

APPENDIX B

SOLUTIONS TO SELF-TEST
PROBLEMS (WEB)

CHAPTER 2

ST2A-1	HENDERSON'S TAXES AS A CORPORATION	2003	2004	2005
	Income before salary and taxes	\$52,700	\$90,000	\$150,000
	Less: salary	<u>(40,000)</u>	<u>(40,000)</u>	<u>(40,000)</u>
	Taxable income, corporate	\$12,700	\$50,000	\$110,000
	Total corporate tax	<u>1,905^a</u>	<u>7,500</u>	<u>26,150</u>
	Salary	\$40,000	\$40,000	\$ 40,000
	Less exemptions and deductions	<u>(18,700)</u>	<u>(18,700)</u>	<u>(18,700)</u>
	Taxable personal income	\$21,300	\$21,300	\$ 21,300
	Total personal tax	<u>\$ 2,685^b</u>	<u>\$ 2,685</u>	<u>\$ 2,685</u>
	Combined corporate and personal tax:	<u>\$ 4,590</u>	<u>\$10,185</u>	<u>\$ 28,835</u>
	HENDERSON'S TAXES AS A PROPRIETORSHIP			
	Total income	\$52,700	\$90,000	\$150,000
	Less: exemptions and deductions	<u>(18,700)</u>	<u>(18,700)</u>	<u>(18,700)</u>
	Taxable personal income	\$34,000	\$71,300	\$131,300
	Tax liability of proprietorship	<u>\$ 4,500^c</u>	<u>\$13,047</u>	<u>\$ 29,801</u>
	Advantage to being a corporation:	<u>(\$ 90)</u>	<u>\$ 2,862</u>	<u>\$ 966</u>

^a Corporate tax in 2003 = $(0.15)(\$12,700) = \$1,905$.

^b Personal tax (if Henderson incorporates) in 2003 = $\$1,200 + (\$21,900 - \$12,000)(0.15) = \$2,685$.

^c Proprietorship tax in 2003 = $\$1,200 + (\$34,000 - \$12,000)(0.15) = \$4,500$.

Notice that in 2003, the proprietorship has a slightly lower tax liability; however, in 2004 and 2005, the corporate form has the lower tax liability. Thus, the corporate form of organization allows Henderson to pay the lowest taxes in 2004 and 2005. Therefore, on the basis of taxes over the 3-year period, Henderson should incorporate her business. However, note that to get additional money out of the corporation so she can spend it, Henderson will have to have the corporation pay dividends, which will be taxed to Henderson, and thus she will, sometime in the future, have to pay additional taxes.