Department of the Treasury
Internal Revenue Service

Publication 542
Cat. No. 15072O

Corporations

For use in preparing
2003 Returns

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Contents

Important Change for 2003

Accumulated earnings tax. Effective January 1, 2003, the accumulated earnings tax has decreased from 38% to 15%. For more information, see *Accumulated Earnings Tax*.

Important Reminders

Reportable transactions. You must file **Form 8886,** *Reportable Transaction Disclosure Statement,* to report certain transactions. Reportable corporate transactions include:

1) Transactions that are the same as or substantially similar to tax avoidance transactions identified by the IRS,
2) Transactions offered to you under conditions of confidentiality,
3) Transactions for which you have, or a related party has, contractual protection against disallowance of the tax benefits,
4) Transactions that result in losses of at least $10 million in any single year or $20 million in any combination of years,
5) Transactions resulting in book-tax differences of more than $10 million in any year, and
6) Transactions with asset holding periods of 45 days or less and that result in a tax credit of more than $250,000.

For more information, see the *Instructions for Form 8886.*

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1–800–THE–LOST (1–800–843–5678)** if you recognize a child.

Introduction

This publication discusses the general tax laws that apply to ordinary domestic corporations. It explains the tax law in plain language so it will be easier to understand. However, the information given does not cover every situation and is not intended to 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, *U.S. Income Tax Return for an S Corporation.*

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can email us at ***taxforms@irs.gov**. Please put “Publications Comment” on the subject line.

You can write to us at the following address:

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We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

Useful Items

You may want to see:

Publication

- ❏ **535** Business Expenses
- ❏ **538** Accounting Periods and Methods
- ❏ **544** Sales and Other Dispositions of Assets
- ❏ **925** Passive Activity and At-Risk Rules

Form (and Instructions)

- ❏ **1096** Annual Summary and Transmittal of U.S. Information Returns
- ❏ **1099–DIV** Dividends and Distributions
- ❏ **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
- ❏ **1138** Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback
- ❏ **1139** Corporation Application for Tentative Refund
- ❏ **2220** Underpayment of Estimated Tax by Corporations
- ❏ **3800** General Business Credit
- ❏ **4466** Corporation Application for Quick Refund of Overpayment of Estimated Tax
- ❏ **4562** Depreciation and Amortization (Including Information on Listed Property)
- ❏ **4626** Alternative Minimum Tax—Corporations
- ❏ **5452** Corporate Report of Nondividend Distributions
- ❏ **7004** Application for Automatic Extension of Time To File Corporation Income Tax Return
- ❏ **8109** Federal Tax Deposit Coupon
- ❏ **8810** Corporate Passive Activity Loss and Credit Limitations
- ❏ **8832** Entity Classification Election

See *How To Get Tax Help* 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.

- A business formed under a federal or state law that refers to it as a corporation, body corporate, or body politic.
- A business formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.
- Certain banks.
- A business wholly owned by a state or local government.
- A business specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign businesses.
- Any other business that elects to be taxed as a corporation by filing **Form 8832**.

For more information, see the instructions for Form 8832.

Property Exchanged 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 afterward 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.

TIP *Both the corporation and any person involved in a nontaxable exchange of property for stock must attach to their income tax returns a complete statement of all facts pertinent to the exchange. For more information, see section 1.351–3 of the regulations.*

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 buy 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 recognized by you, Bill, or the corporation.

Example 2. You and Bill transfer the property with a basis of $100,000 to a corporation in exchange for stock with a fair market value of $300,000. This represents only 75% of each class of stock of the corporation. The other 25% was already 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 recognized 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 to recognize gain. You must recognize gain only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring the recognized 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 recognized gain may have to be reported as ordinary income from depreciation. See chapter 3 of Publication 544. No loss is recognized.

Nonqualified preferred stock. Nonqualified preferred stock is treated as property other than stock. Generally, it is preferred stock with any of the following features.

- The holder has the right to require the issuer or a related person to redeem or buy the stock.
- The issuer or a related person is required to redeem or buy the stock.
- The issuer or a related person has the right to redeem or buy 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, the exchange generally is not treated as if you received money or other property. There are two exceptions to this treatment.

- If the liabilities the corporation assumes are more than your adjusted basis in the property you transfer, gain is recognized up to the difference. However, if the liabilities assumed give rise to a deduction when paid, such as a trade account payable or interest, no gain is recognized.
- 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.

For more information on the assumption of liabilities, see section 357(d) of the Internal Revenue Code.

Example. You transfer property to a corporation for stock. Immediately after the transfer, you control the corporation. 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 for which you are personally liable. 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. The recognized gain is limited to $10,000, the 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. For more information, see *Nondeductible Loss* under *Sales and Exchanges Between Related Persons* 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 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 or another party to the exchange assumed from you, unless payment of the liability gives rise to a deduction when paid.

Further decreases may be required when the corporation or another party to the exchange assumes from you a liability that gives rise to a deduction when paid after October 18, 1999, if the basis of the stock would otherwise be higher than its fair market value on the date of the exchange. This rule does not apply if the entity assuming the liability acquired either substantially all of the assets or the trade or business with which the liability is associated.

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 generally has the same basis you had in the property, increased by any gain you recognized on the exchange. However, the increase for the gain recognized may be limited. For more information, see section 362 of the Internal Revenue Code.

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.

Basis. The corporation's 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 the shareholder recognized on the exchange. However, the increase for the gain recognized may be limited. For more information, see section 362 of the Internal Revenue Code.

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, the corporation must reduce the basis of any property acquired with the contribution 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 each category to zero before going on 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 following ratio:

$$\frac{\text{Basis of each piece of property}}{\text{Bases of all properties (within that category)}}$$

If the corporation wishes to make this adjustment in some other way, it must get IRS approval. The corporation files a request for approval 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 if it expects its estimated tax for the year to be $500 or more. If the corporation does not pay the installments when they are due, it could be subject to an underpayment penalty. This section will explain how to avoid this penalty.

When to pay estimated tax. Installment payments are due by the 15th day of the 4th, 6th, 9th, and 12th months of the corporation's tax year. **For 2004**, 20% of any estimated tax otherwise due in September 2004 will not be due until October 1, 2004.

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

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

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

How to figure each required installment. Use ***Form 1120–W*** 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 yields 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 it 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 the first installment only.

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 any required installments.

Refiguring required installments. If after the corporation figures and deposits its estimated tax it finds that its tax liability for the year will be more or less than originally estimated, it may have to refigure its required installments to see if an underpayment penalty may apply. An immediate catchup payment should be made to reduce any penalty resulting from the underpayment of any earlier installments.

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) The interest rate for underpayments 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 any of the following apply.

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.
3) The corporation is a large corporation figuring its first required installment based on the prior year's tax.

How to pay estimated tax. Unless you volunteer or are required to make electronic deposits, you should mail or deliver your payment with a completed ***Form 8109*** to an authorized financial institution. For more information, see the instructions for Form 1120–W.

Electronic Federal Tax Payment System (EFTPS). You may have to deposit taxes using EFTPS. You must use EFTPS to make deposits of all depository tax liabilities (including social security, Medicare, withheld income, excise, and corporate income taxes) you incur in 2004 if you deposited more than $200,000 in federal depository taxes in 2002 or you had to make electronic deposits in 2003. If you first meet the $200,000 threshold in 2003, you must begin depositing using EFTPS in 2005. Once you meet the $200,000 threshold, you must continue to make deposits using EFTPS in later years even if subsequent deposits are less than the $200,000 threshold.

If you must use EFTPS but fail to do so, you may be subject to a 10% penalty.

If you are not required to use EFTPS because you did not meet the $200,000 threshold, then you may voluntarily make your deposits using EFTPS. However, if you are using EFTPS voluntarily, you will not be subject to the 10% penalty if you make a deposit using a paper coupon.

For information about EFTPS, access the IRS website on the Internet at **www.eftps.gov**, or see Publication 966, *Electronic Choices for Paying ALL Your Federal Taxes.*

To enroll in EFTPS, call one of the following phone numbers.

- **1–800–945–8400**
- **1–800–555–4477**

Or to enroll online visit **www.eftps.gov**.

Quick refund of overpayments. A corporation that has overpaid its estimated tax for the tax year may be able to apply for a quick refund. Use **Form 4466** to apply for a quick refund of an overpayment of estimated tax. A corporation can apply for a quick refund if the overpayment is:

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

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

File Form 4466 before the 16th day of the 3rd month after the end of the tax year, but ***before*** the corporation files its income tax return. Do not file Form 4466 before the end of the corporation's tax year. 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 Return

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 in existence for any part of a taxable year (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income.

Which 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 due date is extended to the next business day.

Extension of time to file. File ***Form 7004*** to request a 6-month extension of time to file a corporation income tax return. The IRS will grant the extension if you complete the form properly, file it, and pay any tax due by the original due date for the return.

Form 7004 does not extend the time for paying the tax due on the return. Interest, and possibly penalties, 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, the penalty for late filing is reduced by the amount of the penalty for late payment. 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 the failure to file on time was due to a reasonable cause. A corporation that has a reasonable cause to file late must attach a statement to its tax return explaining the reasonable cause.

Penalty for late payment of tax. A corporation that does not pay the tax when due may be penalized 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.

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 United States Treasury, 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 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.

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 fair market value 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 fair market value of the property. A corporation that fails to withhold may be liable for the tax, and any penalties and interest that apply. For more information, see *U.S. Real Property Interest* in Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities.*

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 Loans

A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan generally is treated as an arm's-length transaction in which the borrower is considered as having received both the following:

- A loan in exchange for a note that requires payment of interest at the applicable federal rate, and
- An additional payment in an amount equal to the forgone interest.

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

See *Below-Market Loans* in chapter 5 of Publication 535 for more information.

Capital Losses

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

A capital loss is carried to other years in the following order.

1) 3 years prior to the loss year.
2) 2 years prior to the loss year.
3) 1 year prior to the loss year.
4) Any loss remaining is carried forward for 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 2003 a calendar year 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. The corporation 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 2000. In 2000, 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 first from the net short-term gain. This results in a net capital gain for 2000 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 the current year's net capital loss, you cannot combine it with a capital loss carried from another year. In other

- words, you can carry capital losses only 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.
- 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 back.

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 the tax you originally owed, use either ***Form 1139*** or ***Form 1120X*** to apply for a refund.

Form 1139. A corporation can get a refund faster by using Form 1139. It cannot file Form 1139 before filing the return for the corporation's capital loss year, but it must file Form 1139 no later than one year after the year it sustains the capital loss.

Form 1120X. If the corporation does not file Form 1139, it must file Form 1120X to apply for a refund. The corporation must file the Form 1120X within 3 years of the due date, including extensions, for filing the return for the year in which it sustains the capital loss.

Charitable Contributions

A corporation can claim a limited deduction for 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, *Charitable Contributions*.

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. The publication is available on the Internet at **www.irs.gov** or your local library may have a copy. You can also call Tax Exempt/Government Entities Customer Service at **1–877–829–5500** to find out if an organization is qualified.

Cash method corporation. A corporation using the cash method of accounting deducts contributions in the tax year paid.

Accrual method corporation. A corporation using an accrual method of accounting can choose to deduct unpaid contributions for the tax year the board of directors authorizes them if it pays them within 2½ months after the close of that tax year. Make the choice by reporting the contribution on the corporation's return for the tax year. A declaration stating that the board of directors adopted the resolution during the tax year must accompany the return. The declaration must include the date the resolution was adopted.

Limit. A corporation cannot deduct charitable contributions that exceed 10% of its taxable income for the tax year. Figure taxable income for this purpose without the following.

- The deduction for charitable contributions.
- The deduction for dividends received.
- 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, within certain limits, to each of the subsequent five years any charitable contributions made during the current year that exceed the 10% limit. You lose any excess not used within that period. For example, if a corporation has a carryover of excess contributions paid in 2002 and it does not use all the excess on its return for 2003, it can carry the rest over to 2004, 2005, 2006, and 2007. 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.

More information. For more information on the charitable contribution deduction, see the instructions for Forms 1120 and 1120–A.

Corporate Preference Items

A corporation must make special adjustments to certain items before it takes them into account in determining its taxable income. These items are known as corporate preference items and they include the following.

- ***Gain on the disposition of section 1250 property.*** For more information, see *Section 1250 Property* under *Depreciation Recapture* in chapter 3 of Publication 544.
- ***Percentage depletion for iron ore and coal (including lignite).*** For more information, see *Mines and Geothermal Deposits* under *Mineral Property* in chapter 10 of Publication 535.
- ***Amortization of pollution control facilities.*** For more information, see *Pollution Control Facilities* in chapter 9 of Publication 535 and section 291(a)(5) of the Internal Revenue Code.
- ***Mineral exploration and development costs.*** For more information, see *Exploration Costs* and *Development Costs* in chapter 8 of Publication 535.

For more information on corporate preference items, see section 291 of the Internal Revenue Code.

Dividends-Received Deduction

A corporation can deduct a percentage of certain dividends received during its tax year. This section discusses the general rules that apply. For more information, see the instructions for Forms 1120 and 1120–A.

Dividends from domestic corporations. A corporation can deduct, within certain limits, 70% of the dividends received if the corporation receiving the dividend owns ***less than*** 20% of the corporation distributing the dividend. If the corporation owns 20% or ***more*** of the distributing corporation's stock, it can, subject to certain limits, deduct 80% of the dividends received.

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.

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

Dividends from regulated investment companies. Regulated investment company dividends received are subject to certain limits. Capital gain dividends received from a regulated investment company do not qualify for the deduction. For more information, see section 854 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 (REIT).
2) A corporation exempt from tax under section 501 or 521 of the Internal Revenue Code either for the tax year of the distribution or the preceding tax year.
3) A corporation whose stock was held less than 46 days during the 90-day period beginning 45 days before the stock became ex-dividend with respect to the dividend. Ex-dividend means the holder has no ***rights*** to the dividend.
4) A corporation whose preferred stock was held less than 91 days during the 180-day period beginning 90 days before the stock became ex-dividend with respect to the dividend if the dividends received 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 with respect to positions in substantially similar or related property.

Dividends on deposits. Dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are interest, not dividends. 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, then
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 corpora-

tions (reducing taxable income by the total dividends received from 20%-owned corporations).

For exceptions, see Schedule C on Form 1120 and the instructions for Forms 1120 and 1120–A.

Figuring the limit. In figuring the 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 nontaxable part of an extraordinary dividend (see *Extraordinary Dividends,* later).
4) Any capital loss carryback to the tax year.

Effect of net operating loss. If a corporation has a net operating loss (NOL) for a tax year, the limit of 80% (or 70%) of taxable income does not apply. To determine whether a corporation has an NOL, 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 ($100,000 – $25,000) before the deduction for dividends received. If it claims the full dividends-received deduction of $80,000 ($100,000 × 80%) and combines it with an operations loss of $25,000, it will have an NOL of ($5,000). Therefore, the 80% of taxable income limit does not apply. The corporation can deduct the full $80,000.

Example 2. Assume the same facts as in Example 1, except that the corporation only loses $15,000 from operations. Its taxable income is $85,000 before the deduction for dividends received. After claiming the dividends-received deduction of $80,000 ($100,000 × 80%), its taxable income is $5,000. Because the corporation will not have an NOL after applying 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 of time the corporation held the stock.

Disqualified preferred stock is any stock preferred as to dividends if any of the following apply.

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.
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 section 1059 of the Internal Revenue Code.

Going Into Business

When you go into business, treat all costs you incur to get your business started as capital expenses. 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 choose to amortize certain costs for setting up your business over a period of 60 months or more. The costs must qualify as one of the following.

- A business start-up cost.
- An organizational cost.

Business start-up costs. Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Start-up costs include any amounts paid or incurred in connection with an activity engaged in for profit or for the production of income in anticipation of the activity becoming an active trade or business.

Qualifying costs. A start-up cost is amortizable if it meets both of the following tests.

- It is a cost you could deduct if you paid or incurred it to operate an existing active trade or business (in the same field).
- It is a cost you pay or incur before the day your active trade or business begins.

Start-up costs include costs for the following items.

- An analysis or survey of potential markets, products, labor supply, transportation facilities, 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 similar professional services.

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

Purchasing an active trade or business. Amortizable start-up costs for purchasing an active trade or business include only investigative costs incurred in the course of a general search for, or preliminary investigation of, the business. These are the costs that help you decide whether to purchase a new business and which active business to purchase. Costs you incur in an attempt to purchase a specific business are capital expenses that you cannot amortize.

Disposition of business. If you completely dispose of your business before the end of the amortization period, you can deduct any remaining deferred start-up costs. However, you can deduct these deferred start-up costs only 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 of the following tests.

- It is for the creation of the corporation.
- It is chargeable to a capital account.
- It could be amortized over the life of the corporation if the corporation had a fixed life.
- It is incurred before the end of the first tax year in which the corporation is in business. A corporation using the cash method of accounting can amortize organizational costs incurred within the first tax year, even if it does not pay them in that year.

The following are examples of organizational costs.

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

Nonqualifying costs. The following costs are not organizational costs. They are capital expenses that you cannot amortize.

- Costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs.
- Costs associated with the transfer of assets to the corporation.

How to amortize. Deduct start-up and organizational costs in equal amounts over a period of 60 months or more. You can choose a period for start-up costs that is different from the period you choose for organizational costs, as long as both are not less than 60 months. The amortization period starts with the month you begin business operations. Once you choose 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 for each month.

How to make the choice. To choose to amortize start-up or organizational costs, you must attach ***Form 4562*** and an accompanying statement to your return for the first tax year you are in business. If you have both start-up and organizational costs, attach a separate statement to your return for each type of cost.

Generally, you must file your return by the due date (including any extensions). However, if you timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). For more information, see the instructions for Part VI of Form 4562.

Once you make the choice to amortize start-up or organizational costs, you cannot revoke it.

Start-up costs. If you choose to amortize your start-up costs, complete Part VI of Form 4562 and prepare a separate statement that contains the following information.

- A description of the business to which the start-up costs relate.
- A description of each start-up cost incurred.
- The month your active business began (or was acquired).
- The number of months in your amortization period (not less than 60).

You can choose to amortize your start-up costs by filing the statement with a return for any tax year before the year your active business begins. If you file the statement early, the choice becomes effective in the month your active business begins.

You can file a revised statement to include any start-up costs not included in your original statement. However, you cannot include on the revised statement any cost you previously treated on your return as a cost other than a start-up cost. You can file the revised statement with a return filed after the return on which you chose to amortize your start-up costs.

Organizational costs. If you choose to amortize your organizational costs, complete Part VI of Form 4562 and prepare a separate statement that contains the following information.

- A description of each cost.
- The amount of each cost.
- The date each cost was incurred.
- The month your active business began (or was acquired).
- The number of months in your amortization period (not less than 60).

Related Persons

A corporation that uses an accrual method of accounting cannot deduct business expenses and interest owed to a related person who uses the cash method of accounting ***until*** the corporation makes the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied, the rule will continue to apply even if the corporation's relationship with the person ends before the expense or interest is includible in the gross income of that person. These rules also deny the deduction of losses on the sale or exchange of property between related persons.

Related persons. For purposes of this rule, the following persons are related to a corporation.

1) Another corporation that is a member of the same controlled group as defined in section 267(f) of the Internal Revenue Code.
2) An individual who owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.
3) A trust fiduciary when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
4) An S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
5) A partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.
6) Any employee-owner if the corporation is a personal service corporation (defined later), regardless of the amount of stock owned by the employee-owner.

Ownership of stock. To determine whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries.
2) An individual is treated as owning the stock owned, directly or indirectly, by or for the individual's family. Family includes only brothers and sisters (including half brothers and half sisters), a spouse, ancestors, and lineal descendants.
3) Any individual owning (other than by applying rule (2)) any stock in a corporation is treated as owning the stock owned directly or indirectly by that individual's partner.
4) To apply rule (1), (2), or (3), stock constructively owned by a person under rule (1) is treated as actually owned by that person. But stock constructively owned by an individual under rule (2) or (3) is not treated as actually owned by the individual for applying either rule (2) or (3) to make another person the constructive owner of that stock.

Personal service corporation. For this purpose, 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 is performing personal services. Personal services are those performed in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and performing arts.
3) Its employee-owners substantially perform the services in (2).
4) Its employee-owners own more than 10% of the fair market value of its outstanding stock.

Reallocation of income and deductions. Where it is necessary to clearly show income or prevent tax evasion, the IRS can reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly, or indirectly, by the same interests.

Complete liquidations. The disallowance of losses from the sale or exchange of property between related persons does not apply to liquidating distributions.

More information. For more information about the related person rules, see Publication 544.

Figuring Taxable Income

You 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 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

A corporation generally figures and deducts a net operating loss (NOL) the same way an individual, estate, or trust does. The same carryback and carryforward periods apply, and the same sequence applies when the corporation carries two or more NOLs to the same year. For more information on these general rules, see Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.*

A corporation's NOL generally differs from individual, estate and trust NOLs in the following ways.

1) A corporation can take different deductions when figuring an NOL.
2) A corporation must make different modifications to its taxable income in the carryback or carryforward year when figuring how much of the NOL is used and how much is carried over to the next year.

A corporation also uses different forms when claiming an NOL deduction.

The following discussions explain these differences.

Figuring the NOL

A corporation figures an NOL in the same way it figures taxable income. It starts with its gross income and subtracts its deductions. If its deductions are more than its gross income, the corporation has an NOL.

However, the following rules for figuring the NOL apply.

1) A corporation cannot increase its current year NOL by carrybacks or carryovers from other years.
2) A corporation can take the deduction for dividends received, explained later, without regard to the aggregate limits (based on taxable income) that normally apply.
3) A corporation can figure the deduction for dividends paid on certain preferred stock of public utilities without limiting it to its taxable income for the year.

Dividends-received deduction. The corporation's deduction for dividends received from domestic corporations is generally subject to an aggregate limit of 70% or 80% of taxable income. However, if a corporation sustains an NOL for a tax year, the limit based on taxable income does not apply. In determining if a corporation has an NOL, the corporation figures the dividends-received deduction without regard to the 70% or 80% of taxable income limit.

For more information on the dividends-received deduction, see *Dividends-Received Deduction* under *Income and Deductions,* earlier.

Example. A corporation had $500,000 of gross income from business operations and $625,000 of allowable business expenses. It also received $150,000 in dividends from a domestic corporation for which it can take an 80% deduction, ordinarily limited to 80% of its taxable income before the deduction. It figures its NOL as follows:

Income from business	$500,000
Dividends	150,000
Gross income	$650,000
Deductions (expenses)	(625,000)
Taxable income before special deductions	$25,000
Minus: Deduction for dividends received, 80% of $150,000	(120,000)
Net operating loss	**($95,000)**

Because the corporation had an NOL, the limit based on taxable income does not apply.

Claiming the NOL Deduction

The form a corporation uses to deduct its NOL depends on whether it carries the NOL back or forward.

For a carryback. If a corporation carries back the NOL, it can use either ***Form 1120X*** or ***Form 1139***. A corporation can get a refund faster by using Form 1139. It cannot file Form 1139 before filing the return for the corporation's NOL year, but it must file Form 1139 no later than one year after the year it sustains the NOL.

If the corporation does not file Form 1139, it must file Form 1120X within 3 years of the due date, plus extensions, for filing the return for the year in which it sustains the NOL.

For a carryforward. If a corporation carries forward its NOL, it enters the carryover on Schedule K (Form 1120), line 12. It also enters the deduction for the carryover (but not more than the corporation's taxable income after special deductions) on line 29(a) of Form 1120 or line 25(a) of Form 1120–A.

Carryback expected. If a corporation expects to have an NOL in its current year, it can automatically extend the time for paying all or part of its income tax for the immediately preceding year. It does this by filing ***Form 1138.*** It must explain on the form why it expects the loss.

The payment of tax that may be postponed cannot exceed the expected overpayment from the carryback of the NOL.

Period of extension. The extension is in effect until the end of the month in which the return for the NOL year is due (including extensions).

If the corporation files Form 1139 before this date, the extension will continue until the date the IRS notifies the corporation that its Form 1139 is allowed or disallowed in whole or in part.

Figuring the NOL Carryover

If the NOL available for a carryback or carryforward year is greater than the taxable income for that year, the corporation must modify its taxable income to figure how much of the NOL it will use up in that year and how much it can carry over to the next tax year.

Its carryover is the excess of the available NOL over its modified taxable income for the carryback or carryforward year.

Modified taxable income. A corporation figures its modified taxable income the same way it figures its taxable income, with the following exceptions.

- It can deduct NOLs only from years ***before*** the NOL year whose carryover is being figured.
- The corporation must figure its deduction for charitable contributions without considering any NOL carrybacks.

The modified taxable income for any year cannot be less than zero.

Modified taxable income is used only to figure how much of an NOL the corporation uses up in the carryback or carryforward year and how much it carries to the next year. It is not used to fill out the corporation's tax return or figure its tax.

Ownership change. A loss corporation (one with cumulative losses) that has an ownership change is limited on the taxable income it can offset by NOL carryforwards arising before the date of the ownership change. This limit applies to any year ending after the change of ownership.

See sections 381 through 384, and 269 of the Internal Revenue Code and the related regulations for more information about the limits on corporate NOL carryovers and corporate ownership changes.

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).

The amount at risk generally equals:

- The money and the adjusted basis of property contributed by the taxpayer to the activity, and
- The money borrowed for the activity.

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 you have a rental activity.

The passive activity rules apply to personal service corporations and closely held corporations (other than S 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*, defined later. The testing period for any tax year is the prior 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 performed in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and the performing arts.

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 (even if he or she is an independent contractor for other purposes) 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 or for 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 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 to that rule for qualified personal service corporations. Other exceptions are discussed in the instructions for Schedule J (Form 1120) or Part I (Form 1120–A).

Tax Rate Schedule

If taxable income (line 30, Form 1120, or line 26, Form 1120–A) 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 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 personal services.

   b) Retired employees who had performed the personal services.

   c) An 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(e) of the regulations for details.

Credits

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

- Credit for federal tax on fuels used for certain nontaxable purposes (see Publication 378, *Fuel Tax Credits and Refunds).*
- Credit for prior year minimum tax (see ***Form 8827***).
- Foreign tax credit (see ***Form 1118***).
- General business credit (see *General business credit,* next).
- Nonconventional source fuel credit (see section 29 of the Internal Revenue Code).
- Possessions corporation tax credit (see ***Form 5735***).
- Qualified electric vehicle credit (see ***Form 8834***).
- Qualified zone academy bond credit (see ***Form 8860***).

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.

- 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***).
- Employer-provided childcare facilities and services credit (***Form 8882***).
- Empowerment zone and renewal community 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***).
- New markets credit (***Form 8874***).
- New York Liberty Zone business employee credit (***Form 8884***).
- Orphan drug credit (***Form 8820***).
- Renewable electricity production credit (***Form 8835***).
- Research credit (***Form 6765***).
- Small employer pension plan startup costs credit (***Form 8881***).
- Welfare-to-work credit (***Form 8861***).
- Work opportunity credit (***Form 5884***).

Your general business credit for the current year may be increased by the carryback or carryforward of business credits from other years.

To claim a general business credit, you must first get the form or forms you need to claim your current year business credits. The above list identifies 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 and renewal community employment credit or New York Liberty Zone business employee credit).
- You have a carryback or carryforward of any of these credits (other than the empowerment zone and renewal community employment credit or New York Liberty Zone business employee credit).
- Any of these credits (other than the low-income housing credit, the empowerment zone and renewal community employment credit, or the New York Liberty Zone business employee credit) is from a passive activity. (For information about passive activity credits, see ***Form 8810.***)

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

The New York Liberty Zone business employee credit is an expansion of the work opportunity credit to include a new targeted group of employees in the New York Liberty Zone. This credit is figured separately on Form 8884 and is, generally, not carried to Form 3800. For more information, see the instructions for Form 8884.

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

Recapture Taxes

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

- Employer-provided childcare facilities and services credit (see the instructions for ***Form 8882***).
- Indian employment credit (see the instructions for ***Form 8845***).
- Investment credit (see the instructions for ***Form 4255***).
- Low-income housing credit (see the instructions for ***Form 8611***).
- New markets credit (see the instructions for ***Form 8874***).
- 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 corporate alternative minimum tax (AMT) ensures that these corporations pay at least a minimum amount of tax on their economic income. A corporation owes AMT if its tentative minimum tax is more than its regular tax.

TIP *The tentative minimum tax of a small corporation is zero. This means that a small corporation will not owe AMT.*

Small corporation exemption. A corporation is treated as a small corporation exempt from the AMT for its tax year beginning in 2003 if that year is the corporation's first tax year in existence (regardless of its gross receipts for the year) ***or:***

1) It was treated as a small corporation exempt from the AMT for all prior tax years beginning after 1997, ***and***
2) Its average annual gross receipts for the 3-tax-year period (or portion thereof during which the corporation was in existence) ending before its tax year beginning in 2003 did not exceed $7.5 million ($5 million if the corporation had only 1 prior tax year).

For more information, see the instructions for Form 4626.

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 15%. If the accumulated earnings tax applies, interest applies to the tax from the date the corporate return was originally due, without extensions.

To determine if the corporation is subject to this tax, first treat an accumulation of $250,000 or less generally as within the reasonable needs of most businesses. Treat an accumulation of $150,000 or less as within the reasonable needs of a business whose principal function is performing services in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and the performing arts.

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.

Reasonable needs of the business include the following.

- Specific, definite, and feasible plans for use of the earnings accumulation in the business.
- 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 or withdrawals by the shareholders classified as personal loans. However, actual moves to expand the business generally qualify as a bona fide use of the accumulations.

The fact that a corporation has an unreasonable accumulation of earnings is sufficient to establish liability for the accumulated earnings tax unless the corporation can show the earnings were not accumulated to allow its individual shareholders to avoid income tax.

Distributions to Shareholders

This section discusses corporate distributions of money, stock, or other property to a shareholder with respect to the shareholder's ownership of stock. However, this section does not discuss the special rules that apply to the following distributions.

- Distributions in redemption of stock. See section 302 of the Internal Revenue Code.
- Distributions in complete liquidation of the corporation. See sections 331 through 346 of the Internal Revenue Code.
- Distributions in corporate organizations. See *Property Exchanged for Stock,* earlier.
- Distributions in corporate reorganizations. See section 351 through 368 of the Internal Revenue Code.
- Certain distributions to 20% corporate shareholders. See section 301(e) of the Internal Revenue Code.

Money or Property Distributions

Most distributions are in money, but they may also be in stock or other property. For this purpose, "property" generally does not include stock in the corporation or rights to acquire this stock. However, see *Distributions of Stock or Stock Rights,* later.

A corporation generally does not recognize a gain or loss on the distributions covered by the rules in this section. However, see *Gain from property distributions,* later.

Amount distributed. The amount of a distribution is generally the amount of any money paid to the shareholder plus the fair market value (FMV) of any property transferred to the shareholder. However, this amount is reduced (but not below zero) by the following liabilities.

- Any liability of the corporation the shareholder assumes in connection with the distribution.

- Any liability to which the property is subject immediately before, and immediately after, the distribution.

The FMV of any property distributed to a shareholder becomes the shareholder's basis in that property.

Gain from property distributions. A corporation will recognize a gain on the distribution of property to a shareholder if the FMV of the property is more than its adjusted basis. This is generally the same treatment the corporation would receive if the property were sold. However, for this purpose, the FMV of the property is the greater of the following amounts.

- The actual FMV.
- The amount of any liabilities the shareholder assumed in connection with the distribution of the property.

If the property was depreciable or amortizable, the corporation may have to treat all or part of the gain as ordinary income from depreciation recapture. For more information on depreciation recapture and the sale of business property, see Publication 544.

Distributions of Stock or Stock Rights

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as "stock options") are distributions by a corporation of rights to acquire its stock. Distributions of stock dividends and stock rights are generally tax-free to shareholders. However, stock and stock rights are treated as property under the rules discussed earlier under *Money or Property Distributions* if any of the following apply to their distribution.

1) Any shareholder has the choice to receive cash or other property instead of stock or stock rights.
2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders.
3) The distribution is in convertible preferred stock and has the same result as in (2).
4) The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders.
5) The distribution is on preferred stock. (An increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right is not a distribution on preferred stock.)

For this purpose, the term "stock" includes rights to acquire stock and the term "shareholder" includes a holder of rights or convertible securities.

Constructive stock distributions. You must treat certain transactions that increase a shareholder's proportionate interest in the earnings and profits or assets of a corporation as if they were distributions of stock or stock rights. These constructive distributions are treated as property if they have the same result as a distribution described in (2), (3), (4), or (5) of the above discussion. Constructive distributions are described later.

This treatment applies to a change in your stock's conversion ratio or redemption price, a difference between your stock's redemption price and issue price, a redemption that is not treated as a sale or exchange of your stock, and any other transaction having a similar effect on a shareholder's interest in the corporation.

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

Constructive Distributions

The following sections discuss transactions that may be treated as distributions.

Below-market loans. If a corporation gives a shareholder a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate, the interest not charged may be treated as a distribution to the shareholder. For more information, see *Below-Market Loans* under *Income and Deductions,* earlier.

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

Transfers of property to shareholders for less than FMV. A sale or exchange of property by a corporation to a shareholder may be treated as a distribution to the shareholder. For a shareholder who is not a corporation, if the FMV of the property on the date of the sale or exchange exceeds the price paid by the shareholder, the excess may be treated as a distribution to the shareholder.

Unreasonable rents. If a corporation rents property from a shareholder and the rent is unreasonably more than the shareholder would charge to a stranger for use of the same property, the excessive part of the rent may be treated as a distribution to the shareholder. For more information, see chapter 4 in Publication 535.

Unreasonable salaries. If a corporation pays an employee who is also a shareholder a salary that is unreasonably high considering the services actually performed by the shareholder-employee, the excessive part of the salary may be treated as a distribution to the shareholder-employee. For more information, see chapter 2 in Publication 535.

Reporting Dividends and Other Distributions

A corporate distribution to a shareholder is generally treated as a distribution of earnings and profits. Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as a dividend. Any part of a distribution that is not from earnings and profits is applied against and reduces the adjusted basis of the stock in the hands of the shareholder. To the extent the balance is more than the adjusted basis of the stock, the shareholder has a gain (usually a capital gain) from the sale or exchange of property.

For information on shareholder reporting of corporate distributions, see Publication 550, *Investment Income and Expenses.*

Form 1099–DIV. File Form 1099–DIV with the IRS for each shareholder to whom you have paid dividends and other distributions on stock of $10 or more during a calendar year. You must generally send Forms 1099–DIV to the IRS with ***Form 1096*** by February 28 (March 31 if filing electronically) of the year following the year of the distribution. For more information, see the general instructions for Forms 1099, 1098, 5498, and W–2G.

Generally, you must furnish Forms 1099–DIV to shareholders by January 31 of the year following the close of the calendar year during which the corporation made the distributions. However, you may furnish the Form 1099–DIV to shareholders after November 30 of the year of the distributions if the corporation has made its final distributions for the year. You may furnish the Form 1099–DIV to shareholders anytime after April 30 of the year of the distributions if you give the Form 1099–DIV with the final distributions for the calendar year.

Backup withholding. Dividends may be subject to backup withholding. For more information on backup withholding, see the general instructions for Forms 1099, 1098, 5498, and W–2G.

Form 5452. File Form 5452 if nondividend distributions were made to shareholders.

A calendar tax year corporation must file Form 5452 with its income tax return for the tax year in which the nondividend distributions were made. A fiscal tax year corporation must file Form 5452 with its income tax return due for the first fiscal year ending after the calendar year in which the nondividend distributions were made.

Current year earnings and profits. If a corporation's earnings and profits for the year (figured as of the close of the year without reduction for any distributions made during the year) are more than the total amount of distributions made during the year, all distributions made during the year are treated as distributions of current year earnings and profits. If the total amount of distributions is more than the earnings and profits for the year, see *Accumulated earnings and profits,* later.

Example. You are the only shareholder of a corporation that uses the calendar year as its tax year. In January, you use the worksheet in the Form 5452 instructions to figure your corporation's current year earnings and profits for the previous year. During the year, the corporation made four $1,000 distributions to you. At the end of the year (before subtracting distributions made during the year), the corporation had $10,000 of current year earnings and profits.

Since the corporation's current year earnings and profits ($10,000) were more than the amount of the distributions it made during the year ($4,000), all of the distributions are treated as distributions of current year earnings and profits.

The corporation must issue a Form 1099–DIV to you by January 31 to report the $4,000 distributed to you during the previous year as dividends. The corporation must use Form 1096 to report this information to the IRS by February 28 (March 31 if filing electronically). The corporation does not deduct these dividends on its income tax return.

Accumulated earnings and profits. If a corporation's current year earnings and profits (figured as of the close of the year without reduction for any distributions made during the year) are less than the total distributions made during the year, part or all of each distribution is treated as a distribution of accumulated earnings and profits. Accumulated earnings and profits are earnings and profits the corporation accumulated before the current year.

If the total amount of distributions is less than current year earnings and profits, see *Current year earnings and profits,* earlier.

Used with current year earnings and profits. If the corporation has current year earnings and profits, figure the use of accumulated and current earnings and profits as follows.

1) Divide the current year earnings and profits by the total distributions made during the year.
2) Multiply each distribution by the percentage figured in(1) to get the amount treated as a distribution of current year earnings and profits.
3) Start with the first distribution and treat the part of each distribution greater than the allocated current year earnings and profits figured in (2) as a distribution of accumulated earnings and profits.
4) If accumulated earnings and profits are reduced to zero, the remaining part of each distribution is applied against and reduces the adjusted basis of the stock in the hands of the shareholders. To the extent that the balance is more than the adjusted basis of the stock, it is treated as a gain from the sale or exchange of property.

Example. You are the only shareholder of a corporation that uses the calendar year as its tax year. In January, you use the worksheet in the Form 5452 instructions to figure your corporation's current year earnings and profits for the previous year. At the beginning of the year, the corporation's accumulated earnings and profits balance was $20,000. During the year, the corporation made four $4,000 distributions to you ($4,000 × 4 = $16,000). At the end of the year (before subtracting distributions made during the year), the corporation had $10,000 of current year earnings and profits.

Since the corporation's current year earnings and profits ($10,000) were less than the distributions it made during the year ($16,000), part of each distribution is treated as a distribution of accumulated earnings and profits. Treat the distributions as follows.

1) Divide the current year earnings and profits ($10,000) by the total amount of distributions made during the year ($16,000). The result is .625.
2) Multiply each $4,000 distribution by the .625 figured in (1) to get the amount ($2,500) of each distribution treated as a distribution of current year earnings and profits.
3) The remaining $1,500 of each distribution is treated as a distribution from accumulated earnings and profits. The corporation distributed $6,000 ($1,500 × 4) of accumulated earnings and profits.

The remaining $14,000 ($20,000 − $6,000) of accumulated earnings and profits is available for use in the following year.

The corporation must issue a Form 1099–DIV to you by January 31 to report the $16,000 distributed to you during the previous year as dividends. The corporation must use Form 1096 to report this information to the IRS by February 28 (March 31 if filing electronically). The corporation does not deduct these dividends on its income tax return.

Used without current year earnings and profits. If the corporation has no current year earnings and profits, figure the use of accumulated earnings and profits as follows.

1) If the current year earnings and profits balance is negative, prorate the negative balance to the date of each distribution made during the year.
2) Figure the available accumulated earnings and profits balance on the date of each distribution by subtracting the prorated amount of current year earnings and profits from the accumulated balance.
3) Treat each distribution as a distribution of these adjusted accumulated earnings and profits.
4) If adjusted accumulated earnings and profits are reduced to zero, the remaining distributions are applied against and reduce the adjusted basis of the stock in the hands of the shareholders. To the extent that the balance is more than the adjusted basis of the stock, it is treated as a gain from the sale or exchange of property.

Example. You are the only shareholder of a corporation that uses the calendar year as its tax year. In January, you use the worksheet in the Form 5452 instructions to figure your corporation's current year earnings and profits for the previous year. At the beginning of the year, the corporation's accumulated earnings and profits balance was $20,000. During the year, the corporation made four $4,000 distributions to you on March 31, June 30, September 30, and December 31. At the end of the year (before subtracting distributions made during the year), the corporation had a negative $10,000 current year earnings and profits balance.

Since the corporation had no current year earnings and profits, all of the distributions are treated as distributions of accumulated earnings and profits. Treat the distributions as follows.

1) Prorate the negative current year earnings and profits balance to the date of each distribution made during the year. The negative $10,000 can be spread evenly by prorating a negative $2,500 to each distribution.
2) The following table shows how to figure the available accumulated earnings and profits balance on the date of each distribution.

March 31 Distribution

Accumulated earnings and profits	$20,000
Prorated current year earnings and profits	($2,500)
Accumulated earnings and profits available	$17,500
Amount of distribution treated as a dividend	($4,000)

June 30 Distribution

Accumulated earnings and profits	$13,500
Prorated current year earnings and profits	($2,500)
Accumulated earnings and profits available	$11,000
Amount of distribution treated as a dividend	($4,000)

September 30 Distribution

Accumulated earnings and profits	$7,000
Prorated current year earnings and profits	($2,500)
Accumulated earnings and profits available	$4,500
Amount of distribution treated as a dividend	($4,000)

December 31 Distribution

Accumulated earnings and profits	$500
Prorated current year earnings and profits	($2,500)
Accumulated earnings and profits available	($2,000)
Amount of distribution treated as a dividend	$0
Nondividend amount (reduction of stock basis or gain from sale/exchange of property)	$4,000
Year-end accumulated earnings and profits	($2,000)

The corporation must issue a Form 1099–DIV to you by the end of January to report $12,000 of the $16,000 distributed to you during the previous year as dividends. The corporation must use Form 1096 to report this information to the IRS by February 28 (March 31 if filing electronically). The corporation does not deduct these dividends on its income tax return. However, the corporation must attach Form 5452 to this return to report the nondividend distribution.

TIP *For more information about figuring earnings and profits, see the* Worksheet for Figuring Current Year Earnings and Profits *in the Form 5452 instructions.*

Sample Returns

Form 1120–A

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 tax year basis.

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 2003, 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.

Item D. You are required to enter total assets here. Rose Flower Shop enters $67,967 from line 12(b) in Part III.

Line 1. Gross sales, line 1a, for the year totaled $450,000 using an accrual method of accounting. Rose had no returned goods and allowances, so line 1c shows net sales of $450,000.

Line 2. Cost of goods sold is $234,000. Figure this using the *Cost of Goods Sold Worksheet*, shown later.

Line 3. Net sales less cost of goods sold results in a gross profit of $216,000.

Line 11. Total income is $216,000.

Line 12. The $60,000 is the salary of the company president.

Line 13. Other salaries and wages of $72,000 are entered here. This includes only salaries and wages not included on line 12.

Line 16. Rent for Rose Flower Shop's store was $48,000 for the year.

Line 17. Deductible taxes totaled $12,500.

Line 19. During the year, Rose Flower Shop contributed $1,500 to various charitable organizations. This amount exceeds the limit for deductible contributions, which is 10% of taxable income figured without the contribution deduction and special deductions which would be entered on line 25b. Taxable income without the contribution deduction is $7,500. Therefore, the contribution deduction is limited to $750 ($7,500 x 10%).

Line 22. Other business deductions consist of $16,000 for advertising. If there were 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 $209,250.

Lines 24, 25c, and 26. Taxable income on line 24 is $6,750. 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 ($1,013) from Part I, line 6, 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 $2,000. Enter this amount on lines 28b, 28d, and 28h. The resulting overpayment is $987, 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 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 2 and 5, the credits and other taxes listed on Part I, do not apply to Rose Flower Shop. The tax of $1,013 is entered on lines 1, 4, and 6.

Part II—Other Information. Answer all questions that apply to your business. Provide the business activity code number, business activity, and product or service information on lines (a), (b), and (c) of question 1. The business activity codes are provided in the instructions for Forms 1120 and 1120–A. Purchases of $186,490 appear on line (1) of question 5a. Other costs of $45,500 appear on line (3) of question 5a. The supporting itemization is not illustrated. These costs are directly related to the sale of flowers, wreaths, and plants, such as flower pots, vases, stands, boxes, and tissue paper.

Rose Flower Shop answers "No" to Question 7 and is required to complete Item D on page 1 and Parts III and IV on page 2.

Part III—Balance Sheets per Books. You are not required to complete Part III if the answer to Question 7 in Part II is "Yes." Rose Flower Shop must complete Part III and 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. You are not required to complete Part IV if the answer to Question 7 in Part II is "Yes." Rose Flower Shop must complete Part IV.

To properly complete Part IV, you will 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		$450,000
Cost of goods sold	$234,000	
Compensation of officers	60,000	
Salaries and wages	72,000	
Rents	48,000	
Taxes	12,500	
Contributions	1,500	
Advertising	16,000	
Federal income tax accrued	1,013	
Net income per books after tax	4,987	
Total	**$450,000**	**$450,000**

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. $4,987 is the net income per books. It appears in the profit and loss account as net income per books after tax.

Line 2. $1,013 is the federal income tax accrued for the tax year.

Line 5. $750 is the nondeductible part of the charitable contribution.

Line 8. $6,750 is the taxable income on line 24, page 1.

Table 1. **Cost of Goods Sold Worksheet (Form 1120–A)**

1.	Inventory at start of year. Enter here and in Part III, line 3, column (a), Form 1120–A	1.	$3,010
2.	Purchases. Enter here and in Part II, line 5a(1), Form 1120–A	2.	186,490
3.	Cost of labor. Enter here and include in total in Part II, line 5a(3), Form 1120–A	3.	–0–
4.	Additional section 263A costs. Enter here and in Part II, line 5a(2), Form 1120–A (see instruction for line 4)	4.	–0–
5.	Other costs. Enter here and include in Part II, line 5a(3), Form 1120–A	5.	45,500
6.	Total. Add lines 1 through 5	6.	235,000
7.	Inventory at end of year. Enter here and in Part III, line 3, column (b), Form 1120–A	7.	1,000
8.	**Cost of goods sold.** Subtract line 7 from line 6. Enter the result here and on page 1, line 2, Form 1120–A	8.	$234,000

Form **1120-A** U.S. Corporation Short-Form Income Tax Return

OMB No. 1545-0890

Department of the Treasury
Internal Revenue Service

For calendar year 2003 or tax year beginning ...., 2003, ending ...., 20 ....

See separate instructions to make sure the corporation qualifies to file Form 1120-A.

2003

A Check this box if the corp. is a personal service corp. (as defined in Regulations section 1.441-3(c)—see instructions) ☐

Use IRS label. Otherwise, print or type.

10-2134567 DEC03 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 8 of instructions) $ 67,967

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Name change (3) ☐ Address change

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

Income	1a	Gross receipts or sales 450,000 b Less returns and allowances c Balance ►	1c	450,000
	2	Cost of goods sold (see page 14 of instructions)	2	234,000
	3	Gross profit. Subtract line 2 from line 1c	3	216,000
	4	Domestic corporation dividends subject to the 70% deduction	4	
	5	Interest	5	
	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 9 of instructions)	10	
	11	**Total income.** Add lines 3 through 10 ►	11	216,000
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see page 10 of instructions)	12	60,000
	13	Salaries and wages (less employment credits)	13	72,000
	14	Repairs and maintenance	14	
	15	Bad debts	15	
	16	Rents	16	48,000
	17	Taxes and licenses	17	12,500
	18	Interest	18	
	19	Charitable contributions (see page 11 of instructions for 10% limitation)	19	750
	20	Depreciation (attach Form 4562) — 20		
	21	Less depreciation claimed elsewhere on return — 21a	21b	
	22	Other deductions (attach schedule)	22	16,000
	23	**Total deductions.** Add lines 12 through 22 ►	23	209,250
	24	Taxable income before net operating loss deduction and special deductions. Subtract line 23 from line 11	24	6,750
	25	**Less:** a Net operating loss deduction (see page 13 of instructions) — 25a; b Special deductions (see page 13 of instructions) — 25b	25c	
Tax and Payments	26	**Taxable income.** Subtract line 25c from line 24	26	6,750
	27	**Total tax** (from page 2, Part I, line 6)	27	1,013
	28	**Payments:**		
	a	2002 overpayment credited to 2003 — 28a		
	b	2003 estimated tax payments — 28b 2,000		
	c	Less 2003 refund applied for on Form 4466 — 28c ( ) Bal ► 28d 2,000		
	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	2,000
	29	Estimated tax penalty (see page 14 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	987
	32	Enter amount of line 31 you want: **Credited to 2004 estimated tax** ► 987 **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 | 2-15-04 | President

Signature of officer | Date | Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

For Paperwork Reduction Act Notice, see page 20 of the instructions. Cat. No. 11456E Form **1120-A** (2003)

Part I Tax Computation (see page 17 of instructions)

1	Income tax. If the corporation is a qualified personal service corporation (see page 17), check here ▶ ☐	1	1,013
2a	General business credit. Check box(es) and indicate which forms are attached. ☐ Form 3800 ☐ Form(s) (specify) ▶	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	1,013
5	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Other (attach schedule)	5	
6	**Total tax.** Add lines 4 and 5. Enter here and on line 27, page 1	6	1,013

Part II Other Information (see page 19 of instructions)

1 See page 21 and enter the:
a Business activity code no. ▶ 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).) ☑ 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 total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year ▶ $ -0-

5a If an amount is entered on line 2, page 1, enter from worksheet on page 14 instr.:
(1) Purchases 186,490
(2) Additional 263A costs (attach schedule)
(3) Other costs (attach schedule) 45,500

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 2003 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 ▶

7 Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than $250,000? ☐ Yes ☑ No
If "Yes," the corporation is **not** required to complete Parts III and IV below.

Part III Balance Sheets per Books

			(a) Beginning of tax year	(b) End of tax year
Assets	1	Cash	18,498	43,574
	2a	Trade notes and accounts receivable		23,393
	b	Less allowance for bad debts	( )	( )
	3	Inventories	3,010	1,000
	4	U.S. government obligations	45,479	
	5	Tax-exempt securities (see instructions)		
	6	Other current assets (attach schedule)		
	7	Loans to shareholders		
	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	66,987	67,967
Liabilities and Shareholders' Equity	13	Accounts payable	7,079	3,072
	14	Other current liabilities (attach schedule)		
	15	Loans from shareholders		
	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	39,908	44,895
	21	Adjustments to shareholders' equity (attach schedule)		
	22	Less cost of treasury stock	( )	( )
	23	Total liabilities and shareholders' equity	66,987	67,967

Part IV Reconciliation of Income (Loss) per Books With Income per Return

1	Net income (loss) per books	4,987	6 Income recorded on books this year not included on this return (itemize)	
2	Federal income tax per books	1,013		
3	Excess of capital losses over capital gains		7 Deductions on this return not charged against book income this year (itemize)	
4	Income subject to tax not recorded on books this year (itemize)			
5	Expenses recorded on books this year not deducted on this return (itemize)	750	8 Income (line 24, page 1). Enter the sum of lines 1 through 5 less the sum of lines 6 and 7	6,750

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 tax year basis.

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.

Item D. You are required to enter total assets here. Tentex Toys enters $1,307,143 from line 15(d) on Schedule L.

Line 1. Gross sales, line 1a, for the year totaled $3,250,000 using an accrual method of accounting. After subtracting returned goods and allowances of $50,000, line 1c shows net sales of $3,200,000.

Line 2. Cost of goods sold is $1,920,000. This is the total from Schedule A (line 8) on page 2.

Line 3. Net sales less cost of goods sold results in a gross profit of $1,280,000.

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 $1,295,500.

Line 12. Enter the salaries of $170,000 paid to company officers listed on Schedule E. Complete Schedule E because total receipts (line 1a plus lines 4 through 10 of page 1) are $500,000 or more.

Line 13. Enter other salaries and wages of $438,000. This includes only salaries and wages not included on line 12 or 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 $12,000 work opportunity credit figured on Form 5884 (not illustrated). You reduce the total amount of other salaries and wages, $450,000, by the $12,000 credit that is included on line 6d, Schedule J. Only the balance, $438,000, 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 $14,000. See chapter 13 of Publication 535 for information on repairs.

Line 15. Tentex uses the specific charge-off method of accounting for bad debts. Actual accounts written off during the year total $3,750. See chapter 11 of Publication 535 for information on bad debt deductions.

Line 16. Rent for Tentex's office facilities was $110,000 for the year.

Line 17. Deductible taxes totaled $43,750.

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 5 of Publication 535 for a discussion of deductible interest.

Line 19. During the year, Tentex contributed $24,500 to the United Community Fund and $16,000 to the State University Scholarship Fund. The total, $40,500, 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 $32,673. The excess, $7,827, 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 $24,000. Enter it on line 20. Reduce this amount by the depreciation ($4,000) included in the amount claimed on line 5 of Schedule A. Enter it on line 21a. Deduct the balance of $20,000 on line 21b since it is the depreciation on the assets used in the indirect operations of the business.

Line 23. Advertising expense was $51,420.

Lines 24. Tentex maintains a profit-sharing plan for its employees. Tentex funded the plan with $32,650 in 2003. For information on retirement plans, see Publication 560, *Retirement Plans for Small Business.*

Line 26. Other business deductions total $58,000. 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 $1,001,443.

Lines 28, 29, and 30. Taxable income on line 28, before the net operating loss deduction and special deductions is $294,057. 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 $286,057.

Tax summary. Enter on line 31 the total tax ($82,812) from Schedule J, page 3. List payments you can apply against the tax on line 32. The only payments on the Tentex return are four estimated tax deposits totaling $90,000. Enter this amount on lines 32b, 32d, and 32h. The resulting overpayment is $7,188, which Tentex chooses to have credited to next year's estimated tax. Tentex could have chosen to have the overpayment refunded.

Signature. An authorized corporate officer must 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 $298,400 and at the end of the year at $755,700, 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 $1,345,100 on line 2. This includes subcontracted parts as well as raw materials. Direct labor, on line 3, is $802,000. This amount includes wages paid to production-line workers and the part of supervisory salaries incurred 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 $85,000 on line 4 is for indirect general administration costs. Other costs of $145,200 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 $4,000 is depreciation on the assets used in the direct operations of the business.

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

Schedule C—Dividends and Special Deductions. Dividend income is $10,000, all of which qualifies 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 $286,057 results in income tax of $94,812. Decrease this amount by the work opportunity credit of $12,000, resulting in a total tax of $82,812.

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.

Tentex answers “No” to Question 13 and is required to complete Schedules L, M–1, and M–2 on page 4.

Page 4

Schedule L—Balance Sheets per Books. You are not required to complete Schedule L if the answer to Question 13 on Schedule K is “Yes.” Tentex must complete Schedule L and 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. You are not required to complete Schedules M–1 and M–2 if the answer to Question 13 on Schedule K is “Yes.” Tentex must complete Schedules M–1 and M–2.

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			$3,250,000
Sales returns and allowances		$50,000	
Cost of goods sold		1,920,000	
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		170,000	
Salaries and wages—indirect		450,000	
Repairs		14,000	
Bad debts		3,750	
Rental expense		110,000	
Taxes		43,750	
Interest expense:			
On loan to buy tax-exempt bonds	$850		
Other	27,200	28,050	
Contributions		40,500	
Depreciation—indirect		18,380	
Advertising		51,420	
Profit-sharing plan		32,650	
Other expenses of operations		58,000	
Loss on securities		3,600	
Federal income tax accrued		82,812	
Net income per books after tax		193,588	
Total		**$3,280,000**	**$3,280,000**

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)		276,400
Reserve for contingencies	$10,000	
Income tax accrued for the year	82,812	
Dividends paid during the year	65,000	
Refund of 2000 income tax		18,000
Balance, December 31	374,588	
Total	**$532,400**	**$532,400**

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. $193,588 is the net income per books. It appears in the profit and loss account as net income per books after tax.

Line 2. $82,812 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 $7,827 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.

1.	Premiums paid on term life insurance on corporate officers	$9,500
2.	Interest paid to purchase tax-exempt securities	850
3.	Reduction of salaries by work opportunity credit	12,000
4.	**Total**	**$22,350**

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 the 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 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), $193,588.

Line 3. This shows all other increases to retained earnings. Enter the $18,000 refund of 2000 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 2003 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 2004 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 2004. 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. $374,588 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.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

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

U.S. Corporation Income Tax Return

OMB No. 1545-0123

2003

For calendar year 2003 or tax year beginning ...., 2003, ending ...., 20....

▶ Instructions are separate. See page 20 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 Regulations sec. 1.441-3(c)— see instructions) ☐

Use IRS label. Otherwise, print or type.

10-9385564 DEC03 071 3998
Tentex Toys, Inc.
36 Division Street
Anytown, IL 60930

B Employer identification number

C Date incorporated 3-1-72

D Total assets (see page 8 of instructions) $ 1,307,143

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income

1a	Gross receipts or sales 3,250,000	b Less returns and allowances 50,000	c Bal ▶	1c	3,200,000
2	Cost of goods sold (Schedule A, line 8)			2	1,920,000
3	Gross profit. Subtract line 2 from line 1c			3	1,280,000
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 9 of instructions—attach schedule)			10	
11	**Total income.** Add lines 3 through 10 ▶			11	1,295,500

Deductions (See instructions for limitations on deductions.)

12	Compensation of officers (Schedule E, line 4)			12	170,000
13	Salaries and wages (less employment credits)			13	438,000
14	Repairs and maintenance			14	14,000
15	Bad debts			15	3,750
16	Rents			16	110,000
17	Taxes and licenses			17	43,750
18	Interest			18	27,200
19	Charitable contributions (see page 11 of instructions for 10% limitation)			19	32,673
20	Depreciation (attach Form 4562)	20	24,000		
21	Less depreciation claimed on Schedule A and elsewhere on return	21a	4,000	21b	20,000
22	Depletion			22	
23	Advertising			23	51,420
24	Pension, profit-sharing, etc., plans			24	32,650
25	Employee benefit programs			25	
26	Other deductions (attach schedule)			26	58,000
27	**Total deductions.** Add lines 12 through 26 ▶			27	1,001,443
28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	294,057
29	**Less:** a Net operating loss (NOL) deduction (see page 13 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	286,057
31	**Total tax** (Schedule J, line 11)					31	82,812
32	**Payments: a** 2002 overpayment credited to 2003	32a					
b	2003 estimated tax payments	32b	90,000				
c	Less 2003 refund applied for on Form 4466	32c	( )	d Bal ▶ 32d	90,000		
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	90,000
33	Estimated tax penalty (see page 14 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	7,188
36	Enter amount of line 35 you want: **Credited to 2004 estimated tax** ▶ 7,188 **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.

Jane Barclay | 3-7-04 | President

Signature of officer | Date | Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

Cat. No. 11450Q

Form **1120** (2003)

Schedule A Cost of Goods Sold (see page 14 of instructions)

1	Inventory at beginning of year	1	298,400
2	Purchases	2	1,345,100
3	Cost of labor	3	802,000
4	Additional section 263A costs (attach schedule)	4	85,000
5	Other costs (attach schedule)	5	145,200
6	**Total.** Add lines 1 through 5	6	2,675,700
7	Inventory at end of year	7	755,700
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on line 2, page 1	8	1,920,000

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 instructions beginning on page 15)

		(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 16 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, on page 10 of instructions)

Note: *Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1) 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	Jane Barclay	581-00-0936	100 %	45 %	%	135,000
			%	%	%	
	Maxine R. Collins	447-00-2604	100 %	15 %	%	70,000
			%	%	%	
	Charlene Gibbons	401-00-2611	50 %	2 %	%	37,857
2	Total compensation of officers					242,857
3	Compensation of officers claimed on Schedule A and elsewhere on return					72,857
4	Subtract line 3 from line 2. Enter the result here and on line 12, page 1					170,000

Schedule J Tax Computation (see page 17 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 17.

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 17) ▶ ☐		3	94,812
4	Alternative minimum tax (attach Form 4626)		4	
5	Add lines 3 and 4		5	94,812
6a	Foreign tax credit (attach Form 1118)	6a		
b	Possessions tax credit (attach Form 5735)	6b		
c	Check: ☐ Nonconventional source fuel credit ☐ QEV credit (attach Form 8834)	6c		
d	General business credit. Check box(es) and indicate which forms are attached. ☐ Form 3800 ☑ Form(s) (specify) ▶ 5884	6d 12,000		
e	Credit for prior year minimum tax (attach Form 8827)	6e		
f	Qualified zone academy bond credit (attach Form 8860)	6f		
7	**Total credits.** Add lines 6a through 6f		7	12,000
8	Subtract line 7 from line 5		8	82,812
9	Personal holding company tax (attach Schedule PH (Form 1120))		9	
10	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Other (attach schedule)		10	
11	**Total tax.** Add lines 8 through 10. Enter here and on line 31, page 1		11	82,812

Schedule K Other Information (see page 19 of instructions)

		Yes	No
1	Check method of accounting: a ☐ Cash b ☑ Accrual c ☐ Other (specify) ▶		
2	See page 21 of the instructions and enter the: a Business activity code no. ▶ 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 employer identification number (EIN), **(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 name and EIN 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,** Corporate Report of Nondividend Distributions. If this is a consolidated return, answer here for the parent corporation and on **Form 851,** Affiliations Schedule, for each subsidiary.		
7	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," enter: **(a)** Percentage owned ▶ and **(b)** Owner's country ▶		
c	The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter number of Forms 5472 attached ▶		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
9	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ 5,000		
10	Enter the number of shareholders at the end of the tax year (if 75 or fewer) ▶ 6		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here ▶ ☐ If the corporation is filing a consolidated return, the statement required by Temporary Regulations section 1.1502-21T(b)(3)(i) or (ii) must be attached or the election will not be valid.		
12	Enter the available NOL carryover from prior tax years (Do not reduce it by any deduction on line 29a.) ▶ $		
13	Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than $250,000?		√
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 4. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ▶ $		

Note: *If the corporation, at any time during the tax year, had assets or operated a business in a foreign country or U.S. possession, it may be required to attach* **Schedule N (Form 1120),** *Foreign Operations of U.S. Corporations, to this return. See Schedule N for details.*

Note: *The corporation is not required to complete Schedules L, M-1, and M-2 if Question 13 on Schedule K is answered "Yes."*

Schedule L Balance Sheets per Books

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash		14,700		18,650
2a Trade notes and accounts receivable	98,400		98,907	
b Less allowance for bad debts	( )	98,400	( )	98,907
3 Inventories		298,400		755,700
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 shareholders				
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)	192,420
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		4,200
15 Total assets		856,700		1,307,143
Liabilities and Shareholders' Equity				
16 Accounts payable		128,900		233,055
17 Mortgages, notes, bonds payable in less than 1 year		4,300		4,300
18 Other current liabilities (attach schedule)		6,800		87,400
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more		248,700		367,800
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		374,588
26 Adjustments to shareholders' equity (attach schedule)				
27 Less cost of treasury stock		( )		( )
28 Total liabilities and shareholders' equity		856,700		1,307,143

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return (see page 20 of instructions)

1 Net income (loss) per books	193,588	7 Income recorded on books this year not included on this return (itemize): Tax-exempt interest $ 5,000; Insurance proceeds 9,500	14,500
2 Federal income tax per books	82,812	8 Deductions on this return not charged against book income this year (itemize): a Depreciation $ 1,620; b Charitable contributions $	1,620
3 Excess of capital losses over capital gains	3,600	9 Add lines 7 and 8	16,120
4 Income subject to tax not recorded on books this year (itemize):		10 Income (line 28, page 1)—line 6 less line 9	294,057
5 Expenses recorded on books this year not deducted on this return (itemize): a Depreciation $; b Charitable contributions $ 7,827; c Travel and entertainment $ See attached itemized statement (not shown) $22,350	30,177		
6 Add lines 1 through 5	310,177		

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	193,588	b Stock	
3 Other increases (itemize): Refund of 2000 income tax due to IRS examination	18,000	c Property	
		6 Other decreases (itemize): Reserve for contingencies	10,000
		7 Add lines 5 and 6	75,000
4 Add lines 1, 2, and 3	449,588	8 Balance at end of year (line 4 less line 7)	374,588

Form **1120** (2003)

- Call the Taxpayer Advocate toll free at **1–877–777–4778.**
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1–800–829–4059** if you are a TTY/TDD user.
- Visit the website at **www.irs.gov/advocate**.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS.*

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services.* It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Internet. You can access the IRS website 24 hours a day, 7 days a week, at **www.irs.gov** to:

- ***E-file.*** Access commercial tax preparation and *e-file* services available for free to eligible taxpayers.
- Check the amount of advance child tax credit payments you received in 2003.
- Check the status of your 2003 refund. Click on "Where's My Refund." Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- See answers to frequently asked tax questions.
- Search publications online by topic or keyword.
- Figure your withholding allowances using our Form W-4 calculator.
- Send us comments or request help by email.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.

You can also reach us using File Transfer Protocol at **ftp.irs.gov**.

Fax. You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call **703–368–9694** from your fax machine. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call **703–487–4608.**

Long-distance charges may apply.

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1–800–829–3676** to order current-year forms, instructions, and publications and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at **1–800–829–4933.**
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to **www.irs.gov** or look in the phone book under "United States Government, Internal Revenue Service."
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1–800–829–4059** to ask tax or account questions or to order forms and publications.
- *TeleTax topics.* Call **1–800–829–4477** to listen to pre-recorded messages covering various tax topics.
- *Refund information.* If you would like to check the status of your 2003 refund, call **1–800–829–4477** for automated refund information and follow the recorded instructions or call **1–800–829–1954**. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

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Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local Center and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to **www.irs.gov** or look in the phone book under "United States Government, Internal Revenue Service."

CD-ROM for tax products. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM,* and obtain:

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- Prior-year forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
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Buy the CD-ROM from National Technical Information Service (NTIS) on the Internet at **www.irs.gov/cdorders** for $22 (no handling fee) or call **1–877–233–6767** toll free to buy the CD-ROM for $22 (plus a $5 handling fee). The first release is available in early January and the final release is available in late February.

CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide,* is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in early April. You can get a free copy by calling **1–800–829–3676** or by visiting the website at **www.irs.gov/smallbiz**.

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To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

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