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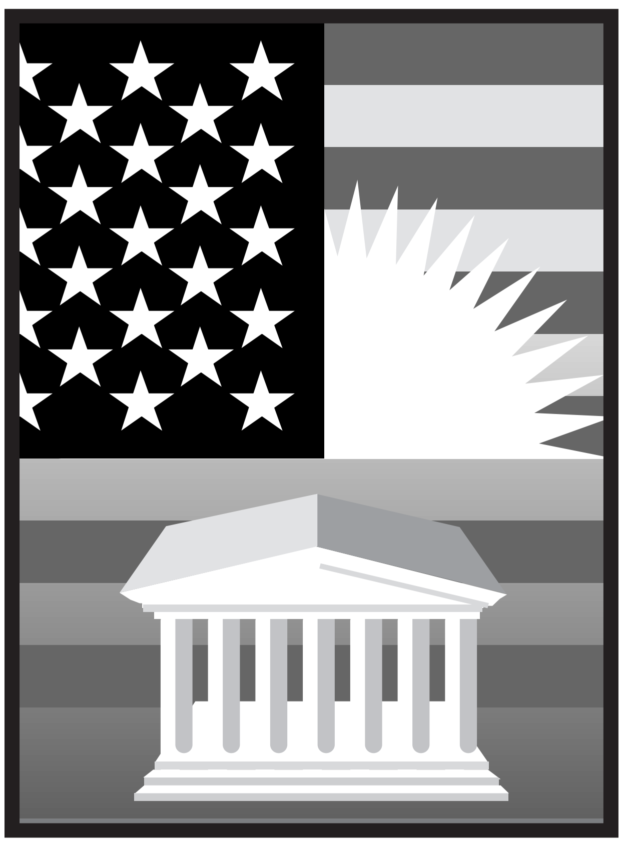
Corporations

For use in preparing

1998 Returns



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Introduction

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

Some corporations may meet the qualifications for electing to be S corporations. For 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.

Important Change for 1998

No alternative minimum tax (AMT) for small corporations. For tax years beginning after 1997, the tentative minimum tax of a small corporation is zero. This means that a small corporation will not owe AMT.

For AMT purposes, a corporation is a small corporation if it meets ***any*** of the following tests.

1) This is its first tax year.
2) This is its second tax year and its annual gross receipts for its first tax year were not more than $5,000,000.
3) This is its third tax year and its average annual gross receipts for its first two tax years were not more than $5,000,000.
4) This is its fourth tax year and its average annual gross receipts for its first three tax years were not more than $5,000,000.
5) This is its fifth or later tax year and it meets both of the following tests.
   a) Its average annual gross receipts for its first 3-tax-year period beginning after 1993 were not more than $5,000,000.
   b) Its average annual gross receipts for all later 3-tax-year periods beginning after 1993 and ending before the current tax year were not more than $7,500,000.

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

For more information on the AMT, see *Alternative Minimum Tax (AMT).*

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 1–877–777–4778 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

- ☐ **526** Charitable Contributions
- ☐ **535** Business Expenses
- ☐ **536** Net Operating Losses
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **925** Passive Activity and At-Risk Rules
- ☐ **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
- ☐ **3800** General Business Credit
- ☐ **4562** Depreciation and Amortization
- ☐ **4626** Alternative Minimum Tax—Corporations
- ☐ **5452** Corporate Report of Nondividend Distributions
- ☐ **7004** Application for Automatic Extension of Time To File Corporation Income Tax Return
- ☐ **8832** Entity Classification Election

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

Business Taxed as a Corporation

The rules you must use to determine whether a business is taxed as a corporation changed for businesses formed after 1996.

Business formed before 1997. A business formed before 1997 and taxed as a corporation under the old rules will generally continue to be taxed as a corporation.

Business 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 it as a corporation, body corporate, or body politic.
2) A business formed under a state law that refers to it 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 that elects to be taxed as a corporation by filing Form 8832.

For more information, see the instructions for Form 8832.

Nontaxable Exchange of Property for Stock

If you transfer property (or money and property) to a corporation in exchange for stock in that corporation (other than nonqualified preferred stock, described later), and immediately afterwards you are in control of the corporation, the exchange is usually not taxable. This rule applies both to individuals and to groups who transfer property to a corporation. It also applies whether the corporation is being formed or is already operating. It does not apply in the following situations.

- The corporation is an investment company.
- You transfer the property in a bankruptcy or similar proceeding in exchange for stock used to pay creditors.
- The stock is received in exchange for the corporation's debt (other than a security), or for interest on the corporation's debt (including a security) that accrued while you held the debt.

If this provision applies to you, you must attach to your return a complete statement of all facts pertinent to the exchange.

Control of a corporation. To be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock.

Example 1. You and Bill Jones purchase property for $100,000. You both organize a corporation when the property has a fair market value of $300,000. You transfer the property to the corporation for all its authorized capital stock, which has a par value of $300,000. No gain is included in income by you, Bill, or the corporation.

Example 2. You and Bill transfer the property having a basis of $100,000 to a corporation in exchange for stock having a fair market value of $300,000. This represents only 75% of each class of stock of the corporation. The other 25% already was issued to someone else. You and Bill recognize a taxable gain of $200,000 on the transaction.

Services rendered. The term ***property*** does not include services rendered or to be rendered to the issuing corporation. The value of stock received for services is income to the recipient.

Example. You transfer property worth $35,000 and render services valued at $3,000 to a corporation in exchange for stock valued at $38,000. Right after the exchange you own 85% of the outstanding stock. No gain is included in income on the exchange of property. However, you recognize ordinary income of $3,000 as payment for services you rendered to the corporation.

Property of relatively small value. The term ***property*** does not include property of a relatively small value when it is compared to the value of stock and securities already owned or to be received for services by the transferor, if the main purpose of the transfer is to qualify for the nonrecognition of gain or loss by other transferors.

Property transferred will not be considered to be of relatively small value if its fair market value is at least 10% of the fair market value of the stock and securities already owned or to be received for services by the transferor.

Stock received in disproportion to property transferred. If a group of transferors exchange property for corporate stock, each transferor does not have to receive stock in proportion to his or her interest in the property transferred. If a disproportionate transfer takes place, it will be treated for tax purposes in accordance with its true nature. It may be treated as if the stock were first received in proportion and then some of it used to make gifts, pay compensation for services, or satisfy the transferor's obligations.

Money or other property received. If, in an otherwise nontaxable exchange of property for corporate stock, you also receive money or property other than stock, you may have a taxable gain. You are taxed only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring the taxable gain in this situation generally follow those for a partially nontaxable exchange discussed in Publication 544 under *Like-Kind Exchanges.* If the property you give up includes depreciable property, the taxable gain may have to be reported as ordinary income because of depreciation. No loss is recognized. See chapter 3 of Publication 544.

Nonqualified preferred stock. Nonqualified preferred stock is treated as property other than stock. Generally, this applies to preferred stock with one or more of the following features.

- The holder has the right to require the issuer or a related person to redeem or purchase the stock.
- The issuer or a related person is required to redeem or purchase the stock.
- The issuer or a related person has the right to redeem the stock and, on the issue date it is more likely than not that the right will be exercised.
- The dividend rate on the stock varies with reference to interest rates, commodity prices, or similar indices.

For a detailed definition of nonqualified preferred stock, see section 351(g)(2) of the Internal Revenue Code.

Liabilities. If the corporation assumes your liabilities, or the property is taken subject to a liability, the exchange is not generally treated as if you received money or other property. There are two exceptions to this treatment.

1) If the liabilities the corporation assumes are more than your adjusted basis in the property you transfer, gain is recognized up to the amount of the excess. However, if the liabilities assumed give rise to a deduction when paid, such as a trade account payable or interest, no gain is recognized.
2) If there is no good business reason for the corporation to assume your liabilities, or if your main purpose in the exchange is to avoid federal income tax, the assumption is treated as if you received money in the amount of the liabilities.

Example. You transfer property to a corporation for stock. You also receive $10,000 in the exchange. Your adjusted basis in the transferred property is $20,000. The stock you receive has a fair market value (FMV) of $16,000. The corporation also assumes a $5,000 mortgage on the property. Gain is realized as follows:

FMV of stock received	$16,000
Cash received	10,000
Liability assumed by corporation	5,000
Total received	$31,000
Minus: Adjusted basis of property transferred	20,000
Realized gain	$11,000

The liability assumed is not treated as money or other property. Therefore, the recognized gain is limited to $10,000, the amount of cash received.

Loss on exchange. If you have a loss from an exchange and own, directly or indirectly, more than 50% of the corporation's stock, you cannot deduct the loss. This is true even if you do not control the corporation (own less than 80% of its stock). For more information, see *Sales and Exchanges Between Related Parties* and its discussion *Nondeductible Loss* in chapter 2 of Publication 544.

Basis of stock or other property received. The basis of the stock you receive is generally the adjusted basis of the property you transfer. Increase this amount by any amount that was treated as a dividend, plus any gain recognized on the exchange. Decrease this amount by any cash you received, the fair market value of any other property you received, and any loss recognized on the exchange. Also decrease this amount by the amount of any liability the corporation assumed or acquired from you, unless payment of the liability gives rise to a deduction when paid.

The basis of any other property you receive is its fair market value on the date of the trade.

Basis of property transferred. A corporation that receives property from you in exchange for its stock has the same basis you had in the property increased by any gain you recognized on the exchange.

Capital Contributions

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. The basis of property contributed to capital by a shareholder is the same as the basis the shareholder had in the property increased by any gain recognized on the exchange.

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.
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.

Paying and Filing Income Taxes

The federal income tax is a pay-as-you-go tax. A corporation generally must make estimated tax payments as it earns or receives income during its tax year. After the end of the year, the corporation must file an income tax return. This section will help you determine when and how to pay and file corporate income taxes.

Estimated Tax

Generally, a corporation must make installment payments of estimated tax if it expects its estimated tax (income tax minus credits) to be $500 or more. If the corporation does not pay the installments when they are due, it may be subject to an underpayment penalty. This section will explain how to 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 the corporation's tax year.

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.

If any date falls on a Saturday, Sunday, or legal holiday, the installment is due on the next regular business day.

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 the corporation will show on its return for the current year.

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

To use Method 2:

1) The corporation must have filed a return 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 the corporation is a large corporation, it can use Method 2 to figure only the first installment.

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 a corporation's income is expected to vary during the year because, for example, its business is seasonal, it 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 the corporation figures and deposits estimated tax, it finds that its tax liability for the year will be much more or less than originally estimated, it may have to refigure its required installments. If earlier installments were underpaid, the corporation may owe an underpayment penalty.

An immediate catchup payment should be made 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.

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

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

If the corporation is 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.

A corporation generally does not have to file Form 2220 with its 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) The annualized income installment method was used to figure any required installment,
2) The adjusted seasonal installment method was used to figure any required installment, or
3) The corporation is a large corporation and Method 2 was used to figure its first required installment.

How to pay estimated 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 1120–W.

Electronic deposits. Use the ***Electronic Federal Tax Payment System (EFTPS)*** to make electronic deposits of tax. A corporation is required to use EFTPS for the following tax payments.

- For all tax payments due after June 1997, if the corporation's total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in 1995.
- For all tax payments due after 1997, if the corporation's total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in 1996.
- For all tax payments due after 1998, if the corporation's total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in 1997.

If you are required to use EFTPS and do not do so, you may be subject to a penalty. 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.

Quick refund of overpayments. Any corporation that overpaid its estimated tax for the tax year 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) The corporation files its 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.

Income Tax Returns

This section will help you determine when and how to report a corporation's income tax.

Who must file. Unless exempt under section 501 of the Internal Revenue Code, all domestic corporations (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income.

What form to file. A corporation must generally file ***Form 1120*** to report its income, gains, losses, deductions, credits, and to figure its income tax liability. However, a corporation may file ***Form 1120–A*** if its gross receipts, total income, and total assets are each under $500,000 and it meets certain other requirements. Also, certain organizations must file special returns. For more information, see the instructions for Forms 1120 and 1120–A.

When to file. Generally, a corporation must file its income tax return by the 15th day of the 3rd month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 3rd month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved.

Example 1. A corporation's tax year ends December 31. It must file its income tax return by March 15th.

Example 2. A corporation's tax year ends June 30. It must file its income tax return by September 15th.

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

Extension of time to file. File ***Form 7004*** to request a 6-month extension of time to file a corporation's income tax return. The IRS will grant the extension if the corporation completes the form properly, files it, and pays any balance due by the due date for the return for which the extension applies.

Form 7004 does not extend the time for paying the tax due on the return. Interest will be charged on any part of the final tax due not shown as a balance due on 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.

Penalty for late filing of return. A corporation that does not file its tax return by the due date, including extensions, may be penalized 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 the 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 minimum penalty for a return that is over 60 days late is the smaller of the tax due or $100. The penalty will not be imposed if the corporation can show that the failure to file on time was due to a reasonable cause. Corporations that file late must attach a statement explaining the reasonable cause.

Penalty for late payment of tax. A corporation that does not pay the tax when due may be penalized $\frac{1}{2}$ 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 penalty will not be imposed if the corporation can show that the failure to pay on time was due to a reasonable cause. However, this penalty does not apply to late payments of required installments of estimated tax.

Trust fund recovery penalty. If income, social security, and Medicare taxes that a corporation must withhold from employee wages are not withheld or are not deposited or paid to the IRS, the trust fund recovery penalty may apply. The penalty is the full amount of the unpaid trust fund tax. This penalty may apply to you if these unpaid taxes cannot be immediately collected from the business.

The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so.

A ***responsible person*** can be an officer or employee of a corporation, an accountant, or a volunteer director/trustee. A responsible person also may include one who signs checks for the corporation or otherwise has authority to cause the spending of business funds.

Willfully means voluntarily, consciously, and intentionally. A responsible person acts willfully if the person knows the required actions are not taking place.

For more information on withholding and paying these taxes, see Publication 15, *Circular E, Employer's Tax Guide.*

Amended return. Use ***Form 1120X*** to correct any error in a Form 1120 or Form 1120–A as originally filed, or as later adjusted by an amended return, a claim for refund, or an examination.

Income and Deductions

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.

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 1998, 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 1995. In 1995, 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 1998 first from the net short-term gain. This results in a net capital gain for 1995 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.

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.

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

Publication 78. 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 can find an electronic version of Publication 78 on the IRS Home Page at www.irs.ustreas.gov/prod/bus_info/eo/eosearch.html.

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 $2\frac{1}{2}$ 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.

- 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 1997 and it does not use all the excess on its return for 1998, it can carry the rest over to 1999, 2000, 2001, and 2002. 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.

Corporate Preference Items

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 3 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 the following entities.

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 during the 90-day period beginning 45 days before the stock becomes ex-dividend with respect to the dividend.
4) 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.
5) 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 the following items.

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 *Extraordinary Dividends,* later).
4) The deduction for contributions to a Capital Construction Fund (CCF).
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%).

Extraordinary Dividends

If a corporation receives an extraordinary dividend on stock held 2 years or less before the dividend announcement date, it generally must reduce its basis in the stock by the nontaxed part of the dividend. The nontaxed part is any dividends-received deduction allowable for the dividends.

Extraordinary dividend. 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.

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 it was issued under a written binding contract in effect on that date and thereafter before the issuance of the stock.

More information. For more information on extraordinary dividends, see Internal Revenue Code section 1059.

Going Into Business

When you go into business, treat all costs you incur to get your business started as capital expenses. Capital expenses are part of your basis in the business. Generally, you recover costs for particular assets through depreciation deductions. However, you generally cannot recover other costs until you sell the business or otherwise go out of business. See *Capital Expenses* in chapter 1 of Publication 535 for a discussion of how to treat these costs if you do not go into business.

You can elect to amortize certain costs for setting up your business. To be amortizable, the cost must qualify as one of the following.

1) A business start-up cost.
2) An organizational cost.

Business start-up costs. Start-up costs are costs for setting up an active trade or business or investigating the possibility of creating or acquiring an active trade or business. Start-up costs include any amounts paid or incurred in connection with any activity engaged in for profit and for the production of income before the trade or business begins, in anticipation of the activity becoming an active trade or business.

To be amortizable, your start-up cost must meet both of the following tests.

1) It must be a cost you could deduct if you paid or incurred it to operate an existing active trade or business.
2) You must pay or incur the cost before the day your active trade or business begins.

Start-up costs ***include*** what you pay for investigating a prospective business and getting the business started. They may include costs for the following items.

- A survey of potential markets.
- An analysis of available facilities, labor, supplies, etc.
- Advertisements for the opening of the business.
- Salaries and wages for employees who are being trained, and their instructors.
- Travel and other necessary costs for securing prospective distributors, suppliers, or customers.
- Salaries and fees for executives and consultants, or for other professional services.

Start-up costs ***do not include*** deductible interest, taxes, and research and experimental costs.

Disposition of business. You can deduct any remaining deferred start-up costs for the business if you completely dispose of your business before the end of the amortization period. However, you can only deduct these deferred start-up costs to the extent they qualify as a loss from a business.

Organizational costs. The costs of organizing a corporation are the direct costs of creating the corporation.

Qualifying costs. You can amortize an organizational cost only if it meets all three of the following tests.

1) It must be for the creation of the corporation.
2) It must be chargeable to a capital account.
3) You could amortize the cost over the life of the corporation, if the corporation had a fixed life.

You must have incurred the cost before the end of the first tax year in which the corporation was in business. A corporation using the cash method of accounting can amortize organizational expenses incurred within the first tax year, even if it does not pay them in that year.

The following are examples of organizational costs.

- Expenses of temporary directors.
- The cost of organizational meetings.
- State incorporation fees.
- Accounting services for setting up the organization.
- The cost of legal services (such as drafting the charter, bylaws, terms of the original stock certificates, and minutes of organizational meetings).

Costs you cannot amortize. You cannot amortize costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs, because they are not organizational costs. Also, you cannot amortize costs associated with the transfer of assets to the corporation. You must capitalize these costs.

How to amortize. You deduct start-up and organizational costs in equal amounts over a period of 60 months or more. You can elect a period for start-up costs that is different from the period you elect for organizational costs, as long as both are 60 months or more. Once you elect an amortization period, you cannot change it.

To figure your deduction, divide your total start-up or organizational costs by the months in the amortization period. The result is the amount you can deduct each month.

When to begin amortization. The amortization period starts with the month you begin business operations.

Making the election. You must complete Part VI of Form 4562 and attach it to your income tax return. You must also attach one or more statements to your return. If you have both start-up and organizational costs, attach a separate statement to your return for each type of cost. Each statement should have the following information.

- The total start-up or organizational costs you will amortize.
- What each cost is for.
- The date each cost was incurred.
- The month your active business began (or the month you acquired the business).
- The number of months in your amortization period (not less than 60).

Attach Form 4562 and the accompanying statements to your return for the first tax year you are in business. You must file the return by the due date (including any extensions).

Only your corporation can elect to amortize its start-up or organizational costs. A shareholder cannot make this election.

You cannot amortize any costs you incur in setting up your corporation. The corporation can amortize these costs, but only if it reimburses you for them. These costs then become part of the basis of your interest in the business. You can recover them only when you sell your interest in the corporation.

Related Persons

The related person rules apply to the following entities.

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.
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 persons. They also deny the deduction of certain unpaid business expenses and interest on transactions between the persons. 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.

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 persons 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 persons. A corporation's deduction for interest expense may be limited if it paid (or accrued) interest to related persons ***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 person is not subject to U.S. income tax on the interest income. For example, the related person 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.

U.S. Real Property Interest

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, *Withholding of Tax on Nonresident Aliens and Foreign Corporations.*

Figuring Taxable Income

You can figure a corporation's taxable income by subtracting its allowable deductions from its income on page 1 of Form 1120 or 1120–A. This section discusses some special rules that may apply to the following corporations.

- Any corporation whose deductions for the year are more than its income.
- A closely held corporation.
- A personal service corporation.

Net Operating Losses

If a corporation's deductions for the year are more than its income for the year, the corporation has a net operating loss (NOL). A corporation can use an NOL by deducting it from income in another year or years. However, there are rules for figuring the NOL that either limit what it can deduct or permit deductions not ordinarily allowed.

For more information on how to figure an NOL, when to use it, how to claim an NOL deduction, and how to figure an NOL carryover, see Publication 536.

At-Risk Limits

The at-risk rules limit your losses from most activities to your amount at risk in the activity. The at-risk limits apply to certain closely held corporations (other than S corporations).

Closely held corporation. For the at-risk rules, a corporation is a closely held corporation if at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned directly or indirectly by or for five or fewer individuals.

To figure if more than 50% in value of the stock is owned by five or fewer individuals, apply the following rules.

1) Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by its shareholders, partners, or beneficiaries.
2) An individual is considered to own the stock owned directly or indirectly by or for his or her family. Family includes only brothers and sisters (including half-brothers and half-sisters), a spouse, ancestors, and lineal descendants.
3) If a person holds an option to buy stock, he or she is considered to be the owner of that stock.
4) When applying rule (1) or (2), stock considered owned by a person under rule (1) or (3) is treated as actually owned by that person. Stock considered owned by an individual under rule (2) is not treated as owned by the individual for again applying rule (2) to consider another the owner of that stock.
5) Stock that may be considered owned by an individual under either rule (2) or (3) is considered owned by the individual under rule (3).

More information. For more information on the at-risk limits, see Publication 925.

Passive Activity Limits

The passive activity rules generally limit your losses from passive activities to your passive activity income. Generally, you are in a passive activity if you have a trade or business activity in which you do not materially participate during the tax year, or a rental activity.

The passive activity rules apply to personal service corporations and closely held corporations.

Personal service corporation. For the passive activity rules, a corporation is a personal service corporation if it meets all of the following requirements.

1) It is not an S corporation.
2) Its principal activity during the "testing period" is performing personal services. The testing period for any tax year is the previous tax year. If the corporation has just been formed, the testing period begins on the first day of its tax year and ends on the earlier of:
   a) The last day of its tax year, or
   b) The last day of the calendar year in which its tax year begins.
3) Its employee-owners substantially perform the services in (2). This requirement is met if more than 20% of the corporation's compensation cost for its activities of performing personal services during the testing period is for personal services performed by employee-owners.
4) Its employee-owners own more than 10% of the fair market value of its outstanding stock on the last day of the testing period.

Personal services. Personal services are those in any of the following fields.

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

Employee-owners. A person is an employee-owner of a personal service corporation if both of the following apply.

1) He or she is an employee of the corporation, or performs personal services for or on behalf of the corporation as an independent contractor, on any day of the testing period.
2) He or she owns any stock in the corporation at any time during the testing period.

Closely held corporation. For the passive activity rules, a corporation is closely held if all of the following apply.

1) It is not an S corporation.
2) It is not a personal service corporation, defined earlier.
3) At any time during the last half of the tax year, more than 50% of the value of its outstanding stock is directly or indirectly owned by five or fewer individuals. “Individual” includes certain trusts and private foundations.

More information. For more information on the passive activity limits, see Publication 925.

Figuring Tax

After you figure a corporation's taxable income, you can figure its tax on Schedule J (Form 1120) or Part I (Form 1120–A). This section discusses the tax rate schedule, credits, recapture taxes, and the alternative minimum tax.

Tax Rate Schedule

Most corporations figure their tax by using the following tax rate schedule. This section discusses an exception that applies to qualified personal service corporations. Other exceptions are discussed in the instructions for Schedule J, Form 1120 (Part I, Form 1120–A).

Tax Rate Schedule

If taxable income 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

Qualified personal service corporation. A qualified personal service corporation is taxed at a flat rate of 35% on taxable income. A corporation is a qualified personal service corporation if it meets ***both*** of the following tests.

1) Substantially all of the corporation's activities involve the performance of personal services (as defined earlier under *Personal services*).
2) At least 95% of the corporation's stock, by value, is owned, directly or indirectly, by any of the following.
   a) Employees performing the services.
   b) Retired employees who had performed the personal services.
   c) Any estate of the employee or retiree described above.
   d) Any person who acquired the stock of the corporation as a result of the death of an employee or retiree (but only for the 2-year period beginning on the date of the employee's or retiree's death).

See section 1.448–1T of the Regulations for details.

Credits

A corporation's tax liability is reduced if it can take any credits. The following list includes some credits that are available to corporations.

- Credit for federal tax on fuels used for certain purposes (see Publication 378).
- Credit for prior year minimum tax (see Form 8827).
- Foreign tax credit (see Form 1118).
- General business credit (see *General business credit,* later).
- Nonconventional source fuel credit (see Internal Revenue Code section 29).
- Possessions tax credit (see Form 5735).
- Qualified electric vehicle credit (see Form 8834).

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

- 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 (Form 8861).
- 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 a 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 used to claim each credit is shown in parentheses. In addition to the credit form, you may also need to file Form 3800.

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

- You have more than one of the credits listed earlier (other than the empowerment zone employment credit).
- You have a carryback or carryforward of any of these credits (other than the empowerment zone employment credit).
- 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.

Recapture Taxes

A corporation's tax liability is increased if it must recapture credits that it has taken in prior years. The following list includes some credits that a corporation may need to recapture.

- Indian employment credit (see the instructions for Form 8845).
- Investment credit (see Form 4255).
- Low-income housing credit (see Form 8611).
- Qualified electric vehicle credit (see the instructions for Form 8834).

Alternative Minimum Tax (AMT)

The tax laws give special treatment to some types of income and allow special deductions and credits for some types of expenses. These laws enable some corporations with substantial economic income to significantly reduce their regular tax. The purpose of the corporate alternative minimum tax (AMT) is to ensure that these corporations pay a minimum amount of tax on their economic income. A corporation owes AMT if its tentative minimum tax is more than its regular tax.

Tentative minimum tax of a small corporation. For tax years beginning after 1997, the tentative minimum tax of a small corporation is zero. This means that a small corporation will not owe AMT.

Small corporation. For AMT purposes, a corporation is a small corporation if it meets ***any*** of the following tests.

1) This is its first tax year.
2) This is its second tax year and its annual gross receipts for its first tax year were not more than $5,000,000.
3) This is its third tax year and its average annual gross receipts for its first two tax years were not more than $5,000,000.
4) This is its fourth tax year and its average annual gross receipts for its first three tax years were not more than $5,000,000.
5) This is its fifth or later tax year and it meets both of the following tests.
   a) Its average annual gross receipts for its first 3-tax-year period beginning after 1993 were not more than $5,000,000.
   b) Its average annual gross receipts for all later 3-tax-year periods beginning after 1993 and ending before the current tax year were not more than $7,500,000.

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

Form 4626. Use Form 4626 to figure the tentative minimum tax of a corporation that is not a small corporation for AMT purposes.

Accumulated Earnings Tax

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 any of the following fields.

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

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 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 1998. 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 1998		62,225	
Total		$1,864,500	$1,864,500

The corporation analyzed the retained earnings and the following items 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 1995 income tax		18,000
Balance, December 31	233,736	
Total	$446,050	$446,050

The following items appear 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

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 16 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		
3 Excess of capital losses over capital gains	3,600		
4 Income subject to tax not recorded on books this year (itemize):		**8** Deductions on this return not charged against book income this year (itemize):	
5 Expenses recorded on books this year not deducted on this return (itemize):		**a** Depreciation $ 1,000	
a Depreciation $		**b** Contributions carryover $	
b Contributions carryover $ 500			
c Travel and entertainment $ See attached itemized statement (not shown) $10,850	11,350		1,000
		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 - 1995 income tax		**c** Property	
		6 Other decreases (itemize): Reserve for contingencies	10,000
	18,000	**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

to the return. These include the following expenses.

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 1995 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 1998 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 1999 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 1999. 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 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 nontaxable.

If the distributions are either partly or completely nontaxable because they exceed current and accumulated earnings and profits, the corporation attaches Form 5452 to its income tax return. See the instructions to Form 5452 for more information. With Form 5452, you will need to attach computations of current and accumulated earnings and profits along with schedules reconciling earnings and profits with taxable income and retained earnings. One format for showing the computation of current year earnings and profits is shown later. See Table 1.

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, 1997, were $1,200. It made cash distributions during its 1998 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, 1998, to common shareholders is a taxable dividend to the extent of $27,318 (99.33%), and the $27,500 distribution on September 15, 1998, to common shareholders is a taxable dividend

Table 1. **Welldon Corporation Current-Year Computation of Earnings and Profits Calendar Tax Year 1998**

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**
12/31/97 Balance forward				$225,000 (A)			$1,200	
1998								
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 1995 federal income taxes				18,000 (O)				1-95
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, 12/15/98								
$8.5089/SH—10,000 share distribution		$85,089 (Q)			$85,089			*
Common:								
3/15/98								
$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						
9/15/98								
$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 12/31/98				$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.

to the extent of $26,118 (94.97%). The balance of retained earnings in Schedule M–2 as of December 31, 1998, is $233,736, but earnings and profits has a zero balance.

Explanation of Items in Table 1

This section contains explanations of items (A) through (Y) in Table 1.

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 1995 income tax and affects the earnings and profits of a prior year.

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

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

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

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

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

U) Same as item (R).

V) Same as item (T).

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

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

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

For more information, see Revenue Procedure 75–17 in Cumulative Bulletin 1975–1 on page 677.

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 cancels 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 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 the corporation can establish to the satisfaction of the IRS that the distribution will not result in a disproportionate distribution.
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 the following.

- 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.
- 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 1998, it filed Form 1120–A.

Page 1

When you prepare your return, use the pre-addressed label sent to you by the IRS. It is designed to expedite processing and prevent errors. If you do not have a pre-addressed label, enter your corporation's name, street address, city, state, 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 have changed for tax years beginning after 1997. The new 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 1998 or tax year beginning ______, 1998, ending ______, 19 ____

OMB No. 1545-0890

1998

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 DEC98 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 11 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	1997 overpayment credited to 1998	28a					
b	1998 estimated tax payments	28b	6,000				
c	Less 1998 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 1999 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 | 2-15-99 — 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 13 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 15 of instructions.)

1 See page 17 and state the: **a** Business activity code no. **(NEW)** ▶ 453110
b Business activity ▶ Florist
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 11:

(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 1998 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	7	Deductions on this return not charged against book income this year (itemize)	
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize)				
5	Expenses recorded on books this year not deducted on this return (itemize)		8	Income (line 24, page 1). Enter the sum of lines 1 through 5 less the sum of lines 6 and 7	34,642

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 is an incentive to hire persons from groups with a particularly high unemployment rate or other special employment needs.

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. The business activity codes for line 2a have changed for tax years beginning after 1997. The new codes are provided in the instructions for Forms 1120 and 1120–A.

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 1995 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 expenses.

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 1995 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 1998 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 1999 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 1999. 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** U.S. Corporation Income Tax Return — OMB No. 1545-0123 — 1998

Department of the Treasury
Internal Revenue Service

For calendar year 1998 or tax year beginning ...., 1998, ending ...., 19 ...
► Instructions are separate. See page 1 for Paperwork Reduction Act Notice.

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 DEC98 071 3998
Tentex Toys, Inc.
36 Division Street
Anytown, IL 60930

I R S

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 12)			31	55,387
32	**Payments: a** 1997 overpayment credited to 1998 — 32a				
b	1998 estimated tax payments — 32b 69,117				
c	Less 1998 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 1999 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 | 3-7-99 — 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 13 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 13.		
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 if a qualified personal service corporation under section 448(d)(2) (see 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	6,000
6	Subtract line 5 from line 3	6	55,387
7	Personal holding company tax (attach Schedule PH (Form 1120))	7	
8	Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611	8	
9	Alternative minimum tax (attach Form 4626)	9	
10	Add lines 6 through 9	10	55,387
11	Qualified zone academy bond credit (attach Form 8860)	11	
12	**Total tax.** Subtract line 11 from line 10. Enter here and on line 31, page 1	12	55,387

Schedule K — Other Information (See page 15 of instructions.)

		Yes	No
1	Check method of accounting: **a** ☐ Cash **b** ☑ Accrual **c** ☐ Other (specify) ►		
2	See page 17 of the instructions and state the:		
a	Business activity code no. (**NEW**) ► 339900		
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 sections 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 1998 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," the corporation may have to file Form 3520		√
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 16 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			
3	Excess of capital losses over capital gains	3,600		Tax-exempt interest $ 5,000	
4	Income subject to tax not recorded on books this year (itemize):			Insurance proceeds 9,500	14,500
			8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):				
a	Depreciation $		a	Depreciation $ 1,620	
b	Contributions carryover $ 850		b	Contributions carryover $	
c	Travel and entertainment $ See attached itemized statement (not shown) $16,850				1,620
		17,700	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 1995 income tax		6	Other decreases (itemize): Reserve for contingencies	10,000
	due to IRS examination	18,000	7	Add lines 5 and 6	75,000
4	Add lines 1, 2, and 3	403,783	8	Balance at end of year (line 4 less line 7)	328,783

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W-4 Employee's Withholding Allowance Certificate*	10220
940 Employer's Annual Federal Unemployment (FUTA) Tax Return*	11234
940EZ Employer's Annual Federal Unemployment (FUTA) Tax Return*	10983
941 Employer's Quarterly Federal Tax Return	17001
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Sch A & B Itemized Deductions & Interest and Ordinary Dividends*	11330
Sch C Profit or Loss From Business*	11334
Sch C-EZ Net Profit From Business*	14374
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1120 U.S. Corporation Income Tax Return	11450
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8283 Noncash Charitable Contributions*	62299
8300 Report of Cash Payments Over $10,000 Received in a Trade or Business*	62133
8582 Passive Activity Loss Limitations*	63704
8606 Nondeductible IRAs*	63966
8822 Change of Address*	12081
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1544SP Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See *How To Get More Information* for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog numbers when ordering.

Form Number and Title	Catalog Number
1040 U.S. Individual Income Tax Return	11320
Sch A & B Itemized Deductions & Interest and Ordinary Dividends	11330
Sch C Profit or Loss From Business	11334
Sch C-EZ Net Profit From Business	14374
Sch D Capital Gains and Losses	11338
Sch E Supplemental Income and Loss	11344
Sch EIC Earned Income Credit	11339
Sch F Profit or Loss From Farming	11346
Sch H Household Employment Taxes	12187
Sch J Farm Income Averaging	25513
Sch R Credit for the Elderly or the Disabled	11359
Sch SE Self-Employment Tax	11358
1040A U.S. Individual Income Tax Return	11327
Sch 1 Interest and Ordinary Dividends for Form 1040A Filers	12075
Sch 2 Child and Dependent Care Expenses for Form 1040A Filers	10749
Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers	12064
1040EZ Income Tax Return for Single and Joint Filers With No Dependents	11329
1040-ES Estimated Tax for Individuals	11340
1040X Amended U.S. Individual Income Tax Return	11360
2106 Employee Business Expenses	11700
2106-EZ Unreimbursed Employee Business Expenses	20604
2210 Underpayment of Estimated Tax by Individuals, Estates and Trusts	11744
2441 Child and Dependent Care Expenses	11862
2848 Power of Attorney and Declaration of Representative	11980
3903 Moving Expenses	12490
4562 Depreciation and Amortization	12906
4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return	13141
4952 Investment Interest Expense Deduction	13177
5329 Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs	13329
6251 Alternative Minimum Tax–Individuals	13600
8283 Noncash Charitable Contributions	62294
8582 Passive Activity Loss Limitations	63704
8606 Nondeductible IRAs	63966
8812 Additional Child Tax Credit	10644
8822 Change of Address	12081
8829 Expenses for Business Use of Your Home	13232
8863 Education Credits	25379