Department of the Treasury

Internal Revenue Service

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Corporations

For use in preparing

1997 Returns

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Contents

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.

If your corporation has a net operating loss, see Publication 536, *Net Operating Losses.* Also, some corporations may meet the qualifications for electing to be S corporations. For information on S corporations, see the instructions for Form 1120S.

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

Please note that “you” is usually used in this publication to refer to the person or persons responsible for filing returns and making tax payments for a corporation.

Important Changes for 1997

Businesses taxed as corporations. The rules you must use to determine whether a business is taxed as a corporation changed for businesses formed after 1996. However, a business formed before 1997 and taxed as a corporation under the old rules will generally continue to be taxed as a corporation. For more information, see *Businesses Taxed as Corporations,* later.

Electronic deposit requirement. If your total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in 1995, you must make electronic deposits for ***all*** depository tax liabilities that occur after June 30, 1997. However, no penalties for not making these electronic deposits will be imposed prior to July 1, 1998. For more information, see *How To Pay Tax* under *Corporation Income Tax Returns,* later.

New holding period for dividends-received deduction. The holding period for the dividends-received deduction has been changed. Generally, for dividends received or accrued after September 4, 1997, a corporation cannot take a deduction for dividends received from:

1) A corporation whose stock has been held less than 46 days during the 90-day period beginning 45 days before the stock becomes ex-dividend with respect to the dividend, or
2) A corporation whose preferred stock has been held less than 91 days during the 180-day period beginning 90 days before the stock becomes ex-dividend with respect to the dividend, if the dividends received on it are for a period or periods totaling more than 366 days.

For more information about the dividends-received deduction, see *Dividends-Received Deduction,* later.

Nonqualified preferred stock not treated as stock. Generally effective for transfers made after June 8, 1997, a person who transfers property to a corporation and receives nonqualified preferred stock must treat such stock as property or money (instead of stock) received. This means that the person may need to recognize at least part of any gain realized on the transfer of the property to the corporation even if that person controls the corporation. For more information, see *Forming a Corporation,* later.

Important Changes for 1998

Certain small corporations not subject to alternative minimum tax (AMT). For tax years beginning after 1997, the tentative minimum tax of certain small corporations will be zero. A corporation is a small corporation for this purpose if its average annual gross receipts for the 3-tax-year period (or, if shorter, the period of existence) ending with:

1) Its first tax year beginning after December 31, 1996, are $5 million or less, ***and***
2) Each later tax year up to and including the current tax year are $7.5 million or less.

For these tests, gross receipts for a short tax year are annualized. For more information about the AMT, see *Alternative Minimum Tax (AMT),* later.

Electronic deposit requirement. If your total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in 1996, you must make electronic deposits for ***all*** depository tax liabilities that occur after 1997. However, no penalties for not making these electronic deposits will be imposed prior to July 1, 1998. For more information, see *How To Pay Tax* under *Corporation Income Tax Returns,* later.

Important Reminders

Unresolved tax problems. The ***Problem Resolution Program*** (PRP), which is administered by the Taxpayer Advocate, is for taxpayers who have been unable to resolve their problems with the IRS. If you have a tax problem you cannot clear up through normal channels, you can call the IRS at 1–800–829–1040 for PRP assistance. If you prefer, you can write to the office that last contacted you (or your local district director) and ask for PRP assistance. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to obtain this assistance.

Although the PRP office cannot change the tax law or a technical tax decision, it can clear up problems that resulted from previous contacts and ensure your case is given a complete and impartial review. For more information, see Publication 1546, *The Problem Resolution Program of the Internal Revenue Service.*

Comments on IRS enforcement actions. The Small Business and Agricultural Regulatory Enforcement Ombudsman and 10 Regional Fairness Boards were established to receive comments from small business about federal agency enforcement actions. The Ombudsman will annually evaluate the enforcement activities and rate each agency's responsiveness to small business. If you wish to comment on the enforcement actions of the IRS, call 1–888–734–3247.

Useful Items

You may want to see:

Publication

- ☐ **535** Business Expenses
- ☐ **526** Charitable Contributions
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **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
- ☐ **8827** Credit For Prior Year Minimum Tax—Corporations
- ☐ **8832** Entity Classification Election

See *How To Get More Information* near the end of this publication for information about getting these publications and forms.

Businesses Taxed as Corporations

The rules you must use to determine whether a business is taxed as a corporation changed for businesses formed after 1996. However, a business formed before 1997 and taxed as a corporation under the old rules will generally continue to be taxed as a corporation.

Businesses formed before 1997. The following businesses formed before 1997 are taxed as corporations.

1) A business that is legally chartered as a corporation.
2) A joint-stock company.
3) An insurance company.
4) Any other business formed before 1997 that has more than 2 of the following characteristics:
   a) Centralization of management.
   b) Continuity of life.
   c) Free transferability of interests.
   d) Limited liability.

Organizations of professional people. Organizations of doctors, lawyers, and other professional people organized under state professional association acts are generally taxed as corporations. A professional service organization must be both ***organized*** and ***operated*** as a corporation to be classified as one. All states and the District of Columbia have professional association acts.

Businesses formed after 1996. The following businesses formed after 1996 are taxed as corporations.

1) A business formed under a federal or state law that refers to the business as a corporation, body corporate, or body politic.
2) A business formed under a state law that refers to the business as a joint-stock company or joint-stock association.
3) An insurance company.
4) Certain banks.
5) A business wholly owned by a state or local government.

6) A business specifically required to be taxed as a corporation by the Internal Revenue Code. (For example, certain publicly traded partnerships.)

7) Certain foreign businesses.

8) Any other business formed after 1996, if an election to be taxed as a corporation is filed for the business on Form 8832 within 75 days of the date it is formed.

For more information, see the instructions for Form 8832.

Forming a Corporation

A corporation is formed by 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:

1) At least 80% of the total combined voting power of all classes of stock entitled to vote, and

2) At least 80% of the total number of shares of all other classes of stock.

Nonqualified preferred stock not treated as stock. Generally effective for transfers made after June 8, 1997, a person who transfers property to a corporation and receives nonqualified preferred stock must treat such stock as property or money (instead of stock) received. This means that the person may need to recognize at least part of any gain realized on the transfer of the property to the corporation even if that person controls the corporation.

Preferred stock is stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Preferred stock is nonqualified if it has ***any*** of the following characteristics.

1) The holder of the stock can require the issuer or a related person to redeem or purchase the stock.

2) The issuer or a related person is required to redeem or purchase the stock.

3) The issuer or a related person has the right to redeem or repurchase the stock and, as of the issue date, it is more likely than not that that right will be exercised.

4) The dividend rate of the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.

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.

Transfer of services. Transfer of your services to a corporation in return for stock results in taxable pay 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 you receive. 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:

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

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

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 (see section 367(a)(3) of the Internal Revenue Code).

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 recognized 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 liability as money received by you for determining your basis. If the corporation assumes your liability, treat the amount of the liability as money received for determining your basis. This rule does not apply to any liabilities you excluded under the excess liability rule discussed earlier 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 if the property is received in a reorganization and consists of stock or securities in a corporation that is a party to the reorganization unless that property is received in exchange for 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 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 you pay or incur in any activity engaged in for profit and for the production of income in anticipation of the activity becoming an active trade or business. Start-up expenses are treated differently than 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 the 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 not currently deduct its organizational expenses. However, it 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. However, this election only applies to expenditures incurred before the end of the tax year the corporation begins business (without regard to whether the corporation files its returns on an accrual or the cash method of accounting or whether the expenses are paid in the tax year they are incurred).

Organizational expenses are those directly for the creation of the corporation that would be chargeable to the capital account. These expenses are of a character which, if spent for the creation of a corporation having a limited life, would be 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. However, you cannot amortize:

1) Expenses of issuing or selling stock or securities, such as commissions, professional fees, and printing costs,
2) Expenses connected with the transfer of assets to a corporation, or
3) Expenses connected with the reorganization of the corporation, unless directly incident to the creation of a 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. Generally, a corporation starts business when it starts the activities for which it was organized. A corporation has not begun business merely by existing as a corporation or by conducting organizational activities. However, consider a corporation to have begun business when its activities reach the point necessary to establish the nature of its business operations. 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 wages, 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. 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.

Stock for debt exception. The stock for debt exception was repealed for transfers made after 1994, unless the corporation filed for bankruptcy (or similar court proceeding) before 1994. Generally, before 1995, a corporation did not realize income because of these stock for debt exchanges if it was in bankruptcy or to the extent it is insolvent. Consequently, there was no gross income to exclude and no reduction of its tax attributes was necessary. The principal difference between the stock for debt exception and the stock for debt exchange is that the corporation does not reduce its tax attributes under the stock for debt exception.

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 pay 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, the 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.*** Generally, 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 that is subject to an allowance for depreciation and that is not and never has been section 1245 property.

  Section 1245 property. This includes any property that is or has been subject to an allowance for depreciation, if the property is either personal property or other section 1245 property described in chapter 4 of Publication 544.

- ***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 or a predecessor was a C corporation for any of the 3 immediately preceding tax years.

Dividends-Received Deduction

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

Dividends from domestic corporations. A corporation can 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 can deduct, with certain limits, 80% of the dividends received or accrued if it owns 20% or more of the paying domestic corporation. The paying corporation is a ***20%-owned corporation.***

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

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.

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

Affiliated corporations. Members of an affiliated group of corporations can 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. A corporation can deduct 42% of the dividends it receives on certain preferred stock (issued before October 1942) of a less-than-20%-owned taxable public utility. A corporation can deduct 48% of the dividends it receives on certain preferred stock of a 20%-or-more-owned taxable public utility. For more information, see section 244 of the Internal Revenue Code.

Dividends from Federal Home Loan Banks. Certain dividends received from Federal Home Loan Banks qualify for the dividends-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.

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

1) A real estate investment trust,
2) A corporation exempt from tax either for the tax year of the distribution or the preceding tax year,
3) A corporation whose stock has been held less than 46 days (for dividends received before September 5, 1997),
4) A corporation whose stock has been held less than 46 days during the 90-day period beginning 45 days before the stock becomes ex-dividend with respect to the dividend (generally for dividends received after September 4, 1997),
5) A corporation whose stock has been held less than 91 days, 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 (for dividends received before September 5, 1997), or
6) A corporation whose preferred stock has been held less than 91 days during the 180-day period beginning 90 days before the stock becomes ex-dividend with respect to the dividend if the dividends received on it are for a period or periods totaling more than 366 days (generally for dividends received after September 4, 1997), or
7) 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 × 80%) and combines it with the operations loss of $25,000, it will have a net operating loss of $5,000. 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 × 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 × 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 generally treated as gain from the sale or exchange of the stock for the tax year the dividend is received. For distributions made before May 4, 1995, this part was treated as gain from the sale or exchange of the stock for the tax year you sell or exchange the stock. For more information about this change, see section 1011 of the Taxpayer Relief Act of 1997 (Public Law 105–34).

An ***extraordinary dividend*** is any dividend on stock that equals or exceeds a certain percentage of the corporation's adjusted basis in the stock. The percentages are:

1) 5% for stock preferred as to dividends, or

2) 10% for other 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.

A 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. Any dividend on disqualified preferred stock is treated as an extraordinary dividend 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 a qualified organization. For more information on qualified organizations, see Publication 526.

TIP *You can ask any organization whether it is a qualified organization, and most will be able to tell you. Or you can check IRS Publication 78,* Cumulative List of Organizations, *which lists most qualified organizations. You may find Publication 78 in your local library's reference section. If not, you can call the IRS tax help telephone number shown for your area in your tax package to find out if an organization is qualified.*

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 can 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's 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. An officer authorized to sign the return must sign the declaration under penalties of perjury.

Limit. A corporation cannot deduct as charitable contributions for a tax year 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,
- 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 1996 and it does not use all the excess on its return for 1997, it can carry the rest over to 1998, 1999, 2000, and 2001. 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 to a succeeding tax year.

Capital Losses

A 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 1997, 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 1994. In 1994, 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 1997 first from the net short-term gain. This results in a net capital gain for 1994 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.

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 controlled by the same person, and
4) An S corporation and a C corporation if controlled by the same persons.

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, see chapters 2 and 8 of Publication 535, and Publication 544.

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

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 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:

1) Excess interest expense, and
2) 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 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. For more information on the at-risk rules, see Publication 925.

Figuring Tax

Corporate taxable income is subject to the tax rates shown in Table 1.

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 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:

1) At least 95% of the value of its stock is held by employees, retired employees, their estates, or (for a limited time) the beneficiaries of such estates, and
2) Its employees perform services at least 95% of the time in any of the following fields:
   a) Health,
   b) Law,
   c) Engineering,
   d) Architecture,
   e) Accounting,
   f) Actuarial science,
   g) Veterinary services,
   h) Performing arts, or
   i) Consulting.

Credits

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

1) Credit for fuels used for certain purposes (see Publication 378),
2) Foreign tax credit (use Form 1118),

3) General business credit (see *General business credit,* below),
4) Possessions tax credit (use Form 5735),
5) Credit for fuel produced from a nonconventional source, and
6) Qualified electric vehicle credit (use Form 8834).

General business credit. Your general business credit consists of your carryforward of business credits from prior years plus your total current year business credits. Current year business credits include the:

- Alcohol used as fuel credit (Form 6478),
- Contributions to selected community development corporations credit (Form 8847),
- Disabled access credit (Form 8826),
- Employer social security and Medicare taxes paid on certain employee tips credit (Form 8846),
- Empowerment zone employment credit (Form 8844),
- Enhanced oil recovery credit (Form 8830),
- Indian employment credit (Form 8845),
- Investment credit (Form 3468),
- Low-income housing credit (Form 8586),
- Orphan drug credit (Form 8820),
- Renewable electricity production credit (Form 8835),
- Research credit (Form 6765),
- Welfare-to-work credit (For wages paid to qualified long-term family assistance recipients who began work after 1997.) (Form 8861), and
- Work opportunity credit (Form 5884).

In addition, your general business credit for the current year may be increased later by the carryback of business credits from later years.

To claim the general business credit, you will first need to get the form or forms you need to claim your current year business credits. The above list contains a list of current year business credits. The form you need to claim a credit is shown in parentheses. In addition to the credit form, you may also need to file Form 3800, *General Business Credit.*

Who must file Form 3800. You must file Form 3800 if any of the following apply:

1) You have more than one of the credits listed earlier (other than the empowerment zone employment credit).
2) You have a carryback or carryforward of any of these credits (other than the empowerment zone employment credit).
3) Any of these credits (other than the low-income housing credit or the empowerment zone employment credit) is from a passive activity. (For information about passive activity credits, get Form 8582–CR.)

The empowerment zone employment credit is subject to special rules. The credit is figured separately on Form 8844 and is not carried to Form 3800. For more information, see the instructions for Form 8844.

See the instructions to Form 3800 for more information about the general business credit.

Other Taxes

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

1) Personal holding company tax (attach Schedule PH (Form 1120)),
2) Investment credit recapture (Form 4255),
3) Low-income housing credit recapture (Form 8611),
4) Qualified electric vehicle credit recapture,
5) Indian employment credit recapture, and
6) Alternative minimum tax.

Alternative Minimum Tax (AMT)

The tax law gives special treatment to some kinds of income and allows special deductions and credits for some kinds of expenses. This special treatment could substantially reduce or eliminate a corporation's income tax. Corporations that benefit from the law in these ways may have to pay at least a minimum amount of tax, through an additional tax. This tax is called the alternative minimum tax (AMT).

TIP *For tax years beginning after 1997, the tentative minimum tax of certain small corporations will be zero. This means that they will no longer be subject to AMT. A corporation is a small corporation for this purpose if its average annual gross receipts for the 3-tax-year period (or, if shorter, the period of existence) ending with:*

1) Its first tax year beginning after December 31, 1996, are $5 million or less, ***and***

2) Each later tax year up to and including the current tax year are $7.5 million or less.

For these tests, gross receipts for a short tax year are annualized.

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 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. For more information, see *Minimum Tax Credit,* later.

The adjustment and 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 preference items are reported on Form 4626 in figuring AMT.

Form 4626. Use Form 4626 to figure your corporation's AMT. File this form if your corporation's taxable income or (loss) before any net operating loss deduction plus its adjustments and preferences total more than $40,000 or, if smaller, its allowable exemption amount. The easiest way to determine whether you must file the form is to fill it out. If line 3 is more than line 9, you will need to attach Form 4626 to your corporation's income tax return.

TIP *Before you can fill out Form 4626, you must fill out most of your corporation's income tax return. For more information on the income tax return, see* Corporation Income Tax Returns, *later.*

How to figure AMT. Before you can figure your corporation's AMT, you must figure its alternative minimum taxable income. The following section contains general information that may help you figure your corporation's AMTI. The next section explains how to use AMTI to figure AMT. For more detailed information, see Form 4626 and its instructions.

Figuring Alternative Minimum Taxable Income (AMTI)

To figure your corporation's AMTI, you must refigure its taxable income using special AMT rules to figure its:

1) Adjustments and preferences,
2) Adjusted current earnings (ACE) adjustment, and
3) Alternative tax net operating loss deduction (ATNOLD).

AMTI is figured on page 1 of Form 4626.

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.

Depreciation of post-1986 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. For more information on depreciation, see Publication 946.

This adjustment applies to property placed in service after 1986, other than transition property not subject to MACRS. It also applies to property placed in service after July

Table 2. **Adjustments and Preferences**
This easy to scan table may help you determine whether your corporation is likely to owe AMT.

Adjustment and preference items (Items subject to special AMT rules.)	**Special AMT rules (Also see *Adjustments and Preferences,* earlier.)**
Accelerated depreciation of leased personal property (pre-1987) (personal holding companies only)	Refigure using SL method.
Accelerated depreciation of real property (pre-1987)	Refigure using SL method.
Adjusted gain or loss	Refigure gain or loss on the disposition of assets using AMT basis.
Amortization of certified pollution control facilities (post-1986 facilities)	• Do not reduce the basis by 20% • Use the SL method over the class life.
Amortization of circulation expenditures (personal holding companies only)	Use the optional 3-year writeoff.
Amortization of mining exploration and development costs	• Do not reduce the basis by 30% • Use the optional 10-year writeoff.
Charitable contributions	Refigure taxable income limit using AMT rules.
Depletion	Refigure using AMT rules.
Depreciation of post-1986 property	Use the alternative depreciation system with special rules.
Installment sales	Do not use installment method for certain dispositions of property.
Intangible drilling costs	See Form 4626 instructions.
Long-term contracts	Use percentage-of-completion method if over 2 years and not home construction.
Loss limitations	Refigure gains and losses from at-risk activities and partnerships using AMT adjustments and preferences.
Merchant marine capital construction funds	Do not exclude or deduct deposits or earnings.
Passive activities (closely held corporations and personal service corporations only)	Refigure passive activity gains and losses using special rules.
Section 833(b) deduction (Blue Cross, Blue Shield, and similar type organizations only)	Do not take this deduction.
Tax-exempt interest from specified private activity bonds	Generally include excluded interest in income.
Tax shelter farm activities (personal service corporations only)	Refigure all gains and losses using special AMT rules.
Other adjustments	Do not include possession tax or alcohol fuel credits in income. Use AMTI instead of taxable income to figure deductions (such as the section 179 deduction) limited by taxable income.

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.*

Accelerated depreciation of pre-1987 property. For property placed in service before 1987, accelerated depreciation is a preference item. Continue to treat depreciation on that property as a preference item. See *Accelerated depreciation of real property (pre-1987)* and *Accelerated depreciation of leased personal property (pre-1987),* discussed later.

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 946).

Amortization of mining exploration and development costs. If you did not choose the *Optional Write-Off,* discussed later, recompute your regular tax deduction for mining exploration and development costs by 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.

Amortization of circulation expenses. This adjustment is for personal holding companies only. If you did not choose the *Optional Write-Off,* discussed later, this adjustment applies. 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 amortized amount.

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
- Certified pollution control facilities.

The adjustment is the difference between the gain (or loss) reported 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.

Installment sales. For any disposition of inventory or stock in trade, the installment method of accounting does not apply for the AMT. 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. However, this adjustment does not apply to certain dispositions of timeshares or residential lots for which you elected to pay interest.

Merchant marine capital construction funds. 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. The adjustment is the total of these deposits deducted or earnings excluded from income. 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 (Blue Cross or Blue Shield or similar health insurance providers) 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 preference items. Determine the AMT gain or loss using the same rules used for the regular tax with the following modifications:

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

A corporation is insolvent to the extent its liabilities exceed the FMV of its assets. 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 preference item that is included as a gain or loss in the computation for a passive activity loss, discussed next.*

Passive activities. 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 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.*

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 preference item. You figure this item separately for each separate piece of property being depleted. Depletion figured using the small producer's and royalty owner's exemption is not a preference item.

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 these costs to the adjusted basis, deduct them before figuring the depletion preference.

Percentage depletion of coal and iron ore. Figure a corporation's (other than an S corporation's) 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 preference item for percentage depletion on the property.

Tax-exempt interest from specified private activity bonds. This 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 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 the bonds received by the company paying the dividend.

Charitable contributions. Refigure the charitable contributions deduction for the AMT. Use only income and deductions allowed for the AMT when refiguring the limit based on taxable income. Also, any AMT carryover of charitable contributions is limited to the cost or other basis (instead of fair market value) for any contribution of capital gain or section 1231 property for which the preference for charitable contributions applied.

Intangible drilling costs (IDCs). If you elected the optional 60-month write-off for IDCs, discussed later, these costs are not a preference item. If you do not elect the 60-month write-off, this 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.

Special rule. Excess IDCs for any oil or gas well are a preference item only for integrated oil companies. However, if you are not an integrated oil company, the reduction in your alternative minimum taxable income (AMTI) cannot exceed 40% of your AMTI for the year figured by taking into account this item, but without regard to the alternative tax NOL deduction, discussed later, under *Other adjustments.*

Accelerated depreciation of real property (pre-1987). This preference item is the depreciation or amortization a corporation took during the tax 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 amount for an item of property you dispose of during the tax year.

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 *Depreciation of post-1986 property,* earlier.

You do not have a preference item if you use a recovery period longer than these periods.

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 of leased personal property (pre-1987). This item applies only if the corporation is a personal holding company. This 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.

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 from the alcohol fuel credit.

Also, the adjustment can be either a positive or negative amount for:

1) Any minimum taxable income adjustment from Schedule K–1 (Form 1041), line 8, if the corporation is the beneficiary of a trust,
2) Any AMT adjustment from a cooperative, or
3) Any related adjustment, discussed next.

Related adjustments. AMT adjustments and preferences may affect deductions that are based on an income limit. You must refigure these deductions using the income limit as modified for AMT purposes. You include this adjustment on line 2s 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.

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 the following optional write-off periods.

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. The cost a corporation can choose to deduct, in equal installments over a 3-year period, is 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 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 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.

Adjusted Current Earnings (ACE)

Increase AMTI by 75% of any excess of the corporation's ACE for the tax year over preadjustment AMTI. Preadjustment 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 preadjustment AMTI over ACE to the extent of the net positive adjustments for ACE in prior tax years.

ACE is the corporation's preadjustment 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 adjustment. 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 *Depreciation of post-1986 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 preadjustment AMTI but that are included in determining E & P. 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 from E & P. These are items that are not taken into account in figuring E & P. No deduction is allowed for them when figuring ACE. These items will generally increase ACE to the extent they were deductible in figuring the preadjustment 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.

Circulation expenses. For purposes of figuring ACE, the amortization provisions do not apply to expenses paid or incurred after 1989. You must treat the expenses in accordance with the case law in effect before 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 expenses paid or incurred after 1989. 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).

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 IRC section 453A percentage of the gain from an installment sale to which that section 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.

Basis adjustments in determining gain or loss from sale or exchange 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) of the IRC, you must refigure the property's adjusted basis for ACE purposes. The difference is a negative amount if:

1) The ACE gain is less than the AMT gain,
2) The ACE loss is more than the AMT loss, or
3) 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.

Alternative Tax Net Operating Loss Deduction (ATNOLD)

The ATNOLD replaces any net operating loss (NOL) deduction your corporation is allowed on Form 1120, line 29a (Form 1120–A, line 25). If your corporation has an NOL deduction, you will add it back to taxable income on line 1 of Form 4626. You will replace it with the ATNOLD.

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

- Make the AMT adjustments, under sections 56 and 58 of the IRC, to that year's NOL that you figured for regular tax purposes, and
- Reduce that year's NOL by the preference items under section 57 of the IRC, to the extent they 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 NOL deduction.

You can carry the NOL back or carry it forward using 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. For more information, see Publication 536, *Net Operating Losses.*

In years that a corporation does not have an AMT liability, you still reduce the NOL deduction. 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).

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 is $310,000 or more.

Tentative Minimum Tax

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 an AMT foreign tax credit, subtract it to arrive at the tentative minimum tax.

AMT foreign tax credit. Figure the AMT foreign tax credit in the same manner as the regular tax foreign tax credit, with certain modifications. These include treating pre-credit tentative minimum tax as the tax against which the credit is taken and applying the section 904 foreign tax credit limits on the basis of AMT income, instead of taxable income.

TIP *For tax years beginning after 1997, you may choose to use a new simplified method to figure the AMT foreign tax credit. For more information, see Publication 553.*

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 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.

CAUTION *For tax years beginning after August 5, 1997, the 90% limit will also apply to 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 or possessions tax credit (lines 4a and 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 use these credits to the extent its regular tax liability exceeds its tentative minimum tax. You may apply any unused credit as a carryback or carryover under the usual rules for that credit.

The credits include the:

- Credit for fuel from a nonconventional source, and
- Qualified electric vehicle credit.

Also, the general business credit generally cannot be used to reduce AMT, except for certain parts of the credit indicated next.

Reduction of Alternative Minimum Tax

Reduce alternative minimum tax by any amounts from Form 3800, *General Business Credit,* line 35, Schedule A, and Form 8844, *Empowerment Zone Employment Credit,* line 21. To make this reduction, follow the instructions for line 9 of Schedule J, Form 1120; or line 6 of Part I, Form 1120–A.

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 1997, 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 1996,
- A minimum tax credit carryforward from 1996 to 1997, or
- A nonconventional source fuel credit, an orphan drug credit, or a qualified electric vehicle credit that was not allowed for 1996 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) Credit for fuel from nonconventional sources,
4) Qualified electric vehicle credit,
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.

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 1997, it carries the balance to 1998 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

Generally, you must make installment payments of your corporation's estimated tax (income tax minus credits) if you expect it to be $500 or more. If you do not pay the installments when they are due, your corporation may be subject to an underpayment penalty. This section will help you avoid this penalty.

When To Pay Estimated Tax

Installment payments of estimated tax are due by the 15th day of the 4th, 6th, 9th, and 12th months of your corporation's tax year. If any date falls on a Saturday, Sunday, or legal holiday, the installment is due on the next regular business day.

Example 1. Your corporation's tax year ends December 31. Installment payments of estimated tax are due on April 15, June 15, September 15, and December 15.

Example 2. Your corporation's tax year ends June 30. Installment payments of estimated tax are due on October 15, December 15, March 15, and June 15.

How To Pay Estimated Tax

Pay any required installments of estimated tax by their due date in the same way you pay any income tax your corporation owes when you file its income tax return. For more information, see *How To Pay Tax* under *Corporation Income Tax Returns,* later.

How To Figure Each Required Installment

Use ***Form 1120–W*** as a worksheet to figure each required installment of estimated tax. You will generally use one of the following two methods to figure each required installment. You should use the method that requires the smallest installment payments.

Note: In these discussions, “return” generally refers to the corporation's original return. However, an amended return is considered the original return if the amended return is filed by the due date (including extensions) of the original return.

Method 1. Each required installment is 25% of the income tax you will show on the corporation's return for the current year.

Method 2. Each required installment is 25% of the income tax you showed on the corporation's return for the previous year.

To use Method 2:

1) You must have filed a return for the corporation for the previous year,
2) The return must have been for a full 12 months, and
3) The return must have shown a positive tax liability (not zero).

Also, if your corporation is a large corporation, you can use Method 2 to figure only the first installment.

Large corporation. A large corporation is one with at least $1 million of modified taxable income in any of the last 3 years. Modified taxable income is taxable income figured without net operating loss or capital loss carrybacks or carryovers.

Other methods. If your corporation's income is expected to vary during the year because, for example, its business is seasonal, you may be able to lower the amount of one or more required installments by using one or both of the following methods:

1) The annualized income installment method.
2) The adjusted seasonal installment method.

Use Schedule A of Form 1120–W to see if using one or both of these methods will lower the amount of one or more required installments.

Refiguring required installments. If after you figure and pay a required installment of estimated tax, you find that your corporation's tax liability for the year will be much more or less than you originally estimated, you may have to refigure its required installments. If earlier installments were underpaid, the corporation may owe an underpayment penalty.

TIP ***How to reduce penalties.*** *You should make an immediate catchup payment to reduce the amount of any penalty resulting from the underpayment of any earlier installments, whether caused by a change in an estimate, not making a deposit, or a mistake. If you are charged a penalty, the amount of the penalty depends on the following three factors:*

1) The amount of the underpayment.
2) The period during which the underpayment was due and unpaid.
3) An interest rate that is published quarterly by the IRS in the Internal Revenue Bulletin.

Underpayment Penalty

If you do not pay a required installment of estimated tax by its due date, your corporation may be subject to a penalty. The penalty is figured separately for each installment due date. Your corporation may owe a penalty for an earlier due date, even if you paid enough tax later to make up the underpayment. This is true even if your corporation is due a refund when you file its return.

Form 2220. Use Form 2220 to determine if your corporation is subject to the penalty for underpayment of estimated tax and, if so, the amount of the penalty.

You generally do not have to file Form 2220 with your corporation's income tax return because the IRS will figure any penalty and bill the corporation. However, even if the corporation does not owe a penalty, complete and attach the form to the corporation's tax return if:

1) You used the annualized income installment method to figure any required installment,
2) You used the adjusted seasonal installment method to figure any required installment, or
3) Your corporation is a large corporation and you used Method 2 to figure its first required installment.

Quick Refund of Overpayments

If you overpaid your corporation's estimated tax, you may be able to apply for a quick refund of the overpayment.

Form 4466. Use Form 4466, *Corporation Application for Quick Refund of Overpayment of Estimated Tax,* to apply for a quick refund of an overpayment of estimated tax if the overpayment is:

- At least 10% of the expected tax liability, ***and***
- At least $500.

Use Form 4466 as a worksheet to figure the corporation's expected tax liability and the overpayment of estimated tax.

File Form 4466 after the end of the corporation's tax year but before:

1) The 16th day of the 3rd month after the end of the tax year, and

2) You file the corporation's income tax return.

An extension of time to file the corporation's income tax return will not extend the time for filing Form 4466. The IRS will act on the form within 45 days from the date you file it.

Corporation Income Tax Returns

You must generally file an income tax return each year to report your corporation's income, gains, losses, deductions, credits, and to figure its income tax liability. This section will help you determine when and how to report and pay your corporation's income tax.

Who Must File Form 1120 or Form 1120–A

You must generally file Form 1120 or Form 1120–A if all of the following statements describe your corporation.

1) It is not a foreign corporation.

2) It is not exempt from tax under Internal Revenue Code section 501.

3) It is not required to file a special return.

For more information on special returns for certain corporations, see the instructions for Forms 1120 and 1120–A.

Form 1120–A. Form 1120–A is much shorter than Form 1120. You may be able to use this short form if your corporation's gross receipts, total income, and total assets are all under $500,000. The form instructions list other requirements your corporation must meet before you can use Form 1120–A.

Form 1120X. Use Form 1120X to correct Form 1120 or Form 1120–A as you originally filed it or as it was later adjusted by an amended return, a claim for refund, or an examination. For more information on using this form, see the instructions for Form 1120X.

When To File

Generally, you must file your corporation's income tax return by the 15th day of the 3rd month after the end of its tax year. You must generally file a short-period return for a new corporation by the 15th day of the 3rd month after the short period ends. If your corporation has dissolved, you must generally file by the 15th day of the 3rd month after the date it dissolved.

Example 1. Your corporation's tax year ends December 31. File its income tax return by March 15th.

Example 2. Your corporation's tax year ends June 30. File its income tax return by September 15th.

If the due date falls on a Saturday, Sunday, or legal holiday, file the return on the next regular business day.

Extension of time to file. File ***Form 7004*** to request a 6-month extension of time to file your corporation's income tax return. The IRS will grant the extension if you:

1) Complete the form properly,

2) File it by the due date for filing the corporation's income tax return, and

3) Pay any balance due on the form.

An extension of time to file your corporation's income tax return will not extend the time for paying the tax due on the return. Your corporation will be charged interest on any part of the final tax due not paid with Form 7004. The interest is figured from the original due date of the return to the date of payment.

For more information, see the instructions for Form 7004.

How To Pay Tax

Unless you volunteer to or are required to make electronic deposits, you should mail or deliver your payment with a completed ***Form 8109*** to an authorized financial institution or to the Federal Reserve Bank for your area. For more information, see the instructions for Form 8109.

Electronic deposits. Use the ***Electronic Federal Tax Payment System (EFTPS)*** to make electronic deposits of tax. You are required to use EFTPS:

- For all tax payments due after June 1997, if your corporation's total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in 1995, or
- For all tax payments due after 1997, if your corporation's total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in 1996.

However, no penalties for not making these electronic deposits will be imposed prior to July 1, 1998. If you are not required to use EFTPS, you may volunteer to do so.

To enroll in EFTPS, call 1–800–945–8400 or 1–800–555–4477. For general information about EFTPS, call 1–800–829–1040.

Estimated tax payments. Generally, you must make installment payments of your corporation's estimated tax (income tax minus credits) if you expect it to be $500 or more. For more information, see *Estimated Tax,* earlier.

Interest and Penalties

This section discusses interest and penalties that the IRS may charge your corporation.

Interest. Your corporation will be charged interest on taxes paid late even if the IRS granted an extension of time to file. Interest is also charged from the due date (including extensions) to the date of payment on penalties imposed for:

- Not filing a return,
- Negligence,
- Fraud,
- Gross valuation understatements, and
- Substantial understatements of tax.

Penalty for late filing of return. If you do not file your corporation's tax return by the due date, including extensions, the IRS may charge your corporation 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. If your corporation is charged a penalty for late payment of tax (discussed next) for the same period of time, this penalty is reduced by the amount of that penalty.

The maximum penalty for a return that is over 60 days late is the smaller of:

1) The tax due, or

2) $100.

The IRS will not charge the penalty if you did not file on time due to a reasonable cause. If you file late, attach a statement explaining the reasonable cause.

Penalty for late payment of tax. If you do not pay your corporation's tax when it is due, the IRS may charge your corporation ½ of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax.

The IRS will not charge the penalty if you did not pay on time due to a reasonable cause.

This penalty does not apply to unpaid estimated tax.

Penalty for not making deposits. If you deposit your corporation's taxes after they are due or do not deposit the required tax properly, the corporation may be charged a penalty.

The IRS will not charge the penalty if you did not make proper and timely deposits due to a reasonable cause. For more information on deposits, see *How To Pay Tax,* earlier.

Figuring the penalty. The penalty for not making deposits is charged on the underpayment. The underpayment is the amount that is not deposited properly or timely. Figure the penalty by multiplying the underpayment by one of the following percentages:

1) 2% for deposits made 1 to 5 days late.

2) 5% for deposits made 6 to 15 days late.

3) 10% for deposits:

   a) Made 16 or more days late,

   b) Made at an unauthorized financial institution,

   c) Paid directly to the IRS,

   d) Paid with your tax return, or

   e) Not deposited electronically (when required).

4) 15% for deposits not made by the earlier of:

   a) 10 days after the date of the first notice the IRS sent asking for the tax due, or

   b) The day on which you receive notice and demand for immediate payment.

This penalty does not apply to estimated tax payments.

Trust fund recovery penalty. A person responsible for withholding, accounting for, or depositing or paying withholding taxes who willfully fails to do so can be held liable for a penalty equal to the tax not paid, plus interest.

"Willfully" in this case means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is considered willful behavior.

A responsible person can be an officer of a corporation, a partner, a sole proprietor, or an employee of any form of business. This may include a trustee or agent with authority over the funds of the business.

Other penalties. The IRS can charge other penalties for negligence, substantial understatement of tax, and fraud.

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 most businesses. However, treat an accumulation of $150,000 or less as 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.

The absence of a bona fide business reason for a corporation's accumulated earnings may be indicated by many different circumstances, such as a lack of regular distributions to its shareholders.

The fact that a corporation has an unreasonable accumulation of earnings is sufficient to establish liability for the accumulated earnings tax unless the corporation shows the earnings were not accumulated to allow its individual shareholders to avoid income 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 1997. 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 lives 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 1997	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		$225,000
Net profit (before federal income tax)		203,050
Reserve for contingencies	$10,000	
Income tax accrued for the year	62,225	
Dividends paid during the year	140,089	
Refund of 1994 income tax		18,000
Balance, December 31	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 these 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 lives of corporate officers (corporation is beneficiary)	$9,500
Nondeductible interest incurred to purchase tax-exempt bonds	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 1994 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 1997 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 1998 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 1998. 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 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.

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* under *Distributions,* 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 not taxable.

If the distributions are either partly or completely not taxable 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 later. See Table 3.

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, 1996, were $1,200. It made cash distributions during its 1997 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, 1997, to common shareholders is a taxable dividend to the extent of $27,318 (99.33%), and the $27,500 distribution on September 15, 1997, 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, 1997, 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.

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 946 for more information on MACRS and the section 179 deduction.

O) The refund represents a reduction of the corporation's 1994 income tax and affects the earnings and profits of a prior year.

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 page 15 of 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 attached itemized statement (not shown) $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 - 1994 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

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 1975–1 on page 677. You can get a copy of this revenue procedure from the Superintendent of Documents, U.S. Government Printing Office, Mail Stop: SSOP, Washington, DC 20402–9328.

Distributions

This section discusses corporate distributions to shareholders. These 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 is generally 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, *Investment Income and Expenses.*

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. This information must be furnished 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. Backup withholding is not required for dividend payments of less than $10. However, 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 paid to any shareholder is the money paid plus the FMV (on the distribution date) of other property transferred to the shareholder. Reduce (but not below zero) 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 this stock.

Transfers of property to shareholders for less than FMV. A sale or exchange of property between a corporation and a shareholder that is not a corporation may be a distribution to the shareholder.

If the FMV of the property on the date of the sale or exchange 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.

However, 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.

Distributions of depreciated property. If the FMV of depreciated property distributed to shareholders is more than the adjusted

Table 3. **Welldon Corporation Current-Year Computation of Earnings and Profits Calendar Tax Year 1997**

Incorporated 1/1/46 Accrual Accounting Basis	Schedule M Per Return			Earnings and Profits Current-Year Accumulated			
		DR (Debit)	CR Credit	DR (Debit)	CR (Credit)	CR BAL	KEY
12/31/96 Balance forward			$225,000 (A)			$1,200	
1997							
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 1994 federal income taxes . .			18,000 (O)				1-94
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, 12/15/97 $8.5089/SH—10,000 share distribution	$85,089 (Q)			$85,089			*
Common:							
3/15/97							
$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						
9/15/97							
$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 12/31/97			$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 Schedule M and Earnings and Profits.

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 not taxable.

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, the beginning of its tax year. X had an operating loss of $50,000 for the first 6 months, but had earnings and profits of $5,000 for the entire year. X distributed $15,000 to its shareholders on July 1.

The entire distribution is an ordinary dividend. Consider $5,000 as paid from that year's 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 the year. To figure the available earnings and profits, prorate the deficit to the date of the distribution as follows:

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

However, 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.

Also, the decrease in earnings and profits by the FMV of distributed property in the preceding paragraph is reduced for any liability to which the distributed property is subject and any liability assumed by the shareholder in connection with the distribution.

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 or other property,

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 or other property*** if any shareholders have an election to get either stock, rights to acquire stock, money, 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.

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 this distribution is one which would be subject to the rules that apply to the taxing of dividends.

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 this 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 1997, it filed Form 1120–A.

Page 1

When you prepare your return, use the preaddressed 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, ZIP code, and employer identification number in the appropriate spaces on the first page.

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

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

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

Lines 4 through 10. Other items of income are 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. The $23,000 is the salary of the company president.

Line 13. Other salaries and wages of $24,320 are entered here. 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. This includes interest both on debts for business operations and debts to carry investments. It does 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, 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 and special deductions entered on line 25b.

Line 22. Other business deductions consist of $3,000 for advertising. If there had been several expenses included in the total, Rose Flower Shop 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. Taxable income, before the net operating loss deduction and special deductions, on line 24 is $34,642. Since Rose Flower Shop did not have a net operating loss or special deduction, the same amount is shown on line 26.

Tax summary. Rose Flower Shop enters on line 27 the total tax ($5,196) from Part I, line 7, page 2. It lists payments that can be applied against the tax on line 28. The only payments on the Rose Flower Shop return are four estimated tax deposits totaling $6,000. Enter this amount on lines 28b, 28d, and 28h. The resulting overpayment is $804, which Rose Flower Shop chooses to have credited to the next year's estimated tax. Rose Flower Shop could have chosen to 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. The tax of $5,196 is entered on lines 1, 4, and 7.

Part II—Other Information. Answer all questions that apply to your business. Provide the business activity code number, business activity, and product or service information on lines (a), (b), and (c) of question 1. The business activity codes are provided in the instructions for Forms 1120 and 1120–A. 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, you need additional information from the corporation's books and records. The following profit and loss account appeared in the books of Rose Flower Shop for the calendar year.

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 appears in the profit and loss account 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** 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 1997 or tax year beginning ...., 1997, ending ...., 19....

OMB No. 1545-0890

1997

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, print or type.

10-2134567 DEC97 5995
Rose Flower Shop, Inc.
38 Superior Lane
Fair City, MD 20715

IRS

B Employer identification number

C Date incorporated: 7-1-82

D Total assets (see page 5 of 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 page 10 of 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 18 (attach Form 4797)	9	
10	Other income (see page 6 of 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 page 7 of 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	1,340
19	Charitable contributions (see page 8 of 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)	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 page 9 of instructions) — 25a; **b** Special deductions (see page 10 of 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	1996 overpayment credited to 1997 — 28a		
b	1997 estimated tax payments — 28b 6,000		
c	Less 1997 refund applied for on Form 4466 — 28c ( ) Bal ▶ 28d 6,000		
e	Tax deposited with Form 7004 — 28e		
f	Credit for tax paid on undistributed capital gains (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 page 10 of 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 1998 estimated tax ▶** 804 **Refunded ▶**	32	

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 — Signature of officer | 2-15-98 — 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 ▶ | EIN ▶ | ZIP code ▶

Part I Tax Computation (See page 12 of instructions.)

1 Income tax. If the corporation is a qualified personal service corporation (see page 13), check here ▶ ☐		1	5,196
2a General business credit. Check if from Form(s): ☐ 3800 ☐ 3468 ☐ 5884 ☐ 6478 ☐ 6765 ☐ 8586 ☐ 8830 ☐ 8826 ☐ 8835 ☐ 8844 ☐ 8845 ☐ 8846 ☐ 8820 ☐ 8847 ☐ 8861	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 page 14 of instructions.)

1 See page 16 and state the principal: **a.** Business activity code no. ▶ 5995

b Business activity ▶ Flower Shop

c Product or service ▶ Flowers

2 At the end of the tax year, did any individual, partnership, estate, or trust 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, enter amounts from worksheet on page 10:

(1) Purchases 134,014

(2) Additional sec. 263A costs (attach schedule)

(3) Other costs (attach schedule) 9,466

b If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☐ Yes ☑ No

6 At any time during the 1997 calendar year, did the corporation have an interest in or a signature or other authority over a financial account (such as a bank account, securities account, or other financial account) in a foreign country? ☐ Yes ☑ No

If "Yes," the corporation may have to file Form TD F 90-22.1

If "Yes," enter the name of the foreign country ▶

Part III Balance Sheets per Books

		(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 Additional paid-in capital		
	20 Retained earnings	10,462	39,908
	21 Adjustments to shareholders' equity (attach schedule)		
	22 Less cost of treasury stock	(36,877)	(65,987)
	23 Total liabilities and stockholders' equity		

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		
3 Excess of capital losses over capital gains		7 Deductions on this return not charged against book income this year (itemize)	
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

Form 1120

Tentex Toys, Inc., is the corporation for which this 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, ZIP code, and employer identification number in the appropriate spaces on the first page.

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, deduction, 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. Enter 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 work opportunity 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 4d, Schedule J. Only the balance, $38,000, is shown on line 13.

Note: The work opportunity credit replaces the targeted jobs credit as an incentive to hire persons from groups with a particularly high unemployment rate or other special employment needs. The work opportunity credit applies to wages you pay to a certified member of a targeted group who begins work for you after September 30, 1996, and before July 1, 1998. For more information, see Form 5884.

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 was $9,200 for the year.

Line 17. Deductible taxes totaled $15,000.

Line 18. Interest expense accrued during the year was $27,200. This includes interest both on debts for business operations and debts to carry investments. It does 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 deductions 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.*

Lines 20 and 21. Depreciation from Form 4562 (not illustrated) is $17,600. Enter it on line 20. Reduce this amount by the depreciation ($12,400) included in the amount claimed on line 5 of Schedule A and enter it on line 21a. Deduct the balance of $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, see chapter 13 of Publication 535.

Line 23. Advertising expense was $8,700.

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

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

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

Lines 28, 29, and 30. Taxable income before the net operating loss deduction and special deductions 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, page 3. List payments that you can apply against the tax on line 32. The only payments on the Tentex return are 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 the next year's estimated tax. Tentex could have chosen to have the overpayment refunded.

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

Page 2

Schedule A—Cost of Goods Sold. 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 are $402,000. This amount includes wages paid to production-line workers and the part of the supervisory salaries that was 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 9f. Check all of the boxes that apply to the business.

Schedule C—Dividends and Special Deductions. 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—Compensation of Officers. 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—Tax Computation. Use the tax rate schedules in the form instructions to figure the tax on line 3. Applying the rates to Tentex's taxable income of $200,350 results in income tax of $61,387. Decrease this amount by the work opportunity credit of $6,000, resulting in a total tax of $55,387.

Figure the work opportunity credit on Form 5884. 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 this year.

Schedule K—Other Information. Answer all questions that apply to the business.

Page 4

Schedule L—Balance Sheets. 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.

Schedules M–1 and 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:

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 from 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		
Other	500	24,500	
Depreciation—indirect		3,580	
Advertising		8,700	
Other expenses of operations		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		$238,000
Net profit (before federal income tax)		203,170
Reserve for contingencies	$10,000	
Income tax accrued for the year	55,387	
Dividends paid during the year	65,000	
Refund of 1994 income tax		18,000
Balance, December 31	328,783	
Total	$459,170	$459,170

Schedule M–1—Reconciliation of Income (Loss) per Books With Income per Return. Schedule M–1 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 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 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 these 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 work opportunity 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—Analysis of Unappropriated Retained Earnings per Books. Schedule M–2 analyzes the unappropriated retained earnings as shown in the corporation's balance sheets on 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 1994 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 1997 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 1998 for $5,000 and the attorney's fee is $2,500, Tentex will charge $7,500 to retained earnings (appropriated). It will also deduct $7,500 in arriving at taxable income for 1998. Another common example of items entered on this line is the payment of the 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 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**

Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1997 or tax year beginning .... , 1997, ending .... , 19 ...
► Instructions are separate. See page 1 for Paperwork Reduction Act Notice.

OMB No. 1545-0123

1997

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, print or type.

10-9385564 DEC97 071 3998
Tentex Toys, Inc.
36 Division Street
Anytown, IL 60930

IRS

B Employer identification number

C Date incorporated: 3-1-72

D Total assets (see page 5 of 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 18 (attach Form 4797)		9	
10	Other income (see page 6 of 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 page 8 of 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 page 9 of 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** 1996 overpayment credited to 1997	32a:			
b	1997 estimated tax payments	32b: 69,117			
c	Less 1997 refund applied for on Form 4466	32c: ( )	d Bal ► 32d: 69,117		
e	Tax deposited with Form 7004		32e:		
f	Credit for tax paid on undistributed capital gains (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 page 10 of 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 1998 estimated tax** ► 13,730 **Refunded** ►			36	

Sign Here

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

James O. Barclay — Signature of officer | 3-7-98 — 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 ► | EIN ► | ZIP code ►

Cat. No. 11450Q

Schedule A Cost of Goods Sold (See page 10 of 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	123,300
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:

(i) ☐ Cost as described in Regulations section 1.471-3

(ii) ☑ Lower of cost or market as described in Regulations section 1.471-4

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

b Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c) ▶ ☐

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

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

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☑ Yes ☐ No

f 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 page 11 of 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 page 12 of 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 page 12 of instructions.)

1	Check if the corporation is a member of a controlled group (see sections 1561 and 1563) ▶ ☐ **Important:** Members of a controlled group, see instructions on page 12.		
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 13) ▶ ☐	3	61,387
4a	Foreign tax credit (attach Form 1118) — 4a		
b	Possessions tax credit (attach Form 5735) — 4b		
c	Check: ☐ Nonconventional source fuel credit ☐ QEV credit (attach Form 8834) — 4c		
d	General business credit. Enter here and check which forms are attached: ☐ 3800 ☐ 3468 ☐ 5884 ☑ 6478 ☐ 6765 ☐ 8586 ☐ 8830 ☐ 8826 ☐ 8835 ☐ 8844 ☐ 8845 ☐ 8846 ☐ 8820 ☐ 8847 ☐ 8861 — 4d 6,000		
e	Credit for prior year minimum tax (attach Form 8827) — 4e		
5	**Total credits.** Add lines 4a through 4e	5	
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	
9	Alternative minimum tax (attach Form 4626)	9	
10	**Total tax.** Add lines 6 through 9. Enter here and on line 31, page 1	10	55,387

Schedule K — Other Information (See page 14 of instructions.)

		Yes	No
1	Check method of accounting: a ☐ Cash b ☑ Accrual c ☐ Other (specify) ▶		
2	See page 16 of the instructions and state the principal: a Business activity code no. ▶ 3998 b Business activity ▶ Manufacturing c Product or service ▶ Toys		
3	At the end of the tax year, did the corporation 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	At the end of the tax year, did any individual, partnership, corporation, estate or trust 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 1997 calendar year, did the corporation have an interest in or a signature or other authority over a financial account (such as a bank account, securities account, or other financial account) in a foreign country? If "Yes," the corporation may have to file Form TD F 90-22.1. If "Yes," enter name of foreign country ▶		√
9	During the tax year, did the corporation receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," see page 15 of the instructions for other forms the corporation may have to file		√
10	At any time during the tax year, did one foreign person 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 per Books	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 Additional paid-in capital				
24 Retained earnings—Appropriated (attach schedule)		30,000		40,000
25 Retained earnings—Unappropriated		238,000		328,783
26 Adjustments to shareholders' equity (attach schedule)				
27 Less cost of treasury stock		(684,300)		(879,417)
28 Total liabilities and stockholders' equity				

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 page 15 of instructions.)

1 Net income (loss) per books	147,783	7 Income recorded on books this year not included on this return (itemize):	
2 Federal income tax	55,387	Tax-exempt interest $ 5,000	
3 Excess of capital losses over capital gains	3,600	Insurance proceeds 9,500	
4 Income subject to tax not recorded on books this year (itemize):			14,500
5 Expenses recorded on books this year not deducted on this return (itemize):		8 Deductions on this return not charged against book income this year (itemize):	
a Depreciation $		a Depreciation $ 1,620	
b Contributions carryover $ 850		b Contributions carryover $	
c Travel and entertainment $			
See attached itemized statement (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):		c Property	
Refund of 1994 income tax due to IRS examination	18,000	6 Other decreases (itemize): Reserve for contingencies	10,000
		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

How To Get More Information

You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1–800–829–1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your income tax package for the hours of operation.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our "800 number" telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

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Tax Publications for Business Taxpayers

General Guides

- **1** Your Rights as a Taxpayer
- **17** Your Federal Income Tax (For Individuals)
- **225** Farmer's Tax Guide
- **334** Tax Guide for Small Business
- **509** Tax Calendars for 1998
- **553** Highlights of 1997 Tax Changes
- **595** Tax Highlights for Commercial Fishermen
- **910** Guide to Free Tax Services

Employer's Guides

- **15** Employer's Tax Guide (Circular E)
- **15-A** Employer's Supplemental Tax Guide
- **51** Agricultural Employer's Tax Guide (Circular A)
- **80** Federal Tax Guide For Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)
- **179** Guía Contributiva Federal Para Patronos Puertorriqueños (Circular PR)
- **926** Household Employer's Tax Guide

Specialized Publications

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- **579SP** Cómo Preparar la Declaración de Impuesto Federal
- **594SP** Comprendiendo el Proceso de Cobro
- **850** English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- **1544SP** Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

- **W-2** Wage and Tax Statement
- **W-4** Employee's Withholding Allowance Certificate
- **940** Employer's Annual Federal Unemployment (FUTA) Tax Return
- **940EZ** Employer's Annual Federal Unemployment (FUTA) Tax Return
- **1040** U.S. Individual Income Tax Return
  - **Sch A** Itemized Deductions
  - **Sch B** Interest and Dividend Income
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