**CHAPTER 2**

**CORPORATIONS: INTRODUCTION AND**

**OPERATING RULES**

**Lecture Notes**

**SUMMARY OF CHANGES IN THE CHAPTER**

The following are notable changes in the chapter from the 2012 Edition. For major changes, see the Preface to the Instructor’s Edition of the text.

News Boxes

* Added Tax in the News titled *Not all Corporations are Treated Equal*.
* Removed Tax in the News titled *U.S. Corporate Tax Rate Second Highest among OECD States*.

Ethical and Equity Considerations

* Added Ethics and Equity titled *A Long Lost Relative?*
* Removed Ethics and Equity titled *Timing is Everything!*

Global Tax Issues

* Added Global Tax Issues titled *U.S. Corporate Tax Rate and Global Competitiveness*.
* Removed Global Tax Issues titled *Matching Principle Applies When Related Party is Foreign Taxpayer.*

**2.1 TAX TREATMENT OF VARIOUS BUSINESS FORMS**

1. Business forms include: sole proprietorships, partnerships (covered in Chapters 10 and 11), trusts and estates (covered in Chapter 20), Subchapter S corporations (covered in Chapter 12), and regular Subchapter C corporations.

2. C corporations are separate taxable entities, compute their own taxable income, and pay their own taxes.

**Sole Proprietorship**

3.Sole proprietorship is not a taxable entity. Net income or loss from the proprietorship is computed on Schedule C, which is attached to the proprietor’s Form 1040. Thus, the proprietor pays tax on the profits of the proprietorship.

**Partnerships**

4. Partnerships, which are not taxable entities, must file Form 1065 (an information return). Each partner receives a Schedule K-1 that reports the partner’s share of ordinary business income (loss) along with each separately reported pass-through item. Schedule K-1 items are reported on each partner’s return.

**Corporations**

5. There are two types of corporations: regular corporations governed by Subchapter C and nontaxable corporations governed by Subchapter S. S corporations have the following characteristics.

* Similar to partnerships with respect to tax treatment because both are not taxable entities, but are reporting entities (Form 1120S).
* Income and expense items pass through to shareholders, who report the items on their own returns.
* Generally enjoy the same legal benefits (e.g., limited liability) as C corporations.

6. Many items, such as capital gains and losses, retain their character when passed through to the owners of proprietorships, partnerships, and S corporations.

7. Regular C corporations are subject to double taxation effects.

a. Closely held corporations may attempt to avoid the double taxation by making deductible payments to their shareholders (e.g., salaries, interest, or rents) that are large enough to reduce corporate taxable income to zero.

b. Reduction of the dividend tax rate to a maximum of 15% (0% for low-income taxpayers) alleviates some of the double taxation effect.

(1) Shareholders prefer dividends rather than salary or interest because of the lower tax rate dividends receive.

(2) Corporations prefer payments that are deductible in computing their taxable income. However, dividends do reduce the possible accumulated earning tax, unreasonable compensation, and thin capitalization problems with the IRS.

8. The choice of entity should be based on a combination of tax and nontax factors.

a. Tax Factors. The top corporate rate is 35% (39% on a limited range of taxable income), as is the top rate for individuals. However, for a specified level of income the corporate or individual tax rate can be higher because their tax rate schedules are different.

(1) Tax rate of dividends should also be considered.

(2) With pass-through entities, items of income, gains, deductions, and losses retain their character for the owner. C corporation items do not pass through.

b. Nontax Considerations. Nontax considerations may override tax considerations. Those considerations favoring the corporate form include the following.

* Limited liability.
* Ability to raise large amounts of capital.
* Continuity of life for the entity.
* Free transferability of ownership interests.
* Centralized management.

c. The majority of businesses in the U.S. are small pass through entities. For a recent Congressional Research Service analysis of IRS data on U.S. business tax reporting, see CRS Report R40748 (August 6, 2009).

**Limited Liability Companies**

9. Limited liability company (LLC) offers a very important nontax advantage (limited liability) plus the tax advantage of being treated as a partnership (or proprietorship, in the case of a single-member LLC) and avoiding the double taxation problem associated with C corporations.

a. All 50 states and the District of Columbia recognize LLCs.

b. States vary in the corporate characteristics allowed to LLCs.

**Entity Classification**

10. Classification of an entity was left to the taxpayer when the “check-the-box” Regulations were promulgated.

a. Under these regulations, entities with two or more owners can elect to be treated as a partnership or a corporation. Entities with one owner can elect to be taxed as either a sole proprietorship or a corporation. Election is made on Form 8832, Entity Classification Election. See Rev. Proc. 2009-41, 2009-2 CB 439 for guidance on filing late Form 8832. For a late Form 8832 by a foreign entity, see Rev. Proc. 2010-32, 2010-2 CB 320.

b. Under the default rules, if no election is made, multi-owner entities are treated as partnerships and single-owner entities are sole proprietorships. New entities using a default classification should not file Form 8332.

c. The “check-the-box” election is not available to entities incorporated under state law or are required to be treated as corporations under Federal law (i.e., publicly traded partnerships).

d. An LLC that elects to be treated as a corporation under the check-the-box regulations may elect Subchapter S status. See, e.g., LTR 201140014 [late Form 8832 (Entity Classification Election) and late Form 2553 (Election by a Small Business Corporation) by LLC treated as timely filed].

e. Recently, there has been a lot of litigation regarding the liability for unpaid employment taxes of single-member LLCs (default sole proprietorships). The issue addressed by the courts generally is whether the single-member (sole proprietor) or the LLC is liable for unpaid employment taxes of the LLC. Invariably the sole proprietor is found to be liable for the unpaid employment taxes. [See, e.g., *Comensoli v. Comm.*, 2011–1 USTC ¶50,368, 107 AFTR 2d 2080, 442 Fed. Appx. 412 (CA–6, 2011) (single member liable for unpaid employment taxes of LLC); and *Tony L. Robucci*, 101 TCM 1060, T.C.Memo. 2011–19 (single member liable for self-employment taxes on LLC earnings)].

### 2.2 AN INTRODUCTION TO THE INCOME TAXATION OF CORPORATIONS

**An Overview of Corporate versus Individual Income Tax Treatment**

11. There are similarities and differences between corporate and individual income tax treatment. The tax formulas for these two types of taxpayers are contrasted in Figure 2.1.

a. Determination of gross income is computed in much the same manner for corporations and individuals. However, corporations have no itemized deductions (as all its expenses are business deductions) nor do they have standard deductions or personal and dependency exemptions.

b. Property transaction tax rules apply to both corporate and noncorporate taxpayers.

(1) Includes definition of what are not capital assets (§ 1221) and nontaxable exchanges.

(2) Fewer exclusion provisions are available to corporate taxpayers. The exclusion permitted by § 121 (the sale of a personal residence) does not apply to corporations. This last point seems simple enough, but consider the following illustration.

Example. Ed is employed as general manager of Green Brewing Corporation. In this capacity, Ed is in charge of quality control, a feature highly touted by Green in advertising to its customers. To main­tain constant quality control, Ed is required to live in a residence owned by Green and located adjacent to its brewery. If Green sold this residence for a gain, it may not use § 121 to exclude such gain. Had the residence been owned by Ed (and not Green Brewing Corporation), § 121 would be available to Ed.

c. Credits that are personal in nature (child credit, earned income credit) are not available to corporations.

d. Charitable contributions and casualty/theft losses have substantially different limitations for corporations and individuals.

**Accounting Periods and Methods**

12. C corporations may choose a calendar year or a fiscal year for reporting purposes, but S corporations and personal service corporations (PSCs) are subject to restrictions in the choice of a fiscal year.

13. Cash method of accounting, available to individuals, is not available to most regular corporations. Cash method is allowed for S corporations, qualified PSCs and corporations with average annual gross receipts of not more than $5 million.

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| **ADDITIONAL LECTURE RESOURCE** |

**Related Party Limitation**. The § 267(a)(2) limitation on deducting accrued expense paid to related parties affects many closely held corporations, particularly those that are family owned. For purposes of the more-than-50% shareholder test, an individual is deemed to own the stock owned, directly or indirectly, by family members (i.e., siblings, spouse, ancestors, and lineal descendents) [§ 267(c)]. When a corporation’s stock is only owned by family members, each shareholder will be a related party under the more-than-50% test. For many family-owned (accrual basis) corporations then, § 267(a)(2) will affect the deductibility of many different types of accrued expenditures (e.g., salary, bonus, interest, rent, and lease).

Example. Three brothers (cash basis, calendar year taxpayers) own all of the stock in Brown Corporation (accrual basis, calendar year taxpayer) and are its principal employees. After a particularly profitable year, in December 2012, Brown declares a bonus payable to each of its employees. Brown also accrues interest owed on amounts borrowed from its shareholders. The bonuses and interest are not paid until January 2013. Under the stock attribution rules of § 267, each of the brothers is deemed to own 100% of the stock of Brown. As a result, the bonuses attributable to the brothers and all of the interest are not deductible by Brown Corporation until 2013.

**Capital Gains and Losses**

14. Differences in corporate and individual taxpayer treatment of capital gains and losses.

a. Net capital gains of corporations are not subject to lower rates, as are net capital gains of individuals.

b. Corporate capital losses may only offset capital gains while individuals may deduct up to $3,000 of losses in excess of capital gains.

c. Excess corporate capital losses are carried back 3 and forward 5 years to offset capital gains, while capital losses of individuals are carried forward indefinitely. When corporations carry over capital losses, they are treated as short term. For individuals, capital losses retain their original status as long term or short term.

**Recapture of Depreciation**

15. The § 291 amount is treated as additional § 1250 depreciation recapture. The result is a recharacterization of what would otherwise be § 1231 gain as ordinary income. Corporate taxpayers do not receive a preferential tax rate on long-term capital gains (e.g., a net § 1231 gain), but the recharacterization might reduce a corporation’s ability to utilize capital losses in the current year.

**Passive Losses**

16. Passive loss limitations apply to closely held C corporations and personal service corporations (PSCs). However, closely held C corporations may offset passive losses against active income.

**Charitable Contributions**

17. Corporations are subject to limitations on their charitable contributions.

a. For accrual basis corporations, there is an exception to the rule that deductions for charitable contributions are allowed only for the year in which payment is made. Corporations may deduct charitable contributions in the year preceding payment if the contribution is authorized by the board of directors by the end of that year and is paid on or before the 15th day of the third month of the next year.

b. General rule that the amount of the deduction is fair market value on the date of the donation for long-term capital gain property and adjusted basis (or fair market value, if lower) for ordinary income property applies to corporations. However, there are exceptions to the general rule.

(1) Long-term (held more than 1 year) capital gain property contributed to certain types of private non­operating foundations and contributions of tangible personal property that are not used in the charity’s tax exempt function are limited to adjusted basis on the date of donation.

(2) Contributions of inventory to charities for use in their exempt purpose and solely for the care of the ill, needy, or infants, or where the property is used for research purposes under specified conditions are subject to special rules. The deduction is measured by the adjusted basis of the property plus half of the appreciation on the property. However, the deduction cannot exceed twice the basis of the property.

Example: Gold Publishing Corporation donates 1,000 copies of a high school text on American history to Literacy U.S.A., a private nonoperating founda-tion. Each text costs Gold $3 to produce and retails for $13. The charitable deduction is limited to $6,000 [$3 X 2 (twice the basis) X 1,000 (copies donated)] which is less than $8,000 [$3,000 (basis) + $5,000 (50% of the $10,000 appreciation)].

c. Limitation is 10% of taxable income computed without regard to charitable contribution deductions, net operating loss or capital loss carrybacks, dividends received deduction, and domestic production activities deduction. Any contribution in excess of the 10% limitation is carried forward for 5 years.

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| **ADDITIONAL LECTURE RESOURCE** |

**Art is in the Eye of the Beholder!** (page 2-16). In order for Snipe to qualify for a deduction of $150,000 (fair market value), instead of $60,000 (basis), the museum’s use of the painting must be related to its exempt purpose or function. To satisfy this requirement, Snipe must either establish that the painting was not in fact put to an unrelated use by the museum or that at the time of the contribution it was reasonable to assume that the museum would not put the painting to an unrelated use. For purposes of a gift to a museum, the latter requirement is satisfied if the painting is of a type normally retained by such museum, unless Snipe has actual knowledge to the contrary that the painting would be put to an unrelated use. [Reg. § 1.170A-4(b)(3).] The facts are not clear as to whether any of the above requirements were satisfied at the time of the contribution. However, if the museum sold the painting in the same tax year as Snipe’s contribution, the deduction would be limited to the painting’s basis. [§ 170(e)(1)(B)(i).] Further, if the museum’s sale of the painting occurred within 3 years of the date of the contribution, Snipe would be required to recapture the excess contribution (fair market value in excess of basis) as gross income. [§ 170(e)(7).] Thus, it appears that either an amended return may be required for the year of the charitable deduction or income recognition may be required in the recapture year. As Snipe’s tax practitioner, you are obligated, under Circular 230 and the AICPA Statements on Standards for Tax Services, to inform your client of the issues. (See Chapter 17 for discussion of Circular 230 and AICPA SSTSs.) If the corporation refuses to file a proper return with respect to the contribution, you should consider withdrawing from the engagement.

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| **ADDITIONAL LECTURE RESOURCE** |

**Charitable Contributions of Inventory**. The regulations provide guidance on determining whether inventory is related to a qualified organization’s exempt purpose or function. The regulations also elaborate on the requirement that the corporate donor receive a written statement from the qualified organization regarding the use and disposition of donated inventory [§ 170(e)(3)(A)(iii)], as well as the determination of inventory basis (Reg. § 1.170A-4A.) In some cases, the disposition of inventory by a donee within 3 years of the date of contribution will result in recapture (gross income) to the corporation, equal to the excess of the corporation’s charitable deduction for the inventory over its basis in such property [§ 170(e)(7)]. For a recent ruling where the enhanced inventory deduction was disallowed due to inadequate substantiation, see NSAR 2011380IF (August 15, 2011).

**Domestic Production Activities Deduction**

18. Domestic production activities deduction (DPAD) is based on the income from manufacturing activities (see Chapter 3 for a detailed discussion).

a. For 2012, DPAD is the lower of the following.

* 9% of qualified production activities income.
* 9% of taxable income (modified adjusted gross income for individuals).
* 50% of W-2 wages related to the qualified production activities income.

b. Deduction is available to all types of business entities.

**Net Operating Losses**

19. Individual and corporate taxpayers may have net operating losses (NOLs) that can be carried back 2 years and forward 20 years to offset taxable income.

a. Corporations do not adjust their tax losses for capital losses as individuals do.

b. Corporations do not make adjustments for nonbusiness deductions or for personal exemptions as individuals do.

c. Corporations include their dividends received deduction in computing the NOL.

d. Like individuals, corporations may elect to forgo the carryback period.

**Deductions Available Only to Corporations**

20. Dividends Received Deduction (DRD). For dividend distributions received from other domestic corporations.

a. Purpose of DRD is to mitigate (or eliminate) the triple taxation of corporate-source income.

b. Amount of DRD is limited as follows.

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| Percentage of Ownership  by Corporation Shareholder | Deduction  Percentage |
| Less than 20% | 70% |
| 20% or more but less than 80% | 80% |
| 80% or more and payor corporation is a member of an affiliated group with the payee corporation | 100% |

Example. During all of the current year, Silver Corporation (a calendar taxpayer) owned 4% of Bronze Corporation and 21% of Copper Corporation. Dividends received are: $50,000 from Bronze Corporation and $100,000 from Copper Corporation. Presuming the percentage of taxable income limitation does not apply, DRD =$115,000 [(70% X $50,000) + $80,000 (80% X $100,000)].

c. DRD is limited to a percentage of the taxable income.

(1) Computed without regard to the NOL deduction, DPAD, DRD, and any capital loss carryback to the current tax year.

(2) Percentage of taxable income limitation corresponds to the deduction percentage.

Example. Assume the same facts as in the preceding example. The taxable income percentage limitation for Silver Corporation is 70% for Bronze Corporation dividends and 80% for Copper Corporation dividends.

d. Taxable income limitation does not apply if the corporate shareholder has a net operating loss for the current taxable year or in the case of the 100% DRD available to members of an affiliated group.

e. In working with this myriad of rules, the following steps are useful.

* Multiply the dividends received by the deduction percentage.
* Multiply the taxable income by the deduction percentage.
* DRD is limited to the lesser of Step 1 or Step 2, unless deducting the amount derived in Step 1 results in an NOL. If so, the amount derived in Step 1 should be used. This is referred to as the NOL rule (Example 27).

f. Dividends not qualifying for DRD.

(1) Dividends on stock held for 45 days or less.

(2) Periods for which the corporation has diminished its risk of loss on the stock through a short sales do not count towards 45 day requirement (Reg. § 1.246-5).

g. DRD is reduced to extent of portfolio indebtedness (any indebtedness directly attributable to investment in stock).

(1) Amount of reduction is limited to the allocable amount of the corporation’s interest deduction on the portfolio indebtedness. For determining whether indebtedness is “directly attributable” to stock investment, see, e.g., *OBH, Inc. v. U.S.*, 2005-2 USTC ¶50,627, 96 AFTR2d 6801, 397 F Supp.2d 1148 (D.Ct. Neb., 2005) and Rev. Rul. 88-66, 1988-2 C.B. 35.

(2) If corporation owns at least 50% of voting and value of another corporation’s stock, DRD for this stock is not subject to the reduction.

21. Organizational Expenditures Deduction.

a. Such expenses may be amortized over a 180-month period starting in the month in which the business begins.

b. A special exception allows businesses to immediately expense the first $5,000 of organizational costs. The exception, however, is phased out on a dollar-for-dollar basis when these expenses exceed $50,000.

Example. Fox Corporation had $51,000 of organizational expenditures in the current year. Fox can elect to expense $4,000 [$5,000 – ($51,000 – $50,000)] of this amount and amortize the $47,000 balance ($51,000 – $4,000) over 180 months.

(1) In order for a corporation to qualify for this election, expenditures must be incurred before the end of the taxable year in which the corporation begins business. A corporation is deemed to make an election under § 248 to deduct organizational expenditures.

(2) A corporation may choose to forgo the deemed election by clearly electing to capitalize organizational expenditures for the taxable year in which the business begins. In this case, the organizational expenditures are not deductible until the corporation ceases to do business and liquidates (unless the corporate charter limits the life of the corporation).

c. Startup expenses (investigation and operating expenses incurred before the business begins producing income) are different from organizational costs. However, the amortization, immediate expensing, and deemed election rules described in a. and b. above for organizational expenditures also apply to startup costs.

d. Final Regulations (Reg. §§ 1.195-1 & 1.248-1) were issued in 2011 for organizational expenditures and startup costs (see T.D. 9542).

**2.3 DETERMINING THE CORPORATE INCOME TAX LIABILITY**

**Corporate Income Tax Rates**

22. Corporations compute their Federal income tax liability using the rate structure contained in § 11(b) (Exhibit 2.1 and inside front cover of text have rate schedules).

a. An additional surtax of 5% is imposed on taxable income over $100,000, but such tax is not to exceed $11,750.

(1) Consequently, the tax savings from the lower rates [i.e., 15% (on the first $50,000) and 25% (on the next $25,000)] is completely phased out once taxable income reaches $335,000 (Example 31).

(2) As noted in Chapter 1, the tax law shows definite favoritism towards small businesses.

b. At $10 million corporate rate goes to 35% and at $15 million, an additional 3% surtax applies (which brings total rate to 38% for that bracket). At $18,333,333, the surtax is no longer imposed.

c. Personal service corporations (PSCs) are motivated to reduce taxable income as much as possible since they are taxed at the 35% rate on all taxable income.

(1) PSC is a corporation substantially owned by employees (current, retired, estates thereof, or estate beneficiary) and its business activities consist of the performance of services in qualifying fields.[§§ 11(b)(2) and 448(d)].

(2) This definition of a PSC also applies for purposes of the limitation on the cash method of accounting (outline item 13). However, for purposes of the limitation on the use of a fiscal year (outline item 12), definition of PSC is under §§ 269A(b) and 441(i)(2).

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| **ADDITIONAL LECTURE RESOURCE** |

PSC Substantially All Activity Test. As to the function requirement, Temp. Reg. § 1.448-1T(e)(4) provides that the “substantially all” test is met if 95% or more of the time spent by employees of the corporation is devoted to performing services in qualifying fields. A recent case addressing the function requirement is *Grutman-Mazler Engineering, Inc.,* TC Memo 2008-140, 95 TCM 1551.

Similarly, Temp. Reg. § 1.448-1T(e)(5) establishes a 95% or more threshold for satisfying the stock ownership requirement. A recent case addressing the ownership requirement is *Robertson Strong & Apgar Architects, PC*, T.C. Summary Opinion 2007-48.

**Alternative Minimum Tax**

23. Corporations (other than “small corporations”) are subject to an alternative minimum tax (AMT) that is similar to the AMT of individuals. Most adjustments and preferences are the same as for individuals, but the rates and exemption amounts are different. See Chapter 3 for a detailed discussion of the AMT.

**Tax Liability of Related Corporations**

24. A controlled group of corporations is entitled to one $250,000 accumulated earnings tax credit, one $40,000 exemption for the AMT, and is limited to taxable income in each of the first two brackets as though the group was one corporation. (See Examples 32 and 33) Controlled groups are parent-subsidiary corporations, brother-sister groups, combined groups and certain insurance companies.

Final regulations on which corporations are included in a controlled group were issued in 2009 (T.D. 9451). See Reg. § 1.1563-1 for definition of “controlled group of corporations.”

Final regulations on apportionment of tax items among controlled group members were issued in 2010 (T.D. 9476). See Reg. § 1.1561-1 et seq.

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| **ETHICS & EQUITY** |

**A Long Lost Relative?** (page 2-24). Brenda owns more than 50% of the stock of both Pelican Corporation and Seagull Corporation. Thus, Pelican and Seagull are related corporations and members of a controlled group of corporations (brother-sister controlled group). As a result, the two corporations are treated as if they were one corporation for purposes of the tax brackets below 35%, the $250,000 accumulated earnings credit, and the $40,000 AMT exemption amount. The fact that the bookkeepers lacked tax knowledge means it is very likely that the prior years’ corporate returns failed to reflect the limitations applicable to related corporations. If this is the case, then you should advise the client of the error and recommend amended tax returns to correct the error. If the client refuses to amend any prior year’s return that is in error, then you must consider whether you can prepare a proper income tax return for 2012. [See, e.g., AICPA’s Statements on Standards for Tax Services (Statement No. 6: Knowledge of Error) in Chapter 17 of the text.]

**2.4 PROCEDURAL MATTERS**

**Filing Requirements for Corporations**

25. Corporations must file a tax return (Form 1120 or Form 1120S) on or before the 15th day of the third month following the close of the tax year.

a. Form 1120 should be used if the corporation does not have an S election in effect.

b. Corporations receive an automatic extension of 6 months by filing Form 7004 by the due date of the return.

**Estimated Tax Payments**

26. Corporations must make estimated tax liability payments unless the liability is less than $500.

a. Required annual payment (including any AMT liability) is equal to the lesser of

(1) 100% of the current year’s tax.

(2) 100% of the prior year’s tax (prior year exception).

b. Corporations having taxable income of at least $1 million in any of the prior three years (a “large” corporation) can use the prior year exception only for its first installment payment. Any shortfall of this payment must be remedied in the second installment payment.

Example. Blue Corporation has a $1 million tax liability for the current year and an $800,000 tax liability last year. Using the prior year exception, Blue Corporation’s first installment payment is $200,000 ($800,000 ÷ 4). Second installment payment is $300,000 [($1 million tax ÷ 4) + ($250,000 required quarterly payment using the current year tax – $200,000 paid as first installment)]. Third and fourth installment payments are $250,000 each (See Example 34).

c. Calendar year corporation’s estimated payments are due April 15, June 15, September 15, and December 15.

d. Penalties apply to underpayments.

**Schedule M-1–Reconciliation of Taxable Income and Financial Net Income**

27. Schedule M-1. Reconciles the net income per financial accounting books with taxable income per the tax return. That is, Schedule M-1 computes the book to tax differences for the year.

a. Schedule M-1 is required for corporations with total assets less than $10 million.

b. Taxable income reconciled to net income per books is taxable income before the dividends received deduction and the NOL deduction.

28. Schedule M-2 reconciles unappropriated retained earnings for the year. Computations for Schedules M-1 and M-2 are illustrated in Examples 35 and 36.

**Schedule M-3–Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More**

29 Corporations with at least $10 million in total assets on their financial statements must report much greater detail relative to financial and tax income (loss) differences on Schedule M-3. This form is a response to the financial scandals.

a. Any corporation required to file a Schedule M-3 does not file a Schedule M-1.

b. Objectives of Schedule M-3 are the following.

(1) Create greater transparency between financial statements and tax returns.

(2) Identify corporations engaging in aggressive tax practices by highlighting transactions that create book/tax differences.

c. See Rev. Proc. 2011-13, 2011 C.B. 318 for guidance on when adequate disclosure requirement of §6662(d) (understatement of tax) is satisfied with regards to Schedule M-3.

30. Schedule M-3 has three parts.

a. Part I is financial information and the net income (loss) reconciliation.

(1) Financial net income (loss) sources come from the SEC Form 10-K, financial statements, or the corporation’s books and records.

(2) Any income statement restatements or adjustments for the current or past 5 years should be included.

b. Part II reconciles net income (loss) of includible corporations with taxable income on the return. Corporations included in the financial reporting group may differ from the tax reporting group.

c. Part III reconciles expense and deduction items.

(1) Lists 36 expense and deduction items to reconcile.

(2) Differences between financial and tax amounts must be classified as being temporary or permanent.

Schedule UTP (Uncertain Tax Position Statement)

31. New reporting requirement, beginning with 2010 returns, for corporations with $100 million or more in assets ($10 million or more in assets beginning in 2014) [Reg. 1.6012-2(a)(4) and Announcement 2010-75, 2010-1 C.B. 428]. In general, requires reporting tax positions taken on a current (or prior) year’s tax return and for which the corporation recorded a reserve for Federal income tax in its audited financial statements. Final Regulation [Reg. 1.6012-2(a)(4)] was issued in 2011 (see T.D. 9510). See Chapter 14 for a discussion on financial reporting of tax positions.

Form 1120 Illustration

32. The illustrative example is useful in introducing the corporate Form 1120.

**Solutions to Tax Return and Research Problems appear separately as a download from the Instructor’s Resource Page and on the Instructor’s CD.**