★ Chapter One ★

INCOME TAXATION OF CORPORATIONS

INTRODUCTION AND STUDY OBJECTIVES

Corporations, except for corporations electing to be taxed under Subchapter S, are taxed on their gross income less certain deductions and credits. In general, the computation of taxable income for a corporation is similar to that of an individual—even though some corporations are entitled to special deductions not available to individuals. Upon initial examination of an entity, problems sometimes arise in determining whether or not an organization is taxable as a corporation. Classification as a corporation depends upon a number of corporate characteristics. As a result, corporations for tax purposes may include entities that were established under state law as some other form of organization.

In studying the income tax rules of corporations, the student should have these objectives:

1. To learn the definition of a corporation for Federal income tax purposes.

2. To comprehend the manner in which certain items are treated at the corporate level as compared to the treatment of a similar item at the individual level.

3. To understand how the corporate income tax is computed and to become familiar with the related filing requirements.

STUDY HIGHLIGHTS

OVERVIEW OF BUSINESS FORMS

1. Businesses can be operated as sole proprietorships, partnerships, or corporations. More businesses are operated as proprietorships, however, due to the fact that it is the simplest form available—both personally and legally as well as for tax reasons. For tax purposes, proprietorship ordinary income and deductions are reported on Schedule C (or Schedule F for farms) of the individual proprietor's tax return, Form 1040.

2. Like the sole proprietorship, partnership income receives conduit treatment. Essentially, the partnership never pays tax on its income, but the income (or loss) flows through to the partners and receives tax treatment on the partners' tax returns.

3. The Code also provides an election for certain closely held corporations, known as S corporations, to be taxed as a conduit. Therefore, like a partnership, the income (or loss) flows through to the shareholders.

   Example. During the current year, J Company receives tax-exempt interest, which is distributed to its owner. If J Co. is a regular corporation, the distribution to the shareholders is a dividend, even though it originated from tax-exempt interest. On the other hand, if J Co. is a partnership or S corporation, the tax-exempt interest will retain its identity and pass through to each individual partner.

4. Section 11 imposes a tax on all domestic and foreign corporations, whether their income comes from foreign or domestic sources. While the overall taxation of corporations is similar to individual taxation, several important differences exist. Many of these differences are found in the manner in which certain categories of income are taxed and in the method used to calculate taxable income.

WHAT IS A CORPORATION

5. Section 7701(a)(3) defines the term *corporation* to include associations, joint-stock companies, and insurance companies. Because of the broad definition, taxpayers have had to rely on court decisions and Regulations to help clarify its meaning—especially for associations. The Regulations define associations as having the following characteristics:

   1. Associates;
   2. A profit motive;
   3. Continuity of life;
   4. Centralized management;
   5. Free transferability of interest; and
   6. Limited liability.

   To test to see if an entity is taxed as a corporation, common attributes of the comparing entity are disregarded and a majority of the remaining characteristics means the entity is a corporation.

   Example. X, a professional partnership, possesses the attributes of centralized management, continuity of life, and free transferability of interest. In determining whether the entity is a partnership or a corporation for tax purposes, the first two attributes are ignored (associates and profit motive), and the remaining four are examined. Since X satisfies three of the remaining four attributes, it is treated as an association and therefore is taxed as a corporation even though it may actually be a partnership under state law.

6. State-registered limited liability companies (LLCs) are a relatively new form of business entity. A properly structured LLC is taxed as a partnership for federal income tax purposes, but its members, like corporate shareholders, are not personally liable for the entity's debts and liabilities. An LLC is taxable as a partnership if it lacks two or more of the corporate characteristics listed in **5** above. Most LLCs that are classified as partnerships are found (under their operating agreements and the applicable state statutes) to lack the corporate characteristics of continuity of life and free transferability of interests.

7. Final check-the-box regulations were issued along with new Form 8832, Entity Classification Election that must be filed when making a choice of entity. The check-the-box entity classification has yielded a drastically simpler entity classification system. The new Form 8832 should be used by entities that choose **not** to be classified under the default rules or that wish to change their previous classification.

8. If a corporation has no real business or economic function, it may be considered a sham or dummy corporation. Generally, the IRS, and not the taxpayer, is allowed to disregard the status of the corporation.

9. Certain partnerships, known as *publicly traded partnerships* (PTP) will be treated and taxed as regular corporations. A PTP is a limited partnership organized after December 17, 1987 and is traded on an established securities market.

COMPARISON OF CORPORATE AND INDIVIDUAL INCOME TAXATION

10. A corporation computes its income tax liability in the following manner:

	Economic income
–	Statutory exclusions
	Gross income
–	Deductions
	Taxable income before special deductions
–	Net Operating Loss
–	Dividends-received deduction
	Taxable income
×	Applicable tax rates
	Tax liability

11. Although some differences do exist for exclusions, the definition of gross income is the same for both corporations and individuals. Corporations, however, do not have adjusted gross income (A.G.I.). That is a concept unique to individual taxation. Generally, with few exceptions, all deductions for corporations are trade or business deductions.

12. Corporations are entitled to a special deduction for dividends received from other corporations. In general, the deduction is equal to 70 percent of the dividend, but limited to 70 percent of taxable income (computed without regard to the dividends-received deduction) for corporations that own less than 20 percent of the dividend-paying corporation. If the corporation owns at least 20 percent (but less than 80 percent) of the dividend-paying corporation, however, the dividends-received deduction substitutes 80 for the 70 percent figure. A special rule exists to bar the taxable income limitation and allow the entire 70 (80) percent deduction without limit. It occurs if the 70 (80) percent, when taken, creates or adds to a net operating loss. For 1987, the deduction for dividends received from all other unaffiliated corporations was 80 percent across the board. Prior to 1987, the deduction was 85 percent.

13. The dividends-received deduction is 100 percent for dividends received from other corporations in the same affiliated group.

14. The Jobs Act of 2004 modified §195 and §248 to allow taxpayers can elect to deduct up to $5,000 of start-up expenditures in the tax year in which the business begins. The $5,000 immediate write-off is phased out for each dollar of start-up costs in excess of $50,000. The remainder of any start-up expenditures must be amortized over a 180 month period beginning with the month in which the business begins.

Example If N corporation incurs $23,000 of organization expenses, it could deduct $5,000 and amortize the remaining balance of $18,000 over 15 years (180 months) beginning in July. This would result in amortization of $100/month for 180 months. Organization expenses for the year would be $5,600 computed as follows: First year deduction $5,000 + ($18,000/180 = 100/month × 6 months) 600 = Total organization expense deduction in the first year of $5,600.

15. Computing the net operating loss for corporations is different from that of individuals. A corporation does not adjust its tax for capital gains and losses. It also does not make adjustments for nonbusiness deductions or personal exemptions. The loss is carried back 2 years and forward 20. An election is available to forego the carryback period so that the net operating loss is only carried forward. Various disaster relief provisions often modify the carryback period for selected areas of the United States that experience natural disasters.

16. A corporation is entitled to a deduction for its charitable contributions. A contribution deduction of ordinary income property is normally limited to basis. However, a special rule exists for contributions to the aid of ill, needy, elderly, or infants. In this case, the deduction is basis plus half of the appreciation. Appreciation is defined as fair market value less cost.

Example. B, a corporation that manufactures batteries, donates some of its inventory [FMV of $12,000; cost of $5,000] to the Red Cross to be used in their motorized wheelchairs. B's deduction (before percentage limitation) would amount to $8,500 [$5,000 + ½ of ($12,000 − $5,000)].

17. Long-term capital gain property is generally taken at fair market value. However, if the contribution is made with tangible personal property, unrelated to the exempt organization's function, the deduction is limited to fair market value less the appreciated value, essentially the basis. The same reduction of fair market value is required for contributions of any property to a private foundation.

18. A corporation is limited to the amount of its contribution deduction. The limit is 10 percent of taxable income without regard to:

- the dividends-received deduction
- net operating loss carrybacks
- capital loss carrybacks, and
- the charitable contribution deduction itself.

Any contribution that is in excess of the 10 percent amount is carried forward for five years.

19. A corporation determines its capital gains and losses in the same manner as other taxpayers. However, some differences in the tax treatment do exist. Instead of an exclusion (similar to those received by individuals prior to 1987), corporations are entitled to an "alternative tax" on its "net capital gain." This technique is only used if the tax is less than the regular tax. Effective July 1, 1987 the alternative tax rate became 35 percent. The limited loss deduction of $3,000 is not allowable to corporations. Thus, a corporation can only use capital losses to offset capital gains. Excess capital losses are carried back three years and forward five years. All carrybacks are treated as short-term capital losses.

20. Beginning in 2001, Congress capped an individual's long-term capital gains tax rate to 15 percent, which is less than the 35 percent rate on ordinary income. Congress did not extend this equivalent treatment to corporations. Thus, a corporation's capital gains may be taxed at the corporation's highest tax bracket.

21. In 1982, Congress added § 291 to the tax law to reduce the benefits of ACRS depreciation on real property. As a result of this section, a corporation must treat as ordinary income 20 percent of any § 1231 gain that would have been ordinary income if § 1245 had applied as opposed to § 1250.

22. Under § 267 corporations are not allowed to deduct losses incurred in transactions between related parties. The 1986 Tax Act expanded the definition of a related party to include employee-owners that own any of their personal service corporation. In addition, the character of gain can be reclassified from capital gain to ordinary income in transactions between shareholders owning more than 50 percent of their corporation.

COMPUTATION OF THE CORPORATE TAX

23. Beginning in 1993, Congress raised the top rate applying to corporate taxpayers to 35 percent, but only for those corporations that have taxable income in excess of $10,000,000. The current rate structure is as follows:

$ 1	–	$ 50,000	@	15%
50,001	–	75,000	@	25%
75,001	–	10,000,000	@	34%
10,000,001	–	15,000,000	@	35%

24. Once a corporation reaches a taxable income threshold of $15,000,000, Congress elected to phaseout the 34 percent benefit on the first $10,000,000. This $100,000 benefit (i.e. $10,000,000 @ 1%) is phased-out by adding 3 percent to the tax rate until the $100,000 is recovered. Thus, between $15,000,000 and $18,333,333 the tax rate becomes 38 percent. At $18,333,333 the tax rate drops back to 35 percent. Thus:

$15,000,001	–	$18,333,333	@	38%
18,333,334	–	—	@	35%

25. To restrict the tax benefit of the lower graduated rates, the TRA of 1986 added a surtax on all corporations whose taxable income exceeds $100,000. The additional tax is 5 percent of all income in excess of $100,000 until such time that the $11,750 tax savings on the lower bracket amounts is phased out. This, in essence, causes corporations whose taxable income is between $100,000 and $335,000 to be taxed at a marginal rate of 39 percent after 1987. Once a corporation's income exceeds $335,000, the corporate tax is a flat rate of 34 percent until it reaches $10,000,000. Thus:

$100,001	–	$335,000	@	39%

26. Corporations whose principal activity is the performance of services are known as *personal service corporations* (PSC). PSCs must use a calendar year and are not entitled to use the lower bracket amounts in determining their income tax liability (i.e., they must use a flat 34 percent rate).

27. Corporations often fall into a category known as a *controlled group* of corporations. A controlled group consists of parent-subsidiary corporations, brother-sister corporations, and combined groups. When a controlled group exists, all the corporations comprising the group are limited to a single lower bracket rate for the entire group. The combined tax would be the same as if the entire group filed as one corporation. If an election to apportion the lower bracket amounts is not made, the Internal Revenue will make a pro rata allocation.

28. The 2004 Jobs Act amended the definition of a brother-sister controlled group by deleting the 80 percent text, leaving only the 50 percent test.

Example. Individuals X and Y own the stock of B and S corporations as follows:

	Percent owned		Common
Shareholder	B	S	Ownership
X	76	54	54
Y	0	26	0
	76	80	54

With the *deletion of the 80 percent test* for Corporations B and S, the corporations are now considered component members of a brother-sister controlled group. Under the pre-Jobs Act changes, this ownership would not have qualified for controlled group status.

29. Like individuals, some corporations are subject to the alternative minimum tax. The tax is computed at a rate of 20 percent on all alternative minimum taxable income (AMTI) in excess of $40,000. This $40,000 exemption is phased out once AMTI exceeds $150,000 at a rate of 25 percent. Consequently, the exemption is completely eliminated once AMTI exceeds $310,000. A corporation will only pay the alternative minimum tax when this tax exceeds its regular tax liability. (A comprehensive problem follows the study questions.)

Example. B Corp. has AMTI of $180,000 before the exemption amount. Since the exemption amount must be reduced by $7,500 [25% ($180,000 − $150,000)], the amount remaining becomes $32,500 ($40,000 − $7,500). Thus, the tax base for the AMT will be $147,500 ($180,000 − $32,500). Note that the exemption will phase out entirely when AMTI reaches $310,000.

30. The Tax Reform Act of 1986 significantly expanded the tax base subject to the alternative minimum tax. This tax base is expanded by adding certain tax preference items to AMTI. Section 57 sets forth the tax preference items and specifies each calculation. However, first year corporations and small corporations are exempt from this tax.

31. To alleviate the possibility of a double tax under the new alternative minimum tax computation, Congress introduced an alternative minimum tax credit. Generally, the alternative minimum tax paid in one year may be used as a credit against the corporation's regular tax liability in a future year. This credit can be carried forward indefinitely until used. The credit may not be carried back, nor may it be used to offset a future minimum tax liability.

CORPORATE TAX FORMS

32. A corporation files its information on a Form 1120. The return must be filed by the fifteenth day of the third month following the close of the corporation's tax year. An automatic extension of six months can be received by filing a Form 7004; however, the estimated balance of the tax must be paid with the extension. In essence, the extension is only granted for preparing the tax return and not for deferring the payment.

33. Similar to individual taxation, corporations are required to prepay their tax liability (including any estimated AMT liability) and file estimated tax forms. The estimates are due on the fifteenth day of the fourth, sixth, ninth, and twelfth months. If estimated taxes are not paid or, if paid, they are underestimated, the corporation may be subject to a penalty. There are two exceptions available to waive the penalty. However, neither of those exceptions is available to corporations with taxable income in excess of $1 million.

STUDY QUESTIONS

True or False

______ **1.** Unlike a corporation, a partnership is a conduit and its income is taxed to the respective partners.

______ **2.** An organization may be treated as a corporation for Federal tax purposes even though it is not a corporation under state law.

______ **3.** A dividend from an affiliated corporation owned more than 80 percent is entitled to a 100 percent dividends-received deduction.

______ **4.** A corporate net operating loss may be carried back three years and forward five years.

______ **5.** The alternative tax computation for corporations still applies to the "net capital gain" of the corporation.

______ **6.** Corporations are entitled to the 15 percent long-term capital gain tax rate.

______ **7.** More businesses are operated as corporations than any other form.

______ **8.** Corporations may amortize and deduct organizational expenditures ratably over a period of not less than 40 years.

______ **9.** Corporations A and B each have taxable income of $100,000. If they are members of a controlled group, their aggregate tax liability will be lower than the sum of their tax liabilities if they are not members of a controlled group.

______ **10.** Ignoring exceptions, to avoid a penalty for underpayment of estimated taxes, at least 100% of the corporation's tax due for the year must be paid as estimated taxes.

______ **11.** If a corporation realizes a long-term capital loss during the year that cannot be used in that year, the loss will retain its character when carried to another year.

______ **12.** If a corporation does not elect to amortize organizational expense, the expense may not be utilized until the corporation undergoes a liquidation.

______ **13.** Personal service corporations are always taxed the same as other corporations.

______ **14.** A corporation with a fiscal year ending April 30 must file its tax return by June 15, provided that date is not a Saturday, Sunday, or legal holiday.

______ **15.** A corporation will receive an automatic extension of time for filing a return by submitting an application for extension on Form 7004 and paying the tax due by the due date for the return.

______ **16.** Members of a controlled group of corporations must, in the absence of any other agreement, allocate the use of the lower bracket tax rates to all the members of the group equally.

______ **17.** The net operating loss deduction for a corporation's tax year is the sum of net operating loss carrybacks and carryovers to the tax year plus the net operating loss for that tax year.

______ **18.** If a corporation's capital losses exceed its capital gains, it may elect to carry the capital losses forward for seven years instead of carrying them back three and forward five years.

______ **19.** Mr. T owns 100 percent of the outstanding voting stock of Corporations A and B. Corporation B, in turn, owns 90 percent of the outstanding voting stock of Corporation Z. Corporations A, B, and Z are all members of a controlled group of corporations.

______ **20.** To apply for a quick refund of prior years' taxes due to a net operating loss carryback, a corporation must file Form 1139 (Corporate Application for Tentative Refund) no later than 12 months from the due date of the loss year tax return.

Multiple Choice

1. Ten individuals form an organization to conduct business and share profits. The organization has provided for continuity of life, centralized management, and limited liability of its owners. It also allows individuals to maintain free transferability of interest. How will this organization be taxed?

______ **a.** As a partnership.
b. As a trust.
c. As a joint venture.
d. As an association.
e. As a personal holding company.

2. T, a newly formed corporation, elects to use a calendar year end. On July 1, 2007 the corporation incurred $6,800 of qualified organizational expenses. Assuming the company started business on July 1, 2007, what is the maximum allowable deduction for calendar year 2007?

______ **a.** $0.
b. $680.
c. $1,200.
d. $5,060.
e. $6,000.

3. Which of the following is not considered an organizational expense that is amortizable on a corporation's tax return?

______ **a.** Fee paid to the state for incorporation.
b. Printing fee for stock certificates.
c. Accountant's fees incident to the organization.
d. Legal fees for drafting the bylaws.
e. Temporary director's fees.

4. For the period ended December 31, 2007, T Corporation has income of $160,000 from operations and dividend income of $100,000 from unaffiliated domestic corporations in which it owns 25 percent. Business deductions for the year amounted to $170,000. Based upon this information, calculate the dividends-received deduction for 2007.

______ **a.** $0.
b. $72,000.
c. $80,000.
d. $90,000.
e. None of the above.

5. Which of the following receipts will qualify for the dividends-received deduction?

______ **a.** Dividends from an FSC.
b. Dividends from a mutual savings bank.
c. Dividends from a real estate investment trust.
d. Dividends from a tax-exempt corporation.
e. Dividends from a taxable domestic corporation.

6. Which of the following contributions made by T Corporation would be deductible for federal income tax purposes?

______ **a.** $5,000 to Harvard University's scholarship fund.
b. $5,000 to the American Cancer Society.
c. $5,000 to Friends of Fish, a Canadian charity.
d. Only (a) and (b) are deductible.
e. All of the above are deductible.

7. For calendar year 2007, R Corporation had taxable income of $280,000 before deducting charitable contributions. The dividends-received deduction was $34,000. R made cash contributions of $35,000 to qualified charities. What is the 2007 deduction for contributions?

______ **a.** $28,000.
b. $31,400.
c. $32,000.
d. $35,000.
e. None of the above.

8. M Corporation had taxable income for 2007 of $40,000 before deducting contributions to charities. During 2007, it gave $5,000 in securities (basis of $1,000) to a qualified charity. M had a contribution carryover from 2006 of $1,000. What is M's contribution deduction for 2007?

______ **a.** $1,000.
b. $2,000.
c. $4,000.
d. $5,000.
e. $6,000.

9. In 2007, its first year of operation, C Corporation had a gross profit from operations of $360,000 and deductions before any special deductions of $500,000. C also received dividends from unaffiliated domestic corporations in which it owned 50 percent of $100,000. What is C's net operating loss for 2007?

______ **a.** None during first year.
b. $32,000.
c. $40,000.
d. $60,000.
e. $120,000.

10. How will a long-term capital loss of a corporation be treated in a carryback or carryover year?

______ **a.** As a long-term capital loss.
b. As a reduction of ordinary income.
c. As an offset against both ordinary income and long-term capital gains.
d. As an offset against both ordinary income and short-term capital gains.
e. As a short-term capital loss.

11. Which of the following items should not be reflected on schedule M-1 of the corporation's tax return, Form 1120?

______ **a.** Officers' life insurance premium (corporation is the beneficiary).
b. Federal income taxes.
c. Differences in book and tax return depreciation.
d. Pension plan deductions.
e. None of the above.

12. In computing a corporation's taxable income, a net capital loss is treated as follows:

______ **a.** Deductible in full in the year sustained.
b. Never deductible in the year sustained.
c. Limited to a maximum of $3,000 in the year sustained.
d. Limited to 50 percent of the net loss in the year sustained.
e. None of the above.

13. Corporation Y's taxable income for 2007 was $100,000 which was figured by taking into account a charitable contribution deduction of $12,000. What is the correct contribution deduction?

______ **a.** $5,000.
b. $5,600.
c. $10,000.
d. $11,200.
e. $12,000.

14. Corporation B incurred net capital losses of $5,000 in 2004, $10,000 in 2005, and $6,000 in 2006. These losses could not be carried back. In 2007, Corporation B had a net capital gain of $8,000. How much of the capital loss carryover to 2008 originated in the 2004 tax year?

______ **a.** $0.
b. $2,000.
c. $7,000.
d. $8,000.
e. $10,000.

15. Determine Corporation Q's 2007 net operating loss based on the following information.

Income from operations	$1,200,000
Dividends from domestic corporations (30% owned)	300,000
Business deductions	1,400,000
Net operating loss carryover from 2006	200,000

______ **a.** $0.
b. $100,000.
c. $140,000.
d. $280,000.
e. $340,000.

16. During the year Corporation P had a loss from operations of $10,000 and received qualifying dividends from 15 percent owned domestic corporations in the amount of $90,000. P's taxable income is $80,000 before the deduction for dividends received is considered. Determine P's dividends-received deduction.

______ **a.** $56,000.
b. $64,000.
c. $70,000.
d. $80,000.
e. None of the above.

17. For its taxable year ending December 31, 2007, T Corporation has the following taxable income and deductible expenses:

Gross income from operations	$205,000
Deductible expenses of operations	218,000
Dividends received	35,000

The dividends were received from a taxable domestic corporation in which T owns 15 percent of the stock (not debt-financed). What is T Corporation's dividends-received deduction for 2007?

______ **a.** $0
b. $15,400
c. $21,000
d. $24,500
e. $35,000

18. Corporations A, B, and C are *taxable domestic corporations*. All are members of an affiliated group. Corporation A pays a $50,000 dividend to B and a $50,000 dividend to C. Corporations B and C are each entitled to a dividends-received deduction of:

______ **a.** $35,000.
b. $40,000, subject to the taxable income limitation.
c. $50,000.
d. $0.
e. None of the above.

19. Q Corporation has taxable Income of $300,000. What is Q Corporations tax liability for the year?

______ **a.** $102,000
b. $101,500
c. $100,250
d. $90,250
e. None of the above

20. Z Corporation had 2007 taxable income of $600,000 before considering the following:

Gain on the sale of equipment	$15,000
Loss on the sale of equipment	(29,000)
Gain on the sale of land used in the business	70,000
Loss on the sale of investment held five months	(5,000)
Loss on the sale of investment held two years	(18,000)

The equipment sold at a gain originally cost $150,000, and $90,000 of depreciation had been claimed. What is Z Corporation's taxable income for 2007?

______ **a.** $618,000
b. $633,000
c. $647,000
d. $671,000
e. $685,000

Fill In the Blanks

1. A corporation that serves no real or business function may be classified as a ________ corporation.

2. A partnership that possesses the attributes of centralized management, continuity of life, and limited liability will be classified as an ________ .

3. The dividends-received deduction for the parent of an affiliated subsidiary is ________ percent.

4. A brother-sister corporation falls into a category classified as a ________ of corporations.

5. The ________ ________ ________ ________ serves to alleviate the possibility of a double tax under the alternative minimum tax scheme.

6. A corporation's tax return is filed on a Form ________ and can be extended on a Form ________ .

7. Corporations whose principal activities are the performance of services are known as ________ ________ ________ .

8. A corporation's net operating loss can be carried back ________ years and forward ________ years.

Code Section Recognition

For each of the following Code sections, try to match the response that most properly identifies the underlying provision.

1.	§ 11	a. related-party transactions
2.	§ 170	b. controlled groups of corporations
3.	§ 246	c. capital loss carrybacks
4.	§ 267	d. charitable contributions
5.	§ 1212	e. dividends-received deduction
6.	§ 1563	f. corporate tax rates

COMPREHENSIVE ALTERNATIVE MINIMUM TAX PROBLEM

Facts: Assume that T, a calendar year corporation, has pre-tax accounting income of $400,000, as reported on the audited financial statement for 2006, its first year of operation. In addition, the following information is available:

- Nonessential municipal bond interest of $40,000 was earned during 2006 (nontaxable for regular tax but includible for AMT).
- Two asset purchases were made during the year (no § 179 election is made):

- A heavy duty truck with a six-year ADR midpoint was purchased on November 1, 2006 for $10,000.
- A machine with an eight-year ADR midpoint was purchased on May 15, 2006 for $14,000.
- The corporation uses S/L with a half-year convention for book purposes. (Book useful life is the ADR midpoint.)

- Land (investment property > 1 year) was donated to a qualified charitable organization that had a fair market value of $60,000 and a basis of $10,000. (Assume that the corporation expensed the $60,000 for book purposes.)
- Interest used to purchase the municipal bonds amounted to $20,000 for 2006.
- Life insurance received upon the death of an officer amounted to $200,000.
- Dividends received from an 18 percent owned subsidiary amounted to $20,000.
- Assume Adjusted Current Earnings (ACE) is also $400,000.

Requirements: Based upon these facts, calculate the following:

1. Taxable income for 2006 and the associated tax liability.
2. Alternative Minimum Taxable Income for 2006.
3. Tentative Minimum Tax Liability for 2006.

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FEDERAL INCOME TAX RETURN PROBLEM

On January 2, 2005 Soxy Lady, Inc., a calendar year C corporation, was organized with a capitalization of $2,000. During its first year of operations it had a loss of $12,000. For the year 2006, operations look a bit more profitable. The following information is extracted from the books and records of the company.

I.	Gross receipts	$530,000
	Returns and allowances	(4,500)
	Interest income	1,500
	Wages (other than officers)	75,000
	Repairs	1,200
	Interest expense	27,000
	Depreciation	10,000
	Advertising	3,500
	Deliveries	1,000
	Freight	500
	Postage	1,500
	Insurance	32,000
	Office supplies	1,200
	Rent	45,000
	Taxes	28,000
	Telephone	8,500
	Miscellaneous	2,500
	Travel (no meals included)	7,000
	Accounting fees	8,000

During the year, an automobile was purchased that cost $12,000 with an estimated life of four years. The company wants to use modified ACRS depreciation. The MACRS computation for depreciation is already included in the above figure of $10,000. Assume an election to waive bonus depreciation was properly filed.

II.

Beginning Inventory	$ 9,000
Purchases	100,000
Cost of Labor	120,000
Miscellaneous Cost of Goods	8,500
Ending Inventory	12,000

III.

Corporate name:	Soxy Lady, Inc.
Employer ID:	74-9876543
Address:	123 Hosiery Lane
	Argyle, Texas 77700
Business code:	1269
Estimated payments:	$6,000 ****Note**** any refund is applied toward next year's estimated taxes.
Accounting method:	Accrual

Officers' salaries include the following:

Mike Ford—45% owner (full-time);	384-56-7771;	$20,000 compensation.
Linda Harrison—35% (full-time);	426-45-6045;	$14,000 compensation.
James Lee—20% (full-time);	453-37-7042;	$10,000 compensation.

IV. Corporate Balance Sheet.

	12/31/05	*12/31/06*
Cash	$ 14,500	$ 33,000
Accounts Receivable (net)	65,000	54,000
Inventories	9,500	12,000
Depreciable Assets	150,000	162,000
Accumulated Depreciation	−5,000	−15,000
Accounts Payable	14,000	20,900
Note Payable > 1 Year	230,000	230,000
Common Stock	2,000	2,000
Retained Earnings	−12,000	?,???

Required. Prepare the 2006 U.S. Corporate Income Tax Return, Form 1120 along with the supplemental Schedule for Depreciation and Amortization, Form 4562.

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

U.S. Corporation Income Tax Return

For calendar year 2006 or tax year beginning ________, 2006, ending ________, 20 ___
▶ **See separate instructions.**

OMB No. 1545-0123
2006

A Check if:
1 Consolidated return (attach Form 851) ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 required (attach Sch. M-3) ☐

Use IRS label. Otherwise, print or type.
Name
Number, street, and room or suite no. If a P.O. box, see instructions.
City or town, state, and ZIP code

B Employer identification number
C Date incorporated
D Total assets (see instructions)
$

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

Income

1a	Gross receipts or sales ____ **b** Less returns and allowances ____ **c** Bal ▶	1c	
2	Cost of goods sold (Schedule A, line 8)	2	
3	Gross profit. Subtract line 2 from line 1c	3	
4	Dividends (Schedule C, line 19)	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 17 (attach Form 4797)	9	
10	Other income (see instructions—attach schedule)	10	
11	**Total income.** Add lines 3 through 10 ▶	11	

Deductions (See instructions for limitations on deductions.)

12	Compensation of officers (Schedule E, line 4)	12	
13	Salaries and wages (less employment credits)	13	
14	Repairs and maintenance	14	
15	Bad debts	15	
16	Rents	16	
17	Taxes and licenses	17	
18	Interest	18	
19	Charitable contributions	19	
20	Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562)	20	
21	Depletion	21	
22	Advertising	22	
23	Pension, profit-sharing, etc., plans	23	
24	Employee benefit programs	24	
25	Domestic production activities deduction (attach Form 8903)	25	
26	Other deductions (attach schedule) PROFESSIONAL FEES	26	
27	**Total deductions.** Add lines 12 through 26 ▶	27	
28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11	28	
29	**Less: a** Net operating loss deduction (see instructions) 29a ____		
	b Special deductions (Schedule C, line 20) 29b ____	29c	

Tax and Payments

30	**Taxable income.** Subtract line 29c from line 28 (see instructions)	30	
31	**Total tax** (Schedule J, line 10)	31	
32 a	2005 overpayment credited to 2006 32a ____		
b	2006 estimated tax payments 32b ____		
c	2006 refund applied for on Form 4466 32c ( ) **d Bal** ▶ 32d ____		
e	Tax deposited with Form 7004 32e ____		
f	Credits: **(1)** Form 2439 ____ **(2)** Form 4136 ____ 32f ____		
g	Credit for federal telephone excise tax paid (attach Form 8913) 32g ____	32h	
33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐	33	
34	**Amount owed.** 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	
36	Enter amount from line 35 you want: **Credited to 2007 estimated tax** ▶ ____ **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.

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 Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2006)

Form 1120 (2006) Page 2

Schedule A **Cost of Goods Sold** (see instructions)

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	**Total.** Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9a Check all methods used for valuing closing inventory:

(i) ☐ Cost

(ii) ☑ Lower of cost or market

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

b Check if there was a writedown of subnormal goods ▶ ☐

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)

		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations		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		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Total.** Add lines 1 through 8. See instructions for limitation			
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 affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
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 page 1, line 4 ▶			
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			

Schedule E **Compensation of Officers** (see instructions for page 1, line 12)

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			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	
			%	%	%	

2	Total compensation of officers	
3	Compensation of officers claimed on Schedule A and elsewhere on return	
4	Subtract line 3 from line 2. Enter the result here and on page 1, line 12	

Form **1120** (2006)

Form 1120 (2006) Page **3**

Schedule J Tax Computation (see instructions)

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)) ▶ ☐		
2	Income tax. Check if a qualified personal service corporation (see instructions) ▶ ☐	2	
3	Alternative minimum tax (attach Form 4626)	3	
4	Add lines 2 and 3	4	
5a	Foreign tax credit (attach Form 1118) — 5a		
b	Qualified electric vehicle credit (attach Form 8834) — 5b		
c	General business credit. Check applicable box(es): ☐ Form 3800 ☐ Form 6478 ☐ Form 8835, Section B ☐ Form 8844 — 5c		
d	Credit for prior year minimum tax (attach Form 8827) — 5d		
e	Bond credits from: ☐ Form 8860 ☐ Form 8912 — 5e		
6	**Total credits.** Add lines 5a through 5e	6	
7	Subtract line 6 from line 4	7	
8	Personal holding company tax (attach Schedule PH (Form 1120))	8	
9	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Form 8902 ☐ Other (attach schedule)	9	
10	**Total tax.** Add lines 7 through 9. Enter here and on page 1, line 31	10	

Schedule K Other Information (see instructions)

		Yes	No
1	Check accounting method: **a** ☐ Cash **b** ☐ Accrual **c** ☐ Other (specify) ▶		
2	See the instructions and enter the:		
a	Business activity code no. ▶		
b	Business activity ▶		
c	Product or service ▶		
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 ▶ $		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶		
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) 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.*

Form **1120** (2006)

Form 1120 (2006) Page **4**

Schedule L **Balance Sheets per Books**

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash				
2a Trade notes and accounts receivable				
b Less allowance for bad debts	( )		( )	
3 Inventories				
4 U.S. government obligations				
5 Tax-exempt securities (see instructions)				
6 Other current assets (attach schedule)				
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach schedule)				
10a Buildings and other depreciable assets				
b Less accumulated depreciation	( )		( )	
11a Depletable assets				
b Less accumulated depletion	( )		( )	
12 Land (net of any amortization)				
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (attach schedule)				
15 Total assets				
Liabilities and Shareholders' Equity				
16 Accounts payable				
17 Mortgages, notes, bonds payable in less than 1 year				
18 Other current liabilities (attach schedule)				
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more				
21 Other liabilities (attach schedule)				
22 Capital stock: a Preferred stock				
b Common stock				
23 Additional paid-in capital				
24 Retained earnings—Appropriated (attach schedule)				
25 Retained earnings—Unappropriated				
26 Adjustments to shareholders' equity (attach schedule)				
27 Less cost of treasury stock		( )		( )
28 Total liabilities and shareholders' equity				

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return**

Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1 Net income (loss) per books		7 Income recorded on books this year not included on this return (itemize):	
2 Federal income tax per books		Tax-exempt interest $ ____________	
3 Excess of capital losses over capital gains		______________________	
4 Income subject to tax not recorded on books this year (itemize): ____________		______________________	
______________________		8 Deductions on this return not charged against book income this year (itemize):	
5 Expenses recorded on books this year not deducted on this return (itemize):		a Depreciation . . . $ ________	
a Depreciation . . . $ ____________		b Charitable contributions $ ________	
b Charitable contributions $ ____________		______________________	
c Travel and entertainment $ ____________		______________________	
______________________		9 Add lines 7 and 8	
6 Add lines 1 through 5		10 Income (page 1, line 28)—line 6 less line 9	

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

1 Balance at beginning of year		5 Distributions: a Cash	
2 Net income (loss) per books		b Stock	
3 Other increases (itemize): ____________		c Property	
______________________		6 Other decreases (itemize): ________	
______________________		7 Add lines 5 and 6	
4 Add lines 1, 2, and 3		8 Balance at end of year (line 4 less line 7)	

Form **1120** (2006)

Form **4562** | **Depreciation and Amortization** | OMB No. 1545-0172
Department of the Treasury
Internal Revenue Service

(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach to your tax return.

2006 Attachment Sequence No. **67**

Name(s) shown on return	Business or activity to which this form relates	Identifying number

Part I **Election To Expense Certain Property Under Section 179**
Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$108,000
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation	3	$430,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6			

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	
10	Carryover of disallowed deduction from line 13 of your 2005 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 2007. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II **Special Depreciation Allowance and Other Depreciation (Do not** include listed property.**)** (See instructions.)

14	Special allowance for qualified New York Liberty or Gulf Opportunity Zone property (other than listed property) placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III **MACRS Depreciation (Do not** include listed property.**)** (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2006	17	
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2006 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2006 Tax Year Using the Alternative Depreciation System

(a) Classification of property	(b)	(c)	(d)	(e)	(f)	(g)
20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV **Summary** (see instructions)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr.	22	
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2006)

SOLUTIONS TO STUDY QUESTIONS

True or False

1. True.

2. True.

3. True.

4. False. The carryforward is 15 years.

5. True.

6. False. The 15 percent rate is only available to individuals.

7. False. Sole proprietorships are the most common form.

8. False. They are amortized over a 60-month period.

9. False. The tax is greater if the corporations are considered a controlled group.

10. True.

11. False. Carryovers are treated as short-term capital losses.

12. True.

13. False. Qualified PSCs are taxed at a flat 35 percent rate.

14. False. July 15 of the same year without an extension; with an extension, Form 7004, the following January 15.

15. True.

16. True.

17. False. Does not include the current year's tax loss.

18. False. Back three and forward five years.

19. True. A combined controlled group.

20. True.

Multiple Choice

1. **d.**
2. **c.** $5,000 + [(1,800 ÷ 180) × 6 months] = 5,060.
3. **b.**
4. **b.** Limited to 80 percent of taxable income.
5. **e.**
6. **d.**
7. **b.** [$280,000 + $34,000] @ 10 percent.
8. **c.** $5,000 + $1,000 but it is limited to 10 percent of $40,000.
9. **e.** $360,000 + $100,000 − $500,000 − $80,000 = $120,000.
10. **e.** All capital loss carryovers and carrybacks are treated as short-term losses in the year to which carried.
11. **d.** Generally, pension plan deductions reduce both book and taxable income.
12. **b.** Capital losses can only offset capital gains.
13. **d.** 10 percent of ($100,000 + $12,000).
14. **c.** $5,000 of the loss in 2004 and $3,000 of the loss in 2005 was used in 2006; therefore, the remaining $7,000 loss from 2005 carries forward until the five-year period expires.
15. **c.** The 80 percent limitation on taxable income does not apply to this problem because the corporation has a net operating loss.
16. **a.** The 70 percent of taxable income limitation applies.
17. **d.** 70% of $35,000. The other limitation adds to or creates an NOL.
18. **c.** Members of an affiliated group can deduct 100% of dividends from other members.
19. **c.** Tax on first $100,000 = $22,250 + 39% of $200,000 = $100,250.
20. **b.** $600,000 T.I. + $15,000 (§ 1245) + $18,000 (Net Capital Gain) = $633,000.

Fill In the Blanks

1. Dummy or sham.
2. Association.
3. 100.
4. Controlled group.

5. Alternative minimum tax credit.

6. 1120; 7004.

7. Personal service corporations.

8. 2; 20.

Code Section Recognition

1. **f.**

2. **d.**

3. **e.**

4. **a.**

5. **c.**

6. **b.**

SOLUTION TO COMPREHENSIVE ALTERNATIVE MINIMUM TAX PROBLEM

(Pages 1-20 through 1-22)

2006 TAXABLE INCOME

Pre-tax accounting income		$400,000
Tax-exempt municipal bond interest		(40,000)
Interest used to purchase municipal bonds		20,000
Life insurance proceeds		(200,000)
Book depreciation—Truck	$833	
Book depreciation—Machine	875	1,708
(See attachments)		
Tax depreciation—Truck	$500	
Tax depreciation—Machine	3,500	(4,000)
		$177,708
Charitable contribution included in book income		60,000
TI before Charitable & DRD		$237,708
10% charitable contribution limit		23,771
TI before DRD		$213,937
DRD ($20,000 × 70%)		(14,000)
Taxable income		$199,937

2006 REGULAR TAX LIABILITY

Taxable income	$199,937
Tax rate	×34%
	$67,979
Surtax exemption equivalent	(11,750)
	$56,229
§ 11(b) ($199,937 − $100,000) × 5%	4,997
Regular tax liability	$61,226

2006 AMTI

Regular taxable income		$199,937
§ 57(a)(5)(j)—municipal bonds interest		40,000
Interest used to purchase municipal bonds		(20,000)
Regular tax depreciation—Truck	$500	
Machine	3,500	4,000
AMT depreciation—Truck	$313	
Machine	1,641	(1,954)
AMTI before ACE		$221,983
ACE Adj.—56(f)*		133,513
AMTI		$355,496

*Adjusted Current Earnings	$400,000
AMTI before ACE	−221,983
Difference	$178,017
	×75%
ACE Adjustment	$133,513

2006 TENTATIVE MINIMUM TAX LIABILITY

AMTI	$355,496**
Rate—§ 55(b)	×20%
	$71,099

** Exemption is fully phased out at $310,000 of AMTI, therefore, there is no exemption.

DEPRECIATION COMPUTATIONS—Truck

Year	*Book*	*Regular Tax*	*AMT*
1	$833	$500	$313
2	1,667	3,800	2,422
3	1,667	2,280	1,816
4	1,667	1,368	1,406
5	1,667	1,094	1,406
6	1,667	958	1,406
7	832	—	1,231
	$10,000	$10,000	$10,000

	Period	*Method*	*Convention*
Book (useful life)	6 years	S/L	Half-year
Tax (recovery period)	5 years	200 DB	Mid-quarter
AMT (class life)	6 years	150 DB	Mid-quarter

DEPRECIATION COMPUTATIONS—Machine

Year	*Book*	*Regular Tax*	*AMT*
1	$875	$3,500	$1,641
2	1,750	4,200	2,317
3	1,750	2,520	1,883
4	1,750	1,592	1,530
5	1,750	1,592	1,515
6	1,750	596	1,515
7	1,750	—	1,516
8	1,750	—	1,515
9	875	—	568
	$14,000	$14,000	$14,000

	Period	*Method*	*Convention*
Book (useful life)	8 years	S/L	Half-year
Tax (recovery period)	* 5 years	200 DB	Mid-quarter
AMT (class life)	8 years	150 DB	Mid-quarter

* A machine with a class life of eight years is treated as 5-year property under § 168.

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

U.S. Corporation Income Tax Return

For calendar year 2006 or tax year beginning ...., 2006, ending ...., 20 ...
▶ **See separate instructions.**

OMB No. 1545-0123 **2006**

A Check if:
1 Consolidated return (attach Form 851) ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 required (attach Sch. M-3) ☐

Use IRS label. Otherwise, print or type.

Name: SOXY LADY, INC.
Number, street, and room or suite no. If a P.O. box, see instructions.: 123 HOSIERY LANE
City or town, state, and ZIP code: ARGYLE, TEXAS 77700

B Employer identification number: 74 9876543
C Date incorporated: 1-2-02
D Total assets (see instructions): $ 246,000

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

Income

1a	Gross receipts or sales 530,000 **b** Less returns and allowances 4,500 **c** Bal ▶	1c	525,500
2	Cost of goods sold (Schedule A, line 8)	2	226,000
3	Gross profit. Subtract line 2 from line 1c	3	299,500
4	Dividends (Schedule C, line 19)	4	
5	Interest	5	1,500
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 17 (attach Form 4797)	9	
10	Other income (see instructions—attach schedule)	10	
11	**Total income.** Add lines 3 through 10 ▶	11	301,000

Deductions (See instructions for limitations on deductions.)

12	Compensation of officers (Schedule E, line 4)	12	44,000
13	Salaries and wages (less employment credits)	13	75,000
14	Repairs and maintenance	14	1,200
15	Bad debts	15	
16	Rents	16	45,000
17	Taxes and licenses	17	28,000
18	Interest	18	27,000
19	Charitable contributions	19	
20	Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562)	20	10,000
21	Depletion	21	
22	Advertising	22	
23	Pension, profit-sharing, etc., plans	23	2,300
24	Employee benefit programs	24	
25	Domestic production activities deduction (attach Form 8903)	25	
26	Other deductions (attach schedule) SEE SCHEDULE OF OTHER DEDUCTIONS	26	62,200
27	**Total deductions.** Add lines 12 through 26 ▶	27	295,900
28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11	28	5,100
29	**Less: a** Net operating loss deduction (see instructions) — 29a 12,000		
	b Special deductions (Schedule C, line 20) — 29b -	29c	12,000

Tax and Payments

30	**Taxable income.** Subtract line 29c from line 28 (see instructions)	30	(6,900)
31	**Total tax** (Schedule J, line 10)	31	
32a	2005 overpayment credited to 2006 — 32a		
b	2006 estimated tax payments — 32b 6,000		
c	2006 refund applied for on Form 4466 — 32c ( ) **d** Bal ▶ 32d 6,000		
e	Tax deposited with Form 7004 — 32e		
f	Credits: (1) Form 2439 ____ (2) Form 4136 ____ — 32f		
g	Credit for federal telephone excise tax paid (attach Form 8913) — 32g 6,000	32h	
33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐	33	- 0-
34	**Amount owed.** If line 32h is smaller than the total of lines 31 and 33, enter amount owed	34	-0-
35	**Overpayment.** If line 32h is larger than the total of lines 31 and 33, enter amount overpaid	35	6,000
36	Enter amount from line 35 you want: **Credited to 2007 estimated tax** ▶ **Refunded** ▶	36	-0-

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.

Linda Harrison | 3/11/07 | VICE 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 Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2006)

Form 1120 (2006) Page 2

Schedule A **Cost of Goods Sold** (see instructions)

1	Inventory at beginning of year	1	9,500
2	Purchases	2	100,000
3	Cost of labor	3	120,000
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	8,500
6	**Total.** Add lines 1 through 5	6	238,000
7	Inventory at end of year	7	12,000
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	226,000

9a Check all methods used for valuing closing inventory:
- (i) ☑ Cost
- (ii) ☐ Lower of cost or market
- (iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ▶ ☐

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)

		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations		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		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Total.** Add lines 1 through 8. See instructions for limitation			
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 affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
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 page 1, line 4 ▶			
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			

Schedule E **Compensation of Officers** (see instructions for page 1, line 12)

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	MIKE FORD	384-56-7771	100 %	45 %	%	20,000
	LINDA HARRISON	426-45-6045	100 %	35 %	%	14,000
	JAMES LEE	453-37-7042	100 %	20 %	%	10,000
			%	%	%	
			%	%	%	

2	Total compensation of officers	44,000
3	Compensation of officers claimed on Schedule A and elsewhere on return	–
4	Subtract line 3 from line 2. Enter the result here and on page 1, line 12	44,000

Form **1120** (2006)

Form 1120 (2006) Page **3**

Schedule J **Tax Computation** (see instructions)

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)) ▶ ☐		
2	Income tax. Check if a qualified personal service corporation (see instructions) ▶ ☐	2	
3	Alternative minimum tax (attach Form 4626)	3	
4	Add lines 2 and 3	4	
5a	Foreign tax credit (attach Form 1118) — 5a		
b	Qualified electric vehicle credit (attach Form 8834) — 5b		
c	General business credit. Check applicable box(es): ☐ Form 3800 ☐ Form 6478 ☐ Form 8835, Section B ☐ Form 8844 — 5c		
d	Credit for prior year minimum tax (attach Form 8827) — 5d		
e	Bond credits from: ☐ Form 8860 ☐ Form 8912 — 5e		
6	**Total credits.** Add lines 5a through 5e	6	
7	Subtract line 6 from line 4	7	
8	Personal holding company tax (attach Schedule PH (Form 1120))	8	
9	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Form 8902 ☐ Other (attach schedule)	9	
10	**Total tax.** Add lines 7 through 9. Enter here and on page 1, line 31	10	

Schedule K **Other Information** (see instructions)

		Yes	No
1	Check accounting method: **a** ☐ Cash **b** ☑ Accrual **c** ☐ Other (specify) ▶		
2	See the instructions and enter the:		
a	Business activity code no. ▶		
b	Business activity ▶ MANUFACTURER		
c	Product or service ▶ HOSIERY		
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 ▶ $ -0-		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶ 3		
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) 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.) ▶ $ 12,000		
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.*

Form **1120** (2006)

Form 1120 (2006) Page **4**

Schedule L **Balance Sheets per Books**

	Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1	Cash		14,500		33,000
2a	Trade notes and accounts receivable	65,000		54,000	
b	Less allowance for bad debts	(-)	65,000	(-)	54,000
3	Inventories		9,500		12,000
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach schedule)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach schedule)				
10a	Buildings and other depreciable assets	150,000		162,000	
b	Less accumulated depreciation	(5,000)	145,000	(15,000)	147,000
11a	Depletable assets				
b	Less accumulated depletion	( )		( )	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	( )		( )	
14	Other assets (attach schedule)				
15	Total assets		234,000		246,000
	Liabilities and Shareholders' Equity				
16	Accounts payable		14,000		20,900
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach schedule)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more		230,000		230,000
21	Other liabilities (attach schedule)				
22	Capital stock: a Preferred stock				
	b Common stock	2,000	2,000	2,000	2,000
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach schedule)				
25	Retained earnings—Unappropriated		(12,000)		(6,900)
26	Adjustments to shareholders' equity (attach schedule)				
27	Less cost of treasury stock		( )		( )
28	Total liabilities and shareholders' equity		234,000		246,000

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return**

Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1	Net income (loss) per books	5,100	7	Income recorded on books this year not included on this return (itemize): Tax-exempt interest $	- 0 -
2	Federal income tax per books	- 0 -			
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize):		8	Deductions on this return not charged against book income this year (itemize): a Depreciation $ b Charitable contributions $	- 0 -
5	Expenses recorded on books this year not deducted on this return (itemize): a Depreciation $ b Charitable contributions $ c Travel and entertainment $	- 0 -	9	Add lines 7 and 8	- 0 -
6	Add lines 1 through 5	5,100	10	Income (page 1, line 28)—line 6 less line 9	5,100

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

1	Balance at beginning of year (DEFICIT)	(12,000)	5	Distributions: a Cash	
2	Net income (loss) per books	5,100		b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	
			7	Add lines 5 and 6	- 0 -
4	Add lines 1, 2, and 3	(6,900)	8	Balance at end of year (line 4 less line 7)	(6,900)

Form **1120** (2006)

Soxy Lady, Inc.
74-9876543

SCHEDULE OF OTHER EXPENSES

Accounting fees	$8,000.
Deliveries	1,000.
Freight	500.
Insurance	32,000.
Miscellaneous	2,500.
Office supplies	1,200.
Postage	1,500.
Telephone	8,500.
Travel and entertainment	7,000.
Total	$62,000.

(To line 26, page 1 of Form 1120)

Form **4562** | Department of the Treasury Internal Revenue Service

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach to your tax return.

OMB No. 1545-0172 | **2006** | Attachment Sequence No. **67**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
SOXY LADY INC.	FORM 1120, LINE 20, PAGE 1	74-9876543

Part I Election To Expense Certain Property Under Section 179
Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$108,000
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation	3	$430,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6			

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	
10	Carryover of disallowed deduction from line 13 of your 2005 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 2007. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.**)** (See instructions.)

14	Special allowance for qualified New York Liberty or Gulf Opportunity Zone property (other than listed property) placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III MACRS Depreciation (Do not include listed property.**)** (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2006	17	7,000
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2006 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property		12,000	3 YRS	HY	MACRS	3,000
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2006 Tax Year Using the Alternative Depreciation System

(a) Classification of property	(b)	(c)	(d)	(e)	(f)	(g)
20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV Summary (see instructions)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr.	22	10,000
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

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