Chapter 12

1.

2. [LO 1] North Inc. is a calendar-year C corporation, accrual-basis taxpayer. At the end of the year 1, North accrued and deducted the following bonuses for certain employees for financial accounting purposes.

   - $7,500 for Lisa Tanaka, a 30 percent shareholder.
   - $10,000 for Jared Zabaski, a 35 percent shareholder.
   - $12,500 for Helen Talanian, a 20 percent shareholder.
   - $5,000 for Steve Nielson, a 0 percent shareholder.

   Unless stated otherwise, assume these shareholders are unrelated.

   How much of the accrued bonuses can North Inc. deduct in year 1 under the following alternative scenarios?

   a. North paid the bonuses to the employees on March 1 of year 2.

   b. North paid the bonuses to the employees on April 1 of year 2.

   c. North paid the bonuses to employees on March 1 of year 2, and Lisa and Jared are related, so they are treated as owning each other's stock in North.

   d. North paid the bonuses to employees on March 1 of year 2, and Lisa and Helen are related, so they are treated as owning each other's stock in North.

a. North may deduct $35,000 in year 1 because the bonuses were paid within 2 ½ months of year end.

Employee	*Deductible Year 1*	*Deductible Year 2*
Lisa Tanaka	*$7,500*	
Jared Zabaski	*$10,000*	
Helen Talanian	*$12,500*	
Steve Nielson	*$5,000*	
Total	*$35,000*	

b. North may not deduct any of the bonus in year 1 because the bonuses were not paid within 2 ½ months of year end. It may deduct the $35,000 of bonuses in year 2.

Employee	*Deductible Year 1*	*Deductible Year 2*
Lisa Tanaka		*$7,500*
Jared Zabaski		*$10,000*
Helen Talanian		*$12,500*
Steve Nielson		*$5,000*
Total		*$35,000*

c. *North may deduct $17,500 in both year 1 and year 2. Helen and Steve's bonuses are deductible in year 1 because they were paid within 2 ½ months of year end. Lisa and Jared's bonuses are deductible in year 2 which is the year they take the bonuses into income—since they are related persons (own greater than 50 percent).*

Employee	*Deductible Year 1*	*Deductible Year 2*
Lisa Tanaka		*$7,500*
Jared Zabaski		*$10,000*
Helen Talanian	*$12,500*	
Steve Nielson	*$5,000*	
Total	*$17,500*	*$17,500*

d. *North may deduct $35,000 in year 1. All of the shareholders' bonuses are deductible in year 1 because they were paid within 2 ½ months of year end. Helen and Lisa are not considered to be related persons because together they own 50 percent but not more than 50 percent of North.*

Employee	*Deductible Year 1*	*Deductible Year 2*
Lisa Tanaka	*$7,500*	
Jared Zabaski	*$10,000*	
Helen Talanian	*$12,500*	
Steve Nielson	*$5,000*	
Total	*$35,000*	

3. [LO 2] On January 1, year 1, Dave received 1,000 shares of restricted stock from his employer, RRK Corporation. On that date, the stock price was $7 per share. On receiving the restricted stock, Dave made the 83(b) election. Dave's restricted shares will vest at the end of year 2. He intends to hold the shares until the end of year 4, when he intends to sell them to help fund the purchase of a new home. Dave predicts the share price of RRK will be $30 per share when his shares vest and $40 per share when he sells them. Assume that Dave's price predictions are correct and answer the following questions:

   a. What are Dave's taxes due if his ordinary marginal rate is 32 percent and his long-term capital gains rate is 15 percent?

   b. What are the tax consequences of these transactions to RRK?

   a. *Dave's tax consequence on the grant date is that he will recognize $7,000 of ordinary income and pay taxes of $2,240, which is calculated as follows:*

Description	***Amount***	***Explanation***
(1) Shares acquired	*1,000*	
(2) FMV at grant date	*$7.00*	
(3) Ordinary income on grant date	*$7,000*	*(1) × (2)*
(4) Ordinary Marginal Tax Rate	*32%*	

(5) Tax due on grant date	*$2,240*	*(3) × (4)*

Dave will owe no tax on the vesting date since he made the 83(b) election.

Dave will owe $4,950 on the sale, which is calculated as follows:

Description	***Amount***	***Explanation***
(6) Amount realized	*$40,000*	*1,000 shares × $40 per share*
(7) Adjusted basis	*7,000*	*From line 3 above.*
(8) Long-term capital gain	*$33,000*	*(6) – (7)*
(9) Capital Gain Tax Rate	*15%*	
Tax due when shares sold	***$4,950***	*(8) × (9)*

b. RRK will receive a tax benefit of $1,470 on the grant date, which is calculated as follows:

Description	***Amount***	***Explanation***
(1) Shares acquired	*1,000*	
(2) FMV at grant date	*$7.00*	
(3) Ordinary deduction on grant date	*$7,000*	*(1) × (2)*
(4) Ordinary Marginal Tax Rate	*21%*	
***Tax benefit** when shares granted*	***$1,470***	*(3) × (4)*

RRK receives no benefit on the vesting date or when Dave sells the shares.

4. [LO 3] {Tax Planning} Seiko's current salary is $85,000. Her marginal tax rate is 32 percent, and she fancies European sports cars. She purchases a new auto each year. Seiko is currently a manager for Idaho Office Supply. Knowing of her interest in sports cars, her friend tells her about a manager position at the local BMW and Porsche dealer. The new position pays $75,000 per year, but it allows employees to purchase one new car per year at a discount of $15,000. This discount qualifies as a nontaxable fringe benefit. To keep Seiko as an employee, Idaho Office Supply offers her a $10,000 raise. Answer the following questions about this analysis.

    a. What is Idaho Office Supply's annual after-tax cost if it provides Seiko with a $10,000 salary increase?

    b. Financially, which offer is better for Seiko after tax, and by how much? (Assume that Seiko will purchase the new car whether she switches jobs or not.)

    c. What salary would Seiko need from Idaho Office Supply to make her financially indifferent (after taxes) between receiving additional salary from Idaho Office Supply and accepting a position at the auto dealership?

a. *The after-tax cost of providing Seiko with $10,000 of additional salary is $7,900. This is calculated as follows:*

Description	***Amount***	***Explanation***
(1) Additional salary	*$10,000*	
(2) Marginal tax rate	*21%*	
(3) Income tax benefit	*$2,100*	*(1) × (2)*
After-tax cost of additional salary	*$7,900*	*(1) - (3)*

b. *The after-tax value to the employee of Idaho Office Supply's package is $64,600, calculated as follows:*

Salary with $10,000 raise	*$95,000*
	× (1-.32)
After-tax benefit from salary	*$64,600*

The after-tax value to the employee of the car dealer's package is $66,000, calculated as follows:

Salary	*$75,000*
	× (1-.32)
After-tax benefit	*$51,000*
After-tax benefit of discount	*15,000*
After-tax value of second package	*$66,000*

So, the after-tax value of the potential employer is better ($66,000) than Idaho Business Supply ($64,600).

c. *The current employer would have to offer her $97,059 ($95,000 + $2,059), because the after-tax difference between the two offers is $1,400 ($66,000 versus $64,600). Therefore, if Seiko's current employer provided her with $2,059 of additional salary [$1,400/(1-.32)] she would be indifferent.*

Salary increase	*$2,059*
	× (1-.32)
After-tax benefit of extra salary	*$1,400*
Salary (with $10,000 + 2,059 raise)	*$97,059*
	× (1-.32)
After-tax benefit from salary	*$66,000*