by the amount of the contribution used toward the purchase. The amount of any monies contributed by nonshareholders that are not spent to purchase property during the 12-month period reduces first the basis of depreciable property, then amortizable property, depletable property, and all other property. Basis is not reduced below zero. (See Example C:2-45.)

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 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.

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 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.

Form **1120S**

Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation

▶ Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.

OMB No. 1545-0123

2015

For calendar year 2015 or tax year beginning , 2015, ending , 20

A S election effective date: 1/24/2005	Name: Bottle-Up,Inc.	D Employer identification number: XX-XXXXXXX
B Business activity code number (see instructions): 327210	Number, street, and room or suite no. If a P.O. box, see instructions.: 1234 Hill Street	E Date incorporated: 1/08/2005
C Check if Sch. M-3 attached	City or town, state or province, country, and ZIP or foreign postal code: City, ST 33333	F Total assets (see instructions): $ 750,028

TYPE OR PRINT

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☐ No If "Yes," attach Form 2553 if not already filed

H Check if: (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return (5) ☐ S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year . . . ▶ 2

Caution. Include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.

	Line	Description		Amount
Income	1a	Gross receipts or sales	1a	2,500,000
	b	Returns and allowances	1b	15,000
	c	Balance. Subtract line 1b from line 1a	1c	2,485,000
	2	Cost of goods sold (attach Form 1125-A)	2	1,474,000
	3	Gross profit. Subtract line 2 from line 1c	3	1,011,000
	4	Net gain (loss) from Form 4797, line 17 (attach Form 4797)	4	
	5	Other income (loss) (see instructions—attach statement)	5	
	6	Total income (loss). Add lines 3 through 5 ▶	6	1,011,000
Deductions (see instructions for limitations)	7	Compensation of officers (see instructions—attach Form 1125-E)	7	120,000
	8	Salaries and wages (less employment credits)	8	331,020
	9	Repairs and maintenance	9	38,000
	10	Bad debts	10	620
	11	Rents	11	30,000
	12	Taxes and licenses	12	39,480
	13	Interest	13	1,000
	14	Depreciation not claimed on Form 1125-A or elsewhere on return (attach Form 4562)	14	36,311
	15	Depletion (Do not deduct oil and gas depletion.)	15	
	16	Advertising	16	105,000
	17	Pension, profit-sharing, etc., plans	17	
	18	Employee benefit programs	18	11,000
	19	Other deductions (attach statement)	19	226,102
	20	Total deductions. Add lines 7 through 19 ▶	20	938,533
	21	Ordinary business income (loss). Subtract line 20 from line 6	21	72,467
Tax and Payments	22a	Excess net passive income or LIFO recapture tax (see instructions)	22a	
	b	Tax from Schedule D (Form 1120S)	22b	
	c	Add lines 22a and 22b (see instructions for additional taxes)	22c	
	23a	2015 estimated tax payments and 2014 overpayment credited to 2015	23a	
	b	Tax deposited with Form 7004	23b	
	c	Credit for federal tax paid on fuels (attach Form 4136)	23c	
	d	Add lines 23a through 23c	23d	
	24	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶	24	
	25	Amount owed. If line 23d is smaller than the total of lines 22c and 24, enter amount owed	25	
	26	Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid	26	
	27	Enter amount from line 26 Credited to 2016 estimated tax ▶ Refunded ▶	27	

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.

Heuman Hiebert 4/14/16
Date Title

with the preparer shown below No

Paid Check if

Print/Type preparer's name	Preparer's signature	Date	May the IRS discuss this return (see instructions)? Yes
			PTIN
Use Only	Firm's name ▶		Firm's EIN ▶
	Firm's address ▶		Phone no.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11510H Form 1120S (2015)

Schedule B Other Information (see instructions)

		Yes	No
1	counting method: a ☐ Cash b ☐ Accrual c ☐ Other (specify) ►		
2	See the instructions and enter the: a Business activity ► Manufacturing b Product or service ► Glass bottles		
3	At any time during the tax year, was any shareholder of the corporation a disregarded entity, a trust, an estate, or a nominee or similar person? If "Yes," attach Schedule B-1, Information on Certain Shareholders of an S Corporation . .		
4	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 stock issued and outstanding of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below		

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage of Stock Owned	(v) If Percentage in (iv) is 100%, Enter the Date (if any) a Qualified Subchapter S Subsidiary Election Was Made

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital 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 (v) below		

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

		Yes	No
5 a	At the end of the tax year, did the corporation have any outstanding shares of restricted stock?		
	If "Yes," complete lines (i) and (ii) below. (i) Total shares of restricted stock . . . . ► (ii) Total shares of non-restricted stock . . . . ►		
b	At the end of the tax year, did the corporation have any outstanding stock options, warrants, or similar instruments? .		
	If "Yes," complete lines (i) and (ii) below. (i) Total shares of stock outstanding at the end of the tax year ► (ii) Total shares of stock outstanding if all instruments were executed ►		
6	Has this corporation filed, or is it required to file, Form 8918, Material Advisor Disclosure Statement, to provide information on any reportable transaction?		
7	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.		
8	If the corporation: (a) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to the basis of the asset (or the basis of any other property) in the hands of a C corporation and (b) has net unrealized built-in gain in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see instructions) . . . . ► $		
9	Enter the accumulated earnings and profits of the corporation at the end of the tax year. $		
10	Does the corporation satisfy both of the following conditions?		
a	The corporation's total receipts (see instructions) for the tax year were less than $250,000		
b	The corporation's total assets at the end of the tax year were less than $250,000 . . . . If "Yes," the corporation is not required to complete Schedules L and M-1.		
11	During the tax year, did the corporation have any non-shareholder debt that was canceled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt? . . . . If "Yes," enter the amount of principal reduction $		
12	During the tax year, was a qualified subchapter S subsidiary election terminated or revoked? If "Yes," see instructions .		
13 a	Did the corporation make any payments in 2015 that would require it to file Form(s) 1099?		
b	If "Yes," did the corporation file or will it file required Forms 1099?		

Form 1120S (2015) Page 3

Schedule K Shareholders' Pro Rata Share Items

Section	Line	Item	Box	Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 21)	1	72,467
	2	Net rental real estate income (loss) (attach Form 8825)	2	
	3a	Other gross rental income (loss)	3a	
	b	Expenses from other rental activities (attach statement)	3b	
	c	Other net rental income (loss). Subtract line 3b from line 3a	3c	
	4	Interest income	4	1,200
	5	Dividends: a Ordinary dividends	5a	11,600
		b Qualified dividends	5b	11,600
	6	Royalties	6	
	7	Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	7	
	8a	Net long-term capital gain (loss) (attach Schedule D (Form 1120S))	8a	48,666
	b	Collectibles (28%) gain (loss)	8b	
	c	Unrecaptured section 1250 gain (attach statement)	8c	
	9	Net section 1231 gain (loss) (attach Form 4797)	9	(1,100)
	10	Other income (loss) (see instructions) Type ▶	10	
Deductions	11	Section 179 deduction (attach Form 4562)	11	
	12a	Charitable contributions	12a	9,000
	b	Investment interest expense	12b	500
	c	Section 59(e)(2) expenditures (1) Type ▶ (2) Amount ▶	12c(2)	
	d	Other deductions (see instructions) Type ▶ Investment expenses	12d	600
Credits	13a	Low-income housing credit (section 42(j)(5))	13a	
	b	Low-income housing credit (other)	13b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468)	13c	
	d	Other rental real estate credits (see instructions) Type ▶	13d	
	e	Other rental credits (see instructions) Type ▶	13e	
	f	Biofuel producer credit (attach Form 6478)	13f	
	g	Other credits (see instructions) Type ▶	13g	
Foreign Transactions	14a	Name of country or U.S. possession ▶		
	b	Gross income from all sources	14b	
	c	Gross income sourced at shareholder level	14c	
		Foreign gross income sourced at corporate level		
	d	Passive category	14d	
	e	General category	14e	
	f	Other (attach statement)	14f	
		Deductions allocated and apportioned at shareholder level		
	g	Interest expense	14g	
	h	Other	14h	
		Deductions allocated and apportioned at corporate level to foreign source income		
	i	Passive category	14i	
	j	General category	14j	
	k	Other (attach statement)	14k	
		Other information		
	l	Total foreign taxes (check one): ▶ Paid Accrued	14l	9,000
	m	Reduction in taxes available for credit (attach statement)	14m	
	n	Other foreign tax information (attach statement)		
Alternative Minimum Tax (AMT) Items	15a	Post-1986 depreciation adjustment	15a	
	b	Adjusted gain or loss	15b	
	c	Depletion (other than oil and gas)	15c	600
	d	Oil, gas, and geothermal properties—gross income	15d	
	e	Oil, gas, and geothermal properties—deductions	15e	14,500
	f	Other AMT items (attach statement)	15f	
Items Affecting Shareholder Basis	16a	Tax-exempt interest income	16a	
	b	Other tax-exempt income	16b	
	c	Nondeductible expenses	16c	
	d	Distributions (attach statement if		

required) (see instructions) . . . . 16d e Repayment of loans from shareholders 16e

70,000

Form 1120S (2015)

Form 1120S (2015) Page 4

Schedule K Shareholders' Pro Rata Share Items (continued)

				Total amount
Other Information	b	Investment expenses	17b	600
	c	Dividend distributions paid from accumulated earnings and profits	17c	
	d	Other items and amounts (attach statement)		
Reconciliation	18	Income/loss reconciliation. Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14l	18	122,733

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)
1	Cash		15,000		
2a	Trade notes and accounts receivable	41,500		45,180	
b	Less allowance for bad debts	( )	41,500		45,180
3	Inventories		102,000		96,000
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)		10,000		10,000
6	Other current assets (attach statement)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)		103,000		74,000
10a	Buildings and other depreciable assets	374,600			
b	Less accumulated depreciation	(160,484)	214,116		201,900
11a	Depletable assets		160,000		190,000
b	Less accumulated depletion	( )		( )	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	( )	600,616	( )	750,028
14	Other assets (attach statement)				
15	Total assets		36,000		10,000
	Liabilities and Shareholders' Equity		44,000		52,000
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach statement)		20,616		19,666
19	Loans from shareholders		10,000		5,000
20	Mortgages, notes, bonds payable in 1 year or more		210,000 / 10,000		260,000 / 10,000
21	Other liabilities (attach statement)				
22	Capital stock		330,000		393,362
23	Additional paid-in capital				
24	Retained earnings				
25	Adjustments to shareholders' equity (attach statement)				
26	Less cost of treasury stock		( )		( )
27	Total liabilities and shareholders' equity		660,616		750,028

Form 1120S (2015)

*$1,200 interest + $11,600 dividends if shareholders elect to tax dividends at ordinary rates under Sec.163(d)(4)(B).

Form 1120S (2015) Page 5

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

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

1	Net income (loss) per books	133,362	5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize): a Tax-exempt interest $ 600	600
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize)				
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14l (itemize): a Depreciation $ b Travel and entertainment $ 10,500 Penalties 1,000 / Keyperson Life 3,000	14,500	6	Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize): a Depreciation $ 24,529	24,529
			7	Add lines 5 and 6	25,129
4	Add lines 1 through 3	147,862	8	Income (loss) (Schedule K, line 18). Line 4 less line 7	122,733

Undistributed Taxable Income Previously Taxed (see instructions)

		(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year	274,300	0	
2	Ordinary income from page 1, line 21	72,467		
3	Other additions	61,466	600	
4	Loss from page 1, line 21	( )		
5	Other reductions	(25,700)	( )	
6	Combine lines 1 through 5	382,533	600	
7	Distributions other than dividend distributions	70,000		
8	Balance at end of tax year. Subtract line 7 from line 6	312,533	600	

Form 1120S (2015)

Bottle-Up, Inc.
XX-XXXXXXX 2015 Form 1120S

Page 1, Line 12 - Taxes and licenses:

Payroll taxes	$ 36,980
Other taxes	2,500
Total	$ 39,480

Page 1, Line 19 - Other deductions:

Utilities expense	$ 54,000
Automobile and truck expense	26,000
Office supplies expense	9,602
Meals and entertainment expense (net of nondeductible 50%)	10,500
Selling expense	100,000
Accounting and legal expense	4,500
Insurance expense	21,500
Total	$226,102

Page 3, Schedule K, Line 16c - Nondeductible expenses:

Keyperson life insurance premium	$ 3,000
Penalties	1,000
Travel and entertainment expenses	10,500
Total	$ 14,500

Form 1125-A, Line 5 - Other costs:

Supplies	$ 80,000
Utilities	100,000
Depreciation	38,000
Other manufacturing costs	150,000
Total	$368,000

Bottle-Up, Inc.
XX-XXXXXXX 2015 Form 1120S

Page 4, Schedule L, Line 18 - Other current liabilities:	**Beginning of Tax Year**	**End of Tax Year**
Accrued salaries payable	$12,000	$ 6,000
Payroll taxes payable	3,416	7,106
Sales taxes payable	5,200	6,560
Total	$20,616	$19,666

Page 4, Schedule L, Line 24 - Retained earnings reconciliation:	
Retained earnings, beginning of tax year	$330,000
Net income per books	133,362
Distributions, other than dividends	(70,000)
Retained earnings, end of tax year	$393,362

Page 5, Schedule M-2, Line 3 - Other additions:	
Interest income	$ 1,200
Dividend income	11,600
LTCG	48,666
Total	$61,466

Page 5, Schedule M-2, Line 5 - Other reductions:	
Sec. 1231 loss	$ 1,100
Charitable contributions	9,000
Investment expenses	600
Investment interest	500
Nondeductible expenses (See Sch. M-1, Line 3b)	14,500
Total	$25,700

SCHEDULE D (Form 1120S)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses and Built-in Gains

► Attach to Form 1120S.
► Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0123

2015

Name: Bottle-Up, Inc.

Employer identification number: XX-XXXXXXX

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 the 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
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				

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 Tax on short-term capital gain included on line 23 below	6	( )
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column (h). Enter here and on Form 1120S, Schedule K, line 7 or 10	7	

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 the 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
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 *	148,666	100,000		48,666

11 Long-term capital gain from installment sales from Form 6252, line 26 or 37	11	
12 Long-term capital gain or (loss) from like-kind exchanges from Form 8824	12	
13 Capital gain distributions (see instructions)	13	
14 Tax on long-term capital gain included on line 23 below	14	( )
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column (h). Enter here and on Form 1120S, Schedule K, line 8a or 10	15	48,666

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S. Cat. No. 11516V Schedule D (Form 1120S) 2015

Note: Page 2 and Form 8949 not attached.

*Capital assets; acquired 3/3/13; sold 9/15/15.

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

Cost of Goods Sold

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

OMB No. 1545-2225

Name: Bottle-Up, Inc.
Employer identification number: XX-XXXXXXX

1	Inventory at beginning of year	1	102,000
2	Purchases	2	200,000
3	Cost of labor	3	200,000
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	368,000
6	Total. Add lines 1 through 5	6	1,570,000
7	Inventory at end of year	7	96,000
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	1,474,000

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. 12-2012)

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.

OMB No. 1545-0184

2015

Attachment Sequence No. 27

Name(s) shown on return	Identifying number
Bottle-Up, Inc.	XX-XXXXXXX

1 Enter the gross proceeds from sales or exchanges reported to you for 2015 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) 1

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)
1231 Property	6/5/14	12/21/15	8,900		10,000	

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	
7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	(1,100)

Partnerships (except electing large partnerships) and S corporations. Report 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 did not have any prior year section 1231 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	
a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

Part II Ordinary Gains and Losses (see instructions)

...inary 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	
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	

18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return 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	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form 4797 (2015)

671113

Schedule K-1 (Form 1120S) **2015**

Department of the Treasury
Internal Revenue Service

For calendar year 2015, or tax year beginning ________, 2015 ending ________, 20____

Shareholder's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number

XX-XXXXXXX

B Corporation's name, address, city, state, and ZIP code

Bottle-Up, Inc.
1234 Hill Street
City, ST 33333

C IRS Center where corporation filed return

Center City, ST

Part II Information About the Shareholder

D Shareholder's identifying number

XXX-XX-XXXX

E Shareholder's name, address, city, state, and ZIP code

Herman Hiebert

F Shareholder's percentage of stock ownership for tax year . . . . 50 %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1 Ordinary business income (loss) 36,234

2 Net rental real estate income (loss)

3 Other net rental income (loss)

4 Interest income 600

5a Ordinary dividends 5,800

5b Qualified dividends 5,800

6 Royalties

7 Net short-term capital gain (loss)

8a Net long-term capital gain (loss) 24,333

8b Collectibles (28%) gain (loss)

8c Unrecaptured section 1250 gain

9 Net section 1231 gain (loss) (550)

10 Other income (loss)

11 Section 179 deduction

12 Other deductions

A 4,500
K 300
H 250
Q 45,000
R 225,510

13 Credits

14 Foreign transactions

15 Alternative minimum tax (AMT) items

A 4,500

16 Items affecting shareholder basis

A 300
C 7,250
D 35,000
A 600

17 Other information

A *5,800
B 300
T **5,000

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S. IRS.gov/form1120s Cat. No. 11520D Schedule K-1 (Form 1120S) 2015

*Investment income if shareholder elects to tax dividends at ordinary rates under Sec. 163(d)(4)(B).

**Loan repayment to Mr. Hiebert.

671113

Schedule K-1
(Form 1120S)

Department of the Treasury
Internal Revenue Service

2015

For calendar year 2015, or tax year beginning ____________, 2015
ending ____________, 20 ______

Shareholder's Share of Income, Deductions, Credits, etc.

► See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
XX-XXXXXXX

B Corporation's name, address, city, state, and ZIP code
Bottle-Up, Inc.
1234 Hill Street
City, ST 33333

C IRS Center where corporation filed return
Center City, ST

Part II Information About the Shareholder

D Shareholder's identifying number
XXX-XX-XXXX

E Shareholder's name, address, city, state, and ZIP code
Melvin Jones

F Shareholder's percentage of stock ownership for tax year . . . . 50 %

For IRS Use

Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

Line	Item	Amount	Line	Item / Code	Amount
1	Ordinary business income (loss)	36,233	13	Credits	
2	Net rental real estate income (loss)				
3	Other net rental income (loss)				
4	Interest income	600			
5a	Ordinary dividends	5,800			
5b	Qualified dividends	5,800			
6	Royalties				
7	Net short-term capital gain (loss)				
8a	Net long-term capital gain (loss)	24,333			
8b	Collectibles (28%) gain (loss)				
8c	Unrecaptured section 1250 gain				
9	Net section 1231 gain (loss)	(550)			
10	Other income (loss)		15	Alternative minimum tax (AMT) items	
			A		4,500
11	Section 179 deduction		16	Items affecting shareholder basis	
12	Other deductions		A		300
			C		7,250
A		4,500	D		35,000
K		300			
H		250	17	Other information	
Q		45,000	A		600
R		225,510	A		*5,800
			B		300

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S. IRS.gov/form1120s Cat. No. 11520D Schedule K-1 (Form 1120S) 2015

*Investment income if shareholder elects to tax dividends at ordinary rates under Sec. 163(d)(4)(B).

This list identifies the codes used on Schedule K-1 for all shareholders and provides summarized reporting information for shareholders who file Form 1040. For detailed reporting and filing information, see the separate Shareholder's Instructions for Schedule K-1 and the instructions for your income tax return.

1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows:

	Report on
Passive loss	See the Shareholder's Instructions
Passive income	Schedule E, line 28, column (g)
Nonpassive loss	Schedule E, line 28, column (h)
Nonpassive income	Schedule E, line 28, column (j)
2. Net rental real estate income (loss)	See the Shareholder's Instructions
3. Other net rental income (loss)	
Net income	Schedule E, line 28, column (g)
Net loss	See the Shareholder's Instructions
4. Interest income	Form 1040, line 8a
5a. Ordinary dividends	Form 1040, line 9a
5b. Qualified dividends	Form 1040, line 9b
6. Royalties	Schedule E, line 4
7. Net short-term capital gain (loss)	Schedule D, line 5
8a. Net long-term capital gain (loss)	Schedule D, line 12
8b. Collectibles (28%) gain (loss)	28% Rate Gain Worksheet, line 4 (Schedule D instructions)
8c. Unrecaptured section 1250 gain	See the Shareholder's Instructions
9. Net section 1231 gain (loss)	See the Shareholder's Instructions

10. Other income (loss)

Code		
A	Other portfolio income (loss)	See the Shareholder's Instructions
B	Involuntary conversions	See the Shareholder's Instructions
C	Sec. 1256 contracts & straddles	Form 6781, line 1
D	Mining exploration costs recapture	See Pub. 535
E	Other income (loss)	See the Shareholder's Instructions

11. Section 179 deduction — See the Shareholder's Instructions

12. Other deductions

A	Cash contributions (50%)	See the Shareholder's Instructions
B	Cash contributions (30%)	See the Shareholder's Instructions
C	Noncash contributions (50%)	See the Shareholder's Instructions
D	Noncash contributions (30%)	See the Shareholder's Instructions
E	Capital gain property to a 50% organization (30%)	See the Shareholder's Instructions
F	Capital gain property (20%)	See the Shareholder's Instructions
G	Contributions (100%)	See the Shareholder's Instructions
H	Investment interest expense	Form 4952, line 1
I	Deductions—royalty income	Schedule E, line 19
J	Section 59(e)(2) expenditures	See the Shareholder's Instructions
K	Deductions—portfolio (2% floor)	Schedule A, line 23
L	Deductions—portfolio (other)	Schedule A, line 28
M	Preproductive period expenses	See the Shareholder's Instructions
N	Commercial revitalization deduction from rental real estate activities	See Form 8582 instructions
O	Reforestation expense deduction	See the Shareholder's Instructions
P	Domestic production activities information	See Form 8903 instructions
Q	Qualified production activities income	Form 8903, line 7b
R	Employer's Form W-2 wages	Form 8903, line 17
S	Other deductions	See the Shareholder's Instructions

13. Credits

A	Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Shareholder's Instructions
B	Low-income housing credit (other) from pre-2008 buildings	See the Shareholder's Instructions
C	Low-income housing credit (section 42(j)(5)) from post-2007 buildings	See the Shareholder's Instructions
D	Low-income housing credit (other) from post-2007 buildings	See the Shareholder's Instructions

Code		*Report on*
N	Credit for employer social security and Medicare taxes	See the Shareholder's Instructions
O	Backup withholding	See the Shareholder's Instructions
P	Other credits	See the Shareholder's Instructions

14. Foreign transactions

A	Name of country or U.S. possession	Form 1116, Part I
B	Gross income from all sources	Form 1116, Part I
C	Gross income sourced at shareholder level	Form 1116, Part I
	Foreign gross income sourced at corporate level	
D	Passive category	Form 1116, Part I
E	General category	Form 1116, Part I
F	Other	Form 1116, Part I
	Deductions allocated and apportioned at shareholder level	
G	Interest expense	Form 1116, Part I
H	Other	Form 1116, Part I
	Deductions allocated and apportioned at corporate level to foreign source income	
I	Passive category	Form 1116, Part I
J	General category	Form 1116, Part I
K	Other	Form 1116, Part I
	Other information	
L	Total foreign taxes paid	Form 1116, Part II
M	Total foreign taxes accrued	Form 1116, Part II
N	Reduction in taxes available for credit	Form 1116, line 12
O	Foreign trading gross receipts	Form 8873
P	Extraterritorial income exclusion	Form 8873
Q	Other foreign transactions	See the Shareholder's Instructions

15. Alternative minimum tax (AMT) items

A	Post-1986 depreciation adjustment	See the Shareholder's Instructions and the Instructions for Form 6251
B	Adjusted gain or loss	See the Shareholder's Instructions and the Instructions for Form 6251
C	Depletion (other than oil & gas)	See the Shareholder's Instructions and the Instructions for Form 6251
D	Oil, gas, & geothermal—gross income	See the Shareholder's Instructions and the Instructions for Form 6251
E	Oil, gas, & geothermal—deductions	See the Shareholder's Instructions and the Instructions for Form 6251
F	Other AMT items	See the Shareholder's Instructions and the Instructions for Form 6251

16. Items affecting shareholder basis

A	Tax-exempt interest income	Form 1040, line 8b
B	Other tax-exempt income	See the Shareholder's Instructions
C	Nondeductible expenses	See the Shareholder's Instructions
D	Distributions	See the Shareholder's Instructions
E	Repayment of loans from shareholders	See the Shareholder's Instructions

17. Other information

A	Investment income	Form 4952, line 4a
B	Investment expenses	Form 4952, line 5
C	Qualified rehabilitation expenditures (other than rental real estate)	See the Shareholder's Instructions
D	Basis of energy property	See the Shareholder's Instructions
E	Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
F	Recapture of low-income housing credit (other)	Form 8611, line 8
G	Recapture of investment credit	See Form 4255

H Recapture of other credits See the Shareholder's Instructions

I Look-back interest—completed long-term contracts See Form 8697

J Look-back interest—income forecast method See Form 8866

E Qualified rehabilitation expenditures (rental real estate)

F Other rental real estate credits

G Other rental credits

H Undistributed capital gains credit Form 1040, line 71, box a

I Biofuel producer credit

J Work opportunity credit

K Disabled access credit

L Empowerment zone employment credit

M Credit for increasing research activities

See the Shareholder's Instructions

Dispositions of property with section 179 deductions

K Recapture of section 179 deduction

M Section 453(l)(3) information

N Section 453A(c) information

O Section 1260(b) information

P Interest allocable to production expenditures

Q CCF nonqualified withdrawals

R Depletion information—oil and gas

S Amortization of reforestation costs

T Section 108(i) information

U Net investment income

V Other information

See the Shareholder's Instructions

Form **1120S**

Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation

▶ Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.

OMB No. 1545-0123

2015

For calendar year 2015 or tax year beginning , 2015, ending , 20

A S election effective date: 1/1/14	TYPE OR PRINT	Name: Healthwise Medical Supplies Company	D Employer identification number: XX-2017015
B Business activity code number (see instructions): 339110		Number, street, and room or suite no. If a P.O. box, see instructions.: 2400 Second Street	E Date incorporated: 1/1/14
C Check if Sch. M-3 attached		City or town, state or province, country, and ZIP or foreign postal code: City, ST 12345	F Total assets (see instructions): $ 3,466,740

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☒ No If "Yes," attach Form 2553 if not already filed

H Check if: (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return (5) ☐ S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year . . . ▶ 2

Caution. Include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.

	Line	Description		Amount		Amount
Income	1a	Gross receipts or sales	1a	6,000,000		5,700,000
	b	Returns and allowances	1b	300,000		2,160,000
	c	Balance. Subtract line 1b from line 1a			1c	
	2	Cost of goods sold (attach Form 1125-A)			2	
	3	Gross profit. Subtract line 2 from line 1c			3	3,540,000
	4	Net gain (loss) from Form 4797, line 17 (attach Form 4797)			4	
	5	Other income (loss) (see instructions—attach statement)			5	
	6	Total income (loss). Add lines 3 through 5 ▶			6	3,540,000
Deductions (see instructions for limitations)	7	Compensation of officers (see instructions—attach Form 1125-E)			7	150,000
	8	Salaries and wages (less employment credits)			8	840,000
	9	Repairs and maintenance			9	39,000
	10	Bad debts			10	
	11	Rents			11	180,000
	12	Taxes and licenses			12	84,000
	13	Interest			13	28,800
	14	Depreciation not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			14	293,880
	15	Depletion (Do not deduct oil and gas depletion.)			15	
	16	Advertising			16	36,000
	17	Pension, profit-sharing, etc., plans			17	
	18	Employee benefit programs			18	
	19	Other deductions (attach statement)			19	207,000
	20	Total deductions. Add lines 7 through 19 ▶			20	1,858,680
	21	Ordinary business income (loss). Subtract line 20 from line 6			21	1,681,320
Tax and Payments	22a	Excess net passive income or LIFO recapture tax (see instructions)	22a			
	b	Tax from Schedule D (Form 1120S)	22b			
	c	Add lines 22a and 22b (see instructions for additional taxes)			22c	
	23a	2015 estimated tax payments and 2014 overpayment credited to 2015	23a			
	b	Tax deposited with Form 7004	23b			
	c	Credit for federal tax paid on fuels (attach Form 4136)	23c			
	d	Add lines 23a through 23c			23d	
	24	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶			24	
	25	Amount owed. If line 23d is smaller than the total of lines 22c and 24, enter amount owed			25	
	26	Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid			26	
	27	Enter amount from line 26 Credited to 2016 estimated tax ▶		Refunded ▶	27	

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.

▶ *Leisa H. Bailey* 4/14/16 ▶ President

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. 11510H Form 1120S (2015)

Schedule B 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 ► Manufacturing and sales b Product or service ► Medical equipment		
3	At any time during the tax year, was any shareholder of the corporation a disregarded entity, a trust, an estate, or a nominee or similar person? If "Yes," attach Schedule B-1, Information on Certain Shareholders of an S Corporation . .		
4	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 stock issued and outstanding of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below		

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage of Stock Owned	(v) If Percentage in (iv) is 100%, Enter the Date (if any) a Qualified Subchapter S Subsidiary Election Was Made

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital 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 (v) below		

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

		Yes	No
5 a	At the end of the tax year, did the corporation have any outstanding shares of restricted stock?		
	If "Yes," complete lines (i) and (ii) below. (i) Total shares of restricted stock . . . . ► (ii) Total shares of non-restricted stock . . . . ►		
b	At the end of the tax year, did the corporation have any outstanding stock options, warrants, or similar instruments? .		
	If "Yes," complete lines (i) and (ii) below. (i) Total shares of stock outstanding at the end of the tax year ► (ii) Total shares of stock outstanding if all instruments were executed ►		
6	Has this corporation filed, or is it required to file, Form 8918, Material Advisor Disclosure Statement, to provide information on any reportable transaction?		
7	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.		
8	If the corporation: (a) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to the basis of the asset (or the basis of any other property) in the hands of a C corporation and (b) has net unrealized built-in gain in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see instructions) . . . . ► $		
9	Enter the accumulated earnings and profits of the corporation at the end of the tax year. $		
10	Does the corporation satisfy both of the following conditions?		
a	The corporation's total receipts (see instructions) for the tax year were less than $250,000		
b	The corporation's total assets at the end of the tax year were less than $250,000		
	If "Yes," the corporation is not required to complete Schedules L and M-1.		
11	During the tax year, did the corporation have any non-shareholder debt that was canceled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt? If "Yes," enter the amount of principal reduction $		
12	During the tax year, was a qualified subchapter S subsidiary election terminated or revoked? If "Yes," see instructions .		
13 a	Did the corporation make any payments in 2015 that would require it to file Form(s) 1099?		
b	If "Yes," did the corporation file or will it file required Forms 1099?		

Schedule K Shareholders' Pro Rata Share Items

Section	Line	Item	Box	Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 21)	1	1,681,320
	2	Net rental real estate income (loss) (attach Form 8825)	2	
	3a	Other gross rental income (loss) — 3a		
	b	Expenses from other rental activities (attach statement) — 3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a	3c	
	4	Interest income	4	
	5	Dividends: a Ordinary dividends	5a	19,800
		b Qualified dividends — 5b 19,800		
	6	Royalties	6	
	7	Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	7	
	8a	Net long-term capital gain (loss) (attach Schedule D (Form 1120S))	8a	1,008,000
	b	Collectibles (28%) gain (loss) — 8b		
	c	Unrecaptured section 1250 gain (attach statement) — 8c		
	9	Net section 1231 gain (loss) (attach Form 4797)	9	
	10	Other income (loss) (see instructions) Type ▶	10	
Deductions	11	Section 179 deduction (attach Form 4562)	11	
	12a	Charitable contributions	12a	500,000
	b	Investment interest expense	12b	48,000 3,600
	c	Section 59(e)(2) expenditures (1) Type ▶ (2) Amount ▶	12c(2)	
	d	Other deductions (see instructions) Type ▶ Investment expenses	12d	5,400
Credits	13a	Low-income housing credit (section 42(j)(5))	13a	
	b	Low-income housing credit (other)	13b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)	13c	
	d	Other rental real estate credits (see instructions) Type ▶	13d	
	e	Other rental credits (see instructions) Type ▶	13e	
	f	Biofuel producer credit (attach Form 6478)	13f	
	g	Other credits (see instructions) Type ▶	13g	
Foreign Transactions	14a	Name of country or U.S. possession ▶		
	b	Gross income from all sources	14b	
	c	Gross income sourced at shareholder level	14c	
		Foreign gross income sourced at corporate level		
	d	Passive category	14d	
	e	General category	14e	
	f	Other (attach statement)	14f	
		Deductions allocated and apportioned at shareholder level		
	g	Interest expense	14g	
	h	Other	14h	
		Deductions allocated and apportioned at corporate level to foreign source income		
	i	Passive category	14i	
	j	General category	14j	
	k	Other (attach statement)	14k	
		Other information		
	l	Total foreign taxes (check one): ▶ Paid Accrued	14l	
	m	Reduction in taxes available for credit (attach statement)	14m	
	n	Other foreign tax information (attach statement)		
Alternative Minimum Tax (AMT) Items	15a	Post-1986 depreciation adjustment (293,880 – 229,560)	15a	64,320
	b	Adjusted gain or loss	15b	
	c	Depletion (other than oil and gas)	15c	
	d	Oil, gas, and geothermal properties—gross income	15d	
	e	Oil, gas, and geothermal properties—deductions	15e	
	f	Other AMT items (attach statement)	15f	800
Items Affecting Shareholder Basis	16a	Tax-exempt interest income	16a	
	b	Other tax-exempt income	16b	9,000
	c	Nondeductible expenses	16c	1,800,000
	d	Distributions (attach statement if required) (see instructions)	16d	
	e	Repayment of loans from shareholders	16e	

Form 1120S (2015) Page 4

Schedule K Shareholders' Pro Rata Share Items (continued)

				Total amount
Other Information	17a	Investment income	17a	19,800*
	b	Investment expenses	17b	5,400
	c	Dividend distributions paid from accumulated earnings and profits	17c	
	d	Other items and amounts (attach statement)		
Reconciliation	18	Income/loss reconciliation. Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14l	18	2,152,120

Schedule L

		Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1	Cash		596,200		
2a	Trade notes and accounts receivable	648,000		720,000	
b	Less allowance for bad debts	(0)			
3	Inventories		648,000	0	720,000
4	U.S. government obligations		1,200,000		1,440,000
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach statement)		20,000		20,000
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)				
10a	Buildings and other depreciable assets	1,200,000	360,000		0
b	Less accumulated depreciation	(171,480)			
11a	Depletable assets		1,028,520		734,640
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		3,852,720		3,466,740
	Liabilities and Shareholders' Equity				
16	Accounts payable		120,000		130,000
17	Mortgages, notes, bonds payable in less than 1 year		600,000		120,000
18	Other current liabilities (attach statement)		4,200		6,300
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach statement)				
22	Capital stock				
23	Additional paid-in capital				
24	Retained earnings				
25	Adjustments to shareholders' equity (attach statement)				
26	Less cost of treasury stock		( )		( )
27	Total liabilities and shareholders' equity		3,852,720		3,466,740

*Investment income if shareholders elect to tax dividends at ordinary rates under Sec. 163(d)(4)(B).

Form 1120S (2015)

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

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

1	Net income (loss) per books	1,855,920	5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize) Gain on stock sale	288,000	a	Tax-exempt interest $ 800	800
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14l (itemize):		6	Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize):	
a	Depreciation $		a	Depreciation $	
b	Travel and entertainment $ 9,000	9,000	7	Add lines 5 and 6	800
4	Add lines 1 through 3	2,152,920	8	Income (loss) (Schedule K, line 18). Line 4 less line 7	2,152,120

[redacted] Undistributed Taxable Income Previously Taxed (see instructions)

		(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year	128,520[a]	0	
2	Ordinary income from page 1, line 21 . . .	1,681,320		
3	Other additions	1,027,800[b]	800	
4	Loss from page 1, line 21	( )		
5	Other reductions	(566,000[b])	( )	
6	Combine lines 1 through 5	2,271,640	800	
7	Distributions other than dividend distributions	1,800,000		
8	Balance at end of tax year. Subtract line 7 from line 6	471,640	800	

Form 1120S (2015)

[a]Given in problem facts.

[b]See schedule on next page.

Healthwise Medical Supplies Company
XX-2017015 2015 Form 1120S

Page 1, Line 20 - Other deductions:

General insurance	$ 42,000
Travel	24,000
Utilities	72,000
Professional fees	60,000
Meals and entertainment ($18,000 x 0.50)	9,000
Total	$207,000

Page 4, Schedule M-2, Line 3 - Other additions:

Dividend income	$ 19,800
Long-term capital gain	1,008,000
Total	$1,027,800

Page 4, Schedule M-2, Line 5 - Other reductions:

Sec. 179 expense	$500,000
Nondeductible M&E expenses	9,000
Cash contributions	48,000
Investment interest expense	3,600
Investment expenses	5,400
Total	$566,000

SCHEDULE D (Form 1120S)

Department of the Treasury Internal Revenue Service

Capital Gains and Losses and Built-in Gains

► Attach to Form 1120S.
► Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.
► Information about Schedule D and its separate instructions is at *www.irs.gov/form1120s*.

OMB No. 1545-0123

2015

Name: Healthwise Medical Supplies Company

Employer identification number: XX-2017015

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 the 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
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				

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 Tax on short-term capital gain included on line 23 below	6	( )
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column (h). Enter here and on Form 1120S, Schedule K, line 7 or 10	7	

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 the 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
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	*1,080,000	72,000		1,008,000

11 Long-term capital gain from installment sales from Form 6252, line 26 or 37	11	
12 Long-term capital gain or (loss) from like-kind exchanges from Form 8824	12	
13 Capital gain distributions (see instructions)	13	
14 Tax on long-term capital gain included on line 23 below	14	( )
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column (h). Enter here and on Form 1120S, Schedule K, line 8a or 10	15	1,008,000

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S. Cat. No. 11516V Schedule D (Form 1120S) 2015

Note: Page 2 and Form 8949 not attached.

*1,000 shares Fastgrowth, Inc.: acquired 1/2/12; sold 7/2/15.

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

Cost of Goods Sold

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

OMB No. 1545-2225

Name: Healthwise Medical Supplies Company

Employer identification number: XX-2017015

1	Inventory at beginning of year	1	1,200,000
2	Purchases	2	2,400,000
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	3,600,000
7	Inventory at end of year	7	1,440,000
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return (see instructions)	8	2,160,000

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.

Form **4562**

Department of the Treasury
Internal Revenue Service

Depreciation and Amortization

(Including Information on Listed Property)

OMB No. 1545-0172

2015

Attachment Sequence No. 179

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Healthwise Medical Supplies Company	Medical Equipment Manufacturing	XX-2017015

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.*

Line	Description	Box	Amount
1	Maximum amount (see instructions)	1	500,000
2	Total cost of section 179 property placed in service (see instructions)	2	2,000,000
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	500,000
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, -0-. If married filing enter separately, see instructions	5	

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		

Line	Description	Box	Amount
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 2014 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	500,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	500,000
13	Carryover of disallowed deduction to 2016. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.) (See instructions.)

Line	Description	Box	Amount
14	cial 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	depreciation (including ACRS)	16	

Part III MACRS Depreciation (Do not include listed property.) (See instructions.)

Section A

Line	Description	Box	Amount
17	MACRS deductions for assets placed in service in tax years beginning before 2015	17	293,880
18	If you are electing to group any assets placed in service during the tax year into one or more ☐		

Section B—Assets Placed in Service During 2015 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	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
b 5-year						
c 7-year						
d 10-year						
e 15-year						
f 20-year						
g 25-year			25 yrs.		S/L	
h Residential			27.5 yrs.	MM	S/L	
i Nonresidential			39 yrs.	MM	S/L	
real property				MM	S/L	

Section C—Assets Placed in Service During 2014 Tax Year Using the Alternative Depreciation System

b 12-year			12 yrs.		S/L	

Line	Description	Box	Amount
21	Listed property. Enter amount from line 28		
		22	293,880*
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 (2015)

* Form 4562 instructions say to omit Sec. 179 deduction from this line for S corporations.

671113

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120S) **2015**

Department of the Treasury
Internal Revenue Service

For calendar year 2015, or tax year beginning ____________, 2015 ending ____________, 20 ____

Shareholder's Share of Income, Deductions, Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number

XX-2017015

B Corporation's name, address, city, state, and ZIP code

City, ST 12345

C IRS Center where corporation filed return

Center City, ST

Part II Information About the Shareholder

D Shareholder's identifying number

XXX-XX-XXXX

E Shareholder's name, address, city, state, and ZIP code

City, ST 12345

F Shareholder's percentage of stock ownership for tax year . . . . 30 %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss) 504,396	13	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends 5,940	14	Foreign transactions
5b	Qualified dividends 5,940		
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss) 302,400		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	15	Alternative minimum tax (AMT) items A 19,296
11	Section 179 deduction 150,000	16	Items affecting shareholder basis
12	Other deductions		A 240
	A 14,400		C 2,700
	H 1,080		D 540,000
	K 1,620		
	Q 576,000		
	R 297,000	17	Other information A 5,940*
			B 1,620

*Dividends are investment income to extent shareholder elects to tax them at ordinary rates under Sec. 163(d)(4)(B).

671113

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120S)

2015

Department of the Treasury
Internal Revenue Service

For calendar year 2015, or tax year beginning ____________, 2015 ending ____________, 20 ______

Shareholder's Share of Income, Deductions, Credits, etc.

▸ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
XX-2017015

B Corporation's name, address, city, state, and ZIP code
City, ST 12345

Part II Information About the Shareholder

C IRS Center where corporation filed return
Center City, ST

D Shareholder's identifying number
XXX-XX-XXXX

E Shareholder's name, address, city, state, and ZIP code
City, ST 54321

F Shareholder's percentage of stock ownership for tax year . . . . 70 %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1 Ordinary business income (loss) 1,176,924

2 Net rental real estate income (loss)

3 Other net rental income (loss)

4 Interest income

5a Ordinary dividends 13,860

5b Qualified dividends 13,860

6 Royalties

7 Net short-term capital gain (loss)

8a Net long-term capital gain (loss) 705,600

8b Collectibles (28%) gain (loss)

8c Unrecaptured section 1250 gain

9 Net section 1231 gain (loss)

10 Other income (loss)

11 Section 179 deduction 350,000

12 Other deductions
A 33,600
H 2,520
K 3,780
Q 1,344,000
R 693,000

13 Credits

14 Foreign transactions

15 Alternative minimum tax (AMT) items
A 45,024

16 Items affecting shareholder basis
A 560
C 6,300
D 1,260,000

17 Other information
A 13,860*
B 3,780*

For Paperwork Reduction Act Notice, see Instructions for Form 1120S. IRS.gov/form1120s Cat. No. 11520D Schedule K-1 (Form 1120S) 2015

*Dividends are investment income to extent shareholder elects to tax them at ordinary rates under Sec. 163(d)(4)(B).

This list identifies the codes used on Schedule K-1 for all shareholders and provides summarized reporting information for shareholders who file Form 1040. For detailed reporting and filing information, see the separate Shareholder's Instructions for Schedule K-1 and the instructions for your income tax return.

1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows:

	Report on
Passive loss	See the Shareholder's Instructions
Passive income	Schedule E, line 28, column (g)
Nonpassive loss	Schedule E, line 28, column (h)
Nonpassive income	Schedule E, line 28, column (j)
2. Net rental real estate income (loss)	See the Shareholder's Instructions
3. Other net rental income (loss)	
Net income	Schedule E, line 28, column (g)
Net loss	See the Shareholder's Instructions
4. Interest income	Form 1040, line 8a
5a. Ordinary dividends	Form 1040, line 9a
5b. Qualified dividends	Form 1040, line 9b
6. Royalties	Schedule E, line 4
7. Net short-term capital gain (loss)	Schedule D, line 5
8a. Net long-term capital gain (loss)	Schedule D, line 12
8b. Collectibles (28%) gain (loss)	28% Rate Gain Worksheet, line 4 (Schedule D instructions)
8c. Unrecaptured section 1250 gain	See the Shareholder's Instructions
9. Net section 1231 gain (loss)	See the Shareholder's Instructions
10. Other income (loss)	
Code	
A Other portfolio income (loss)	See the Shareholder's Instructions
B Involuntary conversions	See the Shareholder's Instructions
C Sec. 1256 contracts & straddles	Form 6781, line 1
D Mining exploration costs recapture	See Pub. 535
E Other income (loss)	See the Shareholder's Instructions
11. Section 179 deduction	See the Shareholder's Instructions
12. Other deductions	
A Cash contributions (50%)	See the Shareholder's Instructions
B Cash contributions (30%)	See the Shareholder's Instructions
C Noncash contributions (50%)	See the Shareholder's Instructions
D Noncash contributions (30%)	See the Shareholder's Instructions
E Capital gain property to a 50% organization (30%)	See the Shareholder's Instructions
F Capital gain property (20%)	See the Shareholder's Instructions
G Contributions (100%)	
H Investment interest expense	Form 4952, line 1
I Deductions—royalty income	Schedule E, line 19
J Section 59(e)(2) expenditures	See the Shareholder's Instructions
K Deductions—portfolio (2% floor)	Schedule A, line 23
L Deductions—portfolio (other)	Schedule A, line 28
M Preproductive period expenses	See the Shareholder's Instructions
N Commercial revitalization deduction from rental real estate activities	See Form 8582 instructions
O Reforestation expense deduction	See the Shareholder's Instructions
P Domestic production activities information	See Form 8903 instructions
Q Qualified production activities income	Form 8903, line 7b
R Employer's Form W-2 wages	Form 8903, line 17
S Other deductions	See the Shareholder's Instructions
13. Credits	
A Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Shareholder's Instructions
B Low-income housing credit (other) from pre-2008 buildings	See the Shareholder's Instructions
C Low-income housing credit (section 42(j)(5)) from post-2007 buildings	See the Shareholder's Instructions
D Low-income housing credit (other) from post-2007 buildings	See the Shareholder's Instructions
E Qualified rehabilitation expenditures (rental real estate)	See the Shareholder's Instructions
F Other rental real estate credits	See the Shareholder's Instructions
G Other rental credits	See the Shareholder's Instructions

Code	Report on
N Credit for employer social security and Medicare taxes	See the Shareholder's Instructions
O Backup withholding	See the Shareholder's Instructions
P Other credits	
14. Foreign transactions	
A Name of country or U.S. possession	Form 1116, Part I
B Gross income from all sources	Form 1116, Part I
C Gross income sourced at shareholder level	Form 1116, Part I
Foreign gross income sourced at corporate level	
D Passive category	Form 1116, Part I
E General category	Form 1116, Part I
F Other	
Deductions allocated and apportioned at shareholder level	
G Interest expense	Form 1116, Part I
H Other	Form 1116, Part I
Deductions allocated and apportioned at corporate level to foreign source income	
I Passive category	Form 1116, Part I
J General category	Form 1116, Part I
K Other	
Other information	
L Total foreign taxes paid	Form 1116, Part II
M Total foreign taxes accrued	Form 1116, Part II
N Reduction in taxes available for credit	Form 1116, line 12
O Foreign trading gross receipts	Form 8873
P Extraterritorial income exclusion	Form 8873
Q Other foreign transactions	See the Shareholder's Instructions
15. Alternative minimum tax (AMT) items	
A Post-1986 depreciation adjustment	See the Shareholder's Instructions and the Instructions for Form 6251
B Adjusted gain or loss	See the Shareholder's Instructions and the Instructions for Form 6251
C Depletion (other than oil & gas)	See the Shareholder's Instructions and the Instructions for Form 6251
D Oil, gas, & geothermal—gross income	See the Shareholder's Instructions and the Instructions for Form 6251
E Oil, gas, & geothermal—deductions	See the Shareholder's Instructions and the Instructions for Form 6251
F Other AMT items	See the Shareholder's Instructions and the Instructions for Form 6251
16. Items affecting shareholder basis	
A Tax-exempt interest income	Form 1040, line 8b
B Other tax-exempt income	See the Shareholder's Instructions
C Nondeductible expenses	See the Shareholder's Instructions
D Distributions	See the Shareholder's Instructions
E Repayment of loans from shareholders	See the Shareholder's Instructions
17. Other information	
A Investment income	Form 4952, line 4a
B Investment expenses	Form 4952, line 5
C Qualified rehabilitation expenditures (other than rental real estate)	See the Shareholder's Instructions
D Basis of energy property	See the Shareholder's Instructions
E Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
F Recapture of low-income housing credit (other)	Form 8611, line 8
G Recapture of investment credit	See Form 4255

H Recapture of other credits See the Shareholder's Instructions

I Look-back interest—completed long-term contracts
See Form 8697

J Look-back interest—income forecast method
See Form 8866

H Undistributed capital gains credit Form 1040, line 71, box a

I Biofuel producer credit
J Work opportunity credit
K Disabled access credit
L Empowerment zone employment credit
M Credit for increasing research activities

See the Shareholder's Instructions

K Dispositions of property with section 179 deductions
L Recapture of section 179 deduction
M Section 453(l)(3) information
N Section 453A(c) information
O Section 1260(b) information
P Interest allocable to production expenditures
Q CCF nonqualified withdrawals
R Depletion information—oil and gas
S Amortization of reforestation costs
T Section 108(i) information
U Net investment income
V Other information

See the Shareholder's Instructions

Healthwise Medical Supplies Company
XX-2017015 2015 Form 1120S

Basis in S corporation stock:

Item	**Bailey**	**Firth**
Basis at 1/1/15	$ 938,556	$1,901,964
S corporation ordinary income	504,396	1,176,924
Dividend income	5,940	13,860
Long-term capital gain	302,400	705,600
Tax-exempt interest	240	560
Distributions	(540,000)	(1,260,000)
Sec. 179 expense	(150,000)	(350,000)
Nondeductible M&E expenses	(2,700)	(6,300)
Charitable contributions (cash)	(14,400)	(33,600)
Investment interest expense	(1,080)	(2,520)
Investment expenses	(1,620)	(3,780)
Basis at 12/31/15	$1,041,732	$2,142,708

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. Compute the income tax for high-income individuals.

7. Describe tax planning considerations for various tax matters.

8. 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, exemptions, 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 the head of household filing status.

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

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

Highlights of Recent Tax Law Changes

The following items of tax law have changed since the 2016 edition of this chapter:

1. The amount of personal and dependency exemptions increased to $4,050.

2. Some of the amounts of standard deduction for each filing status have increased for 2016. (See page I2-10.)

3. The range of taxable income taxed for each filing status at all tax brackets has changed. (See inside front cover.)

4. The floor for filing a tax return for each filing status has increased. (See page I2-35.)

5. The due date for a partnership tax return has changed to 2 ½ months after the end of its tax year.

6. The due date for a C corporation's tax return has changed to 3 ½ months after the end of its tax year.

Teaching Tips

1. Due to the annual changes in many of the rules covered in this chapter (i.e., standard deduction, exemption amount) 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

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

B. Definitions (Tables I:2-2, I:2-3, I:2-4, I:2-5)

Brief definitions of income, exclusions, gross income, deductions for adjusted gross income, adjusted gross income, deductions from adjusted gross income, itemized deductions, standard deduction, personal and dependency exemptions, 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

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

1. The total of qualifying medical expenses, taxes, investment and residential interest, charitable contributions, personal casualty and theft losses, and miscellaneous deductions are claimed only if the total of such items exceeds the standard deduction.

2. Deductions for medical expenses, charitable contributions, personal casualty and theft losses, and miscellaneous items are all limited by varying percentages of adjusted gross income.

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

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.

Filing Status	**Standard Deduction**	
	2015	**2016**
Single individual other than heads of households	$ 6,300	$ 6,300
Married couples filing joint returns and surviving spouses	$12,600	$12,600
Married persons filing separate returns	$ 6,300	$ 6,300
Heads of households	$ 9,250	$ 9,300

Additions to the standard deduction are available for taxpayers who are older than 64 and/or blind. The 2016 additions are $1,250 for married taxpayers and $1,550 for single taxpayers.

EXAMPLE: A single taxpayer in 2016 who is 65 and blind would have a standard deduction of $9,400 [$6,300 + $1,550 (age) + $1,550 (blindness)].

EXAMPLE: A single taxpayer in 2016 has $5,000 of allowable itemized deductions. Since the applicable standard deduction for this taxpayer ($6,300) is greater than his itemized deductions, the taxpayer deducts $6,300 in determining his taxable income.

C. Personal Exemptions (Problem I:2-36)

1. Unless claimed as a dependent on another return, each individual taxpayer is allowed a personal exemption ($4,050 in 2016). No personal exemption is allowed to a taxpayer who is claimed as a dependent on another return.

2. An additional personal exemption is allowed for the spouse on a joint return. On a separate return, if the spouse is not a dependent of another taxpayer <u>and</u> has no gross income, a personal exemption is also allowed for the spouse.

D. Dependency Exemptions (Examples I:2-12, I:2-13, I:2-17, I:2-18, I:2-21; Topic Review I:2-1; Problem I:2-33)

1. A dependency exemption (also $4,050 in 2016) is allowed if

a. For all dependents:
   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 TP, a sibling of the TP, 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 TP; and

iv. TP provides over 50% 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).

c. Additional requirements for "qualifying relatives"

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

ii. Have gross income less than the exemption amount; and

iii. Not provide ½ or more of the dependent's support. See also multiple support agreements on page I2-17.

Children of divorced parents are claimed by the custodial parent unless there is a written agreement to the contrary executed by the custodial parent.

E. Child Credit (Example I:2-22; Problem I:2-51)

1. In 2016, the child credit is $1,000 for each qualifying child (U.S. citizen/national/resident under 17 who qualifies as the taxpayer's dependent descendent, stepchild, or foster child).

2. The total credit for all children is reduced by $50 for each $1,000 (or fraction thereof) of AGI over stated amounts:

$110,000 for married/jointly
$ 75,000 for single
$ 55,000 for married/separate

3. The credit is refundable under certain circumstances.

III. Determining the Amount of Tax (Examples I:2-24, I:2-25; Problem I:2-49; 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 2016, tax brackets of 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% are applicable to individual taxpayers. The income level covered by the six brackets varies with filing status.

A. Joint Return

1. 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.

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

EXAMPLE: Taxpayers obtain a foreign divorce effective on 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.

B. Surviving Spouse (Example I:2-26)

1. 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:

a. has not remarried;
b. is a U.S. citizen or resident;
c. was qualified to file a joint return in the year of death;
d. has at least one dependent child living at home during the entire year; AND
e. paid over half of the expenses of the home.

2. 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 married-filing separately returns are filed.

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

C. Head of Household (Example I:2-27)

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

a. is considered single for tax purposes (see abandoned spouse, below);
b. is a U.S. citizen or resident; AND
c. pays over half the costs of maintaining a household in which a dependent relative lives for more than half of the tax year

Exceptions:

i. Children do not have to be tax dependents to qualify a taxpayer as head of household - all other relatives must qualify a tax dependent.

ii. Parents do not need to live in the taxpayer's household to qualify a taxpayer as head of household - all other relatives (including children) must live in the taxpayer's household.

2. An individual could be legally married and still qualify as single for tax purposes (see section F below).

D. Single Taxpayer (Example I:2-28)
A taxpayer who does not qualify for any other filing status must file under the single status.

E. Married Filing a Separate Return (Example I:2-29; Topic Review I:2-2)

1. Married individuals may choose to file separate returns rather than one joint return.

2. 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. (See section V.D. below).

F. Abandoned Spouse (Examples I:2-30, I:2-31; Question I:2-18)

1. A legally married individual may file as head-of-household if the individual:
   a. lived apart from the spouse for the last 6 months of the year;
   b. 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
   c. is a U.S. citizen or resident.

2. 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.

G. Dependents with Unearned Income (Examples I:2-32, I:2-33; Problem I:2-56)

1. For children under 18 in 2016 unearned income in excess of $2,100 is taxed at the parent's marginal rates. A standard deduction of $1,050 is provided. The first $1,050 of income is taxed at the minor's rate (usually 10%). Rules vary for children under 18 who have earned income. Similar rules are applicable to other dependent children.
2. For simplified situations, this "Kiddie Tax" can be reported and paid with the parent's return(s).

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

A. Definition of Capital Assets

1. Capital assets are assets other than inventory, trade receivables, certain properties created by the efforts of the taxpayer, depreciable business property, business land, and certain government publications.

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

B. Treatment of Gains and Losses

1. In 2016, net long-term capital gains (holding period > one year) are generally taxed at 15% (0% for taxpayers in the 10% or15% bracket – 20% for taxpayers in the 39.6% bracket). Net short-term capital gains are taxed at ordinary income rates (up to 39.6%). Net capital losses offset a maximum of $3,000 of other income, with an unlimited carryover for individuals.

C. Provisions Applicable to Higher Income Taxpayers (Examples I:2-38; I:2-39)

1. A payroll tax of .9% and net investment income tax of 3.8% is applicable to certain high-income taxpayers.

2. Personal and dependency exemptions and certain itemized deductions are phased out for certain high-income taxpayers.

V. Tax Planning Considerations

A. Shifting Income Between Family Members (Examples I:2-40 through I:2-43)

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

2. Care must be taken to avoid assignment of income problems and sham transactions (i.e., certain “family trusts”).

B. Splitting Income (Example I:2-44)
Creating additional taxpayers may reduce the overall tax burden, but administrative costs will reduce the overall savings.

C. Maximizing Itemized Deductions (Examples I:2-45, I:2-46)

1. Grouping a specific type of deductible expense in one tax year can increase the total amount deductible.

2. Favorable timing for medical expenses, casualty and theft losses, and miscellaneous deductions may not be the same tax year as for significant charitable contributions because of an adjusted gross income floor for the first three itemized deductions mentioned, and an adjusted gross income limitation for charitable contributions.

D. Filing Joint or Separate Returns (Examples I:2-47, I:2-48)

Several factors affect the decision of whether married couples should file jointly or separately (i.e., itemized deduction position).

VI. Compliance and Procedural Considerations

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

Generally, the income limitation for filing can be determined by adding the standard deduction for a particular status to the amount for personal exemptions for that status.

EXAMPLE: For 2016, a single taxpayer (under 65, not blind, not a dependent on another return) must file a return when gross income exceeds $10,350 ($6,300 standard deduction plus $4,050 personal exemption).

B. Due Dates for Filing Return

Tax returns for calendar-year individual taxpayers (Forms 1040, 1040EZ, 1040A) are due April 15 following the end of the taxable year, with an automatic four-month extension of time available if the extension is filed by the due date for the return. Forms 1040EZ and 1040A are used for taxpayers that have few complications in the tax year. Only salary, wages, and no more than $1,500 of interest may be reported using form 1040EZ. Only salary, wages, dividends, interest, pensions and annuities, and unemployment income can be reported on Form 1040A. Both forms also have restrictions on deductions and credits allowed. A Form 1040 can always be filed.

C. Systems for Reporting Income

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

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

Court Case Briefs

<u>*Kenneth Royce Boykin v. CIR*</u>, 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.

<u>*Cassius L. Peacock, III v. CIR*</u>, 1978 PH T.C Memo & 78,030, 37 TCM 177.

Cassius L. Peacock, III had never been married in any formal ceremony to the woman, Marie Jones, with whom he cohabited. Prior to the birth of their first child, however, he and his "spouse" signed an agreement to raise their children together. He claimed her as a dependency exemption on his 1974 federal tax return. The IRS disallowed this exemption on the grounds that their relationship was in violation of local law.

The court held that Marie was not the taxpayer's spouse within the meaning of '151 and, therefore, the taxpayer was not eligible to claim an exemption for her as his spouse. The court further held that Marie was not a member of Mr. Peacock's household for exemption purposes because "the relationship between such individual and the taxpayer is in violation of local law." (See Sec. 152(b(5))). The state law of Arizona provided that a person who "lives in a state of open and notorious cohabitation is guilty of a felony punishable by imprisonment in a state prison for not more than three years."

Instructor Aid I:2-1

Relative Tax by Filing Status

(Assuming the
same amount of
taxable income)

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

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

Instructor Aid I:2-2

Capital Assets

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

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

  } In the hands of the creator or a donee of the creator
- Accounts or notes receivable from the ordinary course of a trade or business
- Certain U.S. Government publications

Form **8615**

Department of the Treasury
Internal Revenue Service (99)

Tax for Certain Children Who

▶ Attach only to the child's Form 1040, Form 1040A, or Form 1040NR.
▶ Information about Form 8615 and its separate instructions is at *www.irs.gov/form8615*.

OMB No. 1545-0074
2015
Attachment Sequence No. 33

Child's name shown on return	Child's social security number
Aida Petosa	123-45-6789

Before you begin: If the child, the parent, or any of the parent's other children for whom Form 8615 must be filed must use the Schedule D Tax Worksheet or has income from farming or fishing, see Pub. 929, Tax Rules for Children and Dependents. It explains how to figure the child's tax using the Schedule D Tax Worksheet or Schedule J (Form 1040).

A Parent's name (first, initial, and last). Caution: *See instructions before completing.*	B Parent's social security number
Alfredo Petosa	987-65-4321

C Parent's filing status (check one):

☐ ...le ☐ Married filing jointly ☐ Married filing separately ☒ Head of household ☐ Qualifying widow(er)

Part I Child's Net Unearned Income

2	If $2,100. Otherwise, see instructions		2,100
	do .	3	700
3	Subtract line 2 from line 1. If zero or less, stop; do not complete the rest of this form but attach it to the child's return		1,750
	do	5	700
4	Enter the child's taxable income from Form 1040, line 43; Form 1040A, line 27; or Form 1040NR, ...e 41. If the child files Form 2555 or 2555-EZ, see the instructions	4	
5	...nter the smaller of line 3 or line 4. If zero, stop; do not complete the rest of this form but attach it to the child's return		
6	Enter the parent's taxable income from Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 41; or Form 1040NR-EZ, line 14. If zero or less, enter -0-		
7	Enter the total, if any, from Forms 8615, line 5, of all other children of the parent named above. Do not include the amount from line 5 above		0

Tentative Tax Based on the Tax Rate of the Parent

9	Enter the tax on the amount on line 8 based on the parent's filing status		
8	Add lines 5, 6, and 7 (see instructions)	9	7,498* 52,700
8	minimum tax; Form 1040EZ, line 10; Form 1040NR, line 42; or Form 1040NR-EZ, line 15. Do not include any tax from Form 4972 or 8814 or any tax from recapture of an education credit. If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here . . . . ▶ (see instructions).		
10	Enter the parent's tax from Form 1040, line 44; Form 1040A, line 28, minus any alternative	10	7,323*
11	Subtract line 10 from line 9 and enter the result. If line 7 is blank, also enter this amount on line	11	175

parent files Form 2555 or 2555-EZ, see the instructions. If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) was ...ed to figure the tax, check here . . . . ▶

12a	Add lines 5 and 7	12a	700
b	Divide line 5 by line 12a. Enter the result as a decimal (rounded to at least three places)		
13	Multiply line 11 by line 12b		175
16	Add lines 13 and 15	16	280

Schedule J (Form 1040) is used to figure the tax, check here . . . . ▶

Child's Tax—If lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.

17	Enter the tax on the amount on line 4 based on the child's filing status (see instructions). If	17	175*
18	Enter the larger of line 16 or line 17 here and on the child's Form 1040, line 44; Form 1040A, line 28; or Form 1040NR, line 42. If the child files Form 2555 or 2555-EZ, see the instructions . .		280

15 Enter the tax on the amount on line 14 based on the child's filing status (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or

the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here . . . . ►

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 64113U Form 8615 (2015)

*From 2015 Tax Rate Schedules.

Form 1040A
Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return (99) 2015
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. Apt. no.
520 Chestnut St.

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

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

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 X 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) with dependent child (see instructions)

Exemptions

6a X Yourself. If someone can claim you as a dependent, do not check box 6a.
b X 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 ►	21	85,200

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11327A Form 1040A (2015)

Form 1040A (2015) 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, 1951, Blind } Total boxes
Spouse was born before January 2, 1951, Blind } 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, $6,300
Married filing jointly or Qualifying widow(er), $12,600
Head of household, $9,250

24 Enter your standard deduction. 24 12,600

25 Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-. 25 72,600

26 Exemptions. Multiply $4,000 by the number on line 6d. 26 12,000

27 Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your taxable income. ▶ 27 60,600

28 Tax, including any alternative minimum tax (see instructions). 28 8,168 *

29 Excess advance premium tax credit repayment. Attach Form 8962. 29

30 Add lines 28 and 29. 30 8,168

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 7,168

38 Health care: individual responsibility (see instructions). Full-year coverage X 38

39 Add line 37 and line 38. This is your total tax. 39 7,168

40 Federal income tax withheld from Forms W-2 and 1099. 40 8,000

41 2015 estimated tax payments and amount applied from 2014 return. 41

If you have a qualifying child, attach Schedule EIC.

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. 47 832

48a Amount of line 47 you want refunded to you. If Form 8888 is attached, check here ▶ 48a 832

Direct deposit? See instructions and fill in 48b, 48c, and 48d or Form 8888.

▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings

▶ d Account number

49 Amount of line 47 you want applied to your 2016 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. X No

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

Sign here

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

Paid

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

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.	

Form 1040A (2015)

*From 2015 Tax Rate Schedule.

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2015** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2015, or other tax year beginning , 2015, ending , 20 See separate instructions.

Your first name and initial: John R.
Last name: Lane
Your social security number: 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) with dependent child

Exemptions

6a ✓ Yourself. If someone can claim you as a dependent, do not check box 6a . . . . Boxes checked on 6a and 6b 1

b Spouse . . . . No. of children

c Dependents: on 6c who:

(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)

• lived with you
• did not live with you due to divorce or separation (see instructions)
Dependents on 6c not entered above

If more than four dependents, see instructions and check here ►

Add numbers on lines above ► 1

d Total number of exemptions claimed . . . .

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	5,500
33	Student loan interest deduction	33	
34	Tuition and fees. Attach Form 8917	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 (2015)

Form 1040 (2015) Page 2

Tax and Credits

38 Amount from line 37 (adjusted gross income) . . . 38 45,800

39a Check { X You were born before January 2, 1951, ☐ Blind. } Total boxes 1

if: ☐ Spouse was born before January 2, 1951, ☐ Blind. 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, $6,300
Married filing jointly or Qualifying widow(er), $12,600
Head of household, $9,250

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 $154,950 or less, multiply $4,000 by the number on line 6d. Otherwise, see instructions 42 4,000*

43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0- . . 43 33,800

44 Tax (see instructions). Check if any from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐ 44 4,609***

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 4,609

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

53 Residential energy credits. 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 4,609

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 4,609

Payments

64 Federal income tax withheld from Forms W-2 and 1099 . . 64 6,000

65 2015 estimated tax payments and amount applied from 2014 return 65

If you have a qualifying child, attach Schedule EIC.

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 1,391

76a Amount of line 75 you want refunded to you. If Form 8888 is attached, check here ▶ ☐ 76a 1,391

Direct deposit? See instructions.

▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings

▶ d Account number

77 Amount of line 75 you want applied to your 2016 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 complete. 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 occupation: Accountant

Daytime phone number

PIN, enter it

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alties of perjury, I declare that I have examined this return and ac they are true, correct, and complete. Declaration of preparer (other than tax

Your signature		Date		
Spouse's signature. If a joint return, both must sign.		Date	Spouse's occupation	If the IRS sent you an Identity Protection 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.	

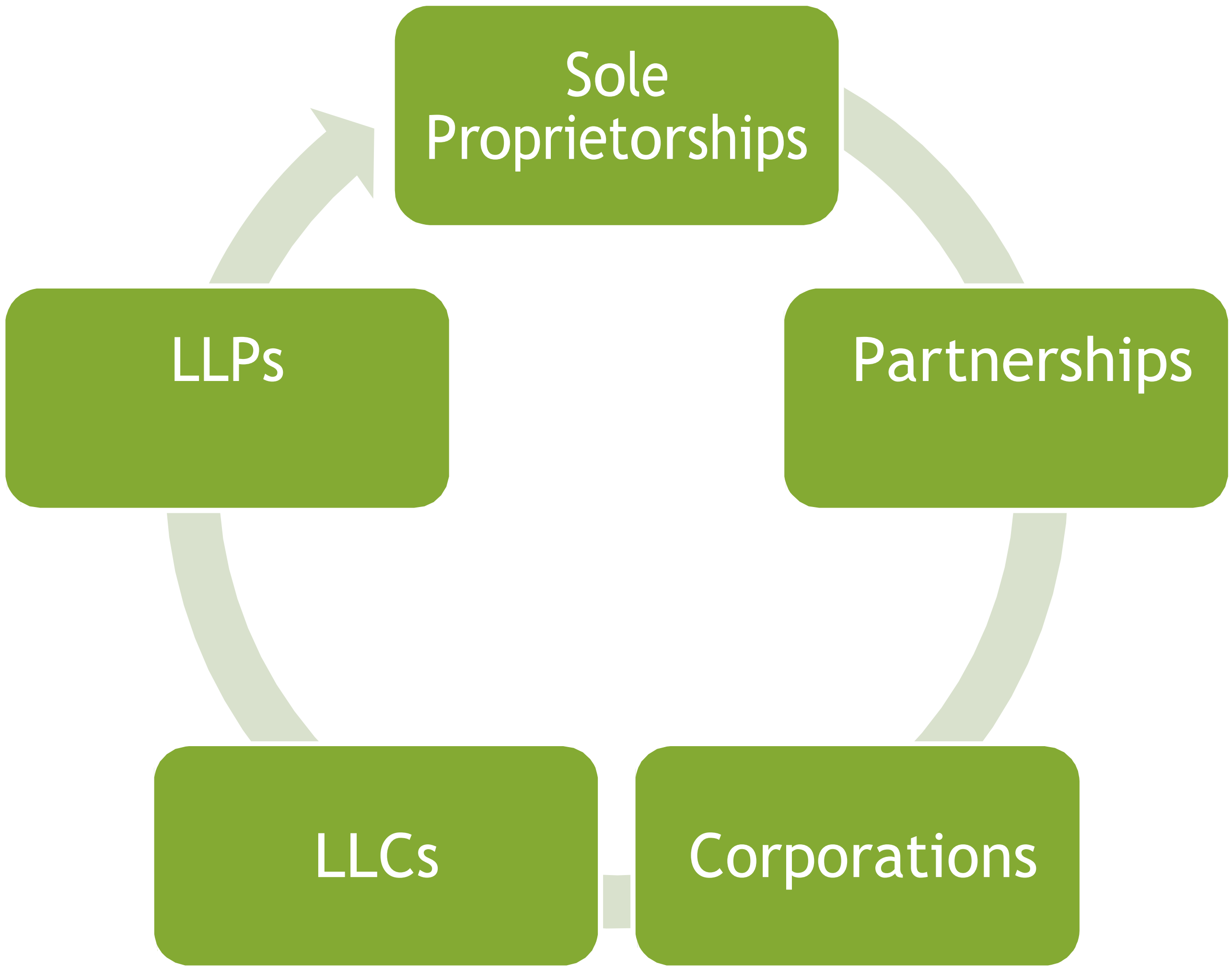
www.irs.gov/form1040 Form 1040 (2015)

*A cousin is not a qualifying relative if he or she does not live with the taxpayer.
**From 2015 Tax Rate Schedule.

Chapter 2: Corporate Formations and Capital Structure

Pearson's Federal Taxation 2017: Corporations, Partnerships, Estates & Trusts

Organizational Forms



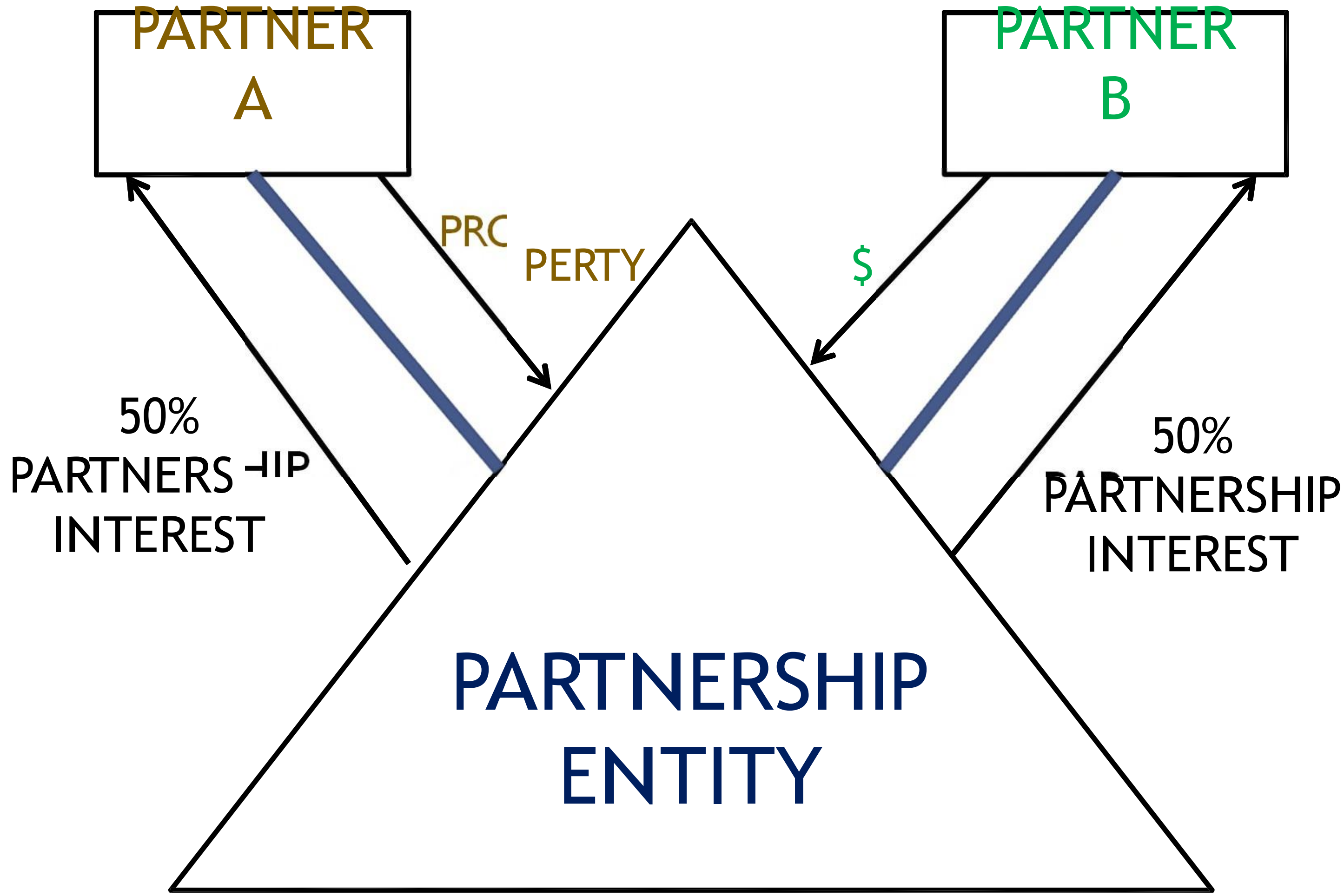
Advantages of Sole Proprietorships

- 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.

Disadvantages of Sole Proprietorships

Certain fringe benefits may be taxable to owner.

Forming a Partnership



General v. Limited Partnerships

GPs have unlimited liability for p'ship debts.

Liability can be greater than capital invested.

LPs are liable only up to capital invested + agreed-upon amounts.

Must have at least one GP and one LP.

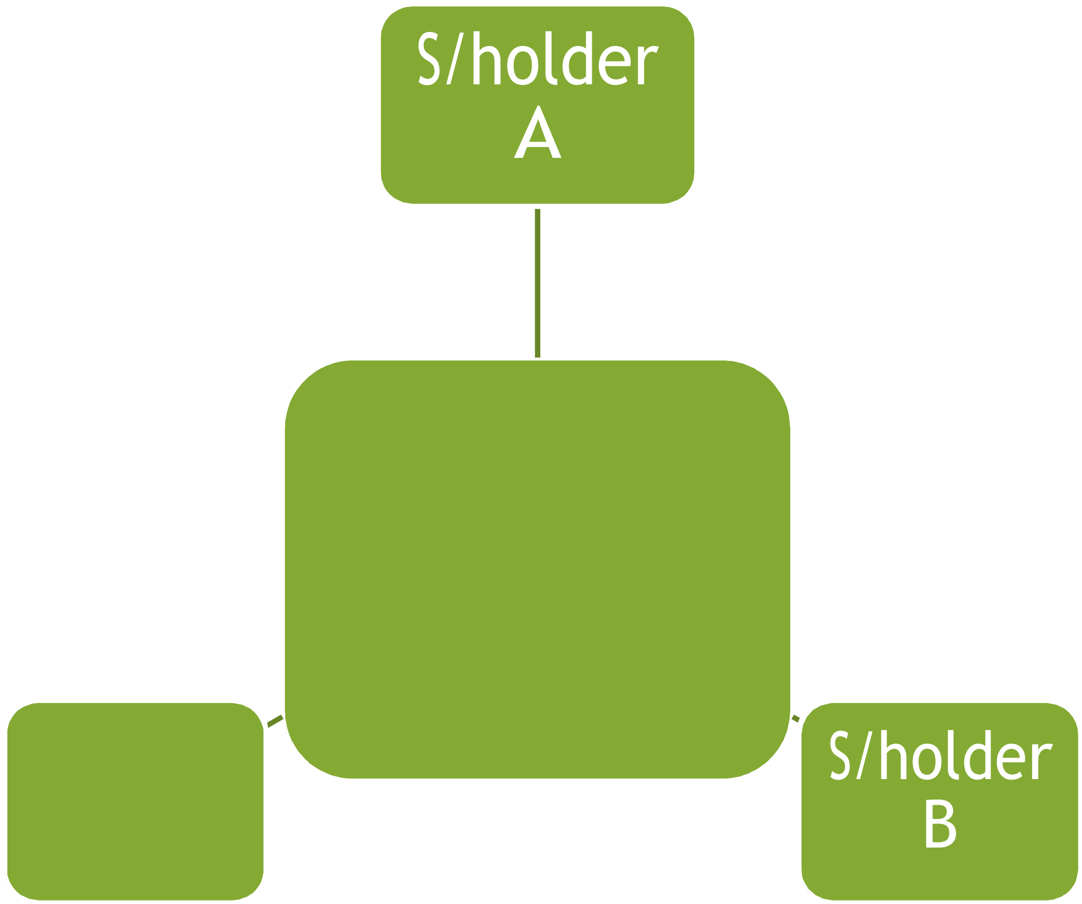
Advantages of Partnerships

- 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.

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.

Corporate Structure



Advantages of C Corporations

Shareholder-employees can have tax-free fringe benefits.

Disadvantages of C Corporations

S/holder may have taxable dividend upon distribution of property.

Advantages of S Corporations

- S Corps not subject to tax at an entity level. No double taxation.
- S/holder may have a lower marginal rate than a C Corporation.
- Non-passive losses can offset any income on s/holder's Form 1040.
- Income/deduction items retain their character.

Disadvantages of S Corporations

- S/holders taxed on all profits even if undistributed.
- S/holders' 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.

Advantages and Disadvantages

LLPs

LLCs

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.

Section 351

- 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).

Section 351(cont'd)

- S/holder takes a carryover basis from the property to the stock.
- Alternative calculation:

FMV of trans property

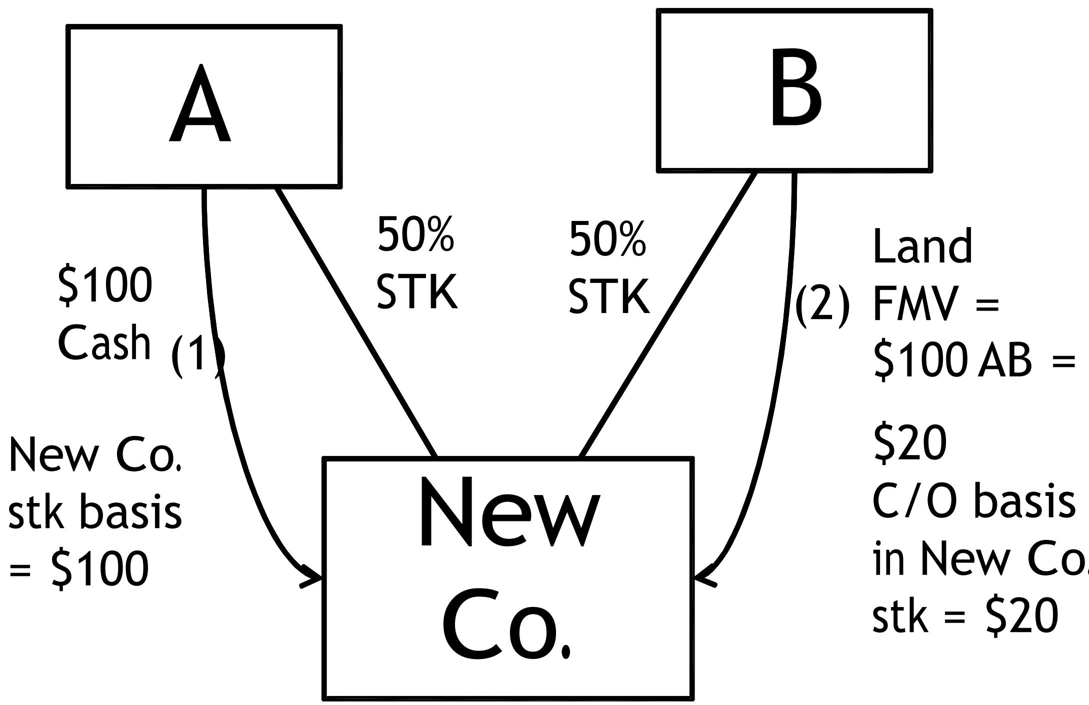
\- deferred gain

or

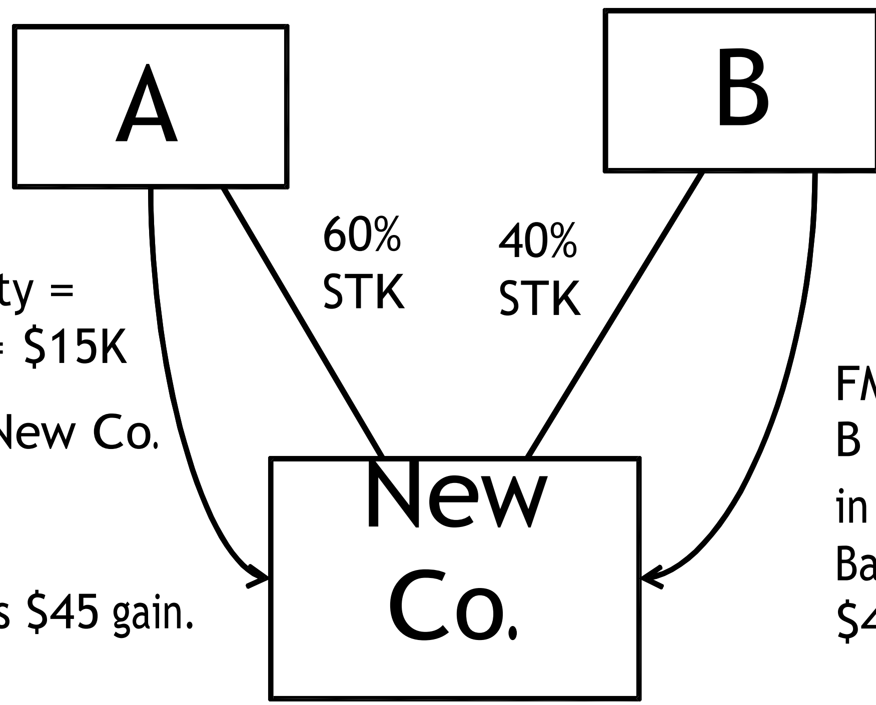
<u>+ deferred loss</u>

Basis in new stock

§ 351 Property Transaction



§ 351 Services Transaction



FMV property = $60K; A/B = $15K

A's basis in New Co. stk = $60K

A recognizes $45 gain.

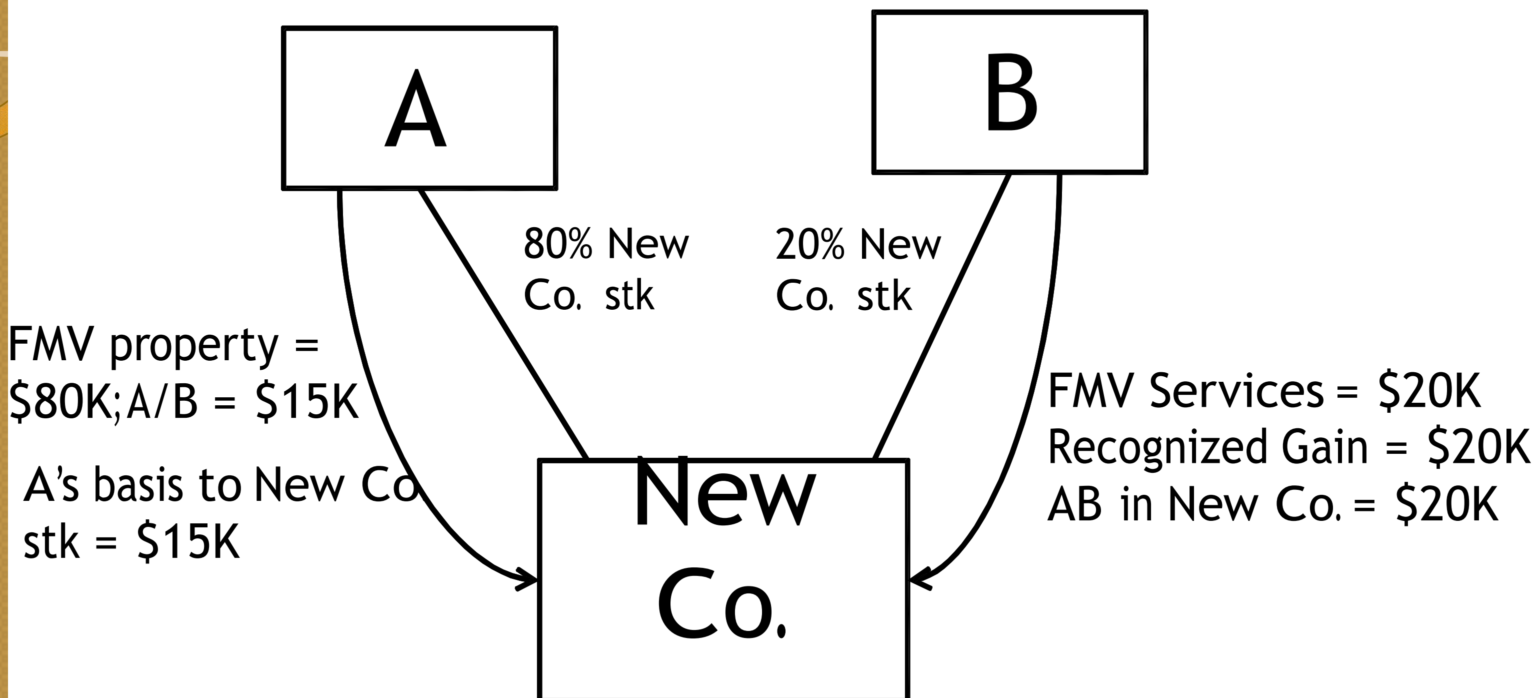
FMV Services = $40K
B Recognizes $40K in income
Basis in New Co. stk = $40K

§ 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.

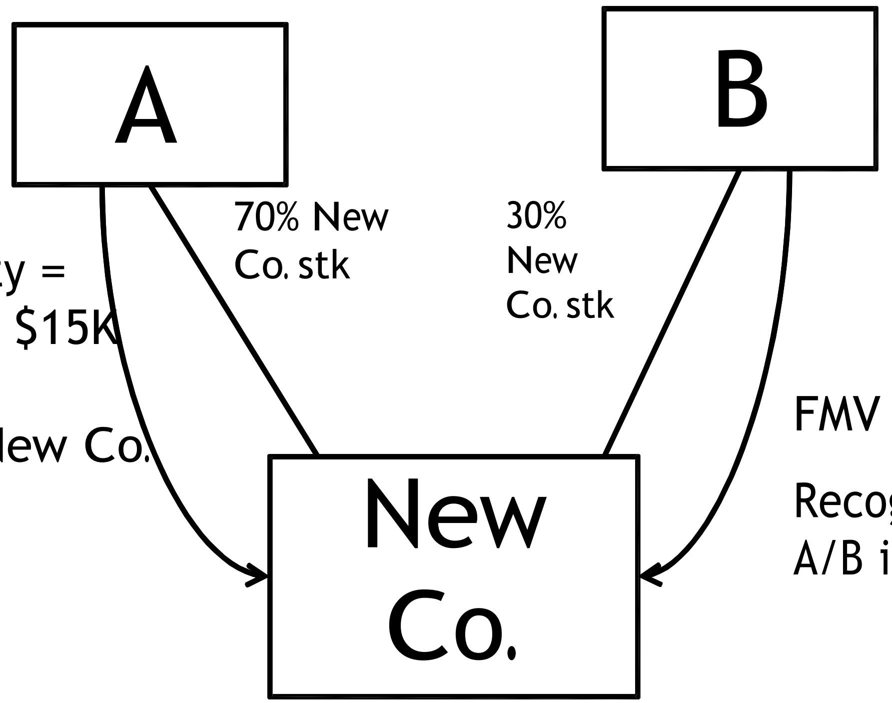
NOTE: must meet 80% threshold for EACH class of stock, not just all nonvoting preferred as a whole.

§ 351 Services Transaction (20%)



80% control requirement is met. A does not have to recognize $65K ($80K - $15K) in Built-In Gain ("BIG").

§ 351 Services Transaction (30%)



FMV property = $70K; A/B = $15K

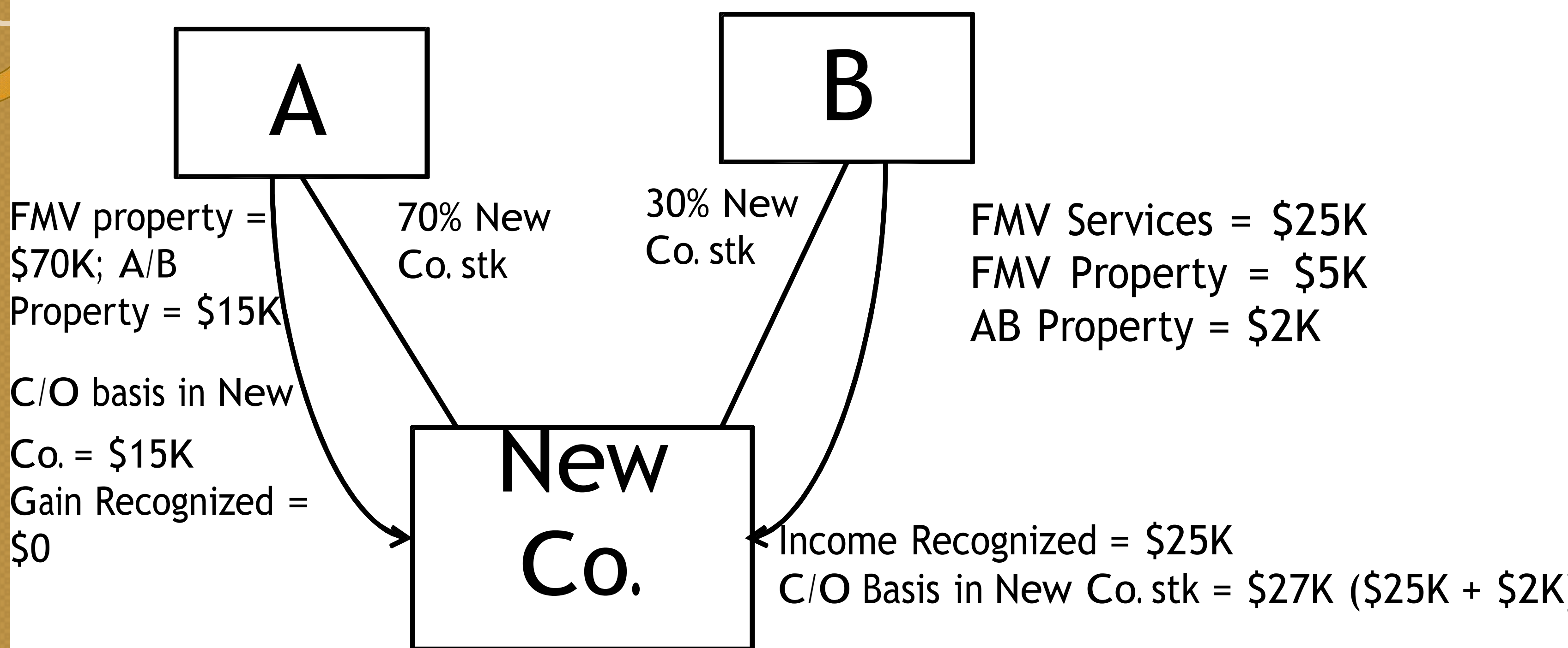
A's basis in New Co. stk = $70K

FMV Services = $30K

Recognized Gain = $30K
A/B in New Co. stk = $30K

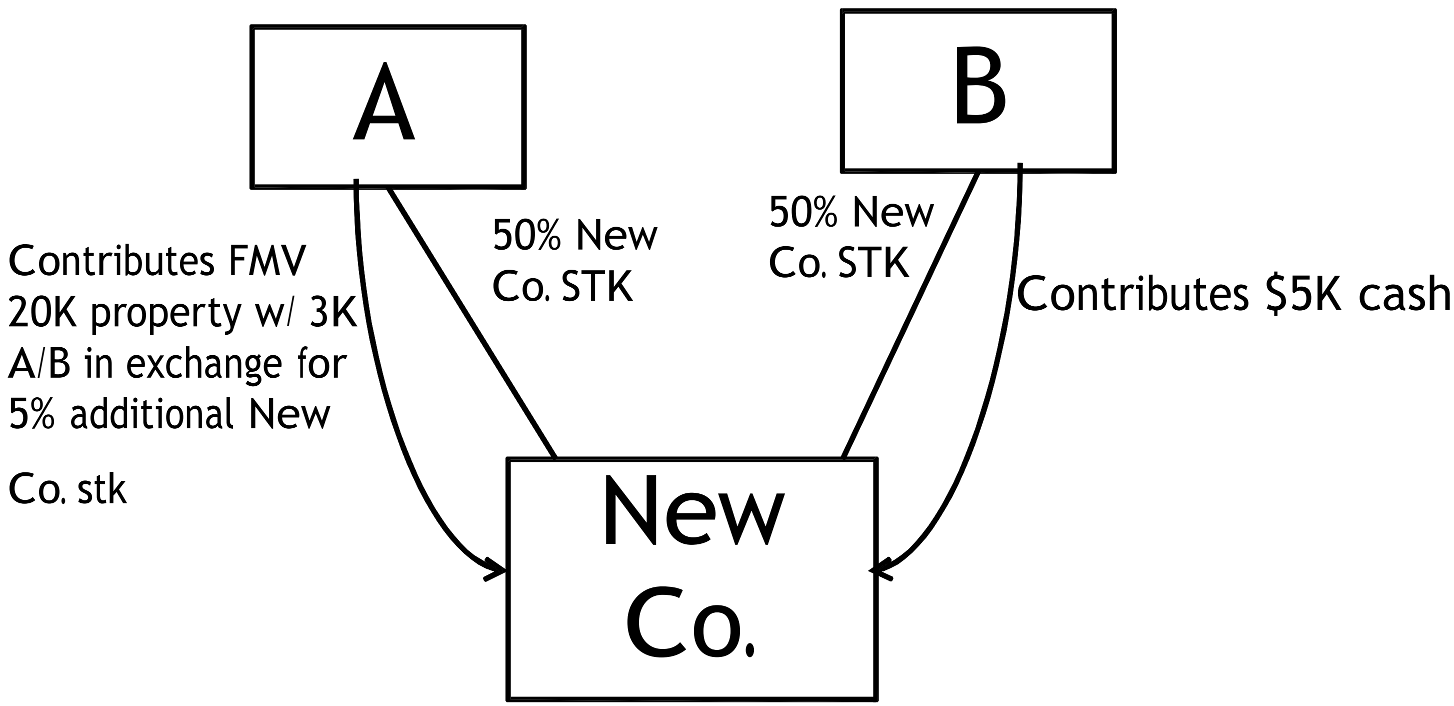
80% control requirement is not met.
A must recognize $55K ($70K - $15K) in BIG.

§ 351 Property/Svcs Transaction



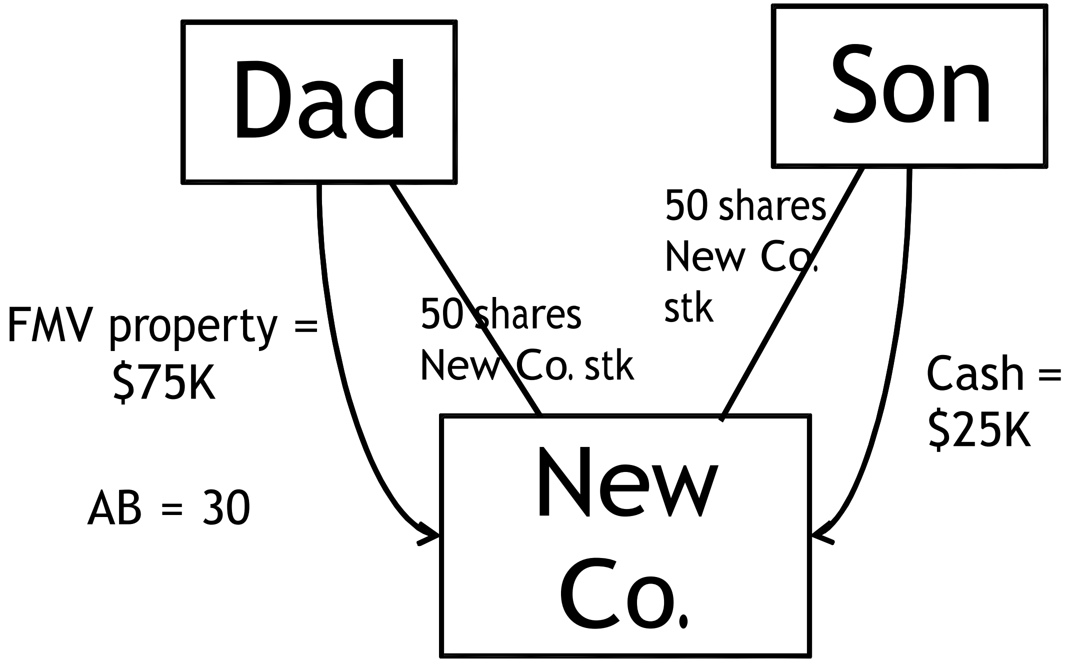
80% control requirement is met since FMV B's property contribution is over 10% the value of services ($25K x 10% = $2.5K; FMV property = $5K)
Therefore, 10% threshold is met.

Prior to contribution, A & B's holdings in New Co. stock is worth $50K each.



§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.

Disproportionate Exchanges



- Dad may owe gift taxes on extra 25 shares transferred to Son.
- §351 is met so Dad can defer $45 gain (75K – 30K)
- Dad deemed to have made gift of 25 shares to Son
- Dad's AB in his 50 shares is $20K (— x 30)
- Son's AB is $35K ($25K cash + 10K basis from 25 shares gift by Dad)

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?

What is Boot?

	Securities
Stock in another company	Boot is NOT stock in transferee co.

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
- <u>Liabilities assumed by New Co.</u>

A/B of Stock Received

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

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?

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!

Effect of § 351 to Transferees – Basis in Property Received

Transferor's A/B in property being transferred to New Co.

+ Gain recognized by transferor

- <u>Any reduction for loss property</u>

New Co.'s basis in property received

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.

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.

Effect of § 351 to Transferees – Receipt of Loss Property

- If a s/holder 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.

Effect of § 351 to Transferees – Receipt of Loss Property (cont'd)

- 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.

Assumption of Transferor's Liabilities

- 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.

Assumption of Transferor's Liabilities (cont'd)

- Can use this treatment as long as:
  a) there was a proper business purpose for the debt; and
  b) 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.

Calculating Transferor's Basis

Assuming New Co. assumes Transferor's liabilities:

Basis in transferred asset

\+ Cash transferred

\+ Gain recognized (excess liab over basis)

\- <u>Transferor's liab assumed by New Co.</u>

Transferor's basis in New Co. stock

§ 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.

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 back 2 years or forward 20.

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%

