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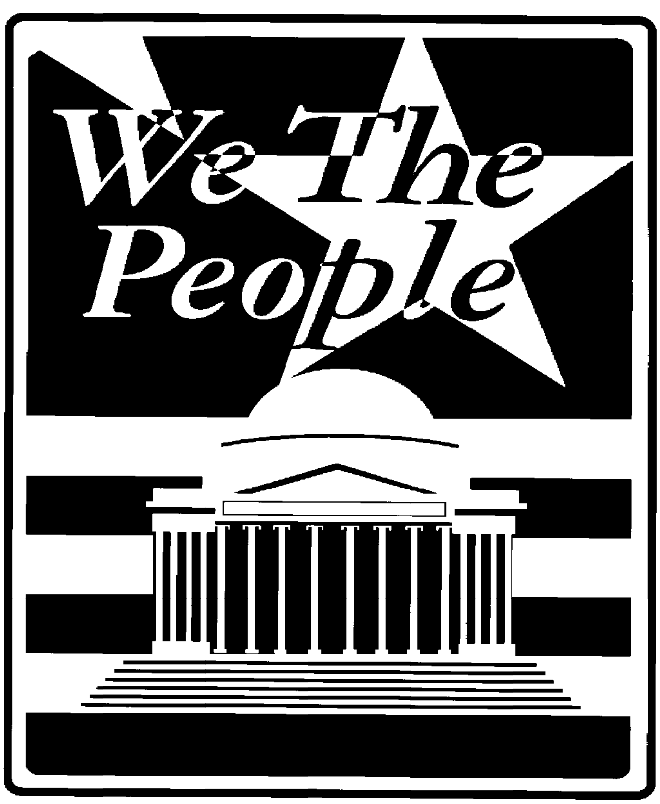
Tax Information on Corporations

For use in preparing

1994 Returns



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Introduction

This publication discusses the general tax laws that apply to ordinary domestic corporations. It explains the tax law in plain language so that it will be easier to understand. However, the information provided does not cover every situation, replace the law, or change its meaning.

Some corporations may meet the qualifications for electing to be S corporations. For a detailed discussion of S corporations, see Publication 589. Also, see Publication 536 if the corporation has an operating loss.

See the sample filled-in Forms 1120 and 1120–A near the end of this publication.

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Useful Items

You may want to see:

Publication

- ❏ **534** Depreciation
- ❏ **535** Business Expenses

Form

- ❏ **1120** U.S. Corporation Income Tax Return
- ❏ **1120–A** U.S. Corporation Short–Form Income Tax Return
- ❏ **1120–W** (WORKSHEET) Estimated Tax for Corporations
- ❏ **1120X** Amended U.S. Corporation Income Tax Return
- ❏ **2220** Underpayment of Estimated Tax by Corporations
- ❏ **4626** Alternative Minimum Tax–Corporations
- ❏ **7004** Application for Automatic Extension of Time To File Corporation Income Tax Return

Definitions

A ***corporation,*** for federal income tax purposes, includes associations, joint stock companies, insurance companies, trusts, and partnerships that operate as associations or corporations.

Professional organizations. Federal tax provisions recognize organizations of doctors, lawyers, and other professional people, organized under state professional association acts or corporation statutes as corporations. To be classified as a corporation, a professional service organization must be both ***organized*** and ***operated*** as a corporation. All states and the District of Columbia have professional association acts.

Unincorporated organizations. Unincorporated organizations having certain corporate characteristics are associations taxed as corporations. To be treated as a corporation for tax purposes, the organization must have associates, be organized to carry on business, and divide the gains from the business. In addition, the organization must have a majority of the following characteristics:

Continuity of life,

Centralization of management,

Limited liability, and

Free transferability of interests.

Consider the presence or absence of these characteristics in determining whether an organization is an association. The facts in each case determine whether the characteristics are present.

However, other factors may be significant in classifying an organization as an association. Treat an organization as an association if its corporate characteristics make it more nearly resemble a corporation than a partnership or trust.

Forming a Corporation

Forming a corporation involves a transfer of money, property, or both by prospective shareholders in exchange for capital stock in the corporation.

Issuance of Stock

If one or more persons transfer money or property to a corporation solely in exchange for stock of that corporation, and immediately after the exchange they control the corporation, neither the transferors nor the transferee corporation recognizes gain or loss.

The transferors must be in control of the corporation immediately after the exchange. To be in control, the transferors must, as a group, 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.

Transferor's loss. A transferor who has a loss from an exchange and who owns more than 50% of the corporation's stock cannot deduct the loss. This is true even if the transferor does not control the corporation (owns less than 80% of its stock). See *Sales and Exchanges Between Related Parties* and its discussion *Nondeductible Loss* in Chapter 2 of Publication 544, *Sales and Other Dispositions of Assets.*

Transfer of services. Transfer of your services to a corporation in return for stock results in taxable compensation to you.

Property or money received. If you receive property or money in addition to stock in exchange for the property you transferred, any gain may be taxable. Gain is taxable only to the extent of the money and fair market value (FMV) of other property received. Property includes securities of the corporation.

Fair market value (FMV). Fair market value (FMV) is the price at which property would change hands between a buyer and seller, neither being required to buy or sell, and both having reasonable knowledge of all relevant facts.

Transfer of Mortgaged Property

If you transfer mortgaged property to a corporation you control, you generally do not recognize gain or loss. If the corporation assumes your liabilities or takes property subject to liability, you generally do not recognize gain or loss.

Gain if liability exceeds basis. If the corporation assumes or takes your property subject to an amount of liability that is more than your adjusted basis of the transferred property, the excess amount is your taxable gain.

Liabilities you can exclude. To determine the excess amount of liability described in the preceding paragraph, you can exclude certain liabilities. These excludible liabilities are the type that would give rise to a deduction if you had paid them. For example, you can exclude trade accounts payable, and other liabilities such as interest and taxes that relate to a transferred trade or business. Your basis in this stock you receive from a corporation is not reduced by the excluded liabilities.

Liabilities you cannot exclude. You cannot exclude a liability if:

1) A deduction for it has already been claimed, or
2) When the liability was incurred it created or increased the basis of any property.

For example, a cash basis taxpayer bought some small handtools on credit which are used in his business. However, before paying the liability, he transfers the handtools and the liability to a controlled corporation. This liability cannot be excluded because when it was incurred, it created a basis in the asset for the taxpayer which offsets the liability.

No gain for certain reorganizations. Even if your liability exceeds basis in the preceding transfers, the excess liability rule for recognizing gain does not apply to transfers you make as part of a:

Title 11 or similar plan of reorganization under section 368(a)(1)(G) of the Internal Revenue Code, or

Reorganization that is a mere change in identity, form, or place of organization, under Code Section 368(a)(1)(F).

Gain if transfer made for nonbusiness purpose. Even if your liability exceeds basis on a transfer to your controlled corporation, if you had no bona fide business purpose in making the transfer or you did so to avoid federal income tax, you cannot use the excess-liability rule to figure any taxable gain. Instead, the gain is taxable to the extent of all the liabilities you transferred or the corporation assumed plus the fair market value of any property (other than the corporation's stock) you received in the exchange.

Gain or Loss Not Recognized

A corporation does not recognize gain or loss if you transfer property and money to the corporation in exchange for corporation stock (including treasury stock). A corporation does not recognize gain or loss on the acquisition or lapse of an option to buy or sell its stock (including treasury stock).

Transfer to Foreign Corporations

Generally, you recognize gain on the transfer of property to a foreign corporation. Exceptions allow nonrecognition of gain on a transfer of certain property. For example, the transfer of property to a foreign corporation that uses it in the active conduct of a trade or business outside the United States.

Basis of Stock

The basis of stock received for the property transferred to a corporation is the same as the basis of property transferred with certain adjustments. The basis is ***decreased*** by:

- The FMV of any other property (except money) you receive,
- Any money you receive, and
- Any loss you recognize on the exchange.

The basis is ***increased*** by:

- Any amount treated as a dividend, and
- Any gain recognized on the exchange.

The basis of property received, other than money or stock, is its FMV.

Assumption of liability. If, in return for stock, securities, or other property, you transfer to a corporation property subject to a liability, treat the amount of the liabilities as money received by you for determining your basis. If the corporation assumes your liabilities, treat the amount of the liabilities as money received for determining your basis. This rule does not apply to liabilities you excluded under the excess liability rule discussed previously in *Gain if liability exceeds basis* under *Transfer of Mortgaged Property.*

Basis of Property Transferred

Generally, the basis of property a corporation receives from you in exchange for its stock:

1) In an 80% control transaction,
2) As paid-in surplus, or
3) As a contribution to capital

has the same basis you had in the property increased by any gain you recognized on the exchange.

Basis pursuant to reorganization. However, the general rule discussed in the preceding paragraph does not apply to stock or securities acquired by a corporation from another corporation that is a party to a reorganization unless it is acquired by the exchange of stock or securities of the transferee (or a corporation that is in control of the transferee) as the consideration in whole or in part for the transfer.

Transferor not in control of corporation. If a corporation receives property by issuing stock for it, other than in an 80% control transaction, its basis for the property is usually the FMV of the stock at the time of the exchange. The corporation can use evidence of the FMV of the transferred property to set the value of the stock if:

1) The stock has no established value, and
2) It issues all outstanding stock in exchange for that property.

Start-Up Expenses

A corporation may not take a deduction for start-up expenses unless it chooses to treat those expenses as deferred expenses and to amortize them. When you amortize start-up expenses, deduct them in equal amounts over a period of 60 months or more. The amortization period starts in the month you start or acquire the active business.

A start-up expense is one you pay or incur for:

1) Creating an active trade or business, or
2) Investigating the possibility of creating or acquiring an active trade or business.

However, to be amortizable, it must be deductible if paid or incurred in the operation of an existing trade or business in the same field.

Start-up expenses also include amounts paid or incurred in any activity engaged in for profit and for the production of income in anticipation of the activity becoming an active trade or business. Do not confuse start-up expenses with organizational expenses, discussed later.

Start-up expenses are those you have before you begin business operations. They include expenses both for investigating a prospective business and getting the business started. For example, they may include costs for the following items:

A survey of potential markets,

An analysis of available facilities, labor supply, etc.,

Advertisements for the opening of your business,

Salaries and wages for employees who are being trained, and for their instructors,

Travel and other necessary expenses for lining up distributors, suppliers, or customers, and

Salaries and fees for executives, consultants, or for other professional services.

Start-up expenses do not include interest, taxes, or research and experimental expenses allowable as deductions.

Choosing to amortize. If you want to amortize start-up expenses, complete Part VI of Form 4562. Attach it to the corporation's tax return for the tax year the amortization period starts. Also, attach a statement to your return. It should show the total amount of those expenses, and describe what they were for, date incurred, month the corporation began business, and months in the amortization period (not less than 60). File the return and statement by the due date of the return (including extensions).

Organizational Expenses

A newly organized corporation may choose to treat its organizational expenses as deferred expenses and amortize them. To amortize, deduct the expenses in equal monthly amounts over a period of 60 months or more. The period starts with the first month the corporation actively engages in business. If the corporation does not make this choice, capitalize and deduct these expenses only in the year the corporation finally liquidates. The corporation must incur these expenses before the end of the first tax year it is in business.

Organizational expenses are those directly for the creation of the corporation that would be chargeable to the capital account. If spent for the creation of a corporation having a limited life, the expenses are amortizable over that limited life. They include expenses of temporary directors, organizational meetings of directors or shareholders, fees paid to a state for incorporation, and accounting or legal services incident to the organization. These services include drafting the charter, the bylaws, minutes of organizational meetings, and terms of the original stock certificates.

Expenses for issuance or sale of stock. A corporation cannot deduct or amortize expenses for issuance or sale of stock or securities, such as commissions, professional fees, and printing costs. No deduction or amortization is allowable for the expenses of transferring assets to the corporation.

Time and manner of choosing. If a corporation wants to amortize organizational expenses, it must choose to do so when it files its return for the first tax year it actively engages in business. Make the choice by the due date (including extensions) of the return for that tax year. The corporation completes Part VI of Form 4562 and attaches it to its return. It must also attach a statement to its return.

The statement should show the description, amount of the expenses, date incurred, month the corporation began business, and months (not less than 60) over which the corporation will deduct the expenses. The time over which the corporation chooses to amortize its organizational expenses is binding.

Start of business. A corporation starts business when it starts the activities for which it was organized. This generally occurs after its charter is issued. However, consider a corporation to have begun business when its activities reach the point necessary to establish the nature of its business operations, even though it has not received its charter. For example, if a corporation acquires the assets necessary to operate its business, it may be considered to have begun business activities.

Special Provisions

Rules on income and deductions that apply to individuals also apply, for the most part, to corporations. However, some of the following special provisions apply only to corporations.

Below-Market Loan

If a corporation issues a shareholder or an employee a below-market loan, the corporation reports additional income.

A below-market loan is a loan which provides for no interest or interest at a rate below the federal rate that applies. Treat a below-market loan as an arm's-length transaction in which the lender is considered to have made:

1) A loan to the borrower in exchange for a note that requires payment of interest at the applicable federal rate, and
2) A payment to the borrower.

Treat the lender's payment to the borrower as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction.

See *Below-Market Interest Rate Loans* in Chapter 8 of Publication 535 for more information.

Transfer of Stock to Creditor

If a corporation transfers its stock in satisfaction of indebtedness and the fair market value of its stock is less than the indebtedness it owes, the corporation has income (to the extent of the difference) from the cancellation of indebtedness. For stock transferred after 1994, a corporation can exclude all or a portion of the income created by the stock for debt transfer if it is in a bankruptcy proceeding or, if it is not in a bankruptcy proceeding, it can exclude the income to the extent it is insolvent. However, the corporation must reduce its tax attributes (to the extent it has any) generally by the amount of excluded income.

Exception to realized income. For stock transferred before 1995, a corporation does not realize income because of such stock for debt exchanges if it is in bankruptcy or to the extent it is insolvent. Consequently, there is no gross income to exclude and no reduction of its tax attributes is necessary. This exception generally applies only to stock transferred before 1995 in satisfaction of its debt. However, if the bankruptcy (or similar court procedure) was filed before 1994, this exception also applies to stock transferred after 1994 in that case.

Golden Parachute Payments

Corporations may enter into ''golden parachute'' contracts with key personnel. Under a typical golden parachute contract, the corporation agrees to make payments to certain officers, shareholders, or highly compensated individuals in certain events. The contract provides for payment when there is:

1) A change in the ownership or control of the corporation, or
2) A change in the ownership of a substantial part of the corporation's assets.

The corporation's deduction is limited if the total present value of the payments to any officer, shareholder, or highly compensated individual equals or exceeds three times the recipient's base amount. It cannot deduct the excess of any parachute payment over the part of the base amount allocated to the payment.

The ***base amount*** is the average annualized includible compensation that was payable to the recipient by the corporation during the 5 tax years ending before the date of the change in ownership or control. The law imposes a nondeductible excise tax of 20% of these payments on the recipient in addition to regular income tax. For more information, see section 280G of the Internal Revenue Code.

U.S. Real Property Interests

If a domestic corporation acquires a U.S. real property interest from a foreign person or firm, the corporation may have to withhold tax on the amount it pays for the property. The amount paid includes cash, FMV of other property, and any assumed liability. If a domestic corporation distributes a U.S. real property interest to a foreign person or firm, it may have to withhold tax on the FMV of the property. A corporation that fails to withhold may be liable for the tax, penalties that apply, and interest. For more information, see *U.S. Real Property Interest* in Publication 515.

Adjustments–Tax Preferences

Tax law gives special treatment to some items of income and deduction called adjustments or tax preference items. They may result in an additional tax called the alternative minimum tax (discussed later). The corporation adjusts the following items before it takes them into account in determining its taxable income:

- ***Section 1250 capital gain treatment.*** For section 1250 property disposed of during the tax year, 20% of any excess of (a) the amount that would be ordinary income if the property was section 1245 property over (b) the amount treated as ordinary income under section 1250, must be recognized as ordinary income under section 1250.

  Section 1250 property. This includes all real property subject to an allowance for depreciation that is not and never has been section 1245 property.

  Section 1245 property. This includes:

  a) Any property that is or has been subject to an allowance for depreciation, and
  b) Any intangible property placed in service after August 10, 1993, that is subject to amortization under section 197 of the Internal Revenue Code

  if such property is either personal property or other section 1245 property described in Chapter 4 of Publication 544, *Sales and Other Dispositions of Assets*.

- ***Percentage depletion.*** For iron ore and coal (including lignite), reduce the allowable percentage depletion deduction by 20% of any excess of (a) the percentage depletion deduction allowable for the tax year (determined without this adjustment), over (b) the adjusted basis of the depletable property at the close of the tax year (figured without the depletion deduction for the tax year).
- ***Pollution control facilities.*** Reduce the amortizable basis of pollution control facilities by 20% in determining the amortization deduction for that property.
- ***Mineral exploration and development costs.*** Reduce the allowable deduction for these costs by 30%. Special rules apply to the amount not allowed because of this adjustment. This reduction also applies to the ***intangible drilling costs*** of an integrated oil company. See section 291(b) of the Internal Revenue Code for more information.

These adjustments apply to all corporations. However, they do not apply to an S corporation unless it was a C corporation for any of the 3 immediately preceding tax years.

Dividends–Received Deduction

A corporation may deduct a percentage of certain dividends received during its tax year.

Dividends from domestic corporations. A corporation may deduct, with certain limits, 70% of the dividends received if the corporation receiving the dividend owns less than 20% of the distributing corporation.

20%-or-more owners allowed 80% deduction. A corporation may deduct, with certain limits, 80% of the dividends received or accrued if it owns 20% or more of the paying domestic corporation. This corporation is a ***20%-owned corporation.***

Ownership. Determine ownership, for these rules, by the amount of voting power and value of stock (other than certain preferred stock) the corporation owns.

Small business investment companies. Small business investment companies may deduct 100% of the dividends received from a taxable domestic corporation.

Affiliated corporations. Members of an affiliated group of corporations may deduct 100% of the dividends received from a member of the same affiliated group if they meet certain conditions. See section 243 of the Internal Revenue Code for the definition of an affiliated group of corporations.

Dividends from regulated investment company. Regulated investment company dividends received are subject to certain limits. Capital gain dividends do not qualify for the deduction. For more information, see section 854 of the Internal Revenue Code.

Dividends on preferred stock of public utilities. For tax years beginning after 1992, a corporation may deduct 42% of the dividends it receives on certain preferred stock (issued before October 1942) of a less-than-20%-owned taxable public utility. For tax years beginning after 1992, a 20%-or-more-owned taxable public utility, may deduct 48%. For more information, see section 244 of the Internal Revenue Code.

Dividends from Federal Home Loan Bank. Certain dividends received from Federal Home Loan Banks qualify for the dividend-received deduction. For more information, see section 246 of the Internal Revenue Code.

Dividends from foreign corporations. A corporation can deduct a percentage of the dividends it receives from 10%-owned foreign corporations. For more information, see section 245 of the Internal Revenue Code.

Dividends on debt-financed portfolio stock. For dividends received on debt-financed portfolio stock of domestic corporations, reduce the 70% or 80% dividends-received deduction. Reduce the deduction by a percentage related to the amount of debt incurred to purchase the stock. This applies to stock whose holding period begins after July 18, 1984. For more information, see section 246A of the Internal Revenue Code.

Dividends in property. When a corporation receives a dividend from a domestic corporation in the form of property other than cash, it includes the dividend in income. The amount included is the lesser of the property's FMV or the adjusted basis of the property in the hands of the distributing corporation, increased by any gain recognized by the distributing corporation on the distribution.

No deduction allowed for certain dividends. Corporations cannot take a deduction for dividends received from:

A real estate investment trust;

A corporation exempt from tax either for the tax year of the distribution or the preceding tax year;

A corporation whose stock has been held by your corporation for 45 days or less;

A corporation whose stock has been held by your corporation for 90 days or less, if the stock has preference as to dividends and the dividends received on it are for a period or periods totaling more than 366 days; or

Any corporation, if your corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments for positions in substantially similar or related property.

Dividends on deposits. So-called dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are interest. They do not qualify for this deduction.

Limit on deduction for dividends. The total deduction for dividends received or accrued is generally limited (in the following order) to:

1) 80% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from 20%-owned corporations, and

2) 70% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from less-than-20%-owned corporations (reducing taxable income by the total dividends received from 20%-owned corporations).

Figuring limit. In figuring this limit, determine taxable income without:

1) The net operating loss deduction,

2) The deduction for dividends received,

3) Any adjustment due to the part of an extraordinary dividend that is not taxable (see *Reduction in Basis of Stock,* later),

4) The deduction for contributions to a Capital Construction Fund (CCF), and

5) Any capital loss carryback to the tax year.

Effect of net operating loss. If a corporation has a net operating loss for a tax year, the limit of 80% (or 70%) of taxable income does not apply. To determine whether a corporation has a net operating loss, figure the dividends-received deduction without the 80% (or 70%) of taxable income limit.

Example 1. A corporation loses $25,000 from operations. It receives $100,000 in dividends from a 20%-owned corporation. Its taxable income is $75,000 before the deduction for dividends received. If it claims the full dividends-received deduction of $80,000 ($100,000 x 80%) and combines it with the operations loss of $25,000, it will have a net operating loss of $5,000. Therefore, the 80% of taxable income limit does not apply. The corporation can deduct $80,000.

Example 2. Assume the same facts as in Example 1 except that the corporation loses $15,000 from operations. Its taxable income is $85,000 before the deduction for dividends received. However, after claiming the dividends-received deduction of $80,000 ($100,000 x 80%), its taxable income is $5,000. But because the corporation will not have a net operating loss after a full dividends-received deduction, its allowable dividends-received deduction is limited to 80% of its taxable income, or $68,000 ($85,000 x 80%).

Reduction in Basis of Stock

If a corporation receives an ***extraordinary dividend*** on stock held 2 years or less before the dividend announcement date, it reduces its basis in the stock by the nontaxed part of the dividend. Do not reduce the basis of the stock below zero. The total nontaxed part of dividends on stock that did not reduce the basis of the stock, due to the limit on reducing basis below zero, is treated as gain from the sale or exchange of the stock for the tax year you sell or exchange the stock.

An ***extraordinary dividend*** is any dividend on stock that equals or exceeds:

- 5% for stock preferred as to dividends, or
- 10% for other stock

of the corporation's adjusted basis in the stock. Treat all dividends received that have ex-dividend dates within an 85-consecutive-day period as one dividend. Treat all dividends received that have ex-dividend dates within a 365-consecutive-day period as extraordinary dividends if the total of the dividends exceeds 20% of the corporation's adjusted basis in the stock. Do not include qualifying dividends, discussed earlier under *Affiliated corporations,* in the definition of extraordinary dividends.

The corporation can elect to determine whether the dividend is extraordinary by using the FMV of the stock rather than its adjusted basis. To make this election, the corporation must establish to the satisfaction of the IRS, the FMV of the stock as of the day before the ex-dividend date. (See Revenue Procedure 87–33 in the Cumulative Bulletin, Volume 1987–2, on page 402.)

The ***nontaxed part*** is any dividends-received deduction allowable for the dividends.

The ***dividend announcement date*** is the date the corporation declares, announces, or agrees to either the amount or the payment of the dividend, whichever is earliest.

Disqualified preferred stock. The rules apply to an extraordinary dividend on disqualified preferred stock regardless of the period the corporation held the stock.

Disqualified preferred stock is any stock preferred as to dividends if:

1) The stock when issued has a dividend rate that declines (or can reasonably be expected to decline) in the future,

2) The issue price of the stock exceeds its liquidation rights or stated redemption price, or

3) The stock is otherwise structured to avoid the rules for extraordinary dividends and to enable corporate shareholders to reduce tax through a combination of dividends-received deductions and loss on the disposition of the stock.

These rules apply to stock issued after July 10, 1989, unless issued under a written binding contract in effect on that date and thereafter before the issuance of the stock.

Charitable Contributions

A corporation can claim a limited deduction for any charitable contributions made in cash or other property. The contribution is deductible if made to or for the use of community chests, funds, foundations, corporations, or trusts organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes. The contribution may also be made to foster national or international amateur sports competition or the prevention of cruelty to children or animals.

You cannot take a deduction if any of the net earnings of an organization receiving contributions benefit any private shareholder or individual.

Cash method corporation. A corporation using the cash method of accounting may deduct contributions only in the tax year paid.

Accrual method corporation. A corporation using an accrual method of accounting can choose to deduct unpaid contributions for the tax year the board of directors authorizes them if it pays them within 2½ months after the close of that tax year. Make the choice by reporting the contribution on the corporation return for the tax year. A copy of the resolution authorizing the contribution and a declaration stating the board of directors adopted the resolution during the tax year must accompany the return. The president or other principal officer must sign the declaration.

Limit. A corporation cannot deduct contributions that total more than 10% of its taxable income. Figure taxable income for this purpose without the following:

- Deduction for contributions,
- Deductions for dividends received and dividends paid,
- Deduction for contributions to a Capital Construction Fund (CCF),
- Any net operating loss carryback to the tax year, and
- Any capital loss carryback to the tax year.

Carryover of excess contributions. You can carry over (with certain limits) any charitable contributions made during the year that are more than the 10% limit to each of the following 5 years. You lose any excess not used within that period. For example, if a corporation has a carryover of excess contributions paid in 1993 and it does not use all the excess on its return for 1994, it may carry the remainder over to 1995, 1996, 1997, and 1998. Do not deduct a carryover of excess contributions in the carryover year until after you deduct contributions made in that year (subject to the 10% limit). You cannot deduct a carryover of excess contributions to the extent it increases a net operating loss carryover in a succeeding tax year.

Capital Losses

A corporation, other than an S corporation, can deduct capital losses only up to its capital gains. In other words, if a corporation has a net capital loss, it cannot deduct the loss in the current tax year. It carries the loss to other tax years and deducts it from capital gains that occur in those years.

First, carry a net capital loss back 3 years. Deduct it from any total net capital gain which occurred in that year. If you do not deduct the full loss, carry it forward 1 year (2 years back) and then 1 more year (1 year back). If any loss remains, carry it over to future tax years, 1 year at a time, for up to 5 years. When you carry a net capital loss to another tax year, treat it as a short-term loss. It does not retain its original identity as long term or short term.

Example. In 1994, a corporation has a net short-term capital gain of $3,000 and a net long-term capital loss of $9,000. The short-term gain offsets some of the long-term loss, leaving a net capital loss of $6,000. It treats this $6,000 as a short-term loss when carried back or forward.

The corporation carries the $6,000 short-term loss back 3 years to 1991. In 1991, the corporation had a net short-term capital gain of $8,000 and a net long-term capital gain of $5,000. It subtracts the $6,000 short-term loss from 1994 first from the net short-term gain. This results in a net capital gain for 1991 of $7,000. This consists of a net short-term capital gain of $2,000 ($8,000 – $6,000) and a net long-term capital gain of $5,000.

S corporation status. A corporation may not carry a capital loss from, or to, a year for which it is an S corporation.

Rules for carryover and carryback. When carrying a capital loss from one year to another, the following rules apply:

When figuring this year's net capital loss, you cannot use any capital loss carried from another year. In other words, you may only carry capital losses to years that would otherwise have a total net capital gain.

If you carry capital losses from 2 or more years to the same year, deduct the loss from the earliest year first. When you fully deduct that loss, deduct the loss from the next earliest year, and so on.

You cannot use a capital loss carried from another year to produce or increase a net operating loss in the year to which you carry it.

Foreign expropriation losses. A corporation cannot carry back foreign expropriation capital losses. However, it may carry these losses over for up to 10 future tax years. Treat the losses as short-term capital losses in each year to which you carry them.

Refunds. When you carry back a capital loss to an earlier tax year, refigure your tax for that year. If your corrected tax is less than you originally owed, you may apply for a refund. File Form 1120X.

Related Taxpayers

The related party rules apply to:

1) An individual and a corporation the individual controls,
2) Two corporations that are members of the same controlled group,
3) A partnership and a corporation owned by the same person, and
4) An S corporation and a C corporation if owned by the same person.

These rules deny the deduction of losses on the sale or exchange of property between related parties. They also deny the deduction of certain unpaid business expenses and interest on transactions between the parties. Losses on the sale or exchange of property between members of the same controlled group of corporations are deferred rather than denied. Under certain conditions, the IRS may reallocate income and deductions between two or more businesses directly or indirectly controlled by the same interests.

For an explanation of these tax rules and their operation, see Chapters 2 and 8 of Publication 535, and Publication 544.

Accrual basis corporation. An accrual basis taxpayer cannot deduct expenses owed to a related cash basis person until payment is made, and the amount is includible in the gross income of the person paid. This rule applies even if the relationship ceases before the amount is includible in the gross income of the person paid.

Complete liquidations. The disallowance of losses from the sale or exchange of property between related parties does not apply to liquidating distributions. It does not apply to any loss of either the distributing corporation or a distributee for a distribution in complete liquidation.

Interest paid to related parties. A corporation's deduction for interest expense may be limited if it is paid (or accrued) interest to related parties ***not subject to tax on the interest*** received. The deduction for this interest is disallowed for any tax year that the corporation has:

- Excess interest expense, and
- A debt to equity ratio greater than 1.5 to 1 at the end of that tax year.

However, the deduction is disallowed only to the extent of the corporation's excess interest expense. The corporation can carry the disallowed interest to later years.

Not subject to tax on the interest means that the related party is not subject to U.S. income tax on the interest income. For example, the related party may be a foreign parent corporation not subject to U.S. tax.

Excess interest expense. Excess interest expense is the excess of the corporation's net interest expense over the sum of 50% of its adjusted taxable income plus any ***excess limit*** carryforward.

Excess limit. Excess limit means the excess of 50% of the corporation's adjusted taxable income over its net interest expense.

If a corporation has an excess limit for a tax year, that amount becomes an excess limit carryforward to the next tax year. When the corporation does not use it up in the next tax year, it can carry it forward only to the following 2 tax years.

More information. For more information, including the definition of ***adjusted taxable income,*** see section 163(j) of the Internal Revenue Code.

Net Income or Loss

At the end of each tax year, a corporation figures its net income or loss. To do this, subtract the operating expenses and other allowable deductions from gross income. Figure the corporation's tax as explained under *Figuring Tax.*

The at-risk rules apply to closely held corporations that engage in any activity as a trade or business or for the production of income. These rules limit a corporation's loss.

The at-risk rules generally do not apply to a qualifying business that is an active business of a qualified corporation (other than an S corporation). For more information on the at-risk rules, see Publication 925.

Figuring Tax

Beginning January 1, 1993, corporate taxable income is subject to the following rate system.

Controlled group of corporations. A controlled group of corporations gets only one apportionable $50,000, $25,000, and $9,925,000 (in that order) amount for each taxable income bracket. For more information, see the instructions for Schedule J of Form 1120.

Personal service corporations. The tax rate for qualified personal service corporations for tax years that began on or after January 1, 1993, is 35% of taxable income. These corporations cannot use the graduated tax rates that apply to other corporations.

A corporation is a ***qualified personal service corporation*** if:

At least 95% of the value of its stock is held by employees, or their estates or beneficiaries, and

Its employees perform services at least 95% of the time in any of the following fields:

- Health,
- Law,
- Engineering,
- Architecture,
- Accounting,
- Actuarial science,
- Veterinary services,
- Performing arts, or
- Consulting.

Credits

A corporation ***decreases*** its tax liability by credits, such as:

1) Credit for fuels used for certain purposes (see Publication 378),
2) Foreign tax credit (use Form 1118),
3) General business credit (use Form 3800),
4) Orphan drug credit (use Form 6765),
5) Possessions tax credit (use Form 5735),
6) Credit for fuel produced from a nonconventional source, and
7) The qualified electric vehicle credit (use Form 8834).

General business credit. The general business credit includes the:

- Investment credit (Form 3468),
- Jobs credit (Form 5884),
- Alcohol fuels credit (Form 6478),
- Research credit (Form 6765),
- Low-income housing credit (Form 8586),
- Disabled access credit (Form 8826),
- Enhanced oil recovery credit (Form 8830),
- Renewable electricity production credit (Form 8835),
- Empowerment zone employment credit (Form 8844),
- Indian employment credit (Form 8845),
- Credit for employer social security and Medicare taxes paid on certain employee tips (Form 8846), and
- Credit for contributions to certain community development corporations (Form 8847).

The empowerment zone employment credit is figured separately after all other business credits have been claimed.

Disregarding any empowerment zone employment credit, if you have only one current year business credit, no carryback or carryover, and the credit (other than the low-income housing credit) is not from a passive activity, do not file Form 3800. Instead, file only the applicable credit form to claim the general business credit. For information about passive activity credits, see Form 8582-CR.

Form 3800. If you have more than one credit, a carryback or carryover, or a credit (other than the low-income housing credit) from a passive activity, you must use Form 3800 to figure your general business credit.

See the instructions to Form 3800 for more information.

Other Taxes

A corporation ***increases*** its tax liability by:

1) Personal holding company tax (attach Schedule PH (Form 1120)),
2) Investment credit recapture,
3) Low-income housing credit recapture,
4) Alternative minimum tax, and
5) Environmental tax.

Environmental tax. A corporation is liable for the tax if its modified alternative minimum taxable income is over $2 million.

Modified alternative minimum taxable income. This is alternative minimum taxable income, defined later under *Alternative Minimum Tax (AMT)* without the:

1) Alternative tax net operating loss deduction,
2) Alternative tax energy preference deduction, and
3) Deduction for the environmental tax.

Alternative Minimum Tax (AMT)

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. So that taxpayers who benefit from these laws will pay at least a minimum amount of tax, a special tax was enacted, the ''alternative minimum tax (AMT)'' for corporations and individuals.

The rules discussed in this section apply to corporations. For information on the alternative minimum tax rules that apply to individuals, see Form 6251, *Alternative Minimum Tax—Individuals* and its instructions.

The AMT rate for corporations is 20%. There is an exemption of up to $40,000. This amount is reduced (but not below zero) by

Table 1. **Tax Rate Schedule**

If taxable income (line 30, Form 1120, or line 26, Form 1120-A) on page 1 is:

Over—	But not over—	Tax is:	Of the amount over—
$0	$50,000	15%	$0
50,000	75,000	$7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	-----	35%	0

25% of the amount by which alternative minimum taxable income (AMTI) exceeds $150,000.

You can apply a minimum tax credit against your regular tax liability in later years for the (AMT) caused by certain preferences and adjustments.

The adjustment and tax preference items for AMT purposes are listed in *Table 2* with a brief description for each item. However, each adjustment and preference item is discussed in more detail separately. These adjustment and tax preference items are reported on Form 4626 in figuring AMT.

Form 4626. You use Form 4626 to figure the corporation's AMT. File this form if the corporation's taxable income before the net operating loss (NOL) deduction plus adjustments and tax preference items totals more than the allowable exemption amount. Also, you use this form to figure the corporation's environmental tax, discussed earlier.

Formula to figure AMT. You figure the AMT by beginning with ***taxable income before any net operating loss deduction*** on the return. For Form 1120, this is line 28 minus line 29b and for Form 1120–A, it is line 24 minus line 25b. With that taxable income, use the following formula to figure AMT.

Add or Subtract
Adjustments and preferences
Equals
Preadjustment alternative minimum taxable income
Add or Subtract
Adjusted current earnings (ACE) adjustment
Equals
Tentative alternative minimum taxable income
Subtract
Alternative tax net operating loss deduction
Equals
Alternative minimum taxable income
Subtract
Exemption amount
Multiply by
20%
Subtract
Alternative minimum tax foreign tax credit
Equals
Tentative minimum tax
Subtract
Regular tax
Equals
Alternative minimum tax

Adjustments and Preferences

To figure AMT, you make certain adjustments to the taxable income on the return. These adjustments eliminate the tax advantages of certain items that receive preferential tax treatment. These items are called ''adjustments and preferences.'' The adjustment for these items is the difference between the recomputed item for AMT purposes and the amount on the return. They can be either increases or decreases (entered as negative amounts on Form 4626).

If an expense or loss claimed for regular tax purposes is more than the recomputed AMT expense or loss, the difference is an increase to taxable income. If the expense or loss claimed for regular tax purposes is less than the recomputed AMT expense or loss, the difference is a decrease to taxable income.

If income or gain reported for regular tax purposes is less than the recomputed AMT income or gain, the difference is an increase to taxable income. If the income or gain reported for regular tax purposes is more than the recomputed AMT income or gain, the difference is a decrease to taxable income.

Accelerated depreciation on property. This adjustment applies to property placed in service after 1986. The depreciation deduction used for AMT is the amount calculated under the alternative depreciation system (ADS) under the modified accelerated cost recovery system (MACRS). For real property, use the straight line method with a 40–year recovery period and the mid-month convention. For most property other than real property, use the 150% declining balance method switching to the straight line method when it gives a larger allowance. This adjustment applies to property placed in service after 1986, other than transition property. It also applies to property placed in service after July 31, 1986, and before 1987 if you elected to use MACRS.

Do not consider the following types of property in figuring this adjustment item.

Property you elect to exclude from MACRS that is depreciated under the unit-of-production method or most other methods of depreciation not expressed in terms of years,

Certain public utility property,

Any motion picture film or video tape, or

Any sound recording.

The adjustment is the difference between the total depreciation for all property for alternative minimum tax purposes and the total depreciation for regular income tax purposes.

The effect of using two different types of depreciation (one for regular income tax and one for alternative minimum tax) is that a corporation will have a different basis in the property for alternative minimum tax. This means, for example, that if a corporation sells the property, the gain will be different for alternative minimum tax purposes. See the later discussion of *Adjusted gain or loss.*

Depreciation for property placed in service before 1987. For property placed in service before 1987, accelerated depreciation is a tax preference item. Continue to treat depreciation on that property as a preference item. See *Accelerated depreciation on real property placed in service before 1987* and *Accelerated depreciation on leased personal property placed in service before 1987,* discussed later.

For more information on depreciation, see Publication 534.

Amortization of certified pollution control facilities. For the AMT, determine your amortization deduction for a certified pollution control facility using the alternative depreciation system under MACRS (see Publication 534).

Mining exploration and development costs. Recompute this deduction by taking your regular tax deduction for mining exploration and development costs and amortizing it ratably over a 10–year period. The adjustment is the difference between the deduction claimed for regular tax and the deduction allowed for AMT.

If you have a loss for mining property, in figuring AMT, deduct all mining exploration and development costs for the property that have not been written off. A loss occurs when you abandon a worthless mine.

Circulation expenses. This adjustment is for personal holding companies only. In figuring AMT, amortize circulation costs over 3 years beginning with the tax year you make the expenditures. The adjustment is the difference between the amount deducted for regular tax purposes and the refigured amortization.

Adjusted gain or loss. If a corporation sold property during the year, refigure the gain or loss from the sale using the corporation's adjusted basis for AMT purposes. The following AMT adjustments require changes to the corporation's regular tax basis.

Depreciation,

Circulation expenses,

Mining exploration and development costs, and

Pollution control facilities.

The adjustment is the difference between the gain (or loss) reported on the corporation's return for regular tax purposes and the recomputed gain (or loss) for AMT purposes.

Long-term contracts. For any long-term contract you enter into after February 28, 1986, apply the percentage of completion method (as modified by the rules for long-term contracts under section 460(b) of the Internal Revenue Code) in determining AMT for that contract.

The adjustment is the difference between income determined using the method of accounting used for regular tax purposes and income determined using the percentage of completion method of accounting.

Home construction contracts. The rules for long-term contracts do not apply to any home construction contract you entered into in a tax year beginning after September 30, 1990, regardless of whether you meet the small home construction contract requirements.

For a construction contract not described above, determine the percentage of the contract completed using the simplified procedures for allocating costs (see section 460(b)(4) of the Internal Revenue Code).

Installment sales. For any disposition of inventory or stock in trade, the installment

Table 2. **Alternative Minimum Tax Adjustments and Preferences**

Item	Description
Accelerated depreciation on property	Figure depreciation under the alternative depreciation system (ADS) of MACRS. Except for personal property, you must use the 150% declining balance method. This does not apply to property described in IRC 168(f)(1) through (4).
Pollution control facilities	Figure amortization under the alternative depreciation system of MACRS.
Mining exploration and development costs	Figure amortization ratably over 10 years.
Circulation expenses	Amortize expenses over 3 years. Applies only to personal holding companies.
Adjusted gain or loss	Refigure gain or loss on the sale of property using certain adjustments listed in this table.
Long-term contracts	Figure income for contracts entered into after 2-28-86 under the percentage of completion method (as modified by IRC 460(b)).
Installment sales	Figure income without using the installment method. This instruction generally applies to dispositions of inventory or stock in trade.
Merchant Marine Fund	Figure income to include amounts deposited in a capital construction fund if deducted, and earnings (including gains and losses) on amounts in the fund that were excludable.
Section 833(b) deduction	Adjustment is the amount of any deduction claimed. (Applies only to certain health insurance organizations.)
Tax shelter farm activities	Refigure all gains and losses from a tax shelter farm activity that is not a passive activity. Take into account all AMT adjustments and preferences. (Applies only to personal service corporations.)
Passive activity losses	Net losses from passive activities (closely held and personal service corporations only), including tax shelter farm activities that are passive activities.
Certain loss limitations	Adjustment is any excess of the loss amount not allowable for AMT over the loss amount not allowable for regular tax purposes. If the loss amount not allowable for regular tax is more than the loss amount not allowable for AMT, the adjustment is a negative amount.
Depletion	Excess of the depletion deduction over your adjusted basis in the property.
Certain tax-exempt interest	Certain interest on specified private activity bonds.
Intangible drilling costs	Excess of IDCs to the extent the excess amount exceeds 65% of net income from the property. If the optional 60-month write-off was elected, IDCs are not a tax preference.
Reserves for losses on bad debts of financial institutions	Excess of the deduction allowable over the amount that would have been allowable under the experience method.
Accelerated depreciation on real property and leased personal property placed in service before 1987 (pre-ACRS and ACRS)	Excess of the depreciation or amortization taken over the amount allowable under straight line (leased personal property; for personal holding companies only).
Other adjustments	Adjustment is for certain income reported for regular tax purposes including: 1) Income eligible for the possession tax credit, and 2) Income from the alcohol fuel credit. Also, the adjustment can be for any minimum taxable income adjustment from Schedule K-1 (Form 1041), line 8, if the corporation is the beneficiary of a trust, for an AMT adjustment from a cooperative, or for any related adjustments*.
Adjusted current earnings (ACE)	Adjustment is 75% of the excess (if any) of the corporation's ACE over the corporation's preadjustment alternative minimum taxable income.
Alternative tax net operating loss (NOL) deduction	Alternative tax NOL deduction (ATNOLD) allowed against AMTI.

* AMT adjustments and tax preference items may affect deductions (such as charitable contributions) that are based on an income limit. If so, you may have to make related adjustments. You do this by refiguring these deductions using the income limit as modified for AMT purposes.

method of accounting does not apply for the AMT. However, it does apply to certain dispositions of timeshares or residential lots for which you elected to pay interest. Because of this, a corporation recognizes all gain realized on the disposition in the year of sale. The adjustment for AMT is the difference between the recognition of all gain in the year of disposition and the gain recognized under the installment method of accounting. For years in which you collect the sale proceeds, decrease regular taxable income to get AMTI.

Merchant Marine Fund. Deposits into a capital construction fund (CCF) established under section 607 of the Merchant Marine Act of 1936 are not deductible in figuring AMT. Also, the earnings (including gains and losses) on amounts in the fund are not excludable in determining AMT. Do not make any reduction in basis required by section 607(g) of the Merchant Marine Act of 1936 for amounts withdrawn from the fund if you included the amounts for purposes of AMT.

Section 833(b) deduction. This deduction is not allowed for AMT purposes. If a corporation took this deduction for regular tax purposes, the adjustment is to add back the amount deducted.

Tax shelter farm activities. This adjustment applies only to personal service corporations. Refigure all gains and losses from a tax shelter farm activity that is not a passive activity by taking into account all AMT adjustment and tax preference items. You do this by determining the corporation's tax shelter farm activity gain or loss for AMT using the same rules used for regular tax purposes with the following modifications:

1) No recomputed loss is allowed, except to the extent the personal service corporation is insolvent, and
2) You cannot use a recomputed loss in the current tax year to offset gains from other tax shelter farm activities. Instead, you must suspend any recomputed loss and carry it forward until either the corporation has a gain in a later tax year from the same activity or it disposes of the activity.

The adjustment is the difference between the gain or loss for AMT purposes and the amount that was reported for regular tax purposes.

Caution: To avoid duplication, do not include any AMT adjustment or tax preference item that is included as a gain or loss in the computation for *Passive activity loss* discussed next.

A corporation is insolvent to the extent its liabilities exceed the FMV of its assets.

Passive activity loss. This adjustment applies only to closely held and personal service corporations. To determine the adjustment for a passive activity, refigure all gains and losses by taking into account the corporation's AMT adjustments, preferences, and AMT prior year unallowed losses. You do this by determining the corporation's passive activity gain or loss for AMT using the same rules used for regular tax purposes. You reduce the loss disallowed by the amount a corporation is insolvent. The adjustment is the difference between the allowable loss reported for regular tax and the refigured AMT loss.

Caution: To avoid duplication, do not include any AMT adjustment or tax preference item that is taken into account in this passive activity computation in the amounts to be entered on any other line of Form 4626.

Certain loss limitations. You must take into account the corporation's AMT adjustments and preferences before you apply certain loss deferral rules.

The loss deferral rules include limits on losses due to:

A partner's basis in the partnership interest, and

The at-risk limits.

The adjustment is the excess of the loss amount that is not allowable for AMT purposes over the loss amount that is not allowable for regular tax purposes. If the loss amount that is not allowable for regular tax purposes is more than the loss amount that is not allowable for AMT purposes, the difference is entered on line 2l of Form 4626 as a negative amount.

Depletion. If a corporation's depletion deduction for the year is more than its adjusted basis in the property at the end of the year (figured before reducing the basis by the depletion deduction), the difference is a tax preference item. You figure this preference item separately for each separate piece of property being depleted. For tax years beginning after December 31, 1992, depletion figured using the small producer's exemption is not a tax preference.

In computing the year-end adjusted basis, do not add the unrecovered cost of machinery and other depreciable equipment to the adjusted depletable basis of mineral property. If you added such costs to the adjusted basis, deduct them before figuring the 1994 depletion preference.

Percentage depletion of coal and iron ore. Figure a corporation's (other than an S corporation's) tax preference for the percentage depletion of coal (including lignite) and iron ore as follows:

1) Subtract the corporation's basis in the property at the end of the year (before adjusting it for the year's depletion) from the year's percentage depletion on the property.
2) Reduce the corporation's percentage depletion by 20% of the amount figured in (1). This is the most the corporation can deduct for percentage depletion on the property.
3) Subtract the corporation's basis in the property (before adjusting it for the year's depletion) from the amount figured in (2).

The result is the corporation's tax preference item for percentage depletion on the property.

Certain tax-exempt interest. This tax preference item is the tax-exempt interest on specified private activity bonds reduced by any deduction that would have been allowable if the interest had been included in gross income for regular tax purposes. A specified private activity bond is one issued after August 7, 1986, or, on or after September 1, 1986, for bonds satisfying pre-Tax Reform Act of 1986 definitions of governmental bonds.

For this tax preference item, a private activity bond does not include:

1) A qualified section 501(c)(3) bond, or
2) Any refunding bond (whether a current or advance refunding) if the refunded bond (or for a series of refundings, the original bond) was issued before August 8, 1986.

Treat any exempt-interest dividends a corporation receives from a mutual fund as interest on a specified private activity bond to the extent of its proportionate share of the interest on such bonds received by the company paying the dividend.

Intangible drilling costs (IDCs). If you elected the optional 60–month write-off for IDCs, discussed later, these costs are not a tax preference item. If you do not elect the 60-month write-off, this tax preference item is the amount by which excess IDCs paid or incurred during the year on a corporation's oil, gas, and geothermal properties are ***more than 65%*** of the net income from these properties.

Excess IDCs. These are costs incurred or paid for oil, gas, and geothermal wells over the amount allowable if the costs had been amortized using a 120–month period or any permitted cost depletion method.

Net income. Net income from oil, gas, and geothermal properties for this purpose is the gross income received or accrued from all these properties less the deductions allocated to these properties. Deductions do not include excess IDCs or costs for nonproductive wells. Nonproductive wells are those plugged and abandoned without producing oil, gas, or geothermal energy in commercial quantities for any substantial period of time. A well that is temporarily shut in is not a nonproductive well.

Integrated oil companies. Every corporation that is an integrated oil company must reduce its deduction for intangible drilling and development costs to 70% of what it could otherwise deduct. Deduct the remaining 30% ratably over a 60–month period, beginning with the month you pay or incur the cost.

Special rule. For a tax year beginning after December 31, 1992, excess IDCs for any oil or gas well are a tax preference item only for integrated oil companies. However, for taxpayers who are not integrated oil companies, the reduction in your alternative minimum taxable income (AMTI) cannot exceed 40% (30% for tax years beginning in 1993) of your AMTI for the year figured by taking into account the tax preference item, but without regard to the alternative tax NOL deduction, discussed later, under *Other Adjustments.*

Reserves for losses on bad debts of financial institutions. The deduction allowed for a reasonable addition to a financial institution's reserve for bad debts minus the amount that would have been allowable based on actual loss experience is a tax preference item.

Accelerated depreciation on real property placed in service before 1987. This tax preference item is the depreciation or amortization a corporation took during the year on real property placed in service before 1987, minus straight line depreciation. Figure this amount separately for each separate item of property. Generally, each building (or its component) is a separate item of property. Do not figure this tax preference for an item of property in the year you dispose of it.

For property depreciated as 15-year real property under the accelerated cost recovery system (ACRS), figure straight line depreciation using a recovery period of 15 years.

For property depreciated as 18-year real property under ACRS, figure straight line depreciation using a recovery period of 18 years.

For property depreciated as 19-year real property under ACRS, figure straight line depreciation using a recovery period of 19 years.

For low-income housing property depreciated under ACRS, figure straight line depreciation using a recovery period of 15 years.

For property a corporation placed in service between July 31, 1986, and 1987, and elected to depreciate under MACRS, see *Accelerated depreciation on property* under *Adjustments and Preferences,* earlier.

If you use a recovery period longer than these periods in depreciating the property, you do not have a tax preference item.

For property depreciated under another method, figure straight line depreciation using the same basis, useful life, and salvage value you first used to depreciate the property. If the corporation did not use a useful life or salvage value, figure straight line depreciation as if it had taken depreciation using that method.

Accelerated depreciation on leased personal property placed in service before 1987. This tax preference item is the depreciation a corporation took during the tax year on personal property it leased to others minus the depreciation using the straight line method.

This is a tax preference item only if the corporation is a personal holding company.

Other adjustments. You must make an adjustment as a negative amount for certain income reported for regular tax purposes including:

1) Income eligible for the possession tax credit, and

2) Income for the alcohol fuel credit.

Also, the adjustment can be either a positive or negative amount for (a) any minimum taxable income adjustment from Schedule K–1 (Form 1041), line 8, if the corporation is the beneficiary of a trust, (b) any AMT adjustment from a cooperative, or (c) any related adjustment discussed next.

Related adjustments. AMT adjustments and tax preference items may affect deductions that are based on an income limit. Therefore, you must refigure these deductions using the income limit as modified for AMT purposes. You include this adjustment on line 2t of Form 4626 for the total difference between the regular tax and AMT amounts for all items not taken into account on any other line on Form 4626. If the AMT deduction is more than the regular tax deduction, enter the difference as a negative amount. See the instructions for Form 4626 for more information.

Preadjustment Alternative Minimum Taxable Income (AMTI)

The adjustment and tax preference items just discussed result in the amount on line 3, Form 4626, called the preadjustment alternative minimum taxable income (AMTI). You are now ready to make the ACE adjustment and figure any alternative tax net operating loss deduction (ATNOLD) for AMT purposes. However, if your corporation has undergone an ownership change, see the following note before beginning your ACE adjustment.

Note: If your corporation has a net unrealized built-in loss (within the meaning of section 382(h) of the IRC), and undergoes an ownership change, you must first adjust the basis of each asset of the corporation (immediately after the ownership change). The new adjusted basis of each asset is its proportionate share (based on the respective fair market values) of the fair market value (FMV) of the corporation's assets (determined under section 382(h) of the IRC), immediately before the ownership change. To determine if your corporation has a net unrealized built-in loss, use the total adjusted basis of its assets that it used for figuring its ACE.

Adjusted Current Earnings (ACE)

You increase AMTI by 75% of any excess of the corporation's ACE for the tax year over pre-adjustment AMTI. Pre-adjustment AMTI is the corporation's AMTI for the tax year determined without the adjustment for ACE and without the alternative tax net operating loss deduction. Make a negative (reduction) adjustment for 75% of any excess pre-adjustment AMTI over ACE to the extent of the net positive adjustments for ACE in prior tax years.

ACE is the corporation's pre-adjustment AMTI for the tax year determined by taking into account certain specified adjustments. You can determine the ACE by completing the *Adjusted Current Earnings Worksheet.* This worksheet is provided in the instructions for Form 4626. The worksheet lists all of the adjustments that may affect the ACE.

Some of these adjustments are briefly discussed next.

ACE depreciation. The adjustment is the excess of AMT depreciation over ACE depreciation. If ACE depreciation exceeds AMT depreciation, the adjustment is a negative amount. The ADS system of MACRS is used for property placed in service after 1989 and before 1994. This system requires use of the straight line method over a specified recovery period. For property placed in service after December 31, 1993, the ACE depreciation expense is the same as the AMT depreciation expense discussed earlier in *Accelerated depreciation on property* under *Adjustments and Preferences.*

Inclusion in ACE of items included in earnings and profits (E & P). These are items that are not taken into account in determining the corporation's pre-adjustment AMTI but that are included in determining E & P. Therefore an adjustment must be made to include them in ACE. These items are listed on the *Adjusted Current Earnings Worksheet* on lines 3a through 3e.

Disallowance of items not deductible in computing E & P. These are items that are not taken into account in figuring E & P. Therefore, no deduction is allowed for them when figuring ACE. These items will generally increase ACE to the extent they were deductible in figuring the pre-adjustment AMTI. However, there are some exceptions to this rule discussed in the instructions for Form 4626. These items are listed on the *Adjusted Current Earnings Worksheet* on lines 4a through 4e.

Intangible drilling costs. To figure the ACE expense, capitalize and amortize these costs over a 60–month period beginning with the month you paid or incurred them. For amounts paid or incurred in tax years beginning after December 31, 1992, this adjustment does not apply to any oil or gas well except for those of integrated oil companies. Subtract the ACE expense (if any) from the AMT expense used to figure the adjustment for line 2p of Form 4626. The difference is the ACE adjustment. If the ACE expense exceeds the AMT expense, the difference is a negative adjustment. You enter any adjustment on line 5a of the worksheet.

Circulation expenses. For purposes of figuring ACE, the amortization provisions do not apply to amounts paid or incurred after 1989. Therefore, for ACE purposes, you must treat the expenses in accordance with the case law in effect prior to the enactment of section 173 of the Internal Revenue Code (IRC). The adjustment is the result of subtracting the ACE expense (if any) from the expense claimed for regular tax purposes (or for personal holding companies, from the expense refigured for AMT purposes in figuring the adjustment for line 2d of Form 4626). If the ACE expense exceeds the regular tax expense (or AMT expense for a personal holding company), the adjustment is a negative amount. You enter any adjustment on line 5b of the worksheet.

Organizational expenses. For purposes of figuring ACE, the amortization provisions do not apply to amounts paid or incurred after 1989. Therefore, for ACE purposes, all organizational expenses are capitalized and are not taken into account until the corporation is sold or otherwise disposed of. You enter any adjustment on line 5c of the worksheet.

LIFO inventory adjustments. The adjustments outlined in section 312(n)(4) of the IRC apply in computing the ACE. You enter any adjustment on line 5d of the worksheet. For more information on figuring this adjustment, see Income Tax Regulation 1.56(g)-1(f)(3) and Notice 94-27 in the Internal Revenue Bulletin 1994-14 on page 13.

Installment sales. For any installment sale that occurs in a tax year beginning after 1989, you figure the ACE as if the corporation did not use the installment method. However, this does not apply to the applicable percentage of the gain from an installment sale to which section 453A(a)(1) applies. The adjustment is the result of subtracting the installment sale income for AMT purposes from the ACE income. If the ACE income is less than the AMT income, the adjustment is a negative amount. You enter any adjustment on line 5e of the worksheet.

Disallowance of loss on exchange of debt pools. A corporation may not recognize any loss on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities for purposes of ACE. The adjustment is added back to ACE to the extent the corporation recognized such a loss for regular tax purposes. You enter the adjustment on line 6 of the worksheet.

Acquisition expenses of life insurance companies for qualified foreign contracts. For purposes of computing ACE, acquisition expenses of life insurance companies for qualified foreign contracts (as defined in section 807(e)(4) of the IRC without regard to the treatment of reinsurance contract rules) must be capitalized and amortized. The adjustment is the result of subtracting the ACE expense (if any) from the expense recognized for regular tax purposes. If the ACE expense exceeds the regular tax expense, the adjustment is a negative amount. You enter the adjustment on line 7 of the worksheet.

Depletion. For purposes of ACE, you compute depletion using the cost depletion method for property placed in service in a tax year beginning after 1989. For tax years beginning after December 31, 1992, this adjustment does not apply to any depletion deduction computed under the independent producers exemption. You subtract the ACE expense (if any) from the expense refigured for AMT purposes (i.e., the preference amount entered on line 2m of Form 4626). You enter the result on line 8 of the worksheet. If the ACE expense exceeds the amount refigured for AMT purposes, you enter the result as a negative amount.

Basis adjustments for determining gain or loss from dispositions of pre-1994 property. For purposes of ACE, if a corporation disposed of property during a tax year for which it is making or has made any of the ACE adjustments described in section 56(g), you must refigure the property's adjusted basis for ACE purposes. The difference is a negative amount if:

a) The ACE gain is less than the AMT gain,

b) The ACE loss is more than the AMT loss, or

c) You have a loss for ACE and a gain for AMT.

See the instructions to line 4 of Form 4626 for more information on the ACE computation. Also, you can figure the ACE using the worksheet provided in the instructions.

Alternative tax net operating loss deduction. The last adjustment for AMT is to figure the corporation's alternative tax net operating loss deduction (ATNOLD). The rules covering years after 1986 are discussed first. The rules covering carryover of pre-1987 net operating losses are discussed later.

Figuring an ATNOLD after 1986. For AMT purposes, you figure a net operating loss (NOL) for a tax year beginning after 1986 in generally the same manner as for regular tax purposes, except:

- You make the AMT adjustments to the NOL that you figured for regular tax purposes, and
- You reduce the NOL by the tax preference items under section 57 for such year as discussed earlier, to the extent the tax preference item increased the NOL for the tax year.

Carrybacks and carryovers. After making the above calculations, determine the NOL you can deduct in a carryback or carryover year. It cannot exceed 90% of the corporation's AMTI for that year figured before the NOLD.

You can carry back the NOL 3 years or carry it forward 15 years. This is the same as under the regular NOL rules. However, if you elect not to use the carryback of an NOL for regular tax purposes, you cannot carry it back for AMT purposes.

In years that a corporation does not have an AMT liability, you still reduce the NOLD. Use Form 4626 to figure AMTI even though the corporation does not have an AMT liability.

Figuring the amount of pre-1987 carryovers. The NOL carryforward from tax years beginning before 1987 that you can carry to tax years beginning after 1986 is the amount of your regular NOL carryover. Adjust the NOL carryforward if the corporation had a deferred add-on minimum tax liability for a year before 1987. See section 701(f)(2)(B) of Public Law 99–514 (10/22/86).

Optional Write-Off

A corporation can choose an optional 60–month, 3–year, or 10–year write-off of certain adjustments and preference items in figuring its regular income tax. If it does, do not consider these items as adjustments or preference items for the alternative minimum tax. A corporation may choose an optional write-off period for the following items.

60–month write-off. A corporation can choose to deduct intangible drilling and development costs in equal installments over a 60–month period beginning with the month the costs were paid or incurred.

3–year write-off. A corporation can choose to deduct, in equal installments over a 3–year period, the cost of increasing the circulation of a newspaper or periodical.

10–year write-off. The costs a corporation can choose to deduct in equal installments over 10 years are: mining exploration and development costs; development expenses; and research and experimental expenses.

Choosing the optional write-off. Choose the optional write-off by the due date (including extensions) of the corporation's income tax return for the year for which you are making the choice. Attach a statement to the corporation's return that includes:

The corporation's name, address, and employer identification number,

The specific write-off you are choosing,

A note that states you make this choice under section 59(e) of the Internal Revenue Code, and

The year for which you make the choice and the tax preference item to which it applies.

You can use Form 4562 to choose the optional write-off. Once you select the optional write-off for any qualified expense, you can revoke it only with IRS consent.

Figuring Alternative Minimum Tax

After you arrive at AMTI, you figure the tax. First, you subtract an ***exemption amount*** from the corporation's AMTI. Next, you multiply the balance by the AMT rate of 20%. This result is the ***tentative minimum tax.*** Now you subtract the corporation's ***regular tax liability*** from the tentative minimum tax. The result is the corporation's AMT liability.

Exemption Amount

The AMT does not apply to corporations in the lower tax brackets with small amounts of adjustments or preference items. This is accomplished by subtracting the exemption amount from the corporation's AMTI before figuring the tentative minimum tax. The exemption amount phases out as the AMTI income gets higher.

The maximum exemption is $40,000. However, you must reduce it by $0.25 for every dollar that the corporation's AMTI exceeds $150,000. This reduction causes the exemption to be zero when the corporation's AMTI exceeds $310,000.

Tentative Minimum Tax

You figure the tentative minimum tax by multiplying the corporation's AMTI, minus the exemption amount, by 20%. This is the corporation's tentative minimum tax unless the corporation has an AMT foreign tax credit. If the corporation has a foreign tax credit, subtract it to arrive at the tentative minimum tax.

Foreign tax credits. You figure a corporation's foreign tax credit by first using taxable income, adjustments, and tax preference items from sources outside the United States. This is the corporation's AMTI from sources outside the United States. Then, using both this amount for taxable income from sources outside the United States and the corporation's AMTI for total taxable income, compute the alternative minimum tax foreign tax credit. You figure the credit on Form 1118.

Limit. The AMT foreign tax credit cannot be more than the amount on Form 4626, line 11, less 10% of the amount that would be on that line if Form 4626 were refigured using zero on line 6 and if the independent producers' exception for intangible drilling costs under section 57(a)(2)(E) of the IRC does not apply. This 90% limit does not apply to certain corporations that meet the requirements of section 59(a)(2)(C) of the IRC.

Regular Tax

After you figure the corporation's tentative minimum tax, subtract its regular tax to get the AMT. Regular tax is the corporation's income tax shown on Page 2, line 1, Part I, Form 1120–A; or line 3, Schedule J, Form 1120, minus any foreign tax credit (lines 4a and 4b, Schedule J, Form 1120) and the possessions tax credit (line 4b, Schedule J, Form 1120).

Credits. If a corporation pays AMT, it will not get any tax benefit from certain credits (listed below). If a corporation has adjustments or preference items but does not pay AMT because of the exemption amount, it may or may not receive any benefit from these credits.

A corporation can only claim these credits to the extent its regular tax liability exceeds its tentative minimum tax. You may use any excess credit as a carryback or carryover under the usual rules for that credit.

The credits include:

Credit for fuel from a nonconventional source,

General business credit, and

Orphan drug credit.

Minimum Tax Credit

A corporation may be eligible to take a minimum tax credit against its regular income tax liability. A corporation figures a minimum tax credit based on the full AMT incurred in tax years beginning after 1989. For tax years beginning after 1986 but before 1990, a corporation figured the credit on the AMT based on deferral items.

Figuring the credit. For 1994, use Form 8827 to figure the credit and any carryforward to later years.

The corporation can qualify for the minimum tax credit if it had:

- An AMT liability in 1993,
- A minimum tax credit carryforward from 1993 to 1994, or
- A 1993 credit for fuel from nonconventional sources or orphan drug credit that was not allowed solely because of the tentative minimum tax limit.

The credit cannot be greater than the corporation's regular tax liability for the tax year to which you carry it, less the following:

1) Foreign tax credit,
2) Possession tax credit,
3) Orphan drug credit,
4) Credit for fuel from nonconventional sources,
5) General business credit, and
6) The tentative minimum tax for the year in which you use the credit.

Reduction for canceled debt. You may have to reduce the minimum tax credit if you exclude from income a debt canceled after 1993:

- In a bankruptcy case,
- When you were insolvent, or
- That was a qualified farm debt.

You reduce the minimum tax credit available at the beginning of the tax year ***following*** the year in which the debt was canceled. For this purpose, complete Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* and attach it to the corporation's return for the year in which the debt was canceled.

Carryforward of credit. A corporation may carry the minimum tax credit forward (indefinitely) to reduce its regular tax liability in future years. If the corporation does not use all the credit in 1994, it carries the balance to 1995 and later tax years. If the corporation's minimum tax in later tax years results in getting an additional credit, add that credit to any carryforward balance from earlier years.

Estimated Tax

Every corporation that expects its tax to be $500 or more must make estimated tax payments. A corporation's estimated tax is its expected tax liability (including AMT and environmental taxes) less its allowable tax credits.

Time and amount of deposits. If a corporation's estimated tax is $500 or more, it deposits its estimated tax with an authorized financial institution or a Federal Reserve Bank. Use Form 8109 to make deposits. Follow the instructions in the coupon book.

Determine the due date of deposits from the table below (but see *Saturday, Sunday, or holiday,* discussed later, under *Due Date of Return*).

Deposit a corporation's estimated tax in installments by the 15th day of the following months of the corporation's tax year.

Required Installment	Month Due
1st	4th month
2nd	6th month
3rd	9th month
4th	12th month

Generally, each installment payment must equal 25% of the required annual estimated tax.

Example 1. The Penn Corporation, a calendar year taxpayer, estimates its tax will be $40,000. The corporation deposits the estimated tax in four $10,000 installments on April 15, June 15, September 15, and December 15.

Example 2. The Jones Company has a fiscal year beginning April 1 and ending March 31. Its estimated tax is $12,000. It deposits $3,000 of its estimated tax on July 15, September 15, December 15, and March 15.

Amended estimated tax. If, after depositing estimated tax, a corporation determines its tax will be substantially larger or smaller than estimated, it refigures the tax before the next installment to determine its remaining deposits.

Example. A calendar year corporation estimates its tax will be $20,000. The corporation deposits the first two installments on April 15 and June 15 in the amount of $5,000 each (25% of $20,000). On July 1, the corporation estimates its tax will be $40,000. The installments payable on September 15 and December 15 will be $15,000 each, figured as follows:

Refigured estimated tax	$40,000
Less: Deposited tax	10,000
Unpaid balance	$30,000
Installments due September 15 and December 15 (unpaid balance $30,000 divided by two remaining installments)	$15,000

Penalty

A corporation that fails to pay a correct installment of estimated tax in full by the due date may be subject to a penalty. The penalty rate applies to the period of underpayment for any installment. Figure the penalty at a rate of interest published quarterly by the IRS.

Figuring the underpayment. The underpayment of any installment is the required payment minus the amount paid by the due date.

For tax years beginning after December 31, 1993, the estimated tax payment required in installments is the lesser of:

1) 100% of the tax shown on the return for the preceding year, or
2) 100% of the tax shown for the current year (the current year tax may be determined on the basis of actual income or annualized income).

However, a large corporation can use (1) or (2), whichever applies, only for determining its first installment in any tax year. If the installment determined under (1) is greater than that determined and paid under (2), add the difference to the next required installment. A large corporation is one with at least $1 million of taxable income in any of the last 3 years.

For tax years that began after June 30, 1992, and before January 1, 1994, the payment required in installments is the lesser of:

1) 97% of the tax shown on the return for the tax year (or if no return is filed, 97% of the tax for the year), or
2) 100% of the tax on the return for the preceding year, if that year was a 12–month tax year and a return filed for that year showed a tax liability.

Order of crediting payments. Credit an estimated tax payment against unpaid installments in the required order of payment.

Annualizing. If you base an installment on 100% of the current year's tax that you would owe if you annualized income, ***no penalty*** applies. You can estimate total income for the tax year by annualizing income. You annualize income by treating income received over a specified period in the tax year as if received at the same rate over the full 12–month year. Add any reduction in a required installment from using the annualization exception to the next required installments if not taken into account in earlier installments.

For tax years beginning after December 31, 1993, you now have three sets of periods over which income may be annualized. The tax law specifies a particular set of periods for annualizing income unless you elect one of two alternative sets of periods by making an election on Form 8842. For the election to be effective, you must file Form 8842 by the due date of the first required installment. Once made the election cannot be revoked. See the instructions for Form 8842 for more information.

Recurring seasonal income. When figuring the penalty for an underdeposit of an installment of estimated tax, there is a special rule for a corporation with recurring seasonal income. The rule applies to corporations whose taxable income for any period of 6 consecutive months has averaged 70% or more of its taxable income for the year during each of the past 3 tax years.

No penalty applies to an installment of estimated tax if the total deposits made by the installment date equals or exceeds 100% of the amount figured as follows:

1) Take the taxable income for all months in the tax year before the month the installment is due,
2) Divide the amount in (1) by the base period percentage, defined next, for those months,
3) Figure the tax on the amount figured in (2), and
4) Multiply the tax figured in (3) by the base period percentage for the filing month and all months during the tax year before the filing month.

The ***base period percentage*** for any period of months is the average percentage that the taxable income for the same period of months in each of the 3 preceding tax years bears to the taxable income for those 3 tax years.

Form 1120–W. As an aid in determining its estimated tax and required installments, a calendar year corporation should get Form 1120–W. Keep this form. Do not file it.

For tax years beginning after December 31, 1993, fiscal-year corporations use the 1994 revision of Form 1120–W to determine the estimated tax payments for the 1994 fiscal year.

Form 2220. Use Form 2220 to determine any underpayment of estimated tax. If it appears from your Form 1120 or 1120–A that you underpaid your estimated tax, use Form 2220 to compute any penalty.

A corporation generally does not have to file Form 2220 because the IRS will figure any penalty and bill it. However, a corporation must complete and attach the form if it:

1) Used the annualizing or recurring income method to determine any installment required, or
2) Is a large corporation computing its first required installment based on the prior year's tax.

Quick Refund of Overpayments

A corporation that overpays its estimated tax may apply on Form 4466 for a quick refund of any overpayment. File the form after the close of the corporation's tax year but before:

- The 16th day of the 3rd month after the close of the tax year, and
- The corporation files its return for that tax year.

The overpayment must be:

1) At least 10% of the amount estimated by the corporation on its application as its income tax liability for the tax year, and
2) At least $500.

The IRS will credit or refund the overpayment within 45 days after you file the application.

Filing Requirements

Each corporation, unless specifically exempt, must file a tax return even if it had no taxable income for the year and regardless of its gross income for the tax year. The income tax return for ordinary corporations is ***Form 1120.*** Certain small corporations can file Form 1120–A. Corporations that normally file Form 1120 may save time if they can use Form 1120–A.

A corporation must file an income tax return unless it has dissolved. It must file even if it has stopped doing business and disposed of all its assets except for a small sum of cash retained to pay state taxes to preserve its corporate charter. A corporation may also have to file a return for any year following the year in which it dissolved if it carries on substantial activities. For example, the collection of assets or payment of obligations in the termination of its business affairs is considered substantial activity.

A corporation that has no assets need not file an income tax return after it stops doing business and dissolves. This is so, even if state law treats it as a corporation for certain limited purposes in winding up its affairs, such as suing or being sued. A receiver or trustee in bankruptcy ordinarily must file tax returns for a corporation in bankruptcy. However, the receiver or trustee may be relieved of this responsibility if dissolution has occurred. A corporation has dissolved if it has ceased business and has neither assets nor income.

Who Can File Form 1120–A

A corporation can use Form 1120–A to report its taxable income if it meets the following requirements:

- Its gross receipts must be under $500,000,
- Its total income must be under $500,000,
- Its total assets must be under $500,000,
- It does not have ownership in a foreign corporation,
- It does not have foreign shareholders who own, directly or indirectly, 50% or more of its stock,

- It is not a member of a controlled group,
- It is not a personal holding company,
- It is not a consolidated corporate return filer,
- It is not a corporation undergoing a dissolution or liquidation,
- It is not filing its final tax return,
- Its only dividend income is from domestic corporations and those dividends qualify for the 70% deduction,
- It has no nonrefundable tax credits other than the general business credit and the credit for the prior-year minimum tax,
- It is not subject to environmental tax,
- It has no liability for interest on certain installment sales of timeshares and residential lots, or interest on deferred tax liability or installment payments of tax,
- It has no liability for interest due under the look-back method on completion of a long-term contract,
- It is not required to file Form 8621,
- It has no liability for tax on a nonqualified withdrawal from a capital construction fund,
- It is not making an election to forego the carryback period of an NOL,
- It is not electing to pay tax on the sale of an intangible as described in section 197(f)(9)(B)(ii) of the Internal Revenue Code, and
- It is not an organization such as an S corporation, life or mutual insurance company, political organization, etc., required to file a specialized form such as Form 1120S, 1120-L, 1120–POL, etc.

For more information, see the instructions for Forms 1120 and 1120–A.

Amending Return

If, after filing Form 1120 or 1120–A, you have to correct an error on the return, use ***Form 1120X.*** File this form if you understated or overstated income, or failed to claim deductions or credits.

Where To File

A corporation files its income tax return with the Internal Revenue Service Center serving the area for the location of the principal office for keeping its books and records. The instructions for the forms have the Service Center locations.

The separate income tax returns of a group of corporations located in several Service Center regions may be filed with the Service Center for the area in which the principal office of the managing corporation (that keeps all the books and records) is located.

Due Date of Return

If a corporation files its income tax return on a calendar year basis, file the return by March 15 following the close of the tax year. If a corporation uses a fiscal year as its tax year, file its return by the 15th day of the 3rd month following the close of its fiscal year.

Saturday, Sunday, or holiday. If the last day for performing any act for tax purposes, such as filing a return or making a tax payment, falls on a Saturday, Sunday, or legal holiday, you may perform the act on the next day that is not a Saturday, Sunday, or legal holiday.

Extension of time to file (Form 7004). A corporation will receive an automatic 6–month extension of time for filing its return by submitting an application for extension on Form 7004. File this form with the Internal Revenue Service Center where the corporation will file its income tax return. The IRS can terminate this extension at any time by mailing a notice of termination to the corporation. File Form 7004 by the due date of the corporation's income tax return.

Any automatic extension of time for filing a corporation income tax return will not extend the time for paying the tax due shown on the return. Deposit the tax on line 6 of Form 7004 using Form 8109.

Interest. If the tax reported on Form 7004 is less than the actual tax due, interest is charged on the difference.

Payment of Tax

Deposit the balance of any tax due, after estimated tax installments, by the due date of the return.

Make income tax deposits either to an authorized financial institution or a Federal Reserve Bank. Make all deposits with Form 8109 according to the instructions in the coupon book.

Penalties

There are several penalties that can apply to a corporation. Some of these penalties are discussed next.

Failure to file. If a corporation does not file its income tax return by the due date (including extensions), and it cannot show reasonable cause, a delinquency penalty of 5% of the tax due will apply if the delinquency is for 1 month or less. An additional 5% is imposed for each additional month or part of a month that the delinquency continues, not exceeding a total of 25%. The tax due is the tax liability that would be shown on a return, less credits and any tax payments before the due date. Reduce the delinquency penalty by an amount equal to that imposed under the failure-to-pay tax penalty.

If the return is not filed within 60 days of the due date (including extensions), the penalty for failure to file will be at least $100 or the balance of tax due, whichever is less, unless reasonable cause is shown.

Reasonable cause. A corporation that wishes to avoid a penalty for failure to file a tax return, pay the tax, or deposit taxes must show reasonable cause. This is done by filing, with the Director of the Service Center where the corporation must file the return, a statement of the facts establishing reasonable cause for the failure. In addition, the statement must contain a declaration that it was made under the penalties of perjury.

Failure to pay tax. Payments made after the due date are subject to an interest charge, even if extensions were granted. Payments of tax other than estimated tax made after the due date may also be subject to a penalty of 0.5% a month or part of a month up to a maximum of 25%. In certain cases, the penalty for failure to pay taxes by the due date increases from 0.5% to 1% a month or part of a month to a maximum of 25% of tax.

Failure to deposit taxes. If a corporation deposits taxes after the due date or does not deposit the required tax, it may be charged a penalty. Deposits of tax after the due date are subject to a penalty on the underpayment. The underpayment is the excess of the required tax deposit over the tax deposited by the due date.

Figuring the penalty. The amount of the penalty is figured by multiplying the underpayment by one of the following percentages:

1) 2% if deposited by the 5th day after the deposit due date,
2) 5% if deposited after the 5th day but by the 15th day after the deposit due date, or
3) 10% if deposited after the 15th day after the deposit due date.

The percentage is 15% if the tax is not deposited by the earlier of:

1) The day that is 10 days after the date of the first delinquency notice to the corporation, or
2) The day on which notice and demand for immediate payment is given.

This penalty does not apply to estimated taxes when the penalty discussed earlier under *Estimated Tax* applies.

Other penalties. There are other civil penalties that can apply because of negligence, substantial understatement of tax, and fraud. Criminal penalties apply to willful failure to file, tax evasion, or making a false statement.

Capital Contributions and Retained Earnings

This section explains the tax treatment of contributions from shareholders and nonshareholders.

Paid-in capital. Contributions to the capital of a corporation, whether or not by shareholders, are ***paid-in capital***. These contributions are not taxable to the corporation.

However, contributions to a corporation in aid of construction or any other contribution as a customer or potential customer is taxable to the corporation.

Basis. For the basis of property contributed by a shareholder, see *Issuance of Stock,* under *Forming a Corporation,* earlier.

The basis of property contributed to capital, by a person other than a shareholder, is zero.

If a corporation receives a cash contribution from a person other than a shareholder, reduce the basis of property acquired with the money during the 12–month period beginning on the day it received the contribution by the amount of the contribution. If the amount contributed is more than the cost of the property acquired, then reduce, but not below zero, the basis of the other properties held by the corporation on the last day of the 12–month period in the following order:

1) Depreciable property,
2) Amortizable property,
3) Property subject to cost depletion but not to percentage depletion, and
4) All other remaining properties.

Reduce the basis of property in a category to zero before going to the next category.

There may be more than one piece of property in each category. Base the reduction of the basis of each property on the ratio of the basis of each piece of property to the total bases of all property in that category. If the corporation wishes to make this adjustment in some other way, it must get IRS consent. The corporation files a request for consent with its income tax return for the tax year in which it receives the contribution.

Accumulation of retained earnings. A corporation can accumulate its earnings for a possible expansion or other bona fide business reasons. However, if a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an ***accumulated earnings tax*** of 39.6%. If the accumulated earnings tax applies, interest applies to an underpayment of tax from the date the corporate return was originally due, without extensions. This tax applies regardless of the number of shareholders.

Treat an accumulation of $250,000 or less generally as within the reasonable needs of a business. However, treat an accumulation of $150,000 or less within the reasonable needs of a business whose principal function is performing services in the fields of:

Health,

Law,

Engineering,

Architecture,

Accounting,

Actuarial science,

Veterinary services,

Performing arts, or

Consulting.

In determining if the corporation has accumulated earnings and profits beyond its reasonable needs, value the listed and readily marketable securities owned by the corporation and purchased with its earnings and profits at net liquidation value, not at cost.

The reasonable needs of the business include:

Specific, definite, and feasible plans for use of the earnings accumulation in the business; and

The amount necessary to redeem the corporation's stock included in a deceased shareholder's gross estate, if the amount does not exceed the reasonably anticipated total estate and inheritance taxes, and funeral and administration expenses incurred by the shareholder's estate.

If a corporation with accumulated earnings of more than $250,000 does not make regular distributions to its shareholders, it should be prepared to show a bona fide business reason for not doing so.

For a corporation to avoid liability for accumulated earnings tax, it must show that tax avoidance by its shareholders is not one of the purposes of the accumulation. The simple existence of a tax avoidance purpose is sufficient for imposing the accumulated earnings tax.

Reconciliation Statements

When you file Form 1120, you must complete Schedules M–1 and M–2 if the total assets of the corporation are at least $25,000. If you file Form 1120–A you must complete Part IV if the total assets of the corporation are at least $25,000.

Schedule M–1. Schedule M–1 starts with the net income (loss) per books. This amount is after allowance of federal income tax accrued for the year for which the return is being filed, as shown in the corporation's profit and loss account. Schedule M–1 provides for necessary adjustments to reconcile this amount with the taxable income shown on Form 1120, line 28, page 1.

Part IV. Part IV, Form 1120–A is similar to Schedule M–1 on Form 1120. It reconciles the income per books with the taxable income on line 24, page 1 of Form 1120–A.

Schedule M–2. Schedule M–2 analyzes the unappropriated retained earnings as shown in the corporation's balance sheet, Schedule L.

To complete these schedules, you must first get additional information from your corporation's books and records.

Example. The following profit and loss account appeared in the books of the Welldon Corporation for calendar year 1994. It files Form 1120 and completes Schedules M–1 and M–2, as illustrated later.

Account		Debit	Credit
Gross sales			$1,840,000
Sales returns and allowances		$ 20,000	
Cost of goods sold		1,520,000	
Interest Income from: Banks	$10,000		
Tax-exempt state bonds	5,000		15,000
Proceeds from life insurance (death of corporate officer)			6,000
Bad debt recoveries (no tax deduction claimed)			3,500
Insurance premiums on life of corporate officers (corporation is beneficiary of policies)		9,500	
Compensation of officers		40,000	
Salaries and wages		28,000	
Repairs		800	
Taxes		10,000	
Contributions: Deductible	$23,000		
Other	500	23,500	
Interest paid (loan to purchase tax-exempt bonds)		850	
Depreciation		5,200	
Loss on securities		3,600	
Net income per books after federal income tax		140,825	
Federal income tax accrued for 1994		62,225	
Total		$1,864,500	$1,864,500

The corporation analyzed the retained earnings and the following appeared in this account on its books:

Item	Debit	Credit
Balance, January 1, 1994		$225,000
Net profit (before federal income tax)		203,050
Reserve for contingencies	$ 10,000	
Income tax accrued for 1994	62,225	
Dividends paid during 1994	140,089	
Refund of 1991 income tax		18,000
Balance, December 31, 1994	233,736	
Total	$446,050	$446,050

The following appears on page 1 of Form 1120:

Gross sales ($1,840,000 less returns and allowances of $20,000)		$1,820,000
Cost of goods sold		1,520,000
Gross profit from sales		$ 300,000
Interest income		10,000
Total income		$ 310,000
Deductions:		
Compensation of officers	$40,000	
Salaries and wages	28,000	
Repairs	800	
Taxes	10,000	
Contributions (maximum allowable)	22,500	
Depreciation	6,200	
Total deductions		107,500
Taxable income		$ 202,500

Schedule M–1

Line 1. $140,825 is the net income per books. It is shown in the profit and loss account previously as net income per books after federal income tax.

Line 2. $62,225 is the federal income tax accrued for the tax year.

Line 3. $3,600 is the excess of capital losses over capital gains. The net loss is from the sale of securities.

Line 4. Line 4 would show all income and credits included in taxable income but not recorded in the corporation's books. This can occur if the corporation valued assets on its books at an amount greater than that used for tax purposes. When it has a sale of such assets, the gain included in taxable income is greater than that recorded in the books. It shows the difference on this line.

Line 5. The corporation shows expenses recorded on its books that it does not deduct on this return. The $500 listed on line 5b is for contributions that were over the 10% limit. The corporation itemizes the remaining nondeductible expenses on a statement attached to the return. These include the following:

Insurance premiums on the life of an officer, corporation is beneficiary	$ 9,500
Nondeductible interest incurred to purchase tax-exempt interest obligation	850
Nondeductible contributions	500
Total	$10,850

Line 6. This is the total of lines 1 through 5.

Line 7. The corporation shows income recorded on its books during the year that it does not include on the return because the income is not taxable. This totals $14,500 and includes interest on tax-exempt state bonds of $5,000, insurance proceeds of $6,000, and a bad debt recovery of $3,500.

Line 8. Line 8 shows the total of all tax deductions on the return not charged against book income. The corporation enters $1,000 on line 8a. It represents the difference between the depreciation claimed on the corporation's income tax return and its books. If the corporation had other deductions to itemize on this line and there was not enough space, it would attach a statement to the return listing them.

Line 9. This is the total of lines 7 and 8.

Line 10. $202,500 is the difference between lines 6 and 9. The amount on line 10 must agree with the taxable income before the net operating loss deduction and special deductions shown on line 28, page 1, Form 1120.

Schedule M–2

Line 1. $225,000 is from Schedule L for the beginning of the tax return year.

Line 2. $140,825 is the net income per books (after federal income tax).

Line 3. $18,000 is the refund of 1991 income tax. Show all other increases to retained earnings on this line.

Line 4. This is the total of lines 1, 2, and 3.

Line 5. $140,089 is the distributions to shareholders charged to retained earnings during the tax year.

Line 6. Line 6 is for any decreases (other than those on line 5) in unappropriated retained earnings. These decreases are not deductible on the tax return at the time of appropriation. However, a deduction may be allowable on a later return. A common example of this is an amount set aside for contingencies. A customer was injured on company property during 1994 and the company retained an attorney. The company set up a contingent liability of $10,000 for the customer's claim. If they settle the claim during 1995 for $5,000 and the attorney's fee is $2,500, the company charges $7,500 to retained earnings (appropriated). It deducts $7,500 in arriving at taxable income for 1995. Another common example of items entered on this line is the payment of the prior years' federal tax. Attach a schedule to the return listing all items taken into account to arrive at the amount shown on this line.

Line 7. This is the total of lines 5 and 6.

Line 8. $233,736 is the corporation's retained earnings at the end of its tax return year. Determine this amount by subtracting the total on line 7 from the total on line 4. This amount must agree with the amount on Schedule L for the end of the return year.
Schedules M–1 & M–2.

Earnings and Profits Computations

In determining the taxable status of corporate distributions to shareholders, it is necessary to know the corporation's earnings and profits. See *Taxable Status of Distribution,* later.

Taxable distributions come first from current earnings and profits and then from accumulated earnings and profits. Accumulated earnings and profits means earnings and profits accumulated since February 28, 1913. To the extent that the distributions are more than both the current and accumulated earnings and profits, the distributions may be partly or completely nontaxable.

If the distributions are either partly or completely nontaxable because they exceed current and accumulated earnings and profits, the corporation attaches Form 5452 to its income tax return. See the instructions to Form 5452 for more information. With Form 5452, you will need to attach computations of current and accumulated earnings and profits along with schedules reconciling earnings and profits with taxable income and retained earnings. One format for showing the computation of current year earnings and profits is shown earlier.

Example. In addition to the facts set out earlier, the Welldon Corporation incorporated on January 1, 1946, and uses an accrual method of accounting. Its accumulated earnings and profits as of December 31, 1993, were $1,200. It made cash distributions during its 1994 calendar tax year of $140,089. This consisted of $85,089 to preferred shareholders and $55,000 to common shareholders. The entire distribution to preferred shareholders is a taxable dividend. The $27,500 distribution on March 15, 1994, to common shareholders is a taxable dividend to the extent of $27,318 (99.33%), and the $27,500 distribution on September 15, 1994, to common shareholders is a taxable dividend to the extent of $26,118 (94.97%). The balance of retained earnings in Schedule M–2 as of December 31, 1994, is $233,736, but earnings and profits has a zero balance.

Explanation of Items in Table 3 of the Example

A) Retained earnings will generally differ from accumulated earnings and profits because of differences in computing book and tax earnings. See item (X), below.

B) Use taxable income (before the special deductions) as the starting point for figuring current-year earnings and profits.

C) Taxes accrued for book income may differ from the amount of the actual federal income tax liability. In this case, earnings and profits reflect only the latter amount.

D) Capital losses are allowable in the year incurred, but must be added back in the tax year they are applied against gains to prevent a double deduction.

E) Excess contributions, like excess capital losses, are allowable in the year made and added back in the year deducted.

F) Since only the premium in excess of the cash surrender value represents an expense to the corporation, only that amount reduces earnings and profits.

G) Nondeductible interest expenses are expenses of the corporation that reduce earnings and profits.

Schedule M-1	Reconciliation of Income (Loss) per Books With Income per Return (See instructions.)		
1 Net income (loss) per books	140,825	7 Income recorded on books this year not included on this return (itemize): Tax-exempt interest $ 5,000 Insurance proceeds 6,000 Bad debt recovery 3,500	14,500
2 Federal income tax	62,225	8 Deductions on this return not charged against book income this year (itemize):	
3 Excess of capital losses over capital gains	3,600	a Depreciation . . . . $ 1,000	
4 Income subject to tax not recorded on books this year (itemize):		b Contributions carryover $	1,000
5 Expenses recorded on books this year not deducted on this return (itemize): a Depreciation . . . . $ b Contributions carryover $ 500 c Travel and entertainment $ See itemized statement attached $10,850	11,350	9 Add lines 7 and 8	15,500
6 Add lines 1 through 5	218,000	10 Income (line 28, page 1)—line 6 less line 9	202,500

Schedule M-2	Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)		
1 Balance at beginning of year	225,000	5 Distributions: a Cash	140,089
2 Net income (loss) per books	140,825	b Stock	
3 Other increases (itemize): Refund 1991- Income Tax	18,000	c Property	
		6 Other decreases (itemize): Reserve for contingencies	10,000
		7 Add lines 5 and 6	150,089
4 Add lines 1, 2, and 3	383,825	8 Balance at end of year (line 4 less line 7)	233,736

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H) Nondeductible contributions — same treatment as item (G).

I) Sum of items (E) through (H).

J) Add tax-exempt interest income to earnings and profits because it is income to the corporation.

K) Insurance proceeds (in excess of cash surrender value) — same treatment as item (J).

L) Recovery of a debt written off on the books but not deducted on tax return.

M) Sum of items (J), (K), and (L).

N) Depreciation claimed on the tax return over the straight line amount increases current earnings and profits.

Note: For tangible property depreciated under MACRS, the adjustment to earnings and profits for depreciation is the amount figured using the alternative depreciation system (ADS) of MACRS. If you take a section 179 deduction, for purposes of figuring earnings and profits, you can only deduct the section 179 amount that is figured ratably over a 5–year period. The 5–year period begins with the tax year you take the section 179 deduction. See Publication 534 for more information on MACRS and the section 179 deduction.

O) The refund represents a reduction of the corporation's 1991 income tax and therefore affects the earnings and profits of a prior year.

P) This amount represents the difference between the corporation's book and tax basis of its reserve for contingencies. It will not affect earnings and profits until the corporation can deduct it in computing taxable income.

Q) Preferred shareholders, in this case, have a right to current-year earnings and profits before common shareholders.

R) Allocable share of remaining current-year earnings and profits.

S) Distributions that are more than the current-year earnings and profits reduce accumulated earnings and profits.

T) Distributions that are more than earnings and profits and that represent dividends that are not taxable to shareholders reduce the corporation's capital.

U) Same as item (R).

V) Same as item (T).

W) Sum of items (Q) through (V).

X) Represents the sum of the current year differences (keyed as x) between figuring the corporation's book and tax earnings. These items plus items (O) and (S) account for the total current-year change of $8,736.

Y) Represents the accumulated differences between the corporation's book earnings and accumulated tax earnings.

For more information, see Revenue Procedure 75–17 in Cumulative Bulletin Volume 1975-1 on page 677. You can get a copy of this revenue procedure from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Distributions

This section discusses corporate distributions to shareholders. Such distributions may be ordinary dividends, stock dividends, or a return of capital. It discusses distributions in property, as well as distributions in money. This discussion generally applies only to regular domestic corporations.

Any distribution to shareholders from earnings and profits generally is a ***dividend.*** However, a distribution is not a taxable dividend if it is a return of capital to the shareholder. Most distributions are in money, but they may also be in stock or other property. For information on shareholder reporting of dividends and other distributions, see Publication 550.

File a Form 1099–DIV with IRS for each shareholder to whom a corporation pays gross dividends of $10 or more during a calendar year. The corporation files Form 1096 to summarize and transmit its Forms 1099–DIV. File Form 5452 if the corporation pays dividends that are not taxable.

The corporation may furnish Forms 1099–DIV to shareholders after November 30 of the year of payment (but not before the final payment for the year). However, it may furnish this statement to shareholders after April 30 of the year of payment if furnished with the final dividend for that calendar year. Furnish this information by January 31 of the year following the close of the calendar year during which the corporation makes the payments.

Withholding on dividends. Backup withholding may require a corporation to withhold tax equal to 31% of the dividends paid to certain shareholders. File Form 1099–DIV if there is backup withholding, regardless of the amount of the dividend. See Publication 505 for more information on backup withholding.

Amount of Distribution

The amount of a distribution received by any shareholder is the money plus the FMV (on the distribution date) of other property received by the shareholder. Reduce (but not below zero)

Table 3. **Welldon Corporation Current-Year Computation of Earnings and Profits Calendar T ax Year 1994**

				Schedule M Per Return		Earnings and Profits Current-Year Accumulated			
Incorporated 1/1/46 Accrual Accounting Basis				**DR (Debit)**	**CR (Credit)**	**DR (Debit)**	**CR (Credit)**	**CR BAL**	**KEY**
12/31/93 Balance forward					$225,000 (A)			$1,200	
1994									
Taxable income (line 28, p. 1) per return					202,500 (B)		$202,500		*
Federal income taxes—per books				$62,225 (C)					a
—per tax returns						$62,225			a
Excess of capital losses over capital gains (Tax Basis)				3,600 (D)		3,600			*
Contributions in excess of 10% limit		$500	(E)			500			*
Life ins. prem. in excess of cash surrender value		9,500	(F)			9,500			*
Nondeductible interest paid for tax-exempt state bonds		850	(G)			850			*
Nondeductible contributions		500	(H)			500			*
Total itemized per line 5, Schedule M-1				11,350 (I)					
Tax-exempt interest received on tax-exempt state bonds		$ 5,000	(J)				5,000		*
Life ins. proceeds in excess of cash surrender value		6,000	(K)				6,000		*
Bad debt recovery (not charged against taxable income)..		3,500	(L)						x
Total itemized per line 7, Schedule M-1					14,500 (M)				
Depreciation on return in excess of straight line........					1,000 (N)		1,000		*
Refund of 1991 federal income taxes					18,000 (O)				1–91
Reserve for contingencies				10,000 (P)					x
						77,175	214,500		
Current-year earnings and profits							137,325		
Cash distributions:									
Preferred:									
3/15, 6/15, 9/15, 12/15/94									
$8.5089/SH—10,000 share distribution		$85,089	(Q)			$ 85,089			*
Common:									
3/15/94									
$1.10/SH—25,000 shares	%								
From current-year earnings and profits. .	94.97	$26,118	(R)			26,118			*
From acc. earnings and profits.............	4.36	1,200	(S)					(1,200)	*
From capital	0.67	182	(T)						x
Total distributions..........................	100%	$27,500							
9/15/94									
$1.10/SH—25,000 shares									
From current-year earnings and profits	94.97	26,118	(U)			26,118			*
From capital	5.03	1,382	(V)						x
Total distributions	100%	$27,500							
Total cash distributions				140,089 (W)					
				227,264	236,000	137,325	137,325		
Current-year change..................................					8,736 (X)			($1,200)	
Balance forward 12/31/94					$233,736 (Y)			–0–	

KEY SYSTEM

* Identical items on the same list in Schedule M and Earnings and Profits.
(Alphabet) Items completely offset in same year. Start with (a) each year.
(Dates) Items which as of the final balance sheet's date have been completely offset in various years. Use consecutive dates to show the years for locating offsets.
(x) Items which have not been completely offset and are differences between Schedul e M and Earnings and Profits.

the distribution by liabilities of the corporation assumed by the shareholder and by liabilities to which the property is subject.

The basis of property received by the shareholder is its FMV, defined earlier.

Property. Property means any property including money, securities, and indebtedness to the corporation, except stock of the distributing corporation or rights to acquire such stock.

Transfers of property to shareholders for less than FMV. A sale or exchange of property between a corporation and shareholder may be a dividend to the shareholder.

If the FMV of the property on the date of distribution exceeds the price paid by the shareholder, the excess is a distribution.

Corporation canceling shareholder's debt. If a corporation cancels a shareholder's debt without repayment by the shareholder, treat the amount canceled as a distribution to the shareholder.

Distributions of Appreciated Property

The distributing corporation generally does not recognize gain or loss on a distribution (not in complete liquidation) of property to its shareholders.

If a corporation distributes property, other than its own obligations, to a shareholder and the property's FMV exceeds the corporation's adjusted basis, treat the property as sold at the time of distribution. The corporation recognizes gain on the excess of the FMV over the adjusted basis of the property.

Note: Under Notice 89–37 in Cumulative Bulletin Volume 1989–1 on page 679, a partnership distribution to a corporate partner of stock in that corporation (or the stock of any member of the partner's affiliated group) may constitute or have the effect of a redemption of such stock with property consisting of that corporation's partnership interest. Consistent with the purposes of the repeal of the *General Utilities Doctrine,* recognize gain (but not loss) to the extent the property has appreciated.

Distributions of depreciated property. If the FMV of depreciated property distributed to shareholders is more than the adjusted basis of that property, the corporation must report ordinary income because of depreciation. This applies even though the distribution, either as a dividend or in liquidation, might otherwise be nontaxable.

Taxable Status of Distribution

The part of a distribution from either current or accumulated earnings and profits is a dividend. First, the part of the distribution that is more than earnings and profits reduces the adjusted basis of the stock in the hands of the shareholder. Second, any amount that exceeds the adjusted basis of that stock is treated by the shareholder as gain from the sale or exchange of property (usually capital gain).

Whether a distribution is a taxable dividend to the shareholders, used to reduce the adjusted basis of their stock, or treated as gain from the sale of property, depends upon whether the distribution is more than:

1) Earnings and profits for the tax year of the distribution (figured as of the close of that year without reduction for any distribution during the year), plus
2) Accumulated earnings and profits since February 28, 1913.

The current earnings and profits at the time of distribution do not necessarily determine whether the distribution is a taxable dividend.

If there is a deficit in earnings and profits for the tax year of the distribution, the taxable status of the distribution depends on the amount of accumulated earnings and profits. In determining accumulated earnings and profits, prorate the deficit in earnings and profits for the current year to the dates of distribution.

Example 1. X, a calendar year corporation, had accumulated earnings and profits of $40,000 as of January 1, 1994, the beginning of its tax year. X had an operating loss of $50,000 for the first 6 months of 1994, but had earnings and profits of $5,000 for all of 1994. X distributed $15,000 to its shareholders on July 1, 1994.

The entire distribution is an ordinary dividend. Consider $5,000 as paid from 1994 earnings and profits and $10,000 as paid from accumulated earnings and profits.

Example 2. Assume the same facts as in Example 1, except that X had a deficit in earnings and profits (E & P) of $55,000 for 1994. To figure the available earnings and profits, prorate the deficit to the date of the distribution as follows:

Accumulated E & P —1/1/94	$ 40,000
E & P deficit for 1994 prorated to the date of distribution — 7/1/94 (½ × $55,000)	(27,500)
E & P available —7/1/94	$ 12,500
Distribution — 7/1/94 – taxable dividend	(12,500)
E & P deficit — 7/1 – 12/31/94	(27,500)
Accumulated E & P —12/31/94	$ (27,500)

This computation shows that the accumulated earnings and profits available at the time of distribution was $12,500. Of the $15,000 distribution, only $12,500 is a taxable dividend. The balance of the distribution, $2,500, reduces the adjusted basis of the stock in the hands of the shareholders. To the extent that the $2,500 balance is more than the adjusted basis of the stock, the shareholders have a gain from the sale or exchange of property.

Nontaxable dividends. Nontaxable dividends are distributions to shareholders on their stock in the ordinary course of business. They are not taxable as dividends because the amount of the distributions is greater than the corporation's earnings and profits. Attach Form 5452 to the corporate return if nontaxable dividends are paid to shareholders. Tax-free stock dividends and distributions in exchange for stock in liquidations or redemptions are not nontaxable dividends.

Adjustment to Earnings and Profits

For a cash distribution, decrease the current earnings and profits by the amount distributed, but not below zero.

For a distribution of an obligation of the distributing corporation, decrease the earnings and profits by the principal amount of that obligation, but not below zero.

For the distribution of an original issue discount obligation, decrease earnings and profits by the total issue price of the obligation, but not below zero.

For a distribution of other property, decrease the earnings and profits by the adjusted basis of that property, but not below zero.

For a distribution of appreciated property (other than the corporation's obligations), increase the earnings and profits by the excess of the FMV over the adjusted basis of the property. Decrease them, but not below zero, by the FMV of the appreciated property and also by the FMV (instead of adjusted basis) of other property distributed under the general rule of the preceding paragraph.

Distribution of Stock and Stock Rights

A shareholder does not include a distribution of stock or rights to acquire stock in your corporation in gross income unless it is one of the following:

1) A distribution instead of money,
2) A disproportionate distribution,
3) A distribution on preferred stock,
4) A distribution of convertible preferred stock, unless your corporation can establish to the satisfaction of the IRS that the distribution will not result in a disproportionate distribution, or
5) A distribution of common and preferred stock resulting in the receipt of preferred stock by some common shareholders and receipt of common stock by other common shareholders.

Even if the distribution falls into one of these five categories, there must be sufficient earnings and profits for the distribution to be a dividend. If the distribution does not fall into one of these categories, the corporation does not adjust its earnings and profits.

A ***distribution is instead of money*** if any shareholders have an election to get either stock, rights to acquire stock, or property. This applies regardless of whether:

1) The distribution is actually made in whole or in part in stock or in stock rights,
2) The election or option is exercised or exercisable before or after the declaration of the distribution,

3) The declaration of the distribution provides that it will be made in one type unless the shareholder specifically requests payment in the other,

4) The election governing the nature of the distribution is provided in the declaration of the distribution, corporate charter, or arises from the circumstances of the distribution, or

5) All or part of the shareholders have the election.

If the common shareholders receive a pro rata distribution of preferred stock with an option to immediately redeem it for money, the distribution is instead of money. They include the distribution in gross income.

A ***distribution is disproportionate*** if some shareholders receive cash or other property and other shareholders receive increased proportionate interests in the assets or earnings and profits of the corporation. However, it is not required that shareholders receive the cash or property by means of a distribution or series of distributions as long as the result is that they did receive it in their capacity as shareholders and that such distribution is one which would be subject to the rules that apply to the taxing of dividends.

In order for a distribution of stock to be considered as one of a series of distributions, it is not necessary that it be pursuant to a plan to distribute cash or property to some shareholders and to increase the proportionate interests of other shareholders. It is sufficient if there is either an actual or deemed distribution of stock and as a result of it, some shareholders receive cash or property and other shareholders increase their proportionate interests.

Example. Your corporation has two classes of common stock outstanding. If it pays regular cash dividends on one class of stock and stock dividends on the other class of stock (whether in common or preferred stock), there is a disproportionate distribution. The stock dividends are distributions of property that may be ordinary dividends.

If there is more than one class of stock outstanding, you must consider each class of stock separately for determining whether a shareholder has increased his or her proportionate interest in the assets or earnings and profits of a corporation.

In determining whether a distribution or series of distributions has the result of a disproportionate distribution, treat any security convertible into stock (whether or not convertible during the tax year) or a right to acquire stock (whether or not exercisable during the tax year) as outstanding stock.

If certain transactions increase a shareholder's proportionate interest in the earnings and profits or assets of the corporation, treat them as distributions of stock. These interest changes include:

A change in the conversion ratio,

A change in redemption price,

A difference between redemption price and issue price,

A redemption treated as a dividend distribution, or

Any transaction (including a recapitalization) having a similar effect on the interest of any shareholder.

You cannot deduct the expenses of issuing a stock dividend. These include printing, postage, cost of advice sheets, fees paid to transfer agents, and fees for listing on stock exchanges. Capitalize these costs.

Constructive Dividends–Insurance Premiums

If a corporation pays part or all of the premiums on insurance issued on the lives of certain shareholders and both the corporation and shareholders derive benefits from it, part or all of the premiums paid by the corporation is a constructive dividend. This is especially true in a closely held corporation.

Sample Returns

Form 1120–A (Short-Form)

Rose Flower Shop, Inc., is the corporation for which the sample return is filled out. Rose Flower Shop operates a business that sells fresh cut flowers and plants. It uses an accrual method of accounting and files its returns on the calendar year.

A corporation can file Form 1120–A if it has gross receipts under $500,000, total income under $500,000, total assets under $500,000, and meets certain other requirements. Since Rose Flower Shop met all these requirements for 1994, it filed Form 1120–A.

Page 1

When you prepare your return use the pre-addressed label sent to you by the IRS. It is designed to expedite processing and prevent errors. If you do not have a pre-addressed label, enter your corporation's name, street address, city, state, and ZIP code in the appropriate spaces on the first page. After putting the pre-addressed label at the top of the page, Rose Flower Shop proceeds to report its income and deductions.

Show the name and employer identification number of the corporation in the top margin of schedules and attachments to Form 1120–A.

Fill in the items of income, deduction, tax, and payments listed on page 1 that applies to the business. Do not alter, substitute for, or cross out the line captions on the return forms.

Line 1. Gross sales for the year totaled $248,000, using an accrual method of accounting. After subtracting $7,500 of returned goods and allowances, line 1c shows net sales of $240,500.

Line 2. Cost of goods sold is $144,000. Compute this using the worksheet (not illustrated) in the form instructions.

Line 3. Net sales less cost of goods sold results in gross profit of $96,500.

Lines 4 through 10. Enter other items of income next. During the year, the only other item of income was taxable interest of $942, shown on line 5.

Line 11. Total income is $97,442.

Line 12. Enter the $23,000 salary of the company president.

Line 13. Enter other salaries and wages of $24,320. This includes only salaries and wages neither included on line 12 nor deducted as part of cost of goods sold on line 2.

Line 16. Rent for Rose Flower Shop's store was $6,000 for the year.

Line 17. Deductible taxes totaled $3,320.

Line 18. Interest expense accrued during the year was $1,340. It does not include interest to carry tax-exempt securities. See Chapter 8 of Publication 535 for a discussion of amounts deductible as interest as well as when to take the deduction.

Line 19. During 1994, Rose Flower Shop contributed $1,820 to various charitable organizations. The $1,820 is less than the limit for deductible contributions, which is 10% of taxable income figured without the contribution deduction.

Line 22. Other deductions consist of $3,000 for advertising. If there had been several expenses included in the total, you would have to prepare and attach a supporting schedule.

Line 23. Total of lines 12 through 22 is $62,800.

Lines 24, 25, and 26. Line 24 shows taxable income of $34,642. Since Rose Flower Shop did not have a net operating loss or special deduction, show the same amount on line 26.

Tax summary. Enter on line 27 the total tax ($5,196) from Part I, line 7, page 2. List payments against the tax on line 28. On the Rose Flower Shop return, the only payment is the four estimated tax deposits totaling $6,000. It enters this amount on lines 28b and 28d, and as a total on line 28h. The resulting overpayment is $804, which Rose Flower Shop has credited to its 1995 estimated tax. Rose Flower Shop could have the overpayment refunded.

Signature. An authorized corporate officer must manually sign the return.

Page 2

Part I–Tax Computation. Use the tax rate schedule in the form instructions to figure the tax on line 1. Lines 3, 5, and 6, the other taxes and credits listed on Part I, do not apply to Rose Flower Shop. Enter the tax of $5,196 on lines 1, 4, and 7.

Part II–Other Information. Answer all questions that apply to the business. Provide the business activity code number, business activity, and product or service information on lines (a), (b), and (c) of question 1. Purchases of $134,014 appear on line (1) of question 5a. Other costs of $9,466 appear on line (3) of question 5a. The supporting itemization is not illustrated. These costs consist of costs directly related to the sale of flowers, wreaths, and plants, such as flower pots, vases, stands, boxes, and tissue paper.

Part III–Balance Sheets. Provide comparative balance sheets for the beginning and end of the tax year. Entries in Part III should agree with amounts shown elsewhere on the return or included on a worksheet. For example, the figures for beginning and ending inventories must be the same as those appearing on the worksheet in the form instructions for cost of goods sold.

Part IV–Reconciliation of Income (Loss) per Books With Income per Return. All Form 1120–A corporate filers must complete Part IV unless total assets on line 12, column (b) of Part III are less than $25,000. Since total assets of Rose Flower Shop exceed this amount, it completes Part IV.

To properly complete Part IV, first get additional information from your corporation's books and records. The following profit and loss account appeared in the books of Rose Flower Shop for the calendar year 1994.

Account	Debit	Credit
Gross sales		$248,000
Sales returns and allowances	$ 7,500	
Cost of goods sold	144,000	
Interest income		942
Compensation of officers	23,000	
Salaries and wages	24,320	
Rents	6,000	
Taxes	3,320	
Interest expense	1,340	
Contributions	1,820	
Advertising	3,000	
Federal income tax accrued	5,196	
Net income per books after tax	29,446	
Total	$248,942	$248,942

Part IV starts with the net income (loss) per books, after reduction for federal income tax accrued, as shown in the corporation's profit and loss account. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 24, page 1.

Line 1. $29,446 is the net income per books. It is in the profit and loss account previously as net income per books after tax.

Line 2. $5,196 is the federal income tax accrued for the tax year.

Line 8. $34,642 is the taxable income on line 24, page 1.

Form 1120-A pg1

Form 1120-A pg2

Form 1120

Tentex Toys, Inc., is the corporation for which the sample return is filled out. Tentex manufactures and sells children's toys and games. It uses an accrual method of accounting and files its returns on the calendar year.

Page 1

When you prepare your return use the pre-addressed label sent to you by the IRS. It is designed to expedite processing and prevent errors. If you do not have a pre-addressed label, enter your corporation's name, street address, city, state, and ZIP code in the appropriate spaces on the first page. After putting the pre-addressed label at the top of the page, Tentex proceeds to report its income and deductions.

Show the name and employer identification number of the corporation in the top margin of schedules and attachments to Form 1120.

Fill in the items of income, deductions, tax, and payments listed on page 1 that apply to the business. Do not alter, substitute for, or cross out the line captions on the return forms.

Line 1. Gross sales, line 1a, for the year totaled $2,010,000, using an accrual method of accounting. After subtracting returned goods and allowances of $20,000, line 1c shows net sales of $1,990,000.

Line 2. Cost of goods sold is $1,520,000. This is the total from Schedule A (line 8) on page 2.

Line 3. Net sales less cost of goods sold results in gross profit of $470,000.

Lines 4 through 10. Show other items of income next. During the year, Tentex received $10,000 of dividends from domestic corporations, $5,000 of tax-exempt interest from state bonds, and $4,000 of taxable interest. It also received $1,500 interest on its business accounts receivable. Enter the gross amount of dividends on line 4 (you take the dividends-received deduction on line 29b). Line 5 shows total taxable interest of $5,500. Do not include tax-exempt interest in income.

Line 11. Total income is $485,500.

Line 12. Enter the salaries of $70,000 paid to company officers, listed on Schedule E. Complete Schedule E because total receipts (line 1a plus lines 4 through 10 of page 1) exceed $500,000.

Line 13. Enter other salaries and wages of $38,000. This includes only salaries and wages neither included on line 12 nor deducted as part of cost of goods sold on line 2. For a manufacturing company such as Tentex, this amount represents nonmanufacturing salaries and wages, such as office salaries. See Chapter 2 of Publication 535 for a discussion of salaries and wages.

Tentex is eligible for a $6,000 jobs credit, figured on Form 5884 (not illustrated). You reduce the total amount of other salaries and wages, $44,000, by the $6,000 credit that is included on line 5, Schedule M-1. Only the balance, $38,000, is shown on line 13.

Line 14. Repairs include only payments for items that do not add to the value of the assets repaired or substantially increase their useful lives. Repairs total $800. See Chapter 16 of Publication 535 for information on repairs, improvements, and replacements.

Line 15. Tentex uses the specific charge-off method of accounting for bad debts. Actual accounts written off during the year total $1,600. See Chapter 14 of Publication 535 for information on bad debt deductions.

Line 16. Rent for Tentex's office facilities is $9,200 for the year.

Line 17. Deductible taxes are $15,000.

Line 18. Interest expense accrued during the year is $27,200. This includes interest both on debts for business operations and debts to carry investments. Do not include interest to carry tax-exempt securities. See Chapter 8 of Publication 535 for a discussion of deductible interest.

Line 19. During the year, Tentex contributed $11,400 to the United Community Fund and $12,600 to the State University scholarship fund. The total, $24,000, is more than the limit for deductible contributions, which is 10% of taxable income figured without the contribution deduction and special deduction entered on line 29b. The amount allowable on line 19 is $23,150. The excess, $850, not deductible this year, can be carried over to a later year, as explained earlier under *Charitable Contributions.* Also, during the year, Tentex made nondeductible contributions of $500.

Lines 20 and 21. Depreciation from Form 4562 (not illustrated) is $17,600. Enter it on line 20. Reduce this amount by the depreciation claimed on Schedule A ($12,400) and enter it on line 21a. Deduct the balance ($5,200) on line 21b since it is the depreciation on the assets used in the indirect operations of the business.

Line 22. Tentex does not have a depletion deduction. For information on depletion, Chapter 13 of Publication 535.

Line 23. Advertising expense is $8,700.

Lines 24 and 25. Tentex does not have a profit-sharing, stock bonus, pension, or annuity plan. For information retirement plans, Chapter 6 of Publication 535.

Line 26. Other business deductions total $78,300. This includes miscellaneous office expenses, sales commissions, legal fees, etc. Attach to the return a schedule that itemizes these expenses, even though this example does not show one.

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

U.S. Corporation Short-Form Income Tax Return

See separate instructions to make sure the corporation qualifies to file Form 1120-A.
For calendar year 1994 or tax year beginning ...., 1994, ending..............., 19.....

OMB No. 1545-0890
1994

A Check this box if the corp. is a personal service corp. (as defined in Temporary Regs. section 1.441-4T—see instructions) ▶ ☐

Use IRS label. Otherwise, please print or type.
Name
10-2134567 DEC94 5995
Rose Flower Shop, Inc.
38 Superior Lane
Fair City, MD 20715

B Employer identification number

C Date incorporated 7-1-82

D Total assets (see Specific Instructions) $ 65,987

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Change of address

F Check method of accounting: (1) ☐ Cash (2) ☑ Accrual (3) ☐ Other (specify) . . ▶

Income	1a	Gross receipts or sales 248,000 b Less returns and allowances 7,500 c Balance ▶	1c	240,500
	2	Cost of goods sold (see instructions)	2	144,000
	3	Gross profit. Subtract line 2 from line 1c	3	96,500
	4	Domestic corporation dividends subject to the 70% deduction	4	
	5	Interest	5	942
	6	Gross rents	6	
	7	Gross royalties	7	
	8	Capital gain net income (attach Schedule D (Form 1120))	8	
	9	Net gain or (loss) from Form 4797, Part II, line 20 (attach Form 4797)	9	
	10	Other income (see instructions)	10	
	11	**Total income.** Add lines 3 through 10 ▶	11	97,442
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions)	12	23,000
	13	Salaries and wages (less employment credits)	13	24,320
	14	Repairs and maintenance	14	
	15	Bad debts	15	
	16	Rents	16	6,000
	17	Taxes and licenses	17	3,320
	18	Interest	18	1,840
	19	Charitable contributions (see instructions for 10% limitation)	19	1,820
	20	Depreciation (attach Form 4562) 20		
	21	Less depreciation claimed elsewhere on return 21a	21b	
	22	Other deductions (attach schedule) Advertising	22	3,000
	23	**Total deductions.** Add lines 12 through 22 ▶	23	62,800
	24	Taxable income before net operating loss deduction and special deductions. Subtract line 23 from line 11	24	34,642
	25	**Less:** a Net operating loss deduction (see instructions) 25a b Special deductions (see instructions) 25b	25c	
Tax and Payments	26	**Taxable income.** Subtract line 25c from line 24	26	34,642
	27	**Total tax** (from page 2, Part I, line 7)	27	5,196
	28	**Payments:**		
	a	1993 overpayment credited to 1994 28a		
	b	1994 estimated tax payments 28b 6,000		
	c	Less 1994 refund applied for on Form 4466 28c ( ) Bal ▶ 28d 6,000		
	e	Tax deposited with Form 7004 28e		
	f	Credit from regulated investment companies (attach Form 2439) 28f		
	g	Credit for Federal tax on fuels (attach Form 4136). See instructions 28g		
	h	**Total payments.** Add lines 28d through 28g	28h	6,000
	29	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐	29	
	30	**Tax due.** If line 28h is smaller than the total of lines 27 and 29, enter amount owed	30	
	31	**Overpayment.** If line 28h is larger than the total of lines 27 and 29, enter amount overpaid	31	804
	32	Enter amount of line 31 you want: **Credited to 1995 estimated tax ▶** 804 **Refunded ▶**	32	

Please 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.

▶ George Rose | 2-15-95 | ▶ President
Signature of officer | Date | Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ▶ ☐ | Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

For Paperwork Reduction Act Notice, see page 1 of the instructions. Cat. No. 11456E Form **1120-A** (1994)

Part I Tax Computation (See instructions.)

1	Income tax. If the corporation is a qualified personal service corporation (see page 14), check here ▶ ☐	1	5,196
2a	General business credit. Check if from: ☐ Form 3800 ☐ Form 3468 ☐ Form 5884 ☐ Form 6478 ☐ Form 6765 ☐ Form 8586 ☐ Form 8830 ☐ Form 8826 ☐ Form 8835 ☐ Form 8844 ☐ Form 8845 ☐ Form 8846 ☐ Form 8847	2a	
b	Credit for prior year minimum tax (attach Form 8827)	2b	
3	Total credits. Add lines 2a and 2b	3	
4	Subtract line 3 from line 1	4	5,196
5	Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611	5	
6	Alternative minimum tax (attach Form 4626)	6	
7	Total tax. Add lines 4 through 6. Enter here and on line 27, page 1	7	5,196

Part II Other Information (See instructions.)

1 Refer to page 19 of the instructions and state the principal:
- a Business activity code no. ▶ 5995
- b Business activity ▶ Flower shop
- c Product or service ▶ Flowers

2 Did any individual, partnership, estate, or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) Schedule not shown. ☑ Yes ☐ No
If "Yes," attach a schedule showing name and identifying number.

3 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ -0-

4 Enter amount of cash distributions and the book value of property (other than cash) distributions made in this tax year ▶ $ -0-

5a If an amount is entered on line 2, page 1, see the worksheet on page 12 for amounts to enter below:
- (1) Purchases 134,014
- (2) Additional sec. 263A costs (see instructions—attach schedule)
- (3) Other costs (attach schedule) 9,466

b Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☐ Yes ☑ No

6 At any time during the 1994 calendar year, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? If "Yes," the corporation may have to file Form TD F 90-22.1 ☐ Yes ☑ No
If "Yes," enter the name of the foreign country ▶

Part III Balance Sheets

		(a) Beginning of tax year	(b) End of tax year
Assets	1 Cash	20,540	18,498
	2a Trade notes and accounts receivable		
	b Less allowance for bad debts	( )	( )
	3 Inventories	2,530	2,010
	4 U.S. government obligations	13,807	45,479
	5 Tax-exempt securities (see instructions)		
	6 Other current assets (attach schedule)		
	7 Loans to stockholders		
	8 Mortgage and real estate loans		
	9a Depreciable, depletable, and intangible assets		
	b Less accumulated depreciation, depletion, and amortization	( )	( )
	10 Land (net of any amortization)		
	11 Other assets (attach schedule)		
	12 Total assets	36,877	65,987
Liabilities and Stockholders' Equity	13 Accounts payable	6,415	6,079
	14 Other current liabilities (attach schedule)		
	15 Loans from stockholders		
	16 Mortgages, notes, bonds payable		
	17 Other liabilities (attach schedule)		
	18 Capital stock (preferred and common stock)	20,000	20,000
	19 Paid-in or capital surplus		
	20 Retained earnings	10,462	39,908
	21 Less cost of treasury stock	( )	( )
	22 Total liabilities and stockholders' equity	36,877	65,987

Part IV Reconciliation of Income (Loss) per Books With Income per Return *(You are not required to complete Part IV if the total assets on line 12, column (b), Part III are less than $25,000.)*

1 Net income (loss) per books	29,446	6 Income recorded on books this year not included on this return (itemize)	
2 Federal income tax	5,196	7 Deductions on this return not charged against book income this year (itemize)	
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize)			
5 Expenses recorded on books this year not deducted on this return (itemize)		8 Income (line 24, page 1). Enter the sum of lines 1 through 5 less the sum of lines 6 and 7	34,642

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Line 27. Total of lines 12 through 26 is $277,150.

Lines 28, 29, and 30. Taxable income on line 28 is $208,350. Since Tentex did not have a net operating loss, its only entry on line 29 is the dividends-received deduction of $8,000 from Schedule C, page 2. Enter this amount on lines 29b and 29c. Taxable income on line 30 is $200,350.

Tax summary. Enter on line 31 the total tax ($55,387) from Schedule J. Payments that you can apply against the tax are on line 32. The only credits on the Tentex return are the four estimated tax deposits totaling $69,117. Enter this amount on lines 32b, 32d, and 32h. The resulting overpayment is $13,730, which Tentex chooses to have credited to its 1995 estimated tax. Tentex could have the overpayment refunded.

Signature. An authorized corporate officer must manually sign the return.

Page 2

Schedule A. Use Schedule A to report your cost of goods sold. This figure is beginning inventory, plus merchandise bought or produced during the year, less ending inventory. Because Tentex is a manufacturer, it must account for its costs of manufacturing as part of cost of goods sold. It valued goods on hand at the beginning of the year at $126,000 and at the end of the year at $298,400, using the lower of cost or market.

Add cost of goods manufactured during the year to beginning inventory. This cost consists of three items: direct materials, direct labor, and overhead. List material costs of $1,127,100 on line 2. This includes subcontracted parts as well as raw materials.

Salaries and wages on line 3 is $402,000. This amount includes wages paid to production-line workers and the part of the supervisory salaries that were for actual production of goods. It also includes 30% of the salaries paid to officers. Do not include payments already deducted on line 12 or 13 of page 1.

The $40,000 on line 4 is for indirect general administration costs. Other costs of $123,300 appear on line 5. These costs include factory overhead such as electricity, fuel, water, small tools, and depreciation on production-line machinery. This example does not show the supporting itemization. Note that $12,400 is depreciation on the assets used in the direct operations of the business.

Lines 9a through 9e. Check all of the boxes that apply to the business.

Schedule C. Dividend income is $10,000, all of which qualified for the 80% dividends-received deduction, line 2, because Tentex is a 20%-or-more owner. Enter the total dividends received on line 19, Schedule C, and on line 4 of page 1. Enter the total dividends-received deduction on line 20, Schedule C and on line 29b of page 1.

Schedule E. Complete this schedule only if your total receipts (line 1a plus lines 4 through 10 of page 1) are $500,000 or more. (Tentex meets this requirement.) Since Tentex has only three officers, these are the only entries on the schedule. Include here only compensation for services rendered. Do not include dividends on stock held by the corporate officers.

Page 3

Schedule J. Use Schedule J to figure the corporation's tax. Applying the rates to Tentex's taxable income of $200,350 results in income tax of $61,387. Decrease this amount by the jobs credit of $6,000, resulting in a total tax of $55,387.

Figure the jobs credit by multiplying $15,000 of wages paid to five qualified employees in their first year of employment by the 40% rate. They are certified members of a targeted group. Each earned $3,000 in salary in 1994. Tentex files Form 5884 (not illustrated) with its return to support this credit.

Other taxes and credits listed on Schedule J do not apply to Tentex for 1994.

Schedule K. Answer all questions that apply to the business.

Page 4

Schedule L. Provide comparative balance sheets for the beginning and end of the tax year. Entries on this page should agree with amounts shown elsewhere on the return. For example, the figures for beginning and ending inventories must be the same as those appearing on Schedule A, page 2. Note that the appropriated retained earnings of Tentex increased from $30,000 to $40,000 during the year, due to the setting aside of $10,000 as a reserve for contingencies. Tentex took this amount out of unappropriated retained earnings, as shown on Schedule M–2.

Tentex completes Schedules M–1 and M–2 because the amount of total assets (line 15, column (d), Schedule L) is over $25,000. To properly complete these schedules, you need additional information from the books and records. The following profit and loss account appeared in the books of Tentex for the calendar year 1994.

Account		Debit	Credit
Gross sales			$2,010,000
Sales returns and allowances		$ 20,000	
Cost of goods sold		1,520,000	
Dividends received			10,000
Interest income:			
On state bonds	$ 5,000		
Taxable	5,500		10,500
Proceeds of life insurance			9,500
Premiums on life insurance		9,500	
Compensation of officers		70,000	
Salaries and wages–indirect		44,000	
Repairs		800	
Bad debts		1,600	
Rental expense		9,200	
Taxes		15,000	
Interest expense:			
On loan to buy tax-exempt bonds	$ 850		
Other	27,200	28,050	
Contributions:			
Deductible	$24,000		
Nondeductible	500	24,500	
Depreciation–indirect		3,580	
Advertising		8,700	
Other expenses of operation		78,300	
Loss on securities		3,600	
Federal income tax accrued		55,387	
Net income per books after tax		147,783	
Total		$2,040,000	$2,040,000

Tentex analyzed its retained earnings and the following appeared in this account on its books:

Item	Debit	Credit
Balance, January 1, 1994		$238,000
Net profit (before federal income tax)		203,170
Reserve for contingencies	$ 10,000	
Income tax accrued for 1994	55,387	
Dividends paid during 1994	65,000	
Refund of 1991 income tax		18,000
Balance, December 31, 1994	328,783	
Total	$459,170	$459,170

Schedule M–1. Schedule M–1 starts with the net income per books, after allowance of federal income tax accrued, as shown in the corporation's profit and loss account. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 28, page 1.

Line 1. $147,783 is the net income per books. It appears in the profit and loss account as net income per books after tax.

Line 2. $55,387 is the federal income tax accrued for the tax year.

Line 3. $3,600 is the excess of capital losses over capital gains. The net loss is from the sale of securities.

Line 4. This would show all income and credits included in income subject to tax but not recorded on the books for this year. This can happen if the corporation valued assets on its books at an amount greater than that used for tax purposes. When it has a sale of such assets, the gain included in taxable income is greater than that recorded on the books. It shows the difference here.

Line 5. Tentex shows expenses recorded on its books that it does not deduct. The $850 listed on line 5b is for contributions over the 10% limit. Tentex itemizes the remaining nondeductible expenses on a statement (not illustrated) attached to the return. These include the following:

Premiums paid on term life insurance on corporate officers	$ 9,500
Interest paid to purchase tax-exempt securities	850
Nondeductible contributions	500
Reduction of salaries by jobs credit	6,000
Total	$16,850

Line 6. Enter the total of lines 1 through 5.

Line 7. This is income recorded on the corporation's books during the year that is not taxable and is not included on the return. This total, $14,500, includes insurance proceeds of $9,500 and tax-exempt interest on state bonds of $5,000.

Line 8. This includes all deductions claimed for tax purposes but not recorded in the corporation's books. Tentex enters $1,620 on line 8a. This is the difference between depreciation claimed on the tax return and the depreciation shown on the corporation's books. If the corporation had other deductions to itemize on this line but not enough space, it would attach an itemized statement to the return.

Line 9. Enter $16,120, the total of lines 7 and 8.

Line 10. The difference, $208,350, between lines 6 and 9 must agree with line 28, page 1.

Schedule M–2. Schedule M–2 analyzes the unappropriated retained earnings as shown in the corporation's balance sheets, Schedule L.

Line 1. This is from line 25 of Schedule L for the beginning of the tax year. Tentex enters $238,000.

Line 2. This is the net income per books (after federal income tax), $147,783.

Line 3. This shows all other increases to retained earnings. Enter the $18,000 refund of 1991 income tax.

Line 4. This is the total of lines 1, 2, and 3.

Line 5. This includes all distributions to shareholders charged to retained earnings during the tax year. Enter the $65,000 dividends paid.

Line 6. This shows any decreases (other than those on Line 5) in unappropriated retained earnings. These decreases are not deductible on the tax return at the time of the appropriation, but a deduction may be allowable on a later return. A common example is amounts set aside for contingencies. A customer was injured on company property during 1994 and the company retained an attorney. Tentex set up a contingent liability of $10,000 for the customer's claim. If they settle the claim during 1995 for $5,000 and the attorney's fee is $2,500, Tentex will charge $7,500 to the retained earnings (appropriated). It will also deduct $7,500 in arriving at taxable income for 1995. Another common example of items entered on this line is the payment of prior year's federal tax. Attach a schedule to the return listing all items taken into account for the amount shown on this line.

Line 7. This is the total of lines 5 and 6.

Line 8. $328,783 is Tentex's retained earnings at the end of its tax return year. It determined this figure by subtracting the total on line 7 from the total on line 4. This figure must agree with the amount on Schedule L for the end of the tax year.

Form 1120 pg1
Form 1120 pg2
Form 1120 pg3
Form 1120 pg4

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

U.S. Corporation Income Tax Return

For calendar year 1994 or tax year beginning ...., 1994, ending ...., 19 ...
▶ Instructions are separate. See page 1 for Paperwork Reduction Act Notice.

OMB No. 1545-0123

1994

A Check if a:
1 Consolidated return (attach Form 851) ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (as defined in Temporary Regs. sec. 1.441-4T—see instructions) ☐

Use IRS label. Otherwise, please print or type.

10-0395674 DEC94 071 3998
Tentex Toys, Inc.
36 Division Street
Anytown, IL 60930

B Employer identification number

C Date incorporated: 3-1-72

D Total assets (see Specific Instructions): $ 879,417

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change of address

Income	1a	Gross receipts or sales 2,010,000	b Less returns and allowances 20,000	c Bal ▶	1c	1,990,000
	2	Cost of goods sold (Schedule A, line 8)			2	1,520,000
	3	Gross profit. Subtract line 2 from line 1c			3	470,000
	4	Dividends (Schedule C, line 19)			4	10,000
	5	Interest			5	5,500
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	
	9	Net gain or (loss) from Form 4797, Part II, line 20 (attach Form 4797)			9	
	10	Other income (see instructions—attach schedule)			10	
	11	**Total income.** Add lines 3 through 10 ▶			11	485,500
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4)			12	70,000
	13	Salaries and wages (less employment credits)			13	38,000
	14	Repairs and maintenance			14	800
	15	Bad debts			15	1,600
	16	Rents			16	9,200
	17	Taxes and licenses			17	15,000
	18	Interest			18	27,200
	19	Charitable contributions (see instructions for 10% limitation)			19	23,150
	20	Depreciation (attach Form 4562)	20	17,600		
	21	Less depreciation claimed on Schedule A and elsewhere on return	21a	12,400	21b	5,200
	22	Depletion			22	
	23	Advertising			23	8,700
	24	Pension, profit-sharing, etc., plans			24	
	25	Employee benefit programs			25	
	26	Other deductions (attach schedule)			26	78,300
	27	**Total deductions.** Add lines 12 through 26 ▶			27	277,150
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	208,350
	29	**Less:** a Net operating loss deduction (see instructions)	29a			
		b Special deductions (Schedule C, line 20)	29b	8,000	29c	8,000
Tax and Payments	30	**Taxable income.** Subtract line 29c from line 28			30	200,350
	31	**Total tax** (Schedule J, line 10)			31	55,387
	32	**Payments:** a 1993 overpayment credited to 1994	32a			
	b	1994 estimated tax payments	32b	69,117		
	c	Less 1994 refund applied for on Form 4466	32c	( )		
		d Bal ▶	32d	69,117		
	e	Tax deposited with Form 7004	32e			
	f	Credit from regulated investment companies (attach Form 2439)	32f			
	g	Credit for Federal tax on fuels (attach Form 4136). See instructions	32g		32h	69,117
	33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐			33	
	34	**Tax due.** If line 32h is smaller than the total of lines 31 and 33, enter amount owed			34	
	35	**Overpayment.** If line 32h is larger than the total of lines 31 and 33, enter amount overpaid			35	13,730
	36	Enter amount of line 35 you want: **Credited to 1995 estimated tax** ▶ 13,730	**Refunded** ▶		36	

Please 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.

▶ James O. Barclay — Signature of officer | 3-7-95 — Date | ▶ President — Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's social security number

Firm's name (or yours if self-employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

Cat. No. 11450Q

Schedule A Cost of Goods Sold (See instructions.)

1	Inventory at beginning of year	1	126,000
2	Purchases	2	1,127,100
3	Cost of labor	3	402,000
4	Additional section 263A costs (attach schedule)	4	40,000
5	Other costs (attach schedule)	5	125,300
6	**Total.** Add lines 1 through 5	6	1,818,400
7	Inventory at end of year	7	298,400
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	1,520,000

9a Check all methods used for valuing closing inventory:

☐ Cost ☑ Lower of cost or market as described in Regulations section 1.471-4

☐ Writedown of subnormal goods as described in Regulations section 1.471-2(c)

☐ Other (Specify method used and attach explanation.) ▶

b Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

c If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 9c

d Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☑ Yes ☐ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☑ No

Schedule C Dividends and Special Deductions (See instructions.)

		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations that are subject to the 70% deduction (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations that are subject to the 80% deduction (other than debt-financed stock)	10,000	80	8,000
3	Dividends on debt-financed stock of domestic and foreign corporations (section 246A)		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs that are subject to the 70% deduction		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs that are subject to the 80% deduction		80	
8	Dividends from wholly owned foreign subsidiaries subject to the 100% deduction (section 245(b))		100	
9	**Total.** Add lines 1 through 8. See instructions for limitation			8,000
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from certain FSCs that are subject to the 100% deduction (section 245(c)(1))		100	
12	Dividends from affiliated group members subject to the 100% deduction (section 243(a)(3))		100	
13	Other dividends from foreign corporations not included on lines 3, 6, 7, 8, or 11			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up (section 78)			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3 (section 246(d))			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on line 4, page 1 ▶	10,000		
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on line 29b, page 1 ▶			8,000

Schedule E Compensation of Officers (See instructions for line 12, page 1.)

Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1, Form 1120) are $500,000 or more.

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned (d) Common	(e) Preferred	(f) Amount of compensation
1	James O. Barclay	581-00-0936	100 %	45 %	%	55,000
			%	%	%	
	George M. Collins	447-00-2604	100 %	15 %	%	31,000
			%	%	%	
	Samuel Adams	401-00-2611	50 %	2 %	%	14,000
2	Total compensation of officers					100,000
3	Compensation of officers claimed on Schedule A and elsewhere on return					30,000
4	Subtract line 3 from line 2. Enter the result here and on line 12, page 1					70,000

Schedule J Tax Computation (See instructions.)

1	Check if the corporation is a member of a controlled group (see sections 1561 and 1563) ▶ ☐		
2a	If the box on line 1 is checked, enter the corporation's share of the $50,000, $25,000, and $9,925,000 taxable income brackets (in that order): (1) $ (2) $ (3) $		
b	Enter the corporation's share of: (1) Additional 5% tax (not more than $11,750) $ (2) Additional 3% tax (not more than $100,000) $		
3	Income tax. Check this box if the corporation is a qualified personal service corporation as defined in section 448(d)(2) (see instructions on page 14) ▶ ☐	3	61,387
4a	Foreign tax credit (attach Form 1118) — 4a		
b	Possessions tax credit (attach Form 5735) — 4b		
c	Orphan drug credit (attach Form 6765) — 4c		
d	Check: ☐ Nonconventional source fuel credit ☐ QEV credit (attach Form 8834) — 4d		
e	General business credit. Enter here and check which forms are attached: ☐ 3800 ☐ 3468 ☑ 5884 ☐ 6478 ☐ 6765 ☐ 8586 ☐ 8830 ☐ 8826 ☐ 8835 ☐ 8844 ☐ 8845 ☐ 8846 ☐ 8847 — 4e 6,000		
f	Credit for prior year minimum tax (attach Form 8827) — 4f		
5	Total credits. Add lines 4a through 4f	5	6,000
6	Subtract line 5 from line 3	6	55,387
7	Personal holding company tax (attach Schedule PH (Form 1120))	7	
8	Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611	8	
9a	Alternative minimum tax (attach Form 4626)	9a	
b	Environmental tax (attach Form 4626)	9b	
10	Total tax. Add lines 6 through 9b. Enter here and on line 31, page 1	10	55,387

Schedule K Other Information (See pages 17 and 18 of instructions.)

		Yes	No
1	Check method of accounting: a ☐ Cash b ☑ Accrual c ☐ Other (specify) ▶		
2	Refer to page 19 of the instructions and state the principal: a Business activity code no. ▶ 3498 b Business activity ▶ Manufacturing c Product or service ▶ Toys		
3	Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing: (a) name and identifying number, (b) percentage owned, and (c) taxable income or (loss) before NOL and special deductions of such corporation for the tax year ending with or within your tax year.		✓
4	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? If "Yes," enter employer identification number and name of the parent corporation ▶		✓
5	Did any individual, partnership, corporation, estate or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing name and identifying number. (Do not include any information already entered in 4 above.) Enter percentage owned ▶		✓
6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See secs. 301 and 316.) If "Yes," file Form 5452. If this is a consolidated return, answer here for the parent corporation and on Form 851, Affiliations Schedule, for each subsidiary.		✓
7	Was the corporation a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.) If "Yes," attach Form 5471 for each such corporation. Enter number of Forms 5471 attached ▶		✓
8	At any time during the 1994 calendar year, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? If "Yes," the corporation may have to file Form TD F 90-22.1. If "Yes," enter name of foreign country ▶		✓
9	Was the corporation the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not the corporation has any beneficial interest in it? If "Yes," the corporation may have to file Forms 926, 3520, or 3520-A		✓
10	Did one foreign person at any time during the tax year own, directly or indirectly, at least 25% of: (a) the total voting power of all classes of stock of the corporation entitled to vote, or (b) the total value of all classes of stock of the corporation? If "Yes," a Enter percentage owned ▶ b Enter owner's country ▶ c The corporation may have to file Form 5472. Enter number of Forms 5472 attached ▶		✓
11	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If so, the corporation may have to file Form 8281.		
12	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ 5,000		
13	If there were 35 or fewer shareholders at the end of the tax year, enter the number ▶		
14	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here ▶ ☐		
15	Enter the available NOL carryover from prior tax years (Do not reduce it by any deduction on line 29a.) ▶ $		

Schedule L Balance Sheets

		Beginning of tax year		End of tax year	
	Assets	(a)	(b)	(c)	(d)
1	Cash		14,700		28,331
2a	Trade notes and accounts receivable	98,400		103,700	
b	Less allowance for bad debts	( )	98,400	( )	103,700
3	Inventories		126,000		298,400
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)		100,000		120,000
6	Other current assets (attach schedule)		26,300		17,266
7	Loans to stockholders				
8	Mortgage and real estate loans				
9	Other investments (attach schedule)		100,000		80,000
10a	Buildings and other depreciable assets	272,400		296,700	
b	Less accumulated depreciation	(88,300)	184,100	(104,280)	192,400
11a	Depletable assets				
b	Less accumulated depletion	( )		( )	
12	Land (net of any amortization)		20,000		20,000
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	( )		( )	
14	Other assets (attach schedule)		14,800		19,300
15	Total assets		684,300		879,417
	Liabilities and Stockholders' Equity				
16	Accounts payable		28,500		34,834
17	Mortgages, notes, bonds payable in less than 1 year		4,300		4,300
18	Other current liabilities (attach schedule)		6,800		7,400
19	Loans from stockholders				
20	Mortgages, notes, bonds payable in 1 year or more		176,700		264,100
21	Other liabilities (attach schedule)				
22	Capital stock: a Preferred stock				
	b Common stock	200,000	200,000	200,000	200,000
23	Paid-in or capital surplus				
24	Retained earnings—Appropriated (attach schedule)		30,000		40,000
25	Retained earnings—Unappropriated		238,000		328,783
26	Less cost of treasury stock		( )		( )
27	Total liabilities and stockholders' equity		684,300		879,417

Note: *You are not required to complete Schedules M-1 and M-2 below if the total assets on line 15, column (d) of Schedule L are less than $25,000.*

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

1	Net income (loss) per books	147,783	7	Income recorded on books this year not included on this return (itemize): Tax-exempt interest $ 5,000 Insurance proceeds – 9,500	14,500
2	Federal income tax	55,387			
3	Excess of capital losses over capital gains	3,600			
4	Income subject to tax not recorded on books this year (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):			a Depreciation $ 1,620	
	a Depreciation $			b Contributions carryover $	
	b Contributions carryover $ 850				
	c Travel and entertainment $ See itemized statement attached (not shown) – 16,850	17,700			1,620
			9	Add lines 7 and 8	16,120
6	Add lines 1 through 5	224,470	10	Income (line 28, page 1)—line 6 less line 9	208,350

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

1	Balance at beginning of year	238,000	5	Distributions: a Cash	65,000
2	Net income (loss) per books	147,783		b Stock	
3	Other increases (itemize): Refund of 1991 income tax due to IRS examination			c Property	
			6	Other decreases (itemize): Reserve for contingencies	10,000
		18,000	7	Add lines 5 and 6	75,000
4	Add lines 1, 2, and 3	403,783	8	Balance at end of year (line 4 less line 7)	328,783

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