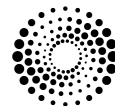


**SELF-STUDY CONTINUING PROFESSIONAL EDUCATION**

**Companion to PPC's**

**1120 Deskbook**



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**Interactive Self-study CPE**  
**Companion to PPC’s Guide to**  
**1120 Deskbook**

**TABLE OF CONTENTS**

	<b>Page</b>
<b><u>COURSE 1: ALTERNATIVE MINIMUM TAX AND PERSONAL HOLDING COMPANY TAX</u></b>	
Overview .....	1
Lesson 1: Alternative Minimum Tax .....	3
Lesson 2: Personal Holding Company Tax .....	43
Glossary .....	83
Index .....	87
<b><u>COURSE 2: ACCUMULATED EARNINGS TAX, CREDITS, AND TAX PAYMENTS</u></b>	
Overview .....	91
Lesson 1: Accumulated Earnings Tax .....	93
Lesson 2: Credits .....	121
Lesson 3: Tax Payments .....	145
Glossary .....	179
Index .....	181
<b>To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.</b>	
<b><u>EXAMINATION INSTRUCTIONS, ANSWER SHEETS, AND EVALUATIONS</u></b>	
Course 1: Testing Instructions for Examination for CPE Credit .....	185
Course 1: Examination for CPE Credit Answer Sheet .....	187
Course 1: Self-study Course Evaluation .....	188
Course 2: Testing Instructions for Examination for CPE Credit .....	189
Course 2: Examination for CPE Credit Answer Sheet .....	191
Course 2: Self-study Course Evaluation .....	192

## INTRODUCTION

*Companion to PPC's 1120 Deskbook* consists of two interactive self-study CPE courses. These are companion courses to *PPC's 1120 Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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Each course is divided into lessons. Each lesson addresses an aspect of corporate taxation. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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**COMPANION TO PPC'S 1120 DESKBOOK**

**COURSE 1**

**Alternative Minimum Tax and Personal Holding Company Tax (T20TG091)**

**OVERVIEW**

**COURSE DESCRIPTION:** This interactive self-study course provides an introduction to the Alternative Minimum Tax as well as the Personal Holding Company Tax. Lesson 1 will introduce the general rules for AMT plus credits and elections. Lesson 2 will cover the classification of companies as personal holding companies and calculation of the PHC tax.

**PUBLICATION/REVISION DATE:** October 2009

**RECOMMENDED FOR:** Users of *PPC's 1120 Deskbook*

**PREREQUISITE/ADVANCE PREPARATION:** Basic knowledge of corporate tax preparation.

**CPE CREDIT:** 6 QAS Hours, 6 Registry Hours  
6 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at [www.nasba.org](http://www.nasba.org) for a listing of states that accept QAS hours.

**Enrolled Agents:** This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

**FIELD OF STUDY:** Taxes

**EXPIRATION DATE:** Postmark by **November 30, 2010**

**KNOWLEDGE LEVEL:** Basic

**Learning Objectives:**

**Lesson 1—Alternative Minimum Tax**

Completion of this lesson will enable you to:

- Identify and apply the rules classifying a company as a small corporation.
- Recognize and apply the general rules for AMT for a C corporation, AMT adjustments and preferences, and the Accumulated Current Earnings (ACE) adjustment.
- Identify and calculate credits that can be claimed against AMT, the Alternative Tax Net Operating Loss (ATNOL), and limitations on the minimum tax credit.
- Identify passive activity losses for CHCs and PSCs.

**Lesson 2—Personal Holding Company Tax**

Completion of this lesson will enable you to:

- Discuss the features of personal holding companies, the tests that must be met for an entity to be classified as a personal holding company, the types of income that are classified as PHC income, and the types of entities that are exempt from PHC tax.

- Identify the components included in undistributed, personal holding company income; the methods used to minimize the penalty for PHCs; and the reporting requirements for dividends paid.

**TO COMPLETE THIS LEARNING PROCESS:**

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters  
Tax & Accounting—R&G  
T20TG091 Self-study CPE  
36786 Treasury Center  
Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

**ADMINISTRATIVE POLICIES:**

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

# Lesson 1: Alternative Minimum Tax

## INTRODUCTION

The alternative minimum tax (AMT) is repealed for small corporations effective for tax years beginning after 1997. This lesson clarifies what constitutes a “small corporation” for these purposes. Corporations that do not qualify as small corporations are effectively subject to two tax systems: the regular income tax and the AMT. A corporation's tax liability is determined based on the larger of the two taxes. The AMT ensures that corporations with economic income, but little or no taxable income, pay at least some current income tax.

Throughout this lesson, it is assumed that any corporation mentioned in an example is not a “small corporation” as defined in IRC Sec. 55(e) unless it is specifically identified as such.

Corporations subject to AMT must file Form 4626 (Alternate Minimum Tax—Corporations) with their tax returns. In addition, these corporations should maintain adequate records to support items required for AMT purposes. The instructions to Form 4626 give the following examples of records that should be kept:

1. Tax forms completed a second time to calculate the AMT.
2. The computation of a carryback or carryforward of net operating loss deductions or credits to other tax years if the AMT amount is different from the regular tax amount.
3. The computation of a carryforward of a passive loss if the AMT amount is different from the regular tax amount.
4. The balance of the excess of the corporation's total increases in alternative minimum taxable income (AMTI) from prior-year adjusted current earnings (ACE) adjustments over the total reductions in AMTI from prior-year ACE adjustments.

### Learning Objectives:

Completion of this lesson will enable you to:

- Identify and apply the rules classifying a company as a small corporation.
- Recognize and apply the general rules for calculating AMT for a C corporation, AMT adjustments and preferences, and the Accumulated Current Earnings (ACE) adjustment.
- Identify and calculate credits that can be claimed against AMT, the Alternative Tax Net Operating Loss (ATNOL), and limitations on the minimum tax credit.
- Identify passive activity losses for CHCs and PSCs.

## Small Corporations: Applying the AMT Exception

### In General

The AMT for “small” corporations has been repealed effective for tax years beginning after 1997. A “small” corporation is defined as one having three-year average annual gross receipts not exceeding \$5 million for its first tax year beginning after 1996, and not having three-year average annual gross receipts exceeding \$7.5 million for any later year.

**Example 1A-1 Small corporations exempt from AMT.**

Eagle Corporation has been in existence since January 1, Year 1 and uses a calendar year-end. Its gross receipts for the previous years have been:

	<u>Annual</u>	<u>Three-year Average</u>
Year 1	\$ 3,000,000	
Year 2	3,500,000	
Year 3	4,500,000	
Year 4	5,500,000	\$ 3,666,667
Year 5	7,000,000	4,500,000
Year 6	7,500,000	5,666,667
Year 7	8,200,000	6,666,667
Year 8	7,000,000	7,666,667

Eagle is exempt from AMT for Year 1 since that was its first year in existence. It qualifies as a small business corporation for Year 2 since its average gross receipts for the first prior three years (or portion thereof) of existence is less than \$5,000,000. In this case the first prior three years (or portion thereof) consists of only Year 1.

Eagle will continue to qualify for the AMT exemption in Year 3 and later years if the average gross receipts for the previous three years (or portion thereof) does not exceed \$7,500,000. Therefore, Eagle remains qualified as a small corporation for Year 3 through Year 7. However, for Year 8, Eagle will no longer qualify for the exemption since its average gross receipts for the previous three-year period were in excess of \$7,500,000. It does not matter that Eagle's gross receipts for Year 8 were less than \$7,500,000 (see the following paragraph for the consequences of losing the exemption).

**Corporations Ceasing to Meet Exception**

A corporation that has been exempt from the AMT as a small corporation and then becomes subject to the AMT when it exceeds the gross receipts threshold will remain liable for the AMT in all future years. However, the AMT for tax years beginning with the first tax year the corporation ceases to meet the exception will be computed with the following modifications. For each of these items, the "change date" is the first day of the first tax year for which the taxpayer ceases to meet the gross receipts test.

1. The adjustments for depreciation and pollution control facilities apply only to property placed in service on or after the change date.
2. The adjustment for mining exploration and development costs applies only to costs paid or incurred on or after the change date.
3. The adjustment for long-term contracts applies only to contracts entered into on or after the change date.
4. The adjustment for the alternative tax net operating loss deduction applies as if, in making adjustments to the NOL computation under IRC Sec. 56(d)(2), the change date is substituted for January 1, 1987 and the day before the change date is substituted for December 31, 1986 each place it appears.
5. The limitation on the allowance of negative adjustments based on adjusted current earnings applies only to prior tax years beginning on or after the change date.
6. The adjustment for depreciation in computing ACE does not apply.
7. Other earnings and profits adjustments and depletion apply as if the day before the change date were substituted for December 31, 1989 each place it appears therein.

The preceding exceptions do not apply to any property acquired by the corporation in a transaction to which IRC Sec. 381 applies or to any property received in a carryover basis transaction if that property was subject to modifications in the hands of the transferor.

**Example 1A-2 Determining the consequences of failing the gross receipts test.**

Budco, Inc. is a calendar-year corporation that met the exemption as a small business corporation for 2007 but lost this exemption in 2009. Most AMT adjustment/tax preference items for the year the exemption is lost are treated as if that year is the first year of corporate existence. This will have the following impact on Budco:

1. In years after 2008, most of Budco's assets placed in service before 2009 on which normal MACRS depreciation was taken will continue to produce a depreciation allowance in excess of the amount that would be allowed if the AMT 150% declining balance (DB) method had been used. However, IRC Sec. 55(e)(2) states that the adjustment for excess depreciation will apply only to property that is placed in service after the change date. As a result, Budco will not have to include an adjustment for excess depreciation on property placed in service before January 1, 2009.
2. Budco has long-term contracts from which income is recognized on the completed contract method of accounting rather than the percentage-of-completion method. The difference in the income that would have been recognized under the percentage-of-completion method over that recognized on the completed contract method is normally an AMT adjustment item. However, IRC Sec. 55(e)(2) states that the adjustment will only apply for those contracts entered into after the change date. Therefore, Budco will not have to make this calculation and include any amount as an AMT adjustment for any contracts entered into before January 1, 2009.

**Qualification of New Corporations**

In a corporation's first year of existence it receives an automatic AMT exemption, regardless of its gross receipts. In its second year, it continues to be exempt if its gross receipts for its first year were no more than \$5 million (on an annualized basis, if the first year was less than 12 months). In its third year, it will be exempt if average gross receipts for the first two years are no more than \$7.5 million (after annualizing the first year's receipts, if necessary). In its fourth and later years, it continues to be exempt from AMT as long as its average gross receipts for the three prior years are no more than \$7.5 million. Once the corporation ceases to qualify for the exemption, there is no opportunity for it to regain the exemption in future years.

**Example 1A-3 Qualification of new corporations.**

Nucorp, a calendar-year corporation, was formed on January 1, Year 1. It has the following gross receipts:

	<u>Annual</u>	<u>Three-year Average</u>
Year 1	\$ 1,500,000	Not applicable in 1st year
Year 2	4,500,000	Test based on Year 1 receipts
Year 3	9,000,000	\$3,000,000
Year 4	11,000,000	5,000,000
Year 5	1,500,000	8,166,666

For Year 1, Nucorp automatically would be exempt from AMT since that was its first year of existence. In Year 2, Nucorp remains exempt because its gross receipts for the first year did not exceed \$5 million. In Year 3, Nucorp is exempt because its average annual gross receipts for its first two years did not exceed \$7.5 million. Nucorp will continue to be exempt in Year 4 since its gross receipts for its first three years did not exceed \$7.5 million. However, for Year 5, and for all years thereafter, Nucorp will be subject to AMT since its average annual gross receipts for the previous three years exceeded \$7.5 million.

**Aggregation Rules**

The rules under IRC Sec. 1563(a) (with certain modifications) are used to determine whether gross receipts of various entities must be aggregated pursuant to IRC Sec. 55(e)(1)(D) when determining if the "small corporation"

gross receipts rules are met. For aggregation purposes, controlled groups are affiliated companies in either a parent-subsidary relationship (when the parent owns more than 50% of the subsidiary), or a brother-sister relationship under IRC Sec. 1563(a)(2). The brother-sister relationship also exists when five or fewer shareholders own at least 80% of the vote and value of each company, and more than 50% of the vote and value when identical stock ownership in each corporation is taken into consideration.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following statements regarding the alternative minimum tax (AMT) is accurate?
  - a. The alternative minimum tax AMT only applies to small corporations.
  - b. The AMT ensures that corporations with economic income, but little or no taxable income, pay at least some current income tax.
  - c. Corporations that do not qualify for the AMT are effectively subject to three tax systems.
  
2. Auto Corp began existence January 1, year 1, and uses a calendar year-end. Determine which of the following statements is accurate by considering the information provided and applying the guidance for classifying the client as either a small corporation or regular corporation.

	<u>Annual Gross Receipts</u>	<u>3-year average</u>
Year 1	\$ 3,000,000	
Year 2	\$ 4,000,000	
Year 3	\$ 4,500,000	
Year 4	\$ 8,500,000	\$ 3,833,333
Year 5	\$ 12,000,000	\$ 5,666,666
Year 6	\$ 13,800,000	\$ 8,333,333

- a. In its first year of business, it was subject to the AMT because its gross receipts were \$3,000,000.
  - b. Starting in year 4, it was subject to the AMT since that was the first year a 3-year average was available.
  - c. Year 5 is the first year the corporation is subject to AMT since its 3-year average reached \$5,666,666.
  - d. Year 6 is the first year the corporation is subject to AMT since its 3-year average reached \$8,333,333.
- 
3. When a taxpayer no longer meets the gross receipts test and becomes subject to AMT, the AMT for the first tax year must be computed with which one of the following modifications?
    - a. The adjustment for depreciation applies only to property placed in service on or after the change date.
    - b. The adjustment for depreciation in computing ACE applies.
    - c. The adjustment for mining exploration and development costs applies to costs paid before the change date.
    - d. The adjustment for long-term contracts applies to contracts entered into before the change date.
  
  4. Eagle Mountain Corporation has just completed their first year of operations. How should their accountants handle the corporation's taxes with respect to the AMT covering this time period?
    - a. Eagle Mountain Corporation is exempt from AMT because it was in its first year of business.
    - b. Eagle Mountain's tax liability for the period will be the larger of the regular income tax or the AMT.
    - c. The alternative minimum tax will not apply until the corporation has a three year average earnings record.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following statements regarding the alternative minimum tax (AMT) is accurate? **(Page 3)**
  - a. The alternative minimum tax AMT only applies to small corporations. [This answer is incorrect. The AMT was repealed for small corporations effective for tax years after 1997 per the IRS.]
  - b. The AMT ensures that corporations with economic income, but little or no taxable income, pay at least some current income tax. [This answer is correct. The AMT ensures that corporations with economic income, but little or no taxable income, pay at least some current income tax to even out tax liability for companies.]**
  - c. Corporations that do not qualify for the Alternative Minimum Tax are effectively subject to three tax systems. [This answer is incorrect. Corporations that do not qualify as small corporations (for which the AMT was repealed) are effectively subject to two tax systems: the regular income tax and the AMT per the IRS.]
2. Auto Corp began existence January 1, year 1, and uses a calendar year-end. Determine which of the following statements is accurate by considering the information provided and applying the guidance for classifying the client as either a small corporation or regular corporation. **(Page 5)**

	<u>Annual Gross Receipts</u>	<u>3-year average</u>
Year 1	\$ 3,000,000	
Year 2	\$ 4,000,000	
Year 3	\$ 4,500,000	
Year 4	\$ 8,500,000	\$ 3,833,333
Year 5	\$ 12,000,000	\$ 5,666,666
Year 6	\$ 13,800,000	\$ 8,333,333

- a. In its first year of business, it was subject to the AMT because its gross receipts were \$3,000,000. [This answer is incorrect. This client was automatically exempt from the AMT because it was its first year of operation. The \$3 million in gross receipts did not affect this qualification.]
  - b. Starting in year 4, it was subject to the AMT since that was the first year a 3-year average was available. [This answer is incorrect. The client was not subject to the AMT in year 4 even though it was the first time a 3-year average was available. The 3-year average did not reach the threshold for AMT.]
  - c. Year 5 is the first year the corporation is subject to AMT since its 3-year average reached \$5,666,666. [This answer is incorrect. The client was not subject to the AMT in year 5 because the 3-year average did not reach the threshold for AMT as defined by the IRS.]
  - d. Year 6 is the first year the corporation is subject to AMT since its 3-year average reached \$8,333,333. [This answer is correct. Year 6 is the first year the corporation is subject to AMT since its 3-year average reached the \$7,500,000.]**
3. When a taxpayer no longer meets the gross receipts test and becomes subject to AMT, the AMT for the first tax year must be computed with which one of the following modifications? **(Page 4)**
    - a. The adjustment for depreciation applies only to property placed in service on or after the change date. [This answer is correct. The adjustments for depreciation and pollution control facilities apply only to property placed in service on or after the change date per the IRS.]**
    - b. The adjustment for depreciation in computing ACE applies. [This answer is incorrect according to IRS Code. The adjustment for depreciation in computing ACE does not apply.]

- c. The adjustment for mining exploration and development costs applies to costs paid before the change date. [This answer is incorrect. The adjustment for mining exploration and development costs applies only to costs paid or incurred on or after the change date according to IRS Code.]
  - d. The adjustment for long-term contracts applies to contracts entered into before the change date. [This answer is incorrect. Per the IRS Code, the adjustment of long-term contracts applies only to contracts entered into on or after the change date.]
4. Eagle Mountain Corporation has just completed their first year of operations. How should their accountants handle the corporation's taxes with respect to the AMT covering this time period? **(Page 5)**
- a. **Eagle Mountain Corporation is exempt from AMT because it was in its first year of business. [This answer is correct. In a corporation's first year of existence, it receives an automatic AMT exemption, regardless of its gross receipts according to IRS Code.]**
  - b. Eagle Mountain's tax liability for the period will be the larger of the regular income tax or the AMT. [This answer is incorrect. Eagle Mountain's tax liability for the period will not be the larger of the regular income tax or the AMT unless the corporation is subject to AMT.]
  - c. The alternative minimum tax will not apply until the corporation has a three year average earnings record. [This answer is incorrect. Having a three-year average earnings record is not the determinant for being subject to the AMT. The three-year average has to have average annual gross receipts exceeding \$7.5 million for any year after its first year.]

## Calculating the Corporate AMT

### General Rules

The following steps can be used to calculate alternative minimum taxable income (AMTI) and the AMT for a C corporation. These steps are followed when completing Form 4626 (Alternative Minimum Tax—Corporations).

1. *Begin with Regular Taxable Income before NOL but after Special Deductions.* The starting point for AMT is regular taxable income. If an NOL has reduced taxable income, it must be added back because the AMT system allows only an alternative tax NOL (ATNOL).
2. *Add or Subtract AMT Adjustments.* The AMT adjustments eliminate the tax impact (for AMT purposes) of items treated differently under the regular tax and AMT systems. Adjustment items can increase or decrease AMTI.
3. *Add AMT Tax Preference Items.* AMT tax preference items are other income items and deductions that receive preferential treatment for regular tax purposes. Only positive preference items increase AMTI. Negative preference amounts are ignored.
4. *Recompute Deductions Based on a Percentage of AMTI.* Instructions to Form 4626 state that for AMT purposes, deductions based on an income limit (e.g., charitable contributions and percentage depletion) must be recomputed based only on income and deductions allowed under the AMT system.
5. *Calculate Preadjustment AMTI.* Preadjustment AMTI is a critical subtotal in the AMT calculation. It is used to calculate the ACE adjustment explained in step 6.
6. *Add or Subtract the Adjusted Current Earning (ACE) Adjustment.* The ACE adjustment keeps corporations from reporting a profit for financial purposes while paying little or no corporate income tax. ACE is a tax concept intended to represent the corporation's economic earnings for the year. The ACE adjustment equals 75% of the difference between ACE and preadjustment AMTI (in absolute numbers). This amount may either be added to or subtracted from AMTI.
7. *Calculate the Allowable ATNOL (Alternative Tax NOL).* The ATNOL is defined as the regular tax NOL, increased or decreased by AMT adjustments and decreased by AMT preferences. An adjustment for an AMT preference is only required to the extent it caused the regular tax NOL to increase. The ATNOL must be carried back or forward in the same manner as a regular tax NOL. The ATNOL cannot exceed 90% of the corporation's AMTI for the year figured before the ATNOL deduction.
8. *Subtract the AMT Exemption.* AMT does not apply to a corporation in the lower income tax brackets with small amounts of AMT adjustments or preference items. Accordingly, an exemption amount is subtracted from AMTI before figuring the tentative minimum tax (TMT). The base exemption is \$40,000. The exemption phases out as income increases at a rate of 25% of the amount that AMTI exceeds \$150,000. Thus a corporation with AMTI of \$310,000 or more is not entitled to any of the exemption amount.
9. *Calculate TMT (Tentative Minimum Tax).* The tentative AMT before foreign tax credit is figured by multiplying the AMTI, after any exemption amount is subtracted, by 20%. The foreign tax credit, if any, is then subtracted to arrive at the TMT.
10. *Compute AMT.* If TMT is greater than regular tax, the difference is AMT. For this purpose regular tax is reduced by the foreign tax credit and the possessions credit.

**Example 1B-1 AMT calculation.**

Dirt Busters, Inc. (DBI), a calendar-year corporation, operates a commercial and residential janitorial/maid service. Selected information related to its current tax year is as follows:

<u>Description</u>	<u>Amount</u>
Taxable income (net of a \$65,000 NOL carryover from previous year)	\$ 385,000
Regular tax liability	130,900
Depreciation—post-1986 properties:	
Regular tax	530,000
AMT	360,000
ACE	220,000 <sup>a</sup>
Adjusted basis of MACRS property sold during the year:	
Regular tax adjusted basis	80,000
AMT adjusted basis	87,500
ACE adjusted basis	91,700
Excess of depreciation deducted on pre-1987 real property over straight-line depreciation	21,000
Tax-exempt interest income (from nonprivate-activity bonds)	11,500
Expenses related to the tax-exempt interest income	100
ATNOL carryover from previous year	32,000

**Note:**

- <sup>a</sup> The ACE depreciation adjustment is eliminated for property placed in service after December 31, 1993. However, an ACE adjustment is still necessary for property placed in service before 1994.

DBI's AMT liability is \$11,480. The corporation's AMT is carried from Form 4626 to line 3, Schedule J, Form 1120.

## Handling Corporate AMT Adjustments

The difference between AMT income and regular taxable income results from AMT adjustments and preferences. These adjustments may be either positive or negative, depending on the relation of the AMT amount compared to the regular tax amount.

**Example 1C-1 Adjustment when long-term contracts are still in progress at year-end.**

PreFabCo, Inc. (PFC), a calendar-year corporation, constructs prefabricated warehouses on a turn-key basis for its customers. Annual sales have averaged about \$8 million for the last several years. For regular tax purposes, PFC qualifies for, and has always used, the completed-contract method of accounting for its long-term contracts. At the end of 2009 PFC had long-term contracts on which it recognized \$251,000 in profits. Had PFC used the percentage-of-completion method the profit reported on long-term contracts would have been only \$220,000.

For 2010 PFC reported no profits from long-term contracts using the completed-contract method. Had it used the percentage-of-completion method, profit on long-term contracts in progress at the end of 2010 would have been \$345,000.

Use of the percentage-of-completion method generally is required for long-term contracts when calculating AMTI. An exception to this rule applies to certain home construction contracts where 80% of construction costs are reasonably expected to relate to single-family houses, townhouses, etc. if they contain four or fewer dwelling units.

In this example, PFC does not meet the exception for home construction contracts. Therefore it is required to use the percentage-of-completion method in computing AMTI. PFC must determine the difference between profits generated by long-term construction projects using the completed-contract method and the percentage-of-completion method on contracts in progress at year-end.

In 2009, PFC recognized \$31,000 more profit using the completed-contract method than the percentage-of-completion method. Therefore, for 2009, PFC is able to deduct this \$31,000 from regular taxable income when computing AMTI. However, in 2010, PFC would have recognized \$345,000 more profit using the percentage-of-completion method than the completed-contract method. This \$345,000 must be added back to regular taxable income in computing AMTI for 2010.

## Depreciation

The most common AMT adjustment item is depreciation calculations. Historically, the AMT computation has required a separate depreciation calculation for regular tax and AMT purposes. For property placed in service after 1986 (MACRS property), different depreciation methods and rates were used for regular tax and AMT purposes. Prior to 1998 taxpayers were required to use the alternative depreciation system under IRC Sec. 168(g) to determine the depreciation method and useful lives of assets for AMT purposes. The 150% declining balance (DB) method was available for personal property. For 1999, and later, the taxpayer is allowed to use MACRS useful lives, but must use the 150% DB method for AMT purposes. An election can be made to use this same method for regular tax purposes for ease of recordkeeping.

The depreciation adjustment is not always lower for AMT purposes. If the 200% DB method is used for regular tax purposes, AMT depreciation for the latter part of these assets' lives will be higher than regular depreciation. Therefore, the adjustment for that property will be negative. If negative depreciation adjustments exceed positive adjustments for any year, the net negative adjustment will reduce AMTI for that year.

Property that is depreciated under a method other than MACRS is not considered for purposes of the depreciation adjustment. For example, property depreciated under a units-of-production method, or on some other basis than the passing of time, would not be subject to this depreciation adjustment. The following example illustrates the consequences of using the two different depreciation systems (regular tax versus AMT) when assets are sold by a corporation.

### Example 1C-2 Recalculating adjusted basis when property is sold.

Bigcorp sold a computer for \$3,500. The computer was acquired three years earlier for \$5,700. When sold, the accumulated depreciation was \$4,060 for regular tax purposes and \$3,325 for AMT purposes.

To determine AMTI, an adjustment is required to account for any difference in the adjusted basis (AMT versus regular tax) of assets sold. Differences arise because of the different depreciation, amortization, and deduction rules allowed with respect to various costs and expenses when calculating AMTI. The most common basis adjustment pertains to depreciable assets. The basis adjustment for depreciable assets only applies to assets placed in service after 1986 (MACRS assets). No basis adjustment is required for property placed in service before 1987.

Bigcorp's basis adjustment equals the difference between the adjusted basis of the computer for regular tax purposes versus the adjusted basis for AMT purposes, or \$735 (\$4,060 – \$3,325). The \$735 will be a negative adjustment in calculating AMTI (decrease AMTI) since the AMT basis of the computer exceeds its regular tax basis.

## Bonus Depreciation

The American Recovery and Reinvestment Act of 2009 extended the 50% bonus depreciation provisions previously enacted in the 2008 Economic Stimulus Act to include eligible assets acquired and placed in service after 2007 but before 2010. The bonus depreciation deduction is allowed for both regular and AMT purposes. That is, there is no AMT depreciation adjustment for qualified property recovered under IRC Sec. 168(k) (i.e., the bonus depreciation amount) for the entire recovery period. In addition, there is no AMT adjustment for the remaining 50% of the cost of qualified property.

## Domestic Production Activities Deduction

Corporations may claim a domestic production activities deduction equal to a certain percentage of net income from qualified production activities conducted in the United States. This percentage is 6% for 2009, and 9% for years 2010 and after.

The corporation may also deduct the domestic production activities deduction when calculating its AMTI. When making the calculations, the following adjustments are required:

1. Qualified production activity income is determined without taking into consideration any AMT adjustments, preferences, or other miscellaneous AMT rules.
2. The deduction is limited to AMTI for the year.

### Example 1C-3 Calculating the domestic production activities deduction for AMT.

PanPacific, Inc. has the following activity for the year:

Income before domestic production activities deduction	\$ 4,000
Domestic production activities deduction	<u>(2,000)</u>
Taxable Income	<u>\$ 2,000</u>
Calculation of AMTI:	
Taxable Income	\$ 2,000
Add back: Regular tax domestic production activities deduction	2,000
AMT adjustments and preferences (net positive)	<u>(3,000)</u>
Tentative AMTI	1,000
Domestic production activities deduction for AMT	<u>(1,000)</u>
AMTI	<u>\$ -0-</u>

Because of the limitation, an ATNOL cannot result from the domestic production activities deduction. The domestic production activities deduction is also allowed in computing adjusted current earnings (ACE).

## Handling Corporate AMT Preferences

Unlike AMT adjustments, AMT preference items can only increase AMTI since there are no negative preference items.

### Depreciation

While accelerated depreciation of property placed in service after 1986 generates an AMT adjustment, accelerated depreciation of certain property placed in service before 1987 generates an AMT preference item. The preference amount is the excess of the depreciation allowed for regular tax purposes over the depreciation computed using the straight-line method with a half-year convention. The depreciable life is based on the ACRS class life. The following example illustrates the calculation of this preference item.

### Example 1D-1 Accelerated depreciation on pre-1987 property.

Laser, Inc. constructed an office building in 1983. The cost of this building was \$100,000. In 1983, Laser elected to use the 150% declining balance method over a useful life of 30 years to depreciate the office building. Assume, this depreciation method provides a deduction of \$1,986 for the current year, while the straight-line method of depreciation would provide a deduction of \$3,333.

IRC Sec. 57(a)(6) provides for an AMT preference item for accelerated depreciation on property placed in service before 1987. The preference item is the amount the accelerated depreciation exceeds straight-line depreciation for the year in question.

Laser, Inc. will have no AMT preference item for accelerated depreciation. Since the accelerated depreciation amount for the current year is less than the straight-line depreciation amount, the preference item is zero. There can be no negative AMT preference items.

### **Tax-exempt Interest**

Interest income (less any related deductions disallowed under the regular tax rules) from specified private-activity bonds must be included in AMTI. **Note:** The American Recovery and Reinvestment Act of 2009 exempts income from tax-exempt private activity bonds issued in 2009 and 2010 from inclusion in AMTI. A specified private-activity bond is generally any private-activity bond issued after August 7, 1986 (or in certain circumstances, after August 31, 1986) on which the interest is not subject to tax under the regular tax system. However, bonds whose proceeds are used to (1) refund a bond originally issued before August 8, 1986 or (2) provide property to be owned by a charitable organization or a governmental unit is not a specified private-activity bond.

A private-activity bond is basically any bond where (1) more than 10% of the proceeds are used in and secured by a nongovernmental activity, or (2) at least 5% of the proceeds or \$5 million, whichever is less, is used to make loans to nongovernmental entities. Fortunately, most practitioners do not need to make their own determination of whether a particular bond is a specified private-activity bond. This information is normally supplied by the client's stockbroker on the year-end brokerage statements.

In addition, tax-exempt interest on these three types of bonds will not be included in the ACE adjustment. These changes will not apply to interest on any refunding bond unless interest on the original bond was not a tax preference item.

## **Calculating the Adjusted Current Earnings (ACE) Amount**

One of the AMT adjustment items is provided by IRC Sec. 56(c)(1) and pertains to adjusted current earnings (ACE) of a corporation. A corporation's AMTI is increased by 75% of the excess of ACE over preadjustment AMTI. When ACE is less than AMTI, there is a negative adjustment to AMTI.

### **Computing the ACE Adjustment**

The rules for computing the ACE adjustment are set forth in IRC Sec. 56(g) and Reg. 1.56(g)-1. Form 4626 and its instructions provide a worksheet that can be used to make the calculation of ACE. The use of this worksheet is essential in guiding the taxpayer through a step-by-step calculation of ACE. The ACE adjustment is then calculated on lines 4a–4e on page 1 of Form 4626 (Alternative Minimum Tax—Corporations).

The starting point for calculating ACE is preadjustment AMTI, as calculated on line 3 of Form 4626. AMTI is regular taxable income as adjusted for AMT adjustments and preference items. Preadjustment AMTI is then adjusted in accordance with IRC Sec. 56(g) to arrive at ACE. The ACE worksheet and instructions give an item-by-item breakdown of these adjustments.

### **ACE Depreciation**

The first adjustment to preadjustment AMTI is the ACE depreciation adjustment shown on lines 2a–2c of the ACE worksheet. To determine ACE, the depreciation deduction for a corporation must be recalculated using allowable ACE depreciation methods and property basis. Once this is accomplished, the ACE depreciation adjustment is the difference between total AMT and ACE depreciation.

### **Inclusion of Items Included in Earning and Profits (E&P)**

Lines 3a–3f of the ACE worksheet list various income items that are not included in preadjustment AMTI but are included in the calculation of E&P. These items must be included in ACE. Any such items may be reduced by all expenses related to that income that were not deducted in arriving at preadjustment AMTI. Exceptions to these ACE inclusion rules are income from the discharge of indebtedness excluded from gross income under IRC Sec. 108, and federal income tax refunds.

**Example 1E-1 Income items included in calculation of E&P and ACE.**

Sullivan Corp. owns several municipal bonds that generated \$5,000 of tax-exempt interest income. During the year, it incurred \$200 of investment expenses related to the bonds. The income and related expenses are excluded from the calculation of preadjustment AMTI.

The bond income and related expenses are included in determining Sullivan's E&P, but are not included in the calculation of preadjustment AMTI since they are not considered in determining regular taxable income and are not added to AMTI as an adjustment or preference. Therefore, they must be included in the calculation of ACE. Line 3a of Sullivan's ACE worksheet would include the amount of \$4,800 (\$5,000 income less \$200 related expenses).

Lines 3b–3d of the ACE worksheet pertain to the treatment of income arising from life insurance contracts owned by a corporation. Life insurance proceeds may be excluded from regular taxable income under IRC Sec. 101 and are not added back in determining preadjustment AMTI. Since they are included in the computation of E&P, they must be added back in calculating ACE. Lines 3b and 3c of the ACE worksheet are used for these additions.

The inside buildup of a life insurance contract must also be included in E&P and, therefore, ACE. The inside buildup is defined as:

1. the excess, if any, of the contract's net surrender value at year-end plus any nontaxable distributions under the policy during the year, over
2. the net surrender value at the beginning of the year plus any premiums paid during the year.

Any income from the inside buildup value of a contract will increase the basis of that contract for ACE purposes only. This basis can then be offset against any proceeds received from the contract when calculating ACE.

The income accruing from the inside buildup of a life insurance contract is shown on line 3d of the ACE worksheet. This amount can only be a positive number. No deduction is allowed if the calculation for a period yields a negative number.

Reg. 1.56(g)-1(c)(6) provides a partial list of other income items that must be included on line 3e of the ACE worksheet. The remaining items are generally not applicable to most taxpayers.

**Items Not Deductible in Computing E&P**

Lines 4a–4e list items that are not deductible in computing E&P and, therefore, cannot be deducted in determining ACE. ACE must be increased for these items to the extent they have been allowed in computing preadjustment AMTI.

Corporations receive a dividends received deduction in determining regular tax for dividends received from certain other corporations. This deduction is not added back in determining preadjustment AMTI, but it is added back in determining E&P. Therefore, it generally must be added back in determining ACE. Line 4a of the worksheet is used for this purpose.

An important exception to this rule pertains to any deduction allowable under IRC Sec. 243 or 245 for any dividend that qualifies for a 100% dividends received deduction and any dividend received from a 20%-owned corporation, but only if the payor is subject to federal income tax on the earnings to which the dividend is attributable.

Another exception to this general rule is the domestic production activities deduction. This deduction will be allowed in computing ACE even though it is not a deduction for computing E&P.

Lines 4b–4d of the ACE worksheet pertain to certain types of dividends paid by a corporation that are deductible in arriving at preadjustment AMTI but not deductible in calculating E&P. Line 4e pertains to any other item not deductible for E&P purposes. Reg. 1.56(g)-1(d)(3) contains a partial list of these items.

## Specific E&P Adjustments in Calculating ACE

Lines 5a–5e and 8 pertain to certain items that receive special treatment under IRC Sec. 56(g)(4) and the regulations thereunder. These items and their required treatment for ACE purposes are as follows:

1. *Line 5a, Intangible Drilling Costs.* Intangible drilling costs (IDCs) on productive wells are capitalized and amortized over a 60-month period beginning with the month the amount is paid or incurred. This rule applies only to integrated oil companies.
2. *Lines 5b–5c, Circulation and Organizational Expenditures.* These costs are not deductible or amortizable. In the case of circulation expenses, an election can be made under IRC Sec. 59(e) to amortize such expenses over three tax years for regular tax purposes. This election is valid for ACE purposes also.
3. *Line 5d, LIFO Inventory Adjustments.* For corporations using LIFO, the increase or decrease in the LIFO recapture amount (excess of inventory value on FIFO basis over LIFO basis) for the tax year is an ACE adjustment. An election can be made to use regular tax inventory to compute the AMT inventory and ACE inventory adjustment.
4. *Line 5e, Installment Sales.* The installment method generally cannot be used in determining ACE; thus, income from installment sales must be included in ACE in the year the property is sold and excluded in later years as the payments are recognized for regular tax purposes.
5. *Line 8, Depletion.* ACE depletion must be determined under the cost depletion method of IRC Sec. 611. However, this ACE adjustment does not apply to percentage depletion taken by independent oil and gas producers and royalty owners under IRC Sec. 613A(c).

Lines 6 and 7 of the worksheet (debt pools and foreign insurance contracts) have limited application. Line 9 is used to make adjustments to gains or losses from sales or exchanges of property having a different basis for ACE purposes than for AMT purposes. The gain or loss on the sale is recalculated using the ACE basis and the difference is entered as either a positive or negative amount on line 9.

## ACE Adjustment

The ACE adjustment is calculated on Lines 4a–4e of Form 4626. The adjustment is 75% of the difference between ACE and preadjustment AMTI and can be a positive or negative adjustment. However, if the adjustment is negative, it is allowed only to the extent the corporation's total adjustment to AMTI in prior years is a positive number and does not exceed 75% of the current year's negative ACE adjustment.

### Example 1E-2 Limitation on negative ACE adjustment.

Zimco, Inc. has the following ACE adjustments in relation to AMTI:

	<u>2005</u>	<u>2006</u>	<u>2007</u>
ACE	\$ 3,000	\$ 1,000	\$ 1,500
AMTI	<u>1,000</u>	<u>2,500</u>	<u>3,000</u>
Difference (positive or negative)	<u>\$ 2,000</u>	<u>\$ (1,500)</u>	<u>\$ (1,500)</u>
Tentative ACE adjustment (75% of excess)	<u>\$ 1,500</u>	<u>\$ (1,125)</u>	<u>\$ (1,125)</u>
Limitation on negative ACE adjustment (cumulative positive adjustments to date)	<u>\$ N/A</u>	<u>\$ 1,500</u>	<u>\$ 375</u>
Final ACE adjustment	<u>\$ 1,500</u>	<u>\$ (1,125)</u>	<u>\$ (375)</u>

The completion of the ACE worksheet and the calculation of the ACE adjustment are illustrated in Example 1B-1.

**ACE Adjustment for Consolidated Groups**

The ACE adjustment for a consolidated group that is filing (or is required to file) a consolidated return is computed on a combined basis. The adjustments required to determine the group's ACE are the same as those for a corporation that is not part of a consolidated group.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. When calculating the corporate AMT, which of the following prevents corporations from reporting a profit for financial purposes while paying little corporate income tax?
  - a. Adjusted current earning (ACE) adjustment.
  - b. Preadjustment alternative minimal taxable income (AMTI).
  - c. Alternative tax NOL (ATNOL).
  - d. Tentative minimum tax (TMT).
  
6. Which of the following is the most common AMT adjustment item?
  - a. Domestic production activities deduction.
  - b. Long-term contracts still in progress at year-end.
  - c. Depreciation methods.
  
7. Based on the information below, what is SunCo Inc.'s domestic production activities deduction for AMT?

Revenue	\$	8,000
Income before domestic production activities deduction	\$	6,000
Domestic production activities deduction	\$	3,000
Taxable income	\$	3,000
AMT adjustment and preference items (net positive)	\$	(4,000)

- a. \$0.
  - b. \$1,000.
  - c. \$2,000.
  - d. \$3,000.
- 
8. When calculating the Accumulated Current Earnings (ACE) Adjustment, which of the following items are exempt from ACE inclusion rules?
    - a. Death benefits from life insurance contracts.
    - b. Federal income tax refunds.
    - c. Tax-exempt interest income.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. When calculating the corporate AMT, which of the following prevents corporations from reporting a profit for financial purposes while paying little corporate income tax? **(Page 10)**
- Adjusted current earning (ACE) adjustment. [This answer is correct. The ACE adjustment keeps corporations from reporting a profit for financial purposes while paying little or no corporate income tax because ACE is a tax concept intended to represent the corporation's economic earnings for the year.]**
  - Preadjustment alternative minimal taxable income (AMTI). [This answer is incorrect. The AMTI is critical in the subtotal in the AMT, however, it does not prevent corporations from reporting a profit for financial purposes while paying little corporation income tax because it is used to calculate the ACE adjustment.]
  - Alternative tax NOL (ATNOL). [This answer is incorrect. The ATNOL is the regular tax NOL, increased or decreased by AMT adjustments and decreased by AMT preferences and does not prevent corporations from reporting a profit for financial purposes while paying little corporate income tax.]
  - Tentative minimum tax (TMT). [This answer is incorrect. The TMT is calculated by multiplying the AMT, after any exemption amount is subtracted, by 20%. This calculation does not prevent corporations from reporting a profit for financial purposes while paying little corporate income tax.]
6. Which of the following is the most common AMT adjustment item? **(Page 12)**
- Domestic production activities deduction. [This answer is incorrect. The domestic production activities deduction can result in an AMT adjustment; however, this is not the most common.]
  - Long-term contracts still in progress at year-end. [This answer is incorrect. Long-term contracts still in progress at year-end can result in an AMT adjustment, however; this is not the most common.]
  - Depreciation methods. [This answer is correct. Different depreciation methods for regular income tax and AMT can result in an AMT adjustment. This is the most common AMT adjustment since almost all companies have depreciation.]**
7. Based on the information below, what is SunCo Inc.'s domestic production activities deduction for AMT? **(Page 13)**

Revenue	\$	8,000
Income before domestic production activities deduction	\$	6,000
Domestic production activities deduction	\$	3,000
Taxable income	\$	3,000
AMT adjustment and preference items (net positive)	\$	(4,000)

- \$0. [This answer is incorrect. \$0 is the AMTI amount.]
- \$1,000. [This answer is incorrect. \$1,000 is not the domestic production activities deduction for AMT.]

c. **\$2,000.** [This answer is correct. \$2,000 is the domestic production activities deduction for AMT.]

Income before domestic production activities deduction	\$ 6,000
Domestic production activities deduction	<u>(3,000)</u>
<b>Taxable Income</b>	<b><u>\$ 3,000</u></b>
<b>Calculation of AMTI:</b>	
Taxable Income	\$ 3,000
Add back: Regular tax domestic production activities deduction	3,000
AMT adjustments and preferences (net positive)	<u>(4,000)</u>
<b>Tentative AMTI</b>	<b>2,000</b>
Domestic production activities deduction for AMT	<u>(2,000)</u>
<b>AMTI</b>	<b><u>\$ -0-</u></b>

d. \$3,000. [This answer is incorrect. \$3,000 is not the domestic production activities deduction for AMT. It is the domestic production activities deduction for regular tax.]

8. When calculating the Accumulated Current Earnings (ACE) Adjustment, which of the following items are exempt from ACE inclusion rules? **(Page 14)**

- a. Death benefits from life insurance contracts. [This answer is incorrect. Life insurance proceeds may be excluded from regular taxable income per IRS Code and are not added back in determining preadjustment AMTI. Since they are included in the computation of E&P, they must be added back in calculating ACE as listed in IRS regulations.]
- b. Federal income tax refunds. [This answer is correct. According to IRS Code, federal income tax refunds are not included in the ACE calculation.]**
- c. Tax-exempt interest income. [This answer is incorrect. Tax-exempt interest income is not included in the calculation of preadjustment AMTI since it is not considered in determining regular taxable income and is not added to AMTI as an adjustment or preference. Therefore, it must be included in the calculation of ACE.]

## Taking Credits against Alternative Minimum Tax

### Claiming the Foreign Tax Credit

Taxpayers are allowed an alternative minimum tax foreign tax credit when computing their AMT. The credit is computed similar to the regular foreign tax credit. However, the limitations on the credit are based on the tentative AMT before taking the AMT credit into account for that year. Any amount of unused AMT foreign tax credit (FTC) can be carried back one year and carried forward for 10 years.

Taxpayers can elect to use foreign source regular taxable income instead of AMTI to compute the FTC limitation for AMT purposes. If elected, the FTC limitation is based on the ratio of regular taxable income from foreign sources (but not in excess of AMTI) to AMTI. Also, deductions are not reallocated and reapportioned. When foreign source regular taxable income exceeds AMTI, and there is income in more than one FTC limitation category (e.g., there are two categories—passive and general), both categories are reduced prorata.

The election to use foreign source regular taxable income can be made only in the first year for which a taxpayer claims an AMT FTC. Thus, the election is not available to taxpayers that claimed an AMT FTC in prior years. Once made, the election applies to all future years unless revoked with IRS consent.

### Claiming the General Business Credit

The total general business credit allowed for any tax year generally cannot exceed the excess of the taxpayer's net income tax over the greater of its tentative minimum tax for the year, or 25% of its net regular tax liability in excess of \$25,000. The effect of AMT must be considered even in years when the taxpayer has no AMT liability, as illustrated in the following example.

#### Example 1F-1 Calculating the limit on the general business credit.

ABC, Inc. has a regular tax liability of \$100,000 for the current year. It has a general business credit of \$80,000. Its tentative minimum tax for the current year is \$90,000.

The general business credit for the current year cannot exceed the excess of ABC's regular income tax over the greater of its tentative minimum tax, or 25% of its net regular tax in excess of \$25,000, as follows:

	Net income tax for the year		\$ 100,000
	Net regular tax in excess of \$25,000	75,000	
		× 25%	
(1)		<u>18,750</u>	
(2)	Tentative minimum tax	<u>90,000</u>	
	Less: Greater of (1) or (2)		<u>\$ (90,000)</u>
	Limitation of credit		<u>\$ 10,000</u>

The impact on AMT must be considered for credits that reduce business deductions (e.g., the work opportunity credit). If the credit cannot be fully used in the current year, or as a carryback, the short-term impact of claiming the credit may increase the tax amount paid for the year. The use of the credit in future years must be weighed against the value of a current deduction for the related expense.

In calculating the limitation on most credits for AMT purposes, two of the factors to be determined are the taxpayer's "regular tax liability" and "tentative minimum tax" for the year.

In general, the term *regular tax liability* means regular income tax without regard to certain other additional taxes. Some of the taxes not included in "regular tax liability" are:

1. Alternative minimum tax.

2. Environmental tax.
3. Accumulated earnings tax.
4. Personal holding company tax.
5. Additional 20% tax related to certain deferred compensation arrangements.

The term *tentative minimum tax* means 20% of AMTI that exceeds the exemption amount, reduced by the AMT foreign tax credit for the year.

The empowerment zone tax credit applies to certain activities in federally designated empowerment zones. The credit is equal to 20% of the first \$15,000 of wages paid to an employee who resides and performs services in a designated zone. An appealing feature of this credit is that it can offset up to 25% of tentative minimum tax. The credit is claimed on Form 8844 (Empowerment Zone and Renewal Community Employment Credit).

The renewal community employment credit (RCEC) is available for certain wages paid beginning in 2002. The RCEC is equal to 15% of the first \$10,000 of qualified zone wages paid for employees who both live in a designated renewal community and work for an employer who is also located in a designated renewal community. The RCEC can also offset up to 25% of a taxpayer's AMT liability, and is claimed on Form 8844.

**Example 1F-2 Calculating the limitation on the empowerment zone and renewal community employment credits against AMT.**

EZ, Inc. has a renewable community employment credit (RCEC) for 2009 of \$6,000. EZ also has regular business credits of \$10,000 and no regular tax liability. EZ has tentative minimum tax (after regular business credits) of \$12,000. How much of the RCEC can be used in 2009?

		\$ 12,000
Net income tax		
Tentative minimum tax reduced by Section 38(a) credits other than RCEC	12,000	
	× 75%	
<b>(3)</b>	<u>\$ 9,000</u>	
<b>(4)</b> 25% of excess net regular tax over \$25,000	<u>\$ -0-</u>	
Less: Greater of (1) or (2)		<u>\$ (9,000)</u>
RCEC credit limit		<u>\$ 3,000</u>

**Using Specified Credits to Offset 100% of AMT**

Certain "specified credits" are allowed to be offset against AMT liability without limitation. These specified credits are:

1. The credit for electricity produced from certain renewable sources.
2. The alcohol fuels credit.
3. The work opportunity tax credit, for years beginning after 2006.
4. The FICA tip credit, for years beginning after 2006.
5. The low-income housing credit, for buildings placed in service after 2007.
6. The railroad track maintenance credit.

7. The energy credit.
8. The rehabilitation credit.

The law provides that the limitation based on a taxpayer's tax liability (as described in Example 1F-1) is calculated separately for these specified credits. This separate calculation will allow these credits to be used directly against the alternative minimum tax without limitation.

**Example 1F-3 Calculation of specified credits for AMT purposes.**

For the current year, AlcoCorp has a regular tax liability of \$60,000 and a tentative minimum tax of \$90,000 before any credits are considered. AlcoCorp has a research credit of \$20,000 and an alcohol fuels credit of \$96,000 for the current year. AlcoCorp's research credit will be limited to the excess of its net income tax for the year (\$60,000 regular tax plus \$30,000 AMT, or \$90,000) over the greater of its tentative minimum tax (\$90,000) or 25% of its regular tax in excess of \$25,000 ( $\$60,000 - \$25,000 \times 25\% = \$8,750$ ). Thus, the general business credit (other than the specified energy credits) allowed for the year is zero.

Net income tax for the year		\$	90,000
Net regular tax in excess of \$25,000	35,000		
	<u>×</u>		<u>25%</u>
(5)		\$	<u>8,750</u>
(6) Tentative minimum tax		\$	<u>90,000</u>
Less: Greater of (1) or (2)		\$	<u>(90,000)</u>
Credit limited to		\$	<u>-0-</u>

However, the calculation of the amount of the alcohol fuels credit allowed against the AMT is done separately from the limitation calculation for other general business credits. AlcoCorp's tentative minimum tax for the year is reduced to zero by the alcohol fuels credit. Therefore the limitation calculation becomes:

Net income tax for the year		\$	90,000
Net regular tax in excess of \$25,000	35,000		
	<u>×</u>		<u>25%</u>
(7)		\$	<u>8,750</u>
(8) Tentative minimum tax		\$	<u>-0-</u>
Less: Greater of (1) or (2)		\$	<u>(8,750)</u>
Specified credit limited to		\$	<u>81,250</u>

AlcoCorp will be able to use \$81,250 of the alcohol fuels credit for the year. The remaining \$14,750 of the credit must be carried back one year. Any amount remaining unused can be carried forward for 20 years.

The carryback and carryforward calculation of the specified credits is also made separately from the calculation of the carryback and carryforward of the general business credit. However, the carryback and carryforward periods remain the same as for other general business credits (one-year carryback and 20-year carryforward).

## Figuring the Alternative Tax Net Operating Loss (ATNOL)

When calculating AMTI, a corporation cannot include a deduction for an NOL determined under the regular tax system. However, a corporation may be entitled to an alternative tax net operating loss (ATNOL) deduction. An

ATNOL is defined as the regular tax NOL, increased or decreased by AMT adjustments and decreased by AMT preferences. An adjustment for an AMT preference is only required to the extent it caused the regular tax NOL to increase.

#### **Example 1G-1 Determining the ATNOL.**

Boston Realty Corp. (BRC), a calendar-year corporation, incurred a \$250,000 regular tax NOL in 2009. In determining its 2009 AMTI, BRC had the following AMT adjustments and preferences:

Post-1986 depreciation adjustment	\$ 68,000
Pre-1987 depreciation preference	500
Tax-exempt interest on specified private-activity bonds issued in 1989	4,000

BRC's 2009 ATNOL is calculated as follows:

Regular tax NOL	\$ (250,000)
Adjust for AMT adjustments and preferences:	
Post-1986 depreciation adjustment	68,000
Pre-1987 depreciation preference	<u>500</u>
ATNOL	<u>\$ (181,500)</u>

The ATNOL is not decreased by the \$4,000 of tax-exempt interest. This preference did not increase the amount of the regular tax NOL. Thus, BRC is not required to adjust its ATNOL for it.

#### **Carryback of ATNOL**

An ATNOL can be carried back two years or forward 20 years. If the taxpayer elects to forgo the carryback period for their regular NOL, the carryback period is also waived for any ATNOL for the same year.

If an ATNOL is carried to a year when AMTI is positive, it is offset against AMTI even if the corporation does not owe any AMT for the year.

#### **Example 1G-2 Carryback of an ATNOL.**

BRC (see Example 1G-1) has a \$181,500 ATNOL for 2009. In 2007, BRC had AMTI of \$300,000, but did not owe any AMT. The 2009 ATNOL is carried back and fully absorbed in 2007, even though no benefit is derived from it. (BRC did not pay any AMT in 2007 even before the carryback.)

In the case of certain natural disasters, special rules have been provided that extend the loss carryback period for taxpayers within the disaster areas. For example, ATNOLs related to the Katrina GO Zone, Kansas disaster area, Midwestern disaster area, and qualified disaster losses under IRC Sec. 172(j), may be carried back five years.

#### **Limitation on ATNOL**

To ensure that a corporation cannot eliminate its entire AMT liability with an NOL, the offset of an ATNOL against AMTI is limited to 90% of AMTI before the ATNOL. However, the 90% limitation is suspended for the portion of the ATNOL related to the Katrina GO Zone, Kansas disaster area and Midwestern disaster area, and qualified disaster losses under IRC Sec. 172(j).

#### **Example 1G-3 Applying the ATNOL limitation.**

For 2009, SBK Corp. has a regular tax NOL of \$90,000 and an ATNOL of \$75,000. The NOL and ATNOL are carried back two years to 2007.

In 2007, SBK had taxable income of \$60,000 and AMTI of \$70,000. SBK's regular NOL carryback eliminated its taxable income for 2007. However, the allowed ATNOL carryback from 2009 is calculated as follows:

(1) Amount of ATNOL from 2008		\$ 75,000
Amount of AMTI for 2006	70,000	
	× 90 %	
(2)	<u>\$ 63,000</u>	
Section 56(d)(1)(A) limitation [lesser of (1) or (2)]		<u>\$ (63,000)</u>
Amount carried forward		<u>\$ 12,000</u>

Therefore, SBK's ATNOL carryback allowed to be used in 2007 will be limited to \$63,000. The remaining \$12,000 can be carried forward to 2008 where the same limitation calculation must be made. Any ATNOL remaining after application to 2008 can be carried forward to 2010 and the following 19 years.

The ATNOL deduction is limited to the lesser of ATNOL or 90% of AMTI determined without regard to the ATNOL and the domestic production activities deduction allowed by IRC Sec. 199.

**Example 1G-4 Applying the ATNOL limitation with a domestic production activities deduction.**

For the current year, Zee Corp. has the following activity:

Income before domestic production activities deduction	\$ 100,000
(3) Domestic production activities deduction	<u>(3,000)</u>
Taxable Income	<u>\$ 97,000</u>
(4) ATNOL carried forward from previous year	<u>\$ 500,000</u>
ATNOL allowed for current year	<u>\$ 90,000</u>

The ATNOL allowed for the current year is 90% of taxable income before taking (1) or (2) into consideration.

When applying the limitation on an ATNOL to a year that includes a Section 382 ownership change, both the Section 56(d)(1)(A) 90% limitation and the Section 382 rules apply. The 90% limitation applies to total AMTI for the year including both pre-change and post-change periods.

**Example 1G-5 Coordination of ATNOL carryover limitation and Section 382 rules.**

Fastprint, Inc. underwent a change of ownership on June 1 of the current year. Fastprint had an ATNOL carryforward of \$50,000 from the previous year. By applying the rules of IRC Sec. 382, Fastprint is allowed to use \$10,000 of the ATNOL against taxable income for the prechange period (January 1 to May 31). However, IRC Sec. 382 would disallow the use of any of the ATNOL during the postchange period.

IRC Sec. 56(d)(1)(A) provides for a 90% limitation that would limit Fastprint to the use of \$15,000 of the ATNOL for the entire year. Therefore, Fastprint's ATNOL deduction for the year would be \$10,000 since the IRS has ruled that the lower of the Section 382 or Section 56(d)(1)(A) limitations will be allowed.

The IRS held that the limitation of NOL carryovers for certain corporate acquisitions provided in IRC Sec. 381(c)(1)(B) applies to the computation of the ATNOL carryover deduction as well. The limitation under IRC Sec. 381 applies to certain corporate acquisitions in connection with reorganizations described in IRC Sec. 368(a)(1)(D). The limitation works to reduce the NOL carryover from the transferor corporation to the first year of the acquiring corporation according to a formula based on the ratio of the days in the tax year after the date of the transfer to the total number of days in the tax year.

## Taking the Minimum Tax Credit

The “minimum tax credit” (MTC) is always available against a corporation’s regular tax liability in years following the year in which the corporation incurred an alternative minimum tax liability. Generally, the credit equals the excess, if any, of the “adjusted net minimum tax” incurred in all prior years beginning after 1986, over the minimum tax credits used in those years.

The credit is limited to the excess of the corporation’s regular tax liability for the year over the sum of all nonrefundable tax credits and the *tentative* minimum tax liability for such year. As such, the corporation’s actual tax liability for a particular year cannot be reduced below the *tentative* minimum tax liability for that year. A corporation’s *tentative* minimum tax liability is the corporation’s minimum tax liability for the year prior to reduction for the current year’s regular tax liability before credits.

The MTC generated in one year can offset only the regular tax of a subsequent year. Unlike the alternative tax net operating loss (ATNOL), the MTC cannot be carried back. Because it can be carried forward indefinitely, no ordering rules exist for use of the MTC. However, the amount of credit that may be used in any year is limited to the excess of the regular tax (after reduction by most credits) over the tentative minimum tax for the year. The amount that may be carried forward as a credit equals the sum of (1) the entire amount of the corporate AMT, (2) the nonconventional fuels credit’s disallowed portion, and (3) the portion of the qualified electric vehicles credit disallowed because of the tentative minimum tax limitation.

Reporting. Form 8827 (Credit for Prior Year Minimum Tax—Corporations) computes the MTC carryforward from prior years, the amount that may be used in the current year, and the amount available for carryforward.

### Example 1H-1 Calculating the minimum tax credit.

Assume that PreFabCo, Inc. (PFC) in Example 1C-1 had an alternative minimum tax liability for 2008 of \$25,000. 2008 was the first year PFC had incurred a minimum tax liability. In 2009, PFC has a regular tax liability of \$10,000 after a jobs credit of \$2,000. The tentative minimum tax liability for 2009 is zero. PFC will be able to use a minimum tax credit of \$10,000 for 2009, calculated as follows:

Alternative minimum tax for 2008	\$ 25,000
Add: Minimum tax credit carryforward for years prior to 2008	<u>—</u>
<b>(5) Total Minimum tax credit available</b>	<b><u>\$ 25,000</u></b>
Regular tax liability for 2009 less credits	\$ 10,000
Less: Tentative minimum tax for 2009	<u>—</u>
<b>(6)</b>	<b><u>\$ 10,000</u></b>
<b>(7) Minimum tax credit [smaller of (1) or (2)]</b>	<b><u>\$ 10,000</u></b>
Minimum tax credit carryforward to 2010 [(1) minus (3)].	<u>\$ 15,000</u>

### Limitation on Minimum Tax Credit

In computing the otherwise allowable minimum tax credit for a corporation exempt from AMT as a small corporation, the corporation must reduce its regular tax liability (after reduction by specified credits) by 25% of the liability in excess of \$25,000.

This situation can arise when a corporation was subject to AMT prior to 1998, before the small business corporation exemption was enacted, and has been unable to fully use the credit since that time. It can also arise when a tax year has an NOL, but not an ATNOL, and the NOL is carried back to a year when regular tax equaled or exceeded the tentative minimum tax. In that case, the NOL carryback increases the AMT (and thus the MTC carryforward) of the carryback year.

**Example 1H-2 Calculating the MTC for exempt small business corporations.**

Moguls, Inc. is a ski equipment manufacturing company. As of December 31, 2000, Moguls had a MTC carryforward of \$100,000. For 2001 and thereafter, Moguls qualified as a small business corporation under the rules of IRC Sec. 55(e). Moguls had small NOLs for years 2002–2008, which it elected to carry forward each year. In 2009, Moguls had a regular tax liability, after all credits other than MTC, of \$32,000. Moguls calculates the amount of MTC allowable for 2009 as follows:

Regular tax liability for 2009	\$ 32,000
Limitation	<u>(25,000)</u>
Excess over \$25,000	<u>\$ 7,000</u>
Reduction in credit (25% of \$7,000)	<u>\$ 1,750</u>
Minimum tax credit allowed (\$32,000 – \$1,750)	<u>\$ 30,250</u>

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Which of the following taxes is allowed to be offset against AMT liability, with limitations?
  - a. Alcohol fuels credit.
  - b. Work opportunities tax credit.
  - c. FICA tip credit.
  - d. Foreign tax credit.
  
10. How To Inc. has a regular tax liability of \$125,000 for the current year. It has a general business credit of \$85,000. Its tentative minimum tax for the current year is \$95,000. What is the limit on the general business credit?
  - a. \$25,000.
  - b. \$30,000.
  - c. \$95,000.
  - d. \$100,000.
  
11. An ATNOL can be carried back \_\_\_ years or forward \_\_\_ years.
  - a. One; ten.
  - b. Two; twenty.
  
12. The minimum tax credit generated in one year does which of the following?
  - a. Offsets current year taxes.
  - b. Offsets subsequent years regular taxes.
  - c. Offsets penalties.
  - d. Can be carried back to prior years.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. Which of the following taxes is allowed to be offset against AMT liability, with limitations? **(Page 20)**

- a. Alcohol fuels credit. [This answer is incorrect. The law provides that alcohol fuels credit offsets AMT liability without limitation.]
- b. Work opportunities tax credit. [This answer is incorrect. The work opportunity tax credit is allowed to be offset against AMT liability without limitation for tax years beginning after 2006 as stated in IRS law.]
- c. FICA tip credit. [This answer is incorrect. The FICA tip credit is not limited when offsetting against AMT liability according to IRS law.]
- d. Foreign tax credit. [This answer is correct. Per IRS Code, the AMT foreign tax credit is limited based on the tentative AMT before taking the AMT credit into account for that year.]**

10. How To Inc. has a regular tax liability of \$125,000 for the current year. It has a general business credit of \$85,000. Its tentative minimum tax for the current year is \$95,000. What is the limit on the general business credit? **(Page 20)**

- a. \$25,000. [This answer is incorrect. \$25,000 is not the limit on the general business credit. This is 25% of the net regular tax in excess of \$25,000.]
- b. \$30,000. [This answer is correct. \$30,000 is the limit on the general business credit based on the calculation for the general business credit.]**

<b>Net income tax for the year</b>	<b>\$ 125,000</b>	
<b>Net regular tax in excess of \$25,000</b>	<b>\$ 100,000</b>	
	<b>× 25%</b>	
<b>(1)</b>	<b>\$ 25,000</b>	
<b>(2) Tentative minimum tax</b>	<b>\$ 95,000</b>	
<b>Less: Greater of (1) or (2)</b>		<b>\$ 95,000</b>
<b>Limitation of credit</b>		<b>\$ 30,000</b>

- c. \$95,000. [This answer is incorrect. \$95,000 is not the limit on the general business credit. This is the tentative minimum tax.]
- d. \$100,000. [This answer is incorrect. \$100,000 is not the limit on the general business credit. This is the net regular tax in excess of \$25,000.]

11. An ATNOL can be carried back \_\_\_ years or forward \_\_\_ years. **(Page 23)**

- a. One; ten. [This answer is incorrect. This is the statute of limitations for unused AMT foreign tax credit and it may be carried back one year and carried forward for ten years.]
- b. Two; twenty. [This answer is correct. An ATNOL can be carried back two years or forward 20 years, according to IRS law.]**

12. The minimum tax credit generated in one year does which of the following? **(Page 25)**

- a. Offsets current year taxes. [This answer is incorrect. The minimum tax credit generated in one year does not offset the current year. The IRS Code provides for MTC in a different manner.]

- b. Offsets subsequent years regular taxes. [This answer is correct. The minimum tax credit generated in one year offsets subsequent years regular taxes per IRS Code.]**
- c. Offsets penalties. [This answer is incorrect. The minimum tax credit generated in one year does not offset penalties since it can offset other taxes.]
- d. Can be carried back to prior years. [This answer is incorrect. The minimum tax credit generated in one year cannot be carried back to prior years. Unlike ATNOL, it cannot be carried back to prior years as stated in IRS Code.]

## Recalculating Passive Activity Losses for CHCs and PSCs

Closely held corporations (CHCs) and personal service corporations (PSCs) must recompute for AMT purposes all passive activity losses (PALs) reported for regular tax purposes. Net income or loss from each passive activity is recalculated to reflect any applicable AMT adjustments and preferences and to pick up any prior-year AMT disallowed losses.

### Definitions of CHC and PSC

The definitions of a CHC and PSC for the passive loss rules apply for this purpose.

### Required Adjustments to Passive Losses

When recalculating a PAL for AMT purposes, deductions not allowed (or income required to be included) in computing AMTI must be taken into account, even if not considered when determining the allowable loss for regular tax purposes. These adjustments are reflected on Form 4626 as part of the passive activity loss adjustment and are not on other lines of Form 4626.

#### **Example 11-1** AMT adjustment for a passive activity loss.

Valcar, Inc., a CHC, has a \$22,000 PAL. For regular tax purposes, the loss is fully deductible against Valcar's active income. Included in the loss is a deduction for accelerated depreciation on real property placed in service prior to 1987. Recalculating depreciation on this property using straight-line depreciation as required for AMT purposes reduces the loss by \$12,000. Under the AMT system, a CHC's PAL is deductible against active income just as it is for regular tax purposes. However, the loss must be adjusted for any AMT preferences or adjustments related to it. Thus Valcar must increase its AMTI by the \$12,000 preference related to the PAL. Valcar reports the \$12,000 adjustment on the passive activity line of Form 4626 under "Adjustments and preferences."

AMT adjustments and preferences related to PALs are counted only once in computing AMTI.

#### **Example 11-2** AMT preferences counted only once.

Valcar's (see Example 11-1) only preference item related to accelerated depreciation on pre-1987 real property is the \$12,000 flowing from the passive activity. Valcar reports zero as a preference for accelerated depreciation on pre-1987 real property when completing its AMTI calculation. The \$12,000 preference was accounted for when the PAL adjustment was determined. It does not have to be added back when the separate pre-1987 depreciation preference is determined. (Although the \$12,000 adjustment should be reported for AMT purposes on the line for PALs, it has the same AMT effect as a nonpassive activity loss depreciation preference that is reportable on the depreciation preference line.)

Although the AMT and regular tax limitations and the definition of a PAL are the same for an insolvent corporation (one whose liabilities exceed the FMV of its assets), the AMT deduction for PALs may actually exceed the regular tax deduction. The additional AMT deduction is allowed to the extent of the corporation's insolvency.

#### **Example 11-3** Insolvent corporation's AMT deduction for PALs.

Jesbroke, Inc. is a PSC. Its liabilities exceed the FMV of its assets at the end of 2009 by \$15,000. Jesbroke has a net PAL of \$25,000 (with no related AMT adjustments or preferences) for the year. What is Jesbroke's deduction for PALs for regular tax and AMT purposes? (Unlike CHCs, PSCs are only allowed to offset PALs with passive activity income when calculating their regular tax liability.)

The full amount of the PAL is suspended for regular tax purposes; however, only \$10,000 is suspended in calculating AMTI. The other \$15,000 is allowed for AMT purposes because Jesbroke can recognize PALs up to the amount by which its liabilities exceed the FMV of its assets.

**Example 11-4 PALs of a corporation that is no longer insolvent.**

Jesbroke (see Example 11-3) is no longer insolvent at the end of 2010. It generates no net passive income for 2010. The \$15,000 deduction allowed in 2009 does not have to be recaptured (as income) in 2010. A literal reading of the statute does not require it, and no regulations have been issued requiring such recapture.

**Carryover of PALs**

As previously discussed, the AMT requirement to adjust PALs by any related AMT adjustments and preferences (and, if applicable, by the special allowance for insolvent taxpayers) creates differences between the allowable PAL for regular tax and AMT purposes. This means the amount of suspended PAL for the year may differ under the regular tax and AMT systems. Thus the amount ultimately deductible under the two systems when the losses are no longer suspended will likely differ, too.

**Example 11-5 AMT versus regular tax carryover of suspended PALs.**

Vancroy, Inc. is a CHC with a 2009 net PAL of \$100,000. (For AMT purposes, the loss includes \$35,000 of adjustments and preferences that must reduce the AMT loss.) In calculating its regular tax and AMT liabilities, Vancroy offsets \$40,000 of the loss with its \$40,000 of active income.

For regular tax purposes, Vancroy's PAL carryover is \$60,000 (\$100,000 – \$40,000), while for AMT purposes the carryover is only \$25,000 (\$100,000 – \$35,000 – \$40,000). The allowable AMT carryover must be reduced not only by the amount used in 2009 (\$40,000) but also by the amount of AMT preferences and adjustments related to the loss (\$35,000).

It is important to keep separate carryover schedules for regular tax and AMT PALs since they can vary greatly.

**Adjusting ACE Asset Basis upon Ownership Change**

A corporation going through a change in ownership at a time when it has a net unrealized built-in loss faces a potentially significant ACE adjustment for post-change periods. A change in ownership essentially occurs when more than 50% in value of a corporation's stock has changed hands. A corporation has a net unrealized built-in loss when the aggregate adjusted basis of all its assets (determined using regular tax basis) exceeds their FMV.

The required adjustment makes the ACE basis of each asset of the corporation equal to its FMV immediately before the ownership change. Effectively, this eliminates the ability to use any net unrealized built-in loss (for ACE purposes) existing at the date of the ownership change. The newly determined bases must be used for all ACE calculations. Thus, ACE depreciation will decrease (on an aggregate basis) and gains will increase (or losses will decrease) on the disposition of assets.

**Example 1J-1 Adjustment of ACE asset basis upon change in ownership.**

Sheila Dawn owns 100% of Land, Inc., a loss corporation. The corporation owns and operates a small retail shopping mall near Boston. For regular tax purposes, Land's adjusted basis in its assets (consisting almost exclusively of the shopping mall) is \$9 million; however, the current FMV of the assets is only \$7 million. In the current year, Sheila sells 100% of the stock in Land to Ernestine Willis.

The basis of Land's assets is stepped down, effective with the date of the sale, by \$2 million. Thus, to the extent the assets are depreciable, ACE depreciation is reduced. Any gain or loss (for ACE purposes) from the sale of such assets (whether depreciable or not) is also affected.

**Other Considerations****Recomputing Deductions Based on a Percentage of AMTI**

The IRS has frequently taken the position that, for AMT purposes, deductions based on an income limit (e.g., contributions and percentage depletion) must be recomputed based on income as determined under the AMT

system. The IRS stated that the percentage limitations for charitable contributions and percentage depletion are computed separately for purposes of the AMT.

#### **Example 1K-1    Recomputing AMT deductions.**

Rexcorp has a \$5,000 NOL for regular tax purposes but is subject to AMT as a result of \$150,000 of AMT adjustments and preferences and a \$7,500 ACE adjustment. The corporation made a \$5,000 cash charitable contribution during the current year, that it was unable to deduct for regular tax purposes because of the 10% taxable income limit. Rexcorp can deduct the \$5,000 charitable contribution when computing its AMT for the current year.

For AMT purposes, taxpayers can deduct charitable contributions based on their AMT figures. As discussed in the instructions to Form 4626, the same rule applies to other deductions based on an income limit, such as percentage depletion subject to the Section 613A(d)(1) percentage depletion limitation (i.e., the 65% of taxable income limit).

The \$5,000 difference between the regular tax and AMT charitable deduction is entered as a negative amount on line 2o of Form 4626. If the \$5,000 had been deducted for regular tax purposes and not for AMT purposes, it would be added back as a positive adjustment when calculating Rexcorp's AMTI.

Rexcorp's charitable contribution carryforward will be different for regular tax and AMT because of the \$5,000 deduction for AMTI purposes.

#### **Adjusting for Wage Credits**

When a corporation takes certain employment related credits allowed by the Code for regular tax purposes, it is required to reduce its deductible wages by the amount of the employment related credits allowable. Both the IRS and the Tax Court have taken the position that this reduction of deductible wages also applies when computing AMTI.

Wages for regular tax and AMT must be reduced by the credit even though the credit is not allowed against AMT. Note however, that the empowerment zone employment tax credit, the renewal community employment credit, and work opportunity credit can be used against the AMT liability.

#### **Short Period Returns**

The computation of a corporation's AMT liability requires a special calculation if the tax year involved is less than a full 12 months. The calculation annualizes AMTI and normally results in a reduction of the benefit of the \$40,000 AMT exemption. Thus, a corporation is more likely to be subject to AMT in a short period than in a normal tax year. Unlike the short period rules for regular tax purposes, the AMT rules apply regardless of the reason for the short period (e.g., the AMT rules apply to short periods created by a corporation's first or last tax year, whereas the regular tax short period rules do not).

#### **Example 1K-2    Calculation of AMT in a short period.**

Pies to Go, Inc. (PTG), a calendar-year corporation, ceased operations at September 30. Taxable income for the short period is \$73,000, resulting in a regular tax liability of \$13,250. AMTI, before any required annualization and before deduction of the AMT exemption, is \$102,500. PTG has no credits or NOLs available to carry into the short year. Is PTG liable for AMT in the short year ending September 30?

PTG owes \$1,250 of AMT (in addition to \$13,250 of regular tax), calculated as follows:

AMTI, before annualization	<u>\$ 102,500</u>
Annualized AMTI (pre-annualized AMTI divided by the number of months in the short period and multiplied by 12) ( $\$102,500 \div 9 \times 12$ )	\$ 136,667
Less: AMT exemption (the full amount is allowed because annualized AMTI does not exceed \$150,000)	<u>(40,000)</u>
	96,667
Minimum tax rate	<u><math>\times</math> 20%</u>
Tentative minimum tax (TMT)	<u>\$ 19,333</u>
Annualized TMT (divide TMT by 12 and multiply by the number of months in the short period) ( $\$19,333 \div 12 \times 9$ )	\$ 14,500
Less: Regular tax liability	<u>(13,250)</u>
Minimum tax liability	<u>\$ 1,250</u>

Absent the requirement to annualize its AMTI, PTG would not owe any AMT in its final year since its \$12,500 of TMT [ $(\$102,500 - \$40,000) \times 20\%$ ] would have been less than its regular tax liability of \$13,250.

### AMT for Consolidated Returns

Prop. Reg. 1.1502-55 was issued by the IRS in 1992. This proposed regulation provides rules for determining a consolidated group's AMT liability (its consolidated AMT) and for allocation of various consolidated AMT attributes to members of the group. The proposed regulation states that consolidated AMT is to be determined under an approach that generally parallels the determination of the group's consolidated regular tax liability. Any reduction to the AMT exemption amount must be apportioned among controlled group members. The regulation provides further refinements to the "consolidated" AMT terms only when necessary to illustrate the adjustments required to compute the consolidated AMT or to allocate consolidated AMT attributes among members.

This proposed regulation will be effective for any consolidated return with a due date (without extensions) that is 60 days or more after final regulations are filed with the Federal Register. Final regulations still have not been published. If the IRS does not address an issue specifically in the regulations (proposed regulations are not considered regulations) the taxpayer can follow the regular tax rules, which state that a consolidated group would compute its regular tax liability and AMT liability and compare them, paying the higher of the two. The proposed regulations specify that each member of the group computes its separate AMTI. Consolidated AMT would be computed based on the total of all the group members' AMT.

### Recognizing the Various Elections That Can Minimize AMT

A corporation can make certain elections that minimize the AMT adjustments and preferences that must be added to taxable income in computing AMTI. The elections also impact the computation of taxable income for regular tax. Thus, an election's effect on both taxable income and AMTI should be determined before it is made.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. Arbors, Inc. is a PSC. Its liabilities exceed the FMV of its assets at the end of the year by \$7,000. Arbors has a net PAL of \$15,000 (with no related AMT adjustments or preferences) for the year. What is Arbors' deduction for PALs for AMT purposes?
  - a. \$7,000.
  - b. \$8,000.
  - c. \$15,000.
  
14. Rally Inc., a CHC, has a passive activity loss of \$20,000. Included in the loss is a deduction for accelerated depreciation on real property placed in service prior to 1987. When recalculated using straight-line depreciation, the loss is reduced by \$10,000. What is the impact of this recalculation for AMT purposes?
  - a. Rally must decrease its AMTI by \$10,000.
  - b. Rally must increase its AMTI by \$10,000.
  - c. No impact on AMT.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. Arbors, Inc. is a PSC. Its liabilities exceed the FMV of its assets at the end of the year by \$7,000. Arbors has a net PAL of \$15,000 (with no related AMT adjustments or preferences) for the year. What is Arbors' deduction for PALs for AMT purposes? **(Page 30)**
- a. **\$7,000. [This answer is correct. \$7,000 is allowed as a deduction for PALs. Arbor can recognize PALs up to the amount by which its liabilities exceed the FMV of its assets.]**
  - b. \$8,000. [This answer is incorrect. \$8,000 is the amount of PAL suspended in calculating AMTI.]
  - c. \$15,000. [This answer is incorrect. \$15,000 is the entire PAL for the year. The AMT deduction for PALs is limited.]
14. Rally Inc., a CHC, has a passive activity loss of \$20,000. Included in the loss is a deduction for accelerated depreciation on real property placed in service prior to 1987. When recalculated using straight-line depreciation, the loss is reduced by \$10,000. What is the impact of this recalculation for AMT purposes? **(Page 30)**
- a. Rally must decrease its AMTI by \$10,000. [This answer is incorrect. The difference between accelerated depreciation versus straight-line depreciation decreases the passive activity loss, but does not decrease AMTI as stated in IRS Code.]
  - b. **Rally must increase its AMTI by \$10,000. [This answer is correct. When the loss is reduced, the AMTI must be adjusted for any AMT preferences or adjustments related to it.]**
  - c. No impact on AMT. [This answer is incorrect. When recalculating a PAL for AMT purposes, deductions not allowed in computing AMTI must be taken into account.]

**EXAMINATION FOR CPE CREDIT**

**Lesson 1 (T20TG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following statements is the best description of the Alternative Minimum Tax for corporations?
  - a. Corporations that do not qualify for the small corporation status are effectively subject to two tax systems: the regular income tax and the AMT.
  - b. A corporation's tax liability is determined based on the larger of the regular income tax and the AMT.
  - c. The Alternative Minimum Tax ensures that corporations with economic income, but little or no taxable income, pay at least some current income tax.
  - d. Corporations not qualifying as a small corporation are subject to two tax systems: the regular income tax and the AMT with the tax liability being the larger of the two. The AMT ensures that corporations with economic income, but little or no taxable income, pay at least some current income tax.
  
2. You are a small practitioner that has just won the contract for a corporation's tax returns. You are reviewing past returns and financial information provided by the client. You quickly apply the guidance for classifying this client as either a small corporation or regular corporation and compare this with the forms actually filed. What do you determine?

	Annual Gross Receipts	3-yr avg.	Filed 4626
Year 1	\$ 3,000,000		No
Year 2	4,000,000		No
Year 3	4,500,000		No
Year 4	6,500,000	\$ 3,833,333	Yes
Year 5	12,000,000	5,000,000	Yes
Year 6	14,000,000	7,666,666	Yes

- a. Years 2 and 3 were improperly classified and the forms should have been filed.
  - b. Years 4 and 5 were improperly classified and the forms should not have been filed.
  - c. Year 6 was improperly classified and the form should not have been filed.
  - d. The corporation was correctly classified each year and all of the forms were correctly filed.
  
3. You have a new client whose annual gross receipts for year 1 were \$9 million, \$8 million for year 2, and \$11 million for year 3. They have hired you to file their income tax returns. When does the client become subject to the AMT?
  - a. Your client is subject to the Alternative Minimum Tax for the first year of business.
  - b. Your client is subject to the Alternative Minimum Tax for the second year of business.
  - c. Your client is subject to the Alternative Minimum Tax for the third year of business.
  - d. Your client is subject to the Alternative Minimum Tax for the fourth year of business.
  
4. AMT income is—
  - a. regular taxable income that has been altered with adjustments and preference items.

- b. gross income that has been altered by adjustments and preference items.
- c. gross receipts that has been altered by adjustments and preference items.
- d. corporate taxable income.
5. Which of the following is the base AMT exemption amount?
- a. \$50,000.
- b. \$40,000.
- c. \$30,000.
- d. \$20,000.
6. Charger Corp purchased a computer three years ago for \$570. The computer was sold this year for \$350. The accumulated depreciation was \$406 for regular tax purposes and \$333 for AMT purposes when it was sold. What will be the basis adjustment in calculating AMTI?
- a. A \$73 positive adjustment in calculating AMTI.
- b. A \$73 negative adjustment in calculating AMTI.
- c. A \$237 positive adjustment in calculating AMTI.
- d. A \$237 negative adjustment in calculating AMTI.
7. With respect to the AMT, which of the following items does **not** affect the calculation?
- a. A positive adjustment.
- b. A negative adjustment.
- c. A positive preference item.
- d. A negative preference item.
8. Which of the following items receives special treatment under IRC Sec. 56(g)(4) for ACE purposes?
- a. Prepaid insurance.
- b. Depreciation.
- c. Installment sales.
- d. Deferred income.
9. Calculate your new client's limitation on the general business credit considering the following information:
- |                         |    |         |
|-------------------------|----|---------|
| Regular Tax Liability   | \$ | 135,000 |
| General Business Credit | \$ | 60,000  |
| Tentative Minimum Tax   | \$ | 85,000  |
- a. \$27,500.
- b. \$50,000.

- c. \$60,000.
  - d. \$85,000.
10. Which term is described by the following: 20% of AMT income that exceeds the exemption amount, reduced by the AMT foreign tax credit for the year?
- a. Alternative Minimum Tax.
  - b. Accumulated Earnings Tax.
  - c. Tentative Minimum Tax.
  - d. Regular Income Tax.
11. What is the name of the credit applicable to certain activities in federally designated zones and is equal to 20% of the first \$15,000 of wages paid to an employee who resides and performs services in that zone?
- a. Accumulated Earnings.
  - b. Empowerment Zone.
  - c. Renewal Community Employment.
  - d. Work Opportunity.
12. A corporation's tentative minimum tax liability is—
- a. The minimum tax liability for the corporation for the year after the reduction for the current year's regular tax liability before credits.
  - b. The minimum tax liability for the corporation for the year before the reduction for the current year's regular tax liability after credits.
  - c. The minimum tax liability for the corporation for the year before the reduction for the current year's regular tax liability before credits.
  - d. Do not select this answer choice.
13. Personal service corporations and closely held corporations must recalculate \_\_\_\_\_ for AMT purposes.
- a. Net operating losses.
  - b. Prior year disallowed NOLs.
  - c. Passive activity losses.
  - d. Do not select this answer choice.
14. Harris, Inc. is a PSC. Its liabilities exceed the FMV of its assets at the end of the year by \$20,000. Harris has a net PAL of \$25,000 (with no related AMT adjustments or preferences) for the year. What is the deduction for PALs for AMT purposes?
- a. \$0.
  - b. \$5,000.

- c. \$20,000.
  - d. \$25,000.
15. A corporation is more likely to be subject to AMT during which of the following?
- a. Normal tax year.
  - b. Short period.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.

# Lesson 2: Personal Holding Company Tax

## INTRODUCTION

This lesson discusses the definition of a personal holding company (PHC) and the penalty tax imposed on any corporation classified as a PHC with undistributed PHC income.

A corporation is a PHC if it meets two objective tests. The penalty tax may apply when the objective tests are met even if there is no accompanying tax-related motive.

- *Stock Ownership Test.* More than 50% of the value of the corporation's outstanding stock is owned (directly or indirectly) by five or fewer persons on any day during the last half of the corporation's tax year. Stock owned by related individuals, partners, and through other businesses will be deemed to be owned by a shareholder. From a practical standpoint, few closely held corporations have sufficient diverse ownership to avoid PHC status based on this test.
- *Income Test.* At least 60% of the corporation's adjusted ordinary gross income (principally, ordinary gross income) is PHC income. PHC income includes dividends, interest income, royalty income, annuities, adjusted rental income, Section 1245 gains, and similar income.

Since many closely held corporations meet the ownership test, the real key is the income test. The presence of significant amounts of investment income increases the likelihood the corporation is a PHC.

Many taxpayers are unaware of the PHC tax and the consequences of inadvertently taking actions that would subject a corporation to this penalty tax. In some cases, a corporation may become a PHC without the taxpayer realizing it. For instance, it could occur when a corporation has sold all, or most, of its operating assets and is simply collecting interest income on installment notes. Practitioners should be alert for these situations so they can assist clients in minimizing or avoiding the PHC tax.

Generally, the tax is assessed by the IRS on audit, which can occur years after the return is filed. Assessment of the PHC tax can subject income to triple taxation: (1) the regular corporation tax, (2) the PHC tax, and (3) a tax to the shareholder when the income is distributed. It can also lead to substantial penalties and interest.

The PHC tax is imposed by IRC Sec. 541. A PHC is penalized by paying a tax (in addition to its regular corporate tax) on its undistributed PHC income at the rate of 15% for 2003 through 2010.

### Learning Objectives:

Completion of this lesson will enable you to:

- Discuss the features of personal holding companies, the tests that must be met for an entity to be classified as a personal holding company, the types of income that are classified as PHC income, and the types of entities that are exempt from PHC tax.
- Identify the components included in undistributed, personal holding company income; the methods used to minimize the penalty for PHCs; and the reporting requirements for dividends paid.

## Definition of a Personal Holding Company (PHC)

A corporation that meets the statutory definition of a personal holding company (PHC) and has undistributed personal holding company income is subject to tax at 15% on that income. This tax is assessed in addition to the regular corporate income tax.

The PHC tax rate is 15% (equal the rate at which the income would be taxed if distributed). For tax years beginning after December 31, 2010, the PHC tax rate will again correspond to the maximum individual tax rate.

## Entities Exempt from the PHC Tax

The following types of corporations are not considered PHCs.

- Tax-exempt organizations.
- Banks or domestic building and loan associations.
- S corporations.
- Certain foreign corporations.
- Certain lending or finance companies.
- Small business investment companies, life insurance companies, and surety companies.
- Corporations in bankruptcy.

## Determining Personal Holding Company Status

As mentioned in the introduction to this lesson, the status of a corporation as a PHC is determined based on two objective tests—a stock ownership test and an income test. Failure to pass either test means the corporation will not be treated as a PHC. The intent or motive of the corporation or shareholders is not relevant.

### Income Test

To fail the PHC income test, a corporation must derive less than 60% of its adjusted ordinary gross income (AOGI) from PHC income. Therefore, the critical steps in performing the test are the calculation of AOGI and PHC income.

Ordinary Gross Income. Gross income, as defined under IRC Sec. 61, is the starting point for determining ordinary gross income for purposes of the PHC income test. Under those rules, gross income is not necessarily the same as gross receipts. Gross income for a manufacturing company, for example, is determined by reducing gross sales by cost of goods sold. With the exception of certain insurance companies, a corporation's ordinary gross income includes all the company's gross income except for capital gains and Section 1231 gains.

Gross receipts from farming must be reduced by farm production costs (i.e., ordinary expenses of farming such as fuel, fertilizer, seed, etc.), in arriving at adjusted ordinary gross income. This ruling means that ordinary gross income of a farming corporation and a manufacturing company is calculated in a similar manner, i.e., by deducting the applicable cost of goods sold or farming expenses from gross sales. If the corporation is a member of a partnership, its distributed share of the partnership's AOGI is included in the corporation's AOGI.

In addition to gross profits from the corporation's ordinary business operations, ordinary gross income includes dividends, interest, rents, and royalties.

The IRS has ruled that Section 1245 gains are within the meaning of ordinary income for PHC purposes. The ruling is based on the language of IRC Sec. 64, which provides that whenever any gain from the sale or exchange of property must be treated as ordinary income under other IRC sections, that gain will be treated as gain from property which is neither a capital asset nor property described in IRC Sec. 1231(b). Therefore, the IRS would also rule that gain that is treated as ordinary income under other sections is ordinary income for PHC purposes.

Adjusted Ordinary Gross Income. A corporation's adjusted ordinary gross income (AOGI) is computed by starting with ordinary gross income and making adjustments for certain rental, royalty, and interest income:

- Rental income must be reduced (but not below zero) by deductions for depreciation and amortization, interest, property taxes, and rent allocable to such rental income. (Certain types of income from rents are excluded from the definition of rental income when calculating AOGI.) The complex issue of rental income as a component in determining a corporation's PHC status is discussed later in this lesson.

- Mineral royalties and working interests must be reduced (but not below zero) by depletion, depreciation, taxes, interest, and rent allocable to such income. These rules are explained later in this lesson.
- Interest on U.S. Government bonds held for sale to customers in the ordinary course of business by a dealer who is making a primary market in such obligations must be excluded. Interest on condemnation awards, judgments, and tax refunds is also excluded.

**Rental Income**

One of the most complex components in determining a corporation's PHC status is the treatment of rental income. Rental income receives special treatment when computing AOGI and PHC income.

Computation of Rental Income in Computing AOGI. When determining AOGI, gross income from rents is reduced by depreciation, property taxes, interest, and rent attributable to the gross rental income. These deductions cannot reduce gross income from rents below zero. (A corporation that owns more than one piece of real estate compares total income and deductions from all properties rather than comparing income and deductions on a separate property basis.) Other normal operating expenses, such as repairs and maintenance, are not deducted from gross rental income in determining AOGI.

When determining AOGI, the following items are not considered "rents" and, therefore, no deductions may be taken for these types of income:

1. Copyright royalties as defined in IRC Sec. 543(a)(4).
2. Produced film rents as defined in IRC Sec. 543(a)(5)(B).
3. Active business computer software royalties [i.e., income from the licensing of computer software developed by or directly related to a corporation's active conduct of a software development business, but only if certain income (at least 50% of ordinary gross income), related expenses, and dividends are paid by the corporation].
4. Income from the use of tangible property by a shareholder owning (directly or indirectly) 25% or more in value of the corporation's stock at any time during the tax year, if the corporation's PHC income, exceeding rents, is greater than 10% of the ordinary gross income.

The deductions may be applied, however, to gross income from the rental of tangible personal property manufactured or produced by the corporation if it is engaged in the business of such production.

All of the previous items may be considered PHC income under different rules.

**Example 2A-1 Computation of rental income for AOGI purposes.**

Elton, Inc. has paid no dividends during the year. It has the following income and expenses for the year:

Operating gross income	\$ 60,000
Dividend income	9,000
Gross rental income	120,000
Interest income	<u>6,000</u>
Ordinary gross income	<u>\$ 195,000</u>
Taxes attributable to rentals	\$ 5,000
Depreciation attributable to rentals	15,000
Interest attributable to rentals	3,000
Repairs and maintenance	10,000

Elton's adjusted ordinary gross income is \$172,000 [sum of operating income (\$60,000), dividends (\$9,000), interest income (\$6,000), and the adjusted income from rents of \$97,000]. When determining adjusted gross income from rents, the taxes, depreciation, and interest expense are deducted. However, the \$10,000 in repairs and maintenance are not deducted.

### Mineral Royalties

AOGI also includes "adjusted" mineral royalties. For this purpose, *mineral royalties* include working interests in oil and gas wells, overriding royalties, and production payments. Gross income from mineral royalties can be reduced by the following expenses for computing AOGI:

- Exhaustion, wear and tear, obsolescence, amortization, and depletion.
- Property and severance taxes.
- Interest.
- Rent.

These expenses are deductible to the extent they can be allocated to mineral royalty income. The amount subtracted cannot exceed the gross income from such royalties.

### Calculating PHC Income

After calculating AOGI, the next step is the actual determination of PHC income. (As noted previously, PHC income is not the base on which the PHC tax is assessed. It is merely a calculation involved in determining whether a corporation is a PHC.)

Only income included in the computation of AOGI can be considered PHC income. However, not all income included in calculating AOGI is also considered PHC income. Only the following specific categories of AOGI are considered PHC income:

1. Dividends, interest, certain royalties, and annuities.
2. Rents (as outlined in the following rules).
3. Mineral, oil, and gas royalties.
4. Copyright royalties.
5. Produced film rent.
6. Use of tangible corporate property by shareholders.
7. Personal service contracts.
8. Income from estates and trusts.

Special rules apply to each category of income in the preceding list. The rules relating to rental income are explained in the following paragraphs.

Computation of Rental Income Included in PHC Income. To determine a corporation's PHC income, a different computation than that used in computing AOGI is applied to rental income. A corporation's "adjusted income from rents" is excludable from personal holding company income if both parts of a two-part test are met.

1. Adjusted income from rents must be at least 50% of the corporation's adjusted ordinary gross income.

2. Undistributed personal holding company income (excluding adjusted income from rents) must be 10% or less of the ordinary gross income. Thus, rental income will be considered personal holding company income under this test if other personal holding income is greater than 10% of the ordinary gross income. Other personal holding company income does not include rent from a 25% or more shareholder's use of corporate property, but it does include copyright royalties and adjusted income from mineral, oil, and gas royalties. This test will be passed if the corporation paid dividends for the year equal to or exceeding the amount by which personal holding company income exceeds 10% of ordinary gross income.

The purpose of this test is to determine if the corporation's rental activity constitutes a business activity rather than purely an investment activity. Since the term *adjusted income from rents* means the gross income from rents reduced by allocable depreciation, property taxes, interest, and rent expense, gross rental income must exceed these items in order for there to be *adjusted income from rents*.

**Example 2A-2 Calculation of adjusted rental income for PHC income purposes.**

Assume the same facts as in Example 2A-1. In this example, Elton meets the 50% test since adjusted income from rents (\$97,000) exceeds 50% of AOGI ( $\$172,000 \times 50\% = \$86,000$ ).

Under the second part of the test, Elton's undistributed, nonrental personal holding company income must be 10% or less of ordinary gross income. Elton's ordinary gross income is \$195,000 (total of all its income). Elton's nonrental PHC income is \$15,000 (dividend and interest income), which is less than 10% of ordinary gross income.

Since Elton meets both parts of the test, the adjusted income from rents is not considered PHC income. Since PHC income (\$15,000), excluding rental income, is less than 60% of its AOGI (\$172,000), Elton is not considered a PHC for this year.

### Personal Service Contracts

Personal service contracts are included in PHC income. A personal service contract is one under which the corporation is to furnish personal services and the contract (1) designates a 25%-or-more shareholder to perform the services, or (2) provides that some person other than the corporation has the right to designate the shareholder who will perform the services. However, an arrangement is not a personal service contract for PHC purposes under IRC Sec. 543(a)(7) when the contract provides that the corporation has the right to substitute other personnel to perform the services. Furthermore, a personal service contract under IRC Sec. 543(a)(7) includes oral as well as written contracts.

**Example 2A-3 Determining if a personal services contract is PHC income.**

Sue Famous is a talented gardening expert. Sue owns 100% of the stock of Famous Gardens, Inc. (FGI). WJDH, a talk show radio station, contacted Sue and asked her to host the 2:00 p.m. to 4:00 p.m. slot on its weekend gardening show for the next year. Because of Sue's expertise, WJDH contracted with FGI for Sue to perform the services personally. FGI cannot substitute another gardening expert to host the show for Sue.

The income FGI earns from providing talk show host services is income from a personal services contract within the meaning of IRC Sec. 543(a)(7). If WJDH allowed FGI to substitute another gardening expert for Sue, the contract would not be a personal services contract.

### Calculating Ordinary Gross Income, AOGI, and PHC Income

The following is a comprehensive example of the calculation of ordinary gross income, AOGI, and PHC income.

**Example 2A-4 Calculation of ordinary gross income, AOGI, and PHC income.**

Softhouse Inc., designs custom software for sale. It also licenses software to vendors in return for a royalty. To help sell software, Softhouse rents computer hardware to customers if they request it. Softhouse's current-year income and expenses include the following components.

Gross receipts		\$ 560,000
Cost of goods sold		<u>(275,000)</u>
Gross profit		285,000
Capital and Section 1231 gain		10,000
Rental income		62,000
Software (copyright) royalties		135,000
Interest income		
Bank CDs	\$ 4,500	
Tax refund	<u>500</u>	
Total interest income		5,000
Consulting income		<u>139,000</u>
Gross income under Reg. 1.542-2		636,000
Operating expenses		(310,000)
Rental expenses		
Personal property tax	4,300	
Interest	25,000	
Depreciation	<u>34,000</u>	
Total rental expense		(63,300)
Royalty expenses		
Interest	12,000	
Amortization	<u>28,000</u>	
Total royalty expense		<u>(40,000)</u>
Net income		<u>\$ 222,700</u>

The consulting income is from a personal service contract. The contract specified that Dale Johnston, Softhouse's founder and majority owner, would personally perform the work required to assist the customer in selecting, acquiring, and installing the software necessary for a new computer system. Only billings for Dale's time are included on the consulting income line (\$139,000).

Softhouse's gross income is \$636,000. The corporation's ordinary gross income and AOGI are \$626,000 and \$563,500, respectively.

Softhouse's PHC income is \$278,500. Softhouse will not be classified as a PHC for the current tax year because less than 60% of its AOGI is PHC income ( $\$278,500 \div \$563,500 = 49.4\%$ ). Certain software royalties referred to as active business computer software royalties are not treated as PHC income. However, the software royalties are PHC income to Softhouse because these royalties are less than 50% of ordinary gross income ( $\$135,000 \div \$626,000 = 22\%$ ) and meet the other requirements.

### Applying the Income Test to Affiliated Groups

The income test is applied at the consolidated group level for affiliated groups that file, or are required to file, a consolidated return. However, this rule does not apply if (1) the parent or a subsidiary of the group receives 10% or more of its AOGI from sources outside the group, and 80% or more of AOGI income is PHC income; or (2) the group contains one or more members who are excluded by statute from being considered a PHC (e.g., a bank or a surety company).

#### Example 2A-5 Ineligible affiliated group.

Agua, Inc., Buena Corporation, and Caliente, Inc. are affiliated corporations that filed a consolidated return for 2009. None of the corporations are excluded by statute from being considered a PHC. Buena and Caliente are wholly owned subsidiaries of Agua and receive no income from sources outside the affiliated group. Agua, the common parent, has gross income of \$500,000 for 2009. \$400,000 of the income is from dividends received from Buena and Caliente. Of the remaining \$100,000 received from sources outside the affiliated group, \$80,000 is PHC income.

The general rule is that the income test is applied at the consolidated group level unless one of the two exceptions is met. In this case, none of the corporations is a corporation excluded by IRC Sec. 542(c) from being a PHC and, therefore, item 2 does not apply. However, the \$100,000 that Agua receives

from outside the affiliated group is more than 10% of its gross income ( $\$100,000 \div \$500,000 = 20\%$ ). In addition, at least 80% of the income Agua received from outside the group is PHC income ( $\$80,000 \div \$100,000 = 80\%$ ). Thus, item 1 applies.

Therefore, the three corporations are an ineligible affiliated group as defined by IRC Sec. 542(b), and the income test must be applied to each corporation individually.

**Applying the Stock Ownership Test**

Even if a corporation passes the PHC income test, it can still avoid classification as a PHC if it does not pass the stock ownership test. That test is met if more than 50% of a corporation's stock value is owned (directly or indirectly) by no more than five individuals during any part of the last half of the tax year. Two points are worth noting about this test.

1. The determination is made only during the last half of the year.
2. The value of stock, rather than the number of shares or voting power, is the measuring rod. The number of shares and voting power are easily quantified and can be determined objectively. However, determining the value of stock that is not traded on an open market can be an extremely subjective process and thus open to challenge from the IRS.

This is the same ownership test that applies for purposes of determining if a corporation is a closely held corporation subject to the at-risk and PAL rules.

**Example 2A-6 Stock ownership based on value.**

Greentrees, Inc. owns a chain of retail plant nurseries. It has 4,000 shares of voting common stock and 1,000 shares of voting cumulative preferred stock outstanding. The common and preferred stock carry identical (per share) rights to vote. The common stock is owned equally by 20 individuals (200 shares per shareholder), while another individual owns 100% of the preferred stock for a total of 21 shareholders. None of the shareholders are related. As a result of an annual dividend right and a \$100/share liquidation preference, the preferred stock represents 60% of the value of the corporation.

As the following table illustrates, if the PHC ownership test was based on either voting power or number of shares, Greentrees would fail the PHC stock ownership test.

<u>Shareholder</u>	<u>Voting Power</u>	<u>Number of Shares</u>
Preferred shareholder	20%	1,000
Any four of the common shareholders	<u>16%<sup>a</sup></u>	<u>800</u>
Total	<u>36%</u>	<u>1,800<sup>b</sup></u>

**Notes:**

<sup>a</sup>  $(4 \times 200 \text{ shares}) \div 5,000 \text{ shares} = 16\%$

<sup>b</sup>  $1,800 \text{ shares} \div 5,000 \text{ shares} = 36\%$

However, because the test is based on stock value, Greentrees easily passes since more than 50% of its stock value is held by fewer than six individuals (the preferred shareholder owns 60% of the value of the corporation as a result of the annual dividend right and liquidation preference).

If a corporation has more than one class of stock outstanding, the relative value of each class should be determined based on all the facts and circumstances. Some of the factors to consider include the company's net worth, its earning and dividend-paying capacity, and any realized but unrecognized appreciation and depreciation in its assets.

**Example 2A-7 Allocating the value of stock among different classes.**

A corporation has 10,000 shares of voting common stock outstanding and 5,000 shares of voting cumulative preferred stock. All shareholders held their stock throughout the tax year. The common stock is equally owned by 20 unrelated individuals. The preferred stock is owned by one individual who is not related to any of the common shareholders. In this situation, the value of each class of stock must be determined. It is determined, based on earnings and dividend-paying capacity, that the common stock has a value of \$20,000, and the preferred stock is valued at \$21,000. The corporation meets the PHC ownership requirement because more than 50% of the total stock value is owned by no more than five individuals [i.e., the preferred shareholder owns 51% of the total value of all outstanding stock (\$21,000/\$41,000)].

If the value of the stock varies greatly from what is recorded on the company's books (i.e., book value), evidence of how the value was determined should be filed with the return. No specific guidance is given in the regulations concerning what form this evidence should take.

**Constructive Ownership**

When determining stock ownership, certain constructive ownership rules apply. In effect, many shareholders will be deemed to own more shares than they have actually been issued. The following rules apply when determining the number of shareholders and the amount of stock each owns:

1. *Attribution from Entities.* Stock owned (directly or indirectly) by a corporation, partnership, estate, or trust is deemed to be owned proportionately by its shareholders, partners, or beneficiaries.
2. *Family Attribution.* An individual is deemed to own stock owned (directly or indirectly) by a brother or sister (by whole or half blood), spouse, ancestor, or lineal descendant.
3. *Partner Attribution.* Stock owned (directly or indirectly) by an individual partner is deemed owned by other partners in the partnership.
4. *Options.* A person holding an option to acquire stock is considered the owner of such stock even though the option remains unexercised.
5. *Convertible Securities.* Convertible securities are considered outstanding stock.
6. *Reattribution.* Stock attributed to a shareholder, partner, or beneficiary from a corporation, partnership, estate, or trust is deemed to be owned directly for purposes of reattributing the stock to someone else under Items 1 and 2. The same is true for the owner of an option. However, stock attributed to an individual from a family member or partner cannot be reattributed to another individual for purposes of making another person the constructive owner of that stock.

**Computing the Stock Ownership Test**

The following example illustrates how to compute the PHC stock ownership test.

**Example 2A-8 Computing the PHC stock ownership test.**

Double T, Inc., a calendar-year corporation, is owned equally by 10 individuals throughout the tax year. Two of the shareholders, Tyler and Travis, are brothers; the remaining eight are not related to each other or the brothers. Even though no five of the individuals own more than 50% of Double T, it still meets the PHC ownership test. Either one of the brothers is deemed to own 20% of the corporation (10% directly and 10% indirectly from his brother); therefore, one of the brothers along with any four of the other shareholders control more than 50% of the company. If the corporation also passes the PHC income test, it is a PHC.

Because it meets the PHC ownership test, Double T is also subject to the at-risk rules and PAL rules.

If either Tyler or Travis sells his stock to a person unrelated to the current shareholders prior to the midpoint of the current tax year, the corporation will fail the PHC ownership test retroactive to the start of the current tax year (since only ownership in the last half of the tax year is measured) because the test requires more than 50% stock ownership, not 50% or more ownership.

### **Stock Ownership Test in Year of Corporate Dissolution**

The timing of a corporate dissolution can have PHC ramifications, as illustrated in the following example.

#### **Example 2A-9 The stock ownership test and the final tax year.**

Hello, Inc., a calendar-year taxpayer, was dissolved on May 31, 2009. As mentioned previously, the determination as to whether the stock ownership test is met is made during the last half of the tax year. A November 19, 1935 (IRS) Special Ruling provides that if a corporation dissolves before the second half of its tax year (as Hello has done in this example), it is not taxed as a PHC because the test for a PHC status is applied during the last half of the tax year.

Based on the Special Ruling, it appears a corporation that dissolves in the first half of its tax year can avoid the PAL and at-risk rules since application of both is based on the Section 542(a)(2) stock ownership test. However, in this situation, the IRS would probably argue either that the Section 469 stock ownership test refers only to the percentage of ownership, not to the timing of that ownership, or that in a short year of five months, the stock ownership test is applied during the last 2½ of the five months of that year. An argument by the IRS that only the percentage of ownership portion of the test applied could be based on the wording of IRC Sec. 465(a)(1)(B). The relevant portion of this Code section says “with respect to which the stock ownership requirement of paragraph (2) of Section 542(a) is met.” The IRS may interpret that to mean percentage, not timing, of ownership.

### **PHC Status in Year of Liquidation**

An otherwise active corporation may find itself classified as a PHC during its final year, particularly if all operating assets have been sold and the proceeds invested prior to final liquidation. Since liquidating dividends can be claimed as a deduction when determining taxable PHC income, there will probably be no PHC tax liability. However, the corporation would still be required to file Form 1120, Schedule PH.

## **Determining the Consequences of PHC Status**

### **In General**

If a corporation meets the definition of a PHC (i.e., it passes the income and stock ownership tests), it is subject to the PHC tax. In addition, it must deal with tax rules that generally do not affect other types of corporations. These issues include (1) the lowering to \$5,000 of the amount at which the penalty for a substantial understatement is imposed, (2) failure to qualify for the special rule for deductions for charitable contributions of scientific property used for research, (3) the at-risk rules and the passive activity loss (PAL) rules (see the following discussion), (4) rules for special treatment of net operating losses (see Example 2B-1), and (5) a special AMT adjustment for circulation expenses.

Accumulated Earnings Tax. A PHC is not subject to the accumulated earnings tax.

S Corporations. The PHC rules do not apply to S corporations. However, a C corporation that makes the S election is still subject to the PHC rules for the years in which it was a C corporation.

While an S corporation is not subject to the PHC tax, it may incur a corporate-level tax on passive investment income if it has (1) accumulated earnings and profits (AE&P) from operating as a C corporation in previous years and (2) passive investment income that exceeds 25% of gross receipts for the year. Furthermore, if passive investment income exceeds 25% of gross receipts for three consecutive tax years, and the S corporation has AE&P at the end of each of those years, the S corporation election will terminate.

## **PHC and the At-risk and PAL Rules**

The rules used to determine whether a corporation is closely held enough to be subject to the at-risk and PAL rules are the same as those used in determining whether a corporation is classified as a PHC. (Therefore, a corporation is subject to the at-risk rules and the PAL rules not because it is a PHC, but because it meets the PHC stock ownership test.)

## **PHCs and NOLs**

An NOL deduction arising from the carryback or carryforward of an NOL from another year is generally not allowed when computing UPHCI. However, an NOL from the immediately preceding year can be used as a deduction against UPHCI in the current year. This is true even if that NOL has already been carried back for regular tax purposes.

The PHC tax is a penalty tax that is combined with a corporation's regular income tax. As such, the determination of a corporation's regular taxable income is a completely separate calculation. A PHC is allowed to carry back and carry forward an NOL for regular tax purposes under the normal rules outlined in IRC Sec. 172.

### **Example 2B-1 PHC use of NOL.**

Fairfield, Inc., had a net operating loss of \$50,000 in 2009. For regular tax purposes, the NOL can be carried back two years and forward 20 years. Fairfield's NOL is carried back to 2007 and applied against regular 2007 taxable income of \$100,000. Thus, the NOL is completely used in 2007 for regular tax purposes. In 2010, Fairfield had undistributed personal holding company income of \$80,000. The full NOL for 2009 (\$50,000) can be carried forward and applied against the 2010 personal holding company income. Therefore, the undistributed personal holding company income for 2009 is reduced to \$30,000 (\$80,000 less the \$50,000 net operating loss carryover).

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Which of the following is **not** a test that must be met in order for a company to be classified as a personal holding company?
- Net income test.
  - Stock ownership test.
  - Income test.
  - Stock ownership test and income test.
16. Which of the following types of entities is **not** automatically exempt from the PHC tax?
- Banks.
  - Life insurance corporations.
  - A corporation 55% owned by five people.
  - Corporations in bankruptcy.
17. Adjusted ordinary gross income (AOGI) is calculated by starting with ordinary gross income and making adjustments for all of the following **except**:
- Mineral royalties.
  - Rental income.
  - Copyright royalties.
  - Working interests.
18. Personal holding company income is derived from certain sources. Classify the following types of income as PHC income or Non-PHC income.
- |                     |                   |
|---------------------|-------------------|
| 1. Business Revenue | a. PHC income     |
| 2. Dividends        | b. Non-PHC income |
| 3. Royalties        |                   |
| 4. W-2 income       |                   |
| 5. Annuities        |                   |
- 1a, 2a, 3a, 4b, 5a.
  - 1b, 2a, 3a, 4b, 5a.
  - 1a, 2b, 3b, 4b, 5a.
  - 1b, 2a, 3a, 4a, 5b.

19. When determining a corporation's PHC status, one of the most difficult components to compute is the treatment of rental income. When determining adjusted ordinary gross income (AOGI), which of the following qualifies as a deduction?
- Produced film rents.
  - A shareholder's (owning 25% or more of stock) income from the use of tangible property.
  - Interests expenses.
  - Copyright royalties.
20. A corporation's adjusted income from rents is excludable from personal holding income if both parts of a two-part test are met. What is the purpose of the test?
- To determine if a corporation's rental activity does not constitute an investment activity, but a rental activity.
  - To determine if a corporation is a PHC.
21. Which of the following statements is correct regarding the stock ownership test in evaluating whether a corporation is classified as a PHC?
- The number of shares is used to determine if more than 50% of a corporation's stock is owned by no more than five individuals.
  - The determination of whether more than 50% of a corporation's stock is owned by no more than five individuals cannot be calculated if the stock is not traded on an open market.
  - The stock ownership test is determined on ownership during the last half of the year.
22. When determining stock ownership, constructive ownership rules apply. Which of the following would **not** be a part of those rules?
- Attribution from entities or reattribution.
  - Family or partner attribution.
  - Options or convertible securities.
  - Insider trading.
23. A corporation can avoid the classification as a PHC if it does not pass the stock ownership test. Would the following company be classified as a PHC based on the following information?

All Done, a calendar-year taxpayer, was dissolved on May 31. The common stock is owned equally by 5 individuals, while another individual owns 100% of the preferred stock for a total of 6 shareholders. None of the shareholders are related. The preferred stock represents 10% of the value of the corporation.

<u>Shareholder</u>	<u>Voting Power</u>	<u>Number of Shares</u>
Preferred shareholder	20%	2,000
Any four of the common shareholders	64%	1,600

- Yes, the corporation would be classified as a PHC.
- No, the corporation would not be classified as a PHC.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Which of the following is **not** a test that must be met in order for a company to be classified as a personal holding company? **(Page 44)**
- a. **Net income test. [This answer is correct. This is not a test for personal holding companies.]**
  - b. Stock ownership test. [This answer is incorrect. The stock ownership test is just one of the tests that must be met for determining personal holding company status, there is a better choice.]
  - c. Income test. [This answer is incorrect. The income test is just one of the tests that must be met for determining personal holding company status, there is a better choice.]
  - d. Stock ownership test and income test. [This answer is incorrect. Both the stock ownership test and the income test are both required to be met in order for a corporation to be a personal holding company.]
16. Which of the following types of entities is **not** automatically exempt from the PHC tax? **(Page 44)**
- a. Banks. [This answer is incorrect. Banks are exempt from the PHC tax as stated by the IRS.]
  - b. Life insurance corporations. [This answer is incorrect. According to IRS Code, life insurance corporations are exempt from the PHC tax.]
  - c. **A corporation 55% owned by five people. [This answer is correct. A corporation with greater than 50% of the value of the corporation's outstanding stock owned by 5 or fewer persons during the last half of the corporation's tax year would not be exempt from the PHC tax.]**
  - d. Corporations in bankruptcy. [This answer is incorrect. Corporations in bankruptcy are exempt from the PHC tax per IRS laws.]
17. Adjusted ordinary gross income (AOGI) is calculated by starting with ordinary gross income and making adjustments for all of the following **except**: **(Page 45)**
- a. Mineral royalties. [This answer is incorrect. Mineral royalties are one adjustment that must be made when AOGI is calculated by starting with ordinary income. Mineral royalties must be reduced by depreciation, taxes, interest, and depletion.]
  - b. Rental income. [This answer is incorrect. Rental income is one adjustment that must be made when AOGI is calculated by starting with ordinary income. Rental income must be reduced by depreciation, taxes, interest, and depletion.]
  - c. **Copyright royalties. [This answer is correct. According to IRC Sec. 543(a)(b), copyright royalties are not considered rents and, therefore, no deductions may be taken when determining AOGI.]**
  - d. Working interests. [This answer is incorrect. Working interests is one adjustment that must be made when AOGI is calculated by starting with ordinary income. Working interest must be reduced by depreciation, taxes, interest, and depletion.]

18. Personal holding company income is derived from certain sources. Classify the following types of income as PHC income or Non-PHC income. **(Page 46)**

- |                     |                   |
|---------------------|-------------------|
| 1. Business Revenue | a. PHC income     |
| 2. Dividends        | b. Non-PHC income |
| 3. Royalties        |                   |
| 4. W-2 income       |                   |
| 5. Annuities        |                   |

a. 1a, 2a, 3a, 4b, 5a. [This answer is incorrect. Business revenue is non-PHC income.]

**b. 1b, 2a, 3a, 4b, 5a. [This answer is correct. Dividends, royalties and annuities are classified as PHC income per the IRS Code.]**

c. 1a, 2b, 3b, 4b, 5a. [This answer is incorrect. Dividends, royalties, and business revenue are incorrectly classified per the IRS Code.]

d. 1b, 2a, 3a, 4a, 5b. [This answer is incorrect. W-2 income and annuities are incorrectly classified.]

19. When determining a corporation's PHC status, one of the most difficult components to compute is the treatment of rental income. When determining adjusted ordinary gross income (AOGI), which of the following qualifies as a deduction? **(Page 46)**

a. Produced film rents. [This answer is incorrect. As defined in IRC Sec. 543(a)(5)(B), produced film rents are not considered "rents" and, therefore do not qualify as a deduction.]

b. A shareholder's (owning 25% or more of stock) income from the use of tangible property. [This answer is incorrect. Income from the use of tangible property by a shareholder owning (directly or indirectly) 25% or more in value of the corporation's stock at any time during the tax year, if the corporation's PHC income, exceeding rents, is greater than 10% of the ordinary gross income is not considered "rents" and, therefore do not qualify as a deduction as stated in IRS laws.]

**c. Interests expenses. [This answer is correct. When determining adjusted gross income from rents, the taxes, depreciation, and interest expense are deducted per IRS regulations.]**

d. Copyright royalties. [This answer is incorrect. As defined in IRC Sec. 543(a)(4), copyright royalties are not considered "rents" and, therefore do not qualify as a deduction.]

20. A corporation's adjusted income from rents is excludable from personal holding income if both parts of a two-part test are met. What is the purpose of the test? **(Page 47)**

**a. To decide if a corporation's rental activity does not constitute an investment activity, but a rental activity. [This answer is correct. The purpose of this test is to determine if the corporation's rental activity constitutes a business activity rather than purely an investment activity. Since the term adjusted income from rents means the gross income from rents reduced by allocable depreciation, property taxes, interest, and rent expense, gross rental income must exceed these items in order for there to be adjusted income from rents.]**

b. To determine if a corporation is a PHC. [This answer is incorrect. If a corporation is able to compute its rental income included in PHC income, then the corporation is already considered a PHC so the test would not apply.]

21. Which of the following statements is correct regarding the stock ownership test in evaluating whether a corporation is classified as a PHC? **(Page 49)**

a. The number of shares is used to determine if more than 50% of a corporation's stock is owned by no more than five individuals. [This answer is incorrect. The value of stock, rather than the number of shares or voting power, is the measuring rod as stated in the stock ownership test of a PHC.]

- b. The determination of whether more than 50% of a corporation's stock is owned by no more than five individuals cannot be calculated if the stock is not traded on an open market. [This answer is incorrect. Determining the value of stock that is not traded on an open market can be accomplished, but the process is extremely subjective and can be challenged by the IRS.]
  - c. The stock ownership test is determined on ownership during the last half of the year. [This answer is correct. The stock ownership test is met if more than 50% of a corporation's stock value is owned by no more than five individuals during any part of the last half of the tax year per the PHC definition.]**
22. When determining stock ownership, constructive ownership rules apply. Which of the following would **not** be a part of those rules? **(Page 50)**
- a. Attribution from entities or reattribution. [This answer is incorrect. Attribution from entities or reattribution is a part of the constructive ownership rules per the IRS.]
  - b. Family or partner attribution. [This answer is incorrect. According to the IRS, family or partner attribution is a part of the constructive ownership rules.]
  - c. Options or convertible securities. [This answer is incorrect. Options or convertible securities are a part of the constructive ownership rules in the IRS rules.]
  - d. Insider trading. [This answer is correct. Insider trading does not have anything to do with constructive ownership rules when determining stock ownership based on the constructive ownership rules in the IRS Code.]**
23. A corporation can avoid the classification as a PHC if it does not pass the stock ownership test. Would the following company be classified as a PHC based on the following information? **(Page 51)**

All Done, a calendar-year taxpayer, was dissolved on May 31. The common stock is owned equally by 5 individuals, while another individual owns 100% of the preferred stock for a total of 6 shareholders. None of the shareholders are related. The preferred stock represents 10% of the value of the corporation.

<u>Shareholder</u>	<u>Voting Power</u>	<u>Number of Shares</u>
Preferred shareholder	20%	2,000
Any four of the common shareholders	64%	1,600

- a. Yes, the corporation would be classified as a PHC. [This answer is incorrect. Even though the corporation is owned by more than 50% by no more than five individuals, All Done would not be classified as a PHC in the final tax year because the test requires more than 50% stock ownership, not 50% or more ownership.]
- b. No, the corporation would not be classified as a PHC. [This answer is correct. Since All Done dissolved during the first half of the year, it is not taxed as a PHC because the test is applied during the last half of the tax year.]**

## Calculating Undistributed Personal Holding Company Income (UPHCI)

### Tax Rate

The determination of whether a company is a PHC is based on the specific, objective tests. If a corporation meets these tests and is considered a PHC, the next step is to compute the amount of PHC tax. This computation is different from the previously discussed computations required to determine whether the corporation is a PHC. A PHC pays regular corporate income tax. Plus, it pays the Section 541 penalty tax (the PHC tax) based on undistributed personal holding company income (UPHCI). The PHC tax rate is 15%. For tax years beginning after December 31, 2010, the PHC tax rate will correspond to the maximum individual tax rate. It is important to remember that, even though a corporation is a PHC, it will not necessarily owe PHC tax.

While corporations with substantial accumulated earnings can be subject to the accumulated earnings tax (AET), the AET, however, does not apply to a personal holding company.

### Undistributed Personal Holding Company Income

UPHCI is computed by making adjustments to the corporation's taxable income, not just its PHC income. The adjustments are set out in IRC Sec. 545(b) and (c). After these adjustments are made, a deduction is taken for dividends paid. The balance remaining is the "undistributed personal holding company income" on which the PHC tax is applied. This procedure is outlined in the following illustration:

Taxable income		\$	XXXX
Increased by:			
Dividends received deduction	\$	XX	
Net operating loss deduction		XX	
Charitable contributions allowed under the corporate regular tax rule		XX	
Excess rental expenses		<u>XX</u>	<u>XX</u>
Decreased by:			
Current year federal income tax liability (with some adjustments)		XX	
Foreign income and profits taxes not deducted in computing taxable income		XX	
Charitable contributions (applying individual rather than corporate limitations)		XX	
Prior year net operating loss (determined without regard to deduction for dividends received)		XX	
Net capital gains (reduced by federal income tax attributable to the capital gains)		<u>XX</u>	(XX)
Decreased by dividends paid			<u>(XX)</u>
UPHCI before deficiency dividends			<u>XXX</u>
Deficiency dividends			<u>(XX)</u>
UPHCI		\$	<u><u>XXX</u></u>

### Dividends Received Deduction

Corporations are generally permitted a special deduction for dividends received. The dividends received deduction is disallowed in the computation of UPHCI, and thus must be added back to the corporation's taxable income when calculating UPHCI.

### Net Operating Loss Deduction

An NOL deduction arising from the carryback or carryforward of an NOL from another year is generally not allowed when computing UPHCI. However, an NOL from the immediately preceding year can be used as a deduction against UPHCI in the current year, even if that NOL has already been carried back for regular tax purposes. The NOL from the immediately preceding year must be reduced by any deductions allowed by the dividends received deduction of IRC Secs. 241–147 and 249 in computing regular taxable income for that year.

#### Example 2C-1 NOL deduction in computing UPHCI.

Green Corp. (Green) is a calendar-year corporation. In 2008, Green incurred a \$5,000 NOL (including a dividends received deduction of \$1,000). For purposes of the regular tax, the NOL was carried back

to 2006 and completely offset against income in that year. In 2009, Green has a large amount of rental income and for the first time meets the definition of a PHC.

In calculating UPHCI in 2009, Green is allowed a deduction for the 2008 NOL to the extent it is not generated by the dividends received deduction. So, Green is entitled to a \$4,000 (\$5,000 – \$1,000) deduction in computing its 2009 UPHCI.

### Charitable Contributions

The deduction limit for regular tax purposes on corporate charitable contributions is 10% of taxable income (after certain adjustments). The more favorable limits applicable to individuals are used in computing UPHCI. Thus, a PHC is generally entitled to deduct contributions up to 50% of its contribution base (with lower limits of 30% and 20% applying in certain situations). The contribution base in this case is defined as taxable income, determined without regard to:

1. the charitable contribution deduction itself,
2. the deductions allowed under IRC Secs. 241–247 and 249 (primarily the dividends received deduction),
3. a carryback of a capital loss or NOL, or
4. a deduction for rental expenses disallowed under IRC Sec. 545(b)(6) because it exceeds related rental income.

No carryover of charitable contributions is allowed.

#### Example 2C-2 Increased charitable contribution limit in determining UPHCI.

Green's (see Example 2C-1) 2009 taxable income is \$7,500, calculated as follows:

Taxable income, before charitable contributions and the dividends received deduction	\$ 25,000
Charitable contributions	<u>(2,500)</u>
Taxable income, before the dividends received deduction	22,500
Dividends received deduction	<u>(15,000)</u>
 Taxable income	 <u>\$ 7,500</u>

Total contributions for 2009 were \$10,000 (all to qualified public charities); however, the 10% rule of IRC Sec. 170(b)(2) limited the deduction to \$2,500 for regular tax purposes. What is Green's charitable contribution deduction when it computes its 2009 UPHCI?

Green is allowed to deduct its entire contribution of \$10,000. The calculation of the UPHCI limit on charitable contributions follows:

Taxable income	\$ 7,500
Increased by:	
Dividends received deduction	15,000
NOL and capital loss carrybacks	—
Regular tax contribution deduction	2,500
Disallowed rental expenses	<u>—</u>
UPHCI contribution base	25,000
Limit for qualified public charities	× <u>50%</u>
 Contribution deduction limit	 <u>\$ 12,500</u>

### Excess Rental Expenses

If a PHC owns or operates rental property that produces a tax loss, the loss is normally not deductible in computing UPHCI to the extent it is generated by Section 162 (trade or business) or 167 (depreciation) expenses (i.e., the

deductions are allowed only to the extent of the compensation or other rent received for the use or right to use the property). Expenses deductible under another Code section are not affected by this rule.

The corporation is allowed to deduct the rental loss if it can prove it is business related. Specifically, the corporation must establish to the satisfaction of the IRS that:

1. the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;
2. the property was held in the course of a business carried on with a bona fide profit motive; and
3. either there was a reasonable expectation of a profit from the property or the property was necessary to the conduct of the business.

A PHC that deducts excess expenses must attach a statement to its return describing the facts and circumstances resulting in the excess expenses and the arguments it relies on for their deduction.

## Taxes

Although not allowed for regular tax purposes, federal income taxes (including the AMT, but not including the PHC tax or the accumulated earnings tax) are deductible in calculating UPHCI. A foreign tax credit cannot be taken against the PHC tax. However, foreign taxes such as income and war profits taxes are deductible when computing UPHCI. (The war profits tax is imposed by a country based on a social principle—profits from war come from a country's tax dollars; therefore, such profits, particularly those in excess of what is obtainable under normal market conditions, should be taxed at a high rate, with the funds raised going into social programs or for payment of the expenses of war. The United States imposed such a tax during World War I, World War II, and the Korean War at rates that were sometimes as high as 90%. An adjustment is made to taxable income for foreign taxes only to the extent they have not been deducted in computing taxable income (i.e., a credit was taken for regular tax purposes). The tax deduction in computing UPHCI is the amount accrued during the tax year, even if the corporation uses the cash method of accounting to determine taxable income. Amounts being contested are not deductible until the outcome of the contest is final.

### Example 2C-3 Deduction for accrued income taxes.

Green (see Examples 2C-1 and 2C-2) uses the cash method of accounting and paid \$1,000 in federal income tax payments during 2009. On an accrual basis, the corporation's federal income tax liability for the year is as follows:

Regular tax	\$ 1,425	
Less: Foreign tax credit	(300)	
Net regular tax	<u>1,125</u>	\$ 1,125
Alternative minimum tax	800	
Less: Foreign tax credit	(300)	
Net AMT	<u>500</u>	
Net income tax liability for the year		<u>\$ 1,625</u>

Green is entitled to a \$1,925 deduction for income tax expense when calculating UPHCI, determined as follows:

Accrued \$1,425 regular tax liability (net of \$300 foreign tax credit)	\$ 1,125
AMT of \$800 (net of \$300 of foreign tax credit)	500
Foreign taxes (taken as a credit, rather than as a deduction, in calculating regular tax and AMT)	<u>300</u>
Tax deduction allowed	<u>\$ 1,925</u>

## Net Capital Gains

A PHC's net capital gains (excess of capital gains over capital losses), less all income taxes (including regular income tax, AMT, etc. other than the PHC tax) attributable to the gain, are deductible in determining UPHCI. The tax attributable to net capital gains is the difference between a corporation's actual income tax liability and its income tax liability computed without including net capital gains (corporate capital gains are taxed at the same rate as ordinary income).

### **Example 2C-4 Deduction for net capital gains.**

Green's (see Examples 2C-1, 2C-2, and 2C-3) taxable income includes \$1,000 of net capital gain. If the gain had not been included in its income, Green's total income tax liability (i.e., regular tax and AMT) for 2009 would have been \$200 less. In determining UPHCI, Green is entitled to an \$800 deduction ( $\$1,000 - \$200$ ) for net capital gains when it calculates UPHCI.

## Reporting UPHCI

UPHCI is calculated and reported on Part I of Form 1120, Schedule PH [U.S. Personal Holding Company (PHC) Tax]. Calculation of the tax is covered in this lesson.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. Which of the following statements regarding computing undistributed personal holding company income (UPHCI) is most accurate?
- a. UPHCI is calculated by making adjustments only to PHC income.
  - b. A PHC is required to pay a penalty based on UPHCI.
  - c. NOL deductions occurring from the carryback or carryforward of an NOL from another year generally are allowed.
25. Which of the following is a feature of the treatment for charitable contributions for personal holding companies?
- a. Unlimited carryovers are available to the PHC.
  - b. A personal holding company is generally entitled to deduct contributions up to 20% of its contribution base.
  - c. They are treated exactly like regular corporations when it comes to charitable contributions.
  - d. A personal holding company is generally entitled to deduct contributions up to 50% of its contribution base.
26. Which of the following statements is correct regarding taxes when calculating UPHCI?
- a. Not only are federal income taxes not deductible in calculating UPHCI, they are not allowed for regular tax purposes.
  - b. Foreign taxes are deductible.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

24. Which of the following statements regarding computing undistributed personal holding company income (UPHCI) is most accurate? **(Page 58)**
- a. UPHCI is calculated by making adjustments only to PHC income. [This answer is incorrect. According to IRC Sec. 545(b) and (c), UPHCI is calculated by making adjustments to the corporation's taxable and PHC income.]
  - b. A PHC is required to pay a penalty based on UPHCI. [This answer is correct. A PHC pays the Section 541 penalty tax (the PHC tax) based on undistributed personal holding company income (UPHCI) at a rate of 15%.]**
  - c. NOL deductions occurring from the carryback or carryforward of an NOL from another year generally are allowed. [This answer is incorrect. An NOL deduction arising from the carryback or carryforward of an NOL from another year is generally not allowed when computing UPHCI.]
25. Which of the following is a feature of the treatment for charitable contributions for personal holding companies? **(Page 59)**
- a. Unlimited carryovers are available to the PHC. [This answer is incorrect. Carryovers of unused charitable contributions are not available to the PHC as stated in IRS Code.]
  - b. A personal holding company is generally entitled to deduct contributions up to 20% of its contribution base. [This answer is incorrect. The percentage of the contribution base allowable as a deduction for a PHC is incorrect based on UPHCI rules.]
  - c. They are treated exactly like regular corporations when it comes to charitable contributions. [This answer is incorrect. Charitable contributions are treated differently for PHCs than for regular corporations. The more favorable limits applicable to individuals are used in computing UPHCI.]
  - d. A personal holding company is generally entitled to deduct contributions up to 50% of its contribution base. [This answer is correct. A personal holding company is generally entitled to deduct contributions up to 50% of its contribution base based on the rules for calculating UPHCI.]**
26. Which of the following statements is correct regarding taxes when calculating UPHCI? **(Page 60)**
- a. Not only are federal income taxes not deductible in calculating UPHCI, they are not allowed for regular tax purposes. [This answer is incorrect. Although not allowed for regular tax purposes, federal income taxes (including the AMT, but not including the PHC tax or the accumulated earnings tax) are deductible in calculating UPHCI, according to IRC Sec. 545(b)(1).]
  - b. Foreign taxes are deductible. [This answer is correct. According to IRC Sec. 545(b)(1), foreign taxes such as income and war profits taxes are deductible when computing UPHCI. However, a foreign tax credit cannot be taken against the PHC tax.]**

## Using the Dividends Paid Deduction to Minimize PHC Tax

### Payment of Dividends Can Reduce PHC Tax

The status of a corporation as a PHC is determined based on a stock ownership test and an income test. If a corporation is classified as a PHC, the primary method of minimizing the penalty tax is through the payment of dividends. Since the main purpose of the tax is to discourage the accumulation of earnings from investment-type activities, the distribution of these earnings as dividends will reduce the impact of the PHC tax.

Several types of dividends can be deducted when computing UPHCI. Dividends paid during the tax year, dividends paid within 2<sup>1</sup>/<sub>2</sub> months after year-end, consent dividends, and liquidating dividends are discussed here.

### Dividends Paid during the Tax Year

A PHC normally is allowed to deduct any dividends actually paid during the tax year when computing its UPHCI for that year. However, the following requirements must be met:

1. *Receipt.* The shareholders generally must receive the dividend during the same tax year it is claimed as a deduction. (An exception for dividends paid within 2<sup>1</sup>/<sub>2</sub> months after year-end.) Thus, an accrual-basis corporation may not merely declare and accrue a dividend on its corporate books.
2. *Earnings and Profits.* The dividend must be paid out of current or accumulated earnings and profits (E&P), unless the PHC has UPHCI but no E&P. (See Example 2D-2.) If the corporation has UPHCI, but no E&P, the distribution is deductible to the extent of the corporation's UPHCI for the tax year. UPHCI can never be reduced below zero by a distribution.
3. *Dividend Taxable.* The dividend must be included in the shareholder's taxable income. Thus, a nontaxable stock dividend generally will not reduce UPHCI.
4. *Preference.* The dividend cannot be preferential. If any portion of a dividend is preferential, the entire distribution becomes nondeductible. (See Example 2D-1.) The following types of dividends are considered preferential and thus do not reduce UPHCI:
  - a. Dividends that are not paid prorata to shareholders based on the number of shares owned by each shareholder within a class of stock. This rule is applied to each distribution separately.
  - b. Dividends paid to one class in an amount more or less than the amount it is entitled to as compared with any other class of stock (i.e., dividends paid to one class but not to another class, unless the rights of a class of stock call for such a dividend).

#### Example 2D-1 Nondeductible preferential dividends.

Jameston, Inc. is a PHC with two equal shareholders (Jim James and Jerry Gerald). Jameston pays a \$5,000 dividend to each. However, Jim's \$5,000 dividend was declared and paid in May, but Jerry's \$5,000 dividend was declared and paid in November. Jameston has current E&P of \$15,000. None of the \$10,000 is deductible because each distribution by itself must be prorata (i.e., \$5,000 to each shareholder). It does not matter that for the tax year as a whole the total dividend is prorata. The \$10,000 of dividends would have been deductible if a \$10,000 distribution had been declared, for example, in May, and both shareholders received \$5,000 when the distribution was made.

#### Example 2D-2 Dividend deduction when corporation does not have E&P.

Walker, Inc. (Walker) is a PHC. For the current year, it has taxable income of \$10,000 and a \$12,000 net capital loss that is not deductible due to a lack of capital gains. Its UPHCI for the current tax year (prior to any deduction for dividends) is \$8,500. During the year, Walker paid a \$9,000 dividend to its shareholders. Its accumulated E&P at the beginning of the year was zero. Is Walker allowed to deduct the \$9,000 dividend when it calculates its UPHCI?

Walker's current E&P is a negative \$2,000. (For E&P purposes, the unused net capital loss is deductible and thus fully offsets the \$10,000 of taxable income.) Since its beginning-of-the-year accumulated E&P is also zero, under the general rule, none of the \$9,000 dividend is deductible in determining UPHCI. However, an exception to the general rule allows a deduction to the extent of UPHCI. Thus Walker is entitled to an \$8,500 deduction, which brings its UPHCI down to zero.

Distributions of property, rather than cash, qualify for the dividends paid deduction if they meet the requirements discussed previously. The PHC's UPHCI deduction for the dividend is limited to the property's adjusted basis in the hands of the distributing company at the time of the distribution. IRC Sec. 311 states that corporations must recognize gain on distributions of appreciated property. The corporation recognizes gain based on the property's FMV but its deduction when computing UPHCI is restricted to adjusted basis. The property's basis in the hands of the recipient shareholder, however, is its FMV.

**Example 2D-3 Deduction for a dividend of appreciated property.**

Bowles Investments Co. (BIC), a PHC, made a property distribution in the current year to its sole shareholder, Mark Bowles. The property had an adjusted basis of \$5,000 and a FMV of \$11,000 at the time of the distribution. BIC recognizes \$6,000 of gain on the distribution (\$11,000 FMV – \$5,000 adjusted basis). BIC's current E&P is \$30,000 and its beginning-of-the-year accumulated E&P is \$225,000. What is BIC's UPHCI dividends paid deduction related to the property distribution?

To be deductible, a dividend must (1) be received during the tax year by the shareholder, (2) be made out of E&P (unless the corporation has UPHCI but no E&P), and (3) not be preferential. The property dividend meets all of these requirements.

BIC must recognize \$6,000 gain on the distribution and the entire \$11,000 is taxable to Mark as a dividend. However, in determining its UPHCI, BIC is allowed only a \$5,000 dividends paid deduction for the adjusted basis of the property. Mark's basis in the property is its FMV, \$11,000.

**Dividends Paid within 2<sup>1</sup>/<sub>2</sub> Months after Year-end**

A PHC will not usually know the exact amount of its UPHCI prior to year-end. As a result, the corporation may not have distributed enough actual dividends to bring UPHCI down to zero and to avoid the PHC tax. One way to correct this problem is to declare a consent dividend. In certain situations, however, this may not be practical. A second alternative is to elect to treat dividends paid after the close of the tax year, but by the 15th day of the third month after year-end, as if paid during the tax year.

The PHC's ability to elect to treat post-year-end dividend payments as paid during the tax year is an important post-year-end strategy available to the tax return preparer, but is limited to the lesser of:

1. the amount of UPHCI for the tax year prior to such payments, or
2. 20% of the dividends actually paid during the tax year (not including consent dividends). Thus, if a corporation failed to pay any dividends during the tax year, it will not be able to claim a deduction for dividends paid after year-end.

The election is made by including the dividends when computing the dividends paid deduction.

**Example 2D-4 Deduction for dividends paid after year-end.**

Arnold Hatfield Co. (AHC) is a calendar-year PHC. Prior to any deduction for dividends, AHC had \$20,000 of UPHCI in 2009. During the year, it paid \$19,000 of dividends qualifying for the UPHCI dividends paid deduction. Therefore, AHC's net UPHCI is \$1,000. On March 1, 2010, AHC paid an additional dividend of \$5,000 that meets the rules for the dividends paid deduction.

AHC can reduce its UPHCI to zero (to avoid the PHC tax) by electing to treat \$1,000 of the March 1, 2010 dividend as paid in 2009 [the lesser of the remaining UPHCI (\$1,000) or 20% of dividends paid

during the tax year ( $20\% \times \$19,000 = \$3,800$ ]. The election is made simply by including the \$1,000 in AHC's dividends paid deduction for 2009. The \$4,000 remainder is deducted when computing UPHCI for 2010.

Assume AHC had paid \$15,000 (rather than \$19,000) of dividends in 2009. In this case, the maximum 2010 dividend payment allowed in 2009 is \$3,000 [the lesser of the remaining UPHCI (\$5,000) or 20% of actual dividends paid in 2009 ( $20\% \text{ of } \$15,000 = \$3,000$ )]. Therefore, AHC would still have \$2,000 ( $\$5,000 - \$3,000$ ) of UPHCI even after claiming a portion of the March 1, 2010 dividend. AHC would have to declare a consent dividend (see the following discussion) to avoid the PHC tax on the remaining UPHCI of \$2,000.

**Example 2D-5 Shareholder tax treatment when corporation deducts dividends paid after year-end.**

AHC (see Example 2D-4) elects to treat \$1,000 of the March 1, 2010 dividend as paid during 2009. A PHC's election to treat post-year-end dividend payments as paid during the tax year only applies to that dividend for purposes of determining the dividends paid deduction. A cash-basis shareholder still recognizes the dividend in the year of receipt.

### Consent Dividends

Consent dividends reduce UPHCI in the same manner as dividends actually paid. As the name implies, a consent dividend is a hypothetical distribution a PHC's shareholders agree to include in income even though it is not actually paid. However, if the IRS later determines the consent dividend was unnecessary because the corporation is not a PHC, the shareholders are not required to include in income the amount specified in the consent.

When a shareholder agrees to a consent dividend, that amount is included in the shareholder's taxable income as a dividend received on the last day of the corporation's tax year. The shareholder is deemed to have then contributed capital to the PHC in the amount of the dividend. This increases the basis of the shareholder's stock.

**Example 2D-6 Avoiding PHC tax by making consent dividends.**

Adam owns all the stock of ABC, Inc., a calendar-year PHC. Prior to year-end, ABC determines that its UPHCI will be approximately \$20,000 for 2009 and that it will not have any funds available for dividend payments prior to March 15, 2010. Adam agrees to a \$20,000 consent dividend. The \$20,000 is included as dividend income on his 2009 Form 1040. Adam increases his stock basis by \$20,000, as if he had contributed that amount to the corporation's capital. ABC is not subject to PHC tax because the \$20,000 consent dividend reduces UPHCI to zero.

A consent dividend is available only with respect to consent stock. Consent stock is defined as stock (either common or preferred) that has (after payment of preferred dividends) unlimited participation rights (other than in a liquidation of the corporation) in the distribution of E&P. The following restrictions limit the amount treated as a consent dividend.

1. A consent dividend can only be made with respect to consent stock owned on the last day of the corporation's tax year. This restriction may cause a problem if stock changes hands after the end of the tax year and before the consent dividend is made because the corporation may not be able to secure the prior shareholder's consent.
2. A consent dividend cannot exceed the greater of a corporation's E&P or remaining UPHCI.
3. A consent dividend cannot include any amount that, if paid in cash, would be a preferential dividend. However, in determining whether it is prorata, consent dividends are combined with actual cash dividends.
4. Consent dividends paid to a foreign shareholder cannot be taken into account for the dividends paid deduction unless the corporation pays an amount equal to the withholding tax that would have been due had an actual cash dividend been paid on the last day of the tax year. The corporation is required to make

this payment by the due date of the tax return for the tax year (not including extensions). IRS Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) and Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding) must be filed with the corporation's return for the year such payments are made.

**Example 2D-7 Avoiding preferential dividends by using consent dividends.**

J. Palmere Enterprises (JPE) is a calendar-year PHC owned equally by Jay Palmere and George Regal. Prior to year-end, JPE determines that its UPHCI will be approximately \$20,000 for the current year and that it will have only \$12,000 available to pay dividends before year-end. JPE does not expect to have any additional funds available for dividend payments prior to March 15 of the following year. George insists any dividend he receives must be in cash. How can JPE structure a dividend payment to decrease its UPHCI as much as possible?

If JPE distributes \$6,000 to each shareholder, UPHCI will decrease by \$12,000 and George's demand for cash-only dividends will be met. However, JPE will still owe PHC tax on \$8,000 of UPHCI. Alternatively, if Jay agrees to an \$8,000 consent dividend, the corporation could distribute a \$12,000 cash dividend unequally (\$10,000 to George and \$2,000 to Jay) and still have the entire dividend qualify for the UPHCI dividends paid deduction. Taken together, the consent dividend and the cash dividend are considered nonpreferential [IRC Sec. 565(d)], even though from a financial standpoint Jay did not get an equal distribution. (Jay and George both have a \$10,000 taxable dividend, but George has \$10,000 of cash while Jay only has \$2,000 of cash and an \$8,000 increase in the basis of his stock.) Although not required by the regulations, it seems prudent to have the consent dividend documented in the corporate minutes when the cash dividend is paid. This ensures the consent dividend and cash dividend are considered part of the same distribution.

## Liquidating Distributions

Liquidating distributions of a PHC can qualify for the dividends paid deduction if the distributions do not exceed the shareholders' allocable share of UPHCI for the tax year. Separate provisions apply for distributions to corporate shareholders and to all other shareholders. The distributions must always be part of a formally adopted plan of liquidation completed within 24 months after the adoption of such plan. In addition, to be included as a deduction in computing UPHCI, any liquidating distribution must not be preferential.

The rules governing the treatment of liquidating distributions to corporate and noncorporate shareholders differ in two significant respects. First, if the Section 562(b)(2) requirements are satisfied, liquidating distributions to corporate shareholders are automatically treated as dividends for purposes of the dividends paid deduction computation. For noncorporate shareholders, the PHC must designate distributions as deductible dividends using special reporting requirements.

The second significant difference relates to the distributee's treatment of the distributions. Although distributions to a corporate shareholder are automatically treated as dividends, the corporation receiving the distributions treats them as liquidating distributions and recognizes taxable gain or loss depending on the basis of the stock. Noncorporate shareholders treat designated dividends as dividend income, subject to a maximum 15% tax rate.

**Example 2D-8 Liquidating distributions to corporate and noncorporate shareholders.**

Cree Exploration Co. (CEC), a PHC, adopts a plan of liquidation on July 1, and distributes all of its assets in complete liquidation on December 31. The corporation has \$30,000 of UPHCI for the year. One class of stock is outstanding. Bill Brown owns 100 shares of the outstanding stock and Mountain Exploration, Inc. (MEI) owns the remaining 50 shares. The liquidating distributions to Bill and MEI exceed their allocable shares of UPHCI of \$20,000 and \$10,000 respectively. Assuming CEC meets the special designation/reporting requirements for liquidating distributions paid to individuals, it may treat up to \$20,000 of the liquidating distribution to Bill as a dividend in computing the dividends paid deduction. Up to \$10,000 of the distribution to MEI is automatically treated as a dividend. What is the effect of the liquidating distributions on CEC and its shareholders?

CEC's UPHCI of \$30,000 is reduced to zero for the year by the dividends paid deduction. Bill is deemed to receive a dividend of \$20,000. His gain or loss on the liquidation is the excess of the total amount distributed to him (less the \$20,000 treated as a dividend) over his basis in CEC's stock. MEI treats its \$10,000 as part of its liquidating distribution from CEC in determining its gain or loss on the liquidation.

Distributions Made More Than 24 Months after Adoption of Liquidation Plan. Distributions made more than 24 months after adoption of a liquidation plan do not qualify for the dividends paid deduction. This is true even though the liquidating corporation was not found to be a PHC until after the plan was adopted and the corporation dissolved.

## Deducting Dividends Carried over from Prior Years

### Carryover of Dividends Allowed in Computing UPHCI

A current-year dividends paid deduction includes an allowance for dividends carried over from the two prior tax years. The amount allowed is the excess of the dividends paid deduction (without regard to a dividend carryover) in each prior year, over the UPHCI for that year (even if the corporation was not a PHC in one or both of the prior tax years).

If a corporation's dividends paid deduction exceeds its UPHCI in the second preceding year but not the first, it must reduce the carryover from the second preceding year by the excess of UPHCI over the dividends paid deduction in the first preceding year.

#### Example 2E-1 Carryover of dividends allowed in computing UPHCI.

Pueblo Corporation is a PHC in 2009, but was not one in 2007 or 2008. In 2007, its UPHCI (if it had been a PHC) would have been \$50,000, not including the \$75,000 of dividends it paid that would have qualified for the dividends paid deduction. For 2008, its UPHCI would have been \$65,000 not including the \$60,000 in dividends it paid. Pueblo's dividend carryover to 2009 is \$20,000, calculated as follows:

2007			
Dividends paid deduction	\$	75,000	
UPHCI		(50,000)	
Dividend carryover			\$ 25,000
2008			
Dividends paid deduction		60,000	
UPHCI		(65,000)	
Dividend carryover			(5,000)
Dividend carryover from 2007 and 2008 to 2009	\$		<u>20,000</u>

#### Example 2E-2 Negative amount in second preceding tax year.

See Example 2E-1. Assume the facts for the prior years were reversed and the 2007 carryover was a negative \$5,000 while the 2008 carryover was \$25,000. When the carryover from the first preceding year (2008) is positive, there is no requirement to reduce it by a negative amount from the second preceding year (2007). Therefore, Pueblo has \$25,000 of dividend carryover (from the 2008 tax year) to use in 2009.

### PHCs Included in an Affiliated Group

Some PHCs are members of an affiliated group of corporations filing or required to file a consolidated return. If such a PHC pays a dividend to another member of the group, the distribution is deductible in computing UPHCI assuming it otherwise meets the requirements for the dividends paid deduction.

## Reporting and Recordkeeping Requirements for the Dividends Paid Deduction

### Recordkeeping

Certain recordkeeping requirements are imposed on PHCs claiming a dividends paid deduction. The corporation is required to keep sufficient permanent records to establish that the dividends related to the deduction were actually paid during the tax year (e.g., canceled checks or receipts from shareholders for noncash dividends) and to supply the information required to be filed with the corporation's tax return.

### Reporting

The following items should be attached to the return for the year of the dividend:

1. A copy of the dividend resolution, if one exists.
2. A statement relating the facts of the dividend payment, including whether it was in cash or other property. (If it was a noncash payment, the statement should provide the property's adjusted basis and FMV at the payment date and details of how these amounts were determined.)

In addition to these general reporting requirements, special rules apply when liquidating distributions are made to noncorporate shareholders. For these types of distributions, the PHC must designate what portion of the distribution is to be treated as a deductible dividend for purposes of the UPHCI calculation. This designation is accomplished by:

1. claiming the dividends paid deduction for such distribution in the return for the year, or in respect of which, the dividend is made;
2. including the amount as a dividend on a Form 1099-DIV filed with the IRS and sent to the shareholders;
3. indicating on the Form 1099-DIV to the shareholder that it has been designated as a dividend under IRC Sec. 316(b)(2)(B) and Reg. 1.316-1(b)(5); and
4. attaching to the PHC's return on which the deduction is claimed a schedule indicating all the facts necessary to determine the noncorporate shareholders' allocable share of UPHCI for the year in which, or in respect of which, the distribution is made.

### Dividend Carryover

A corporation claiming a dividend carryover must include a statement with its return that includes the following information: (1) the amount of the carryover claimed, (2) a detailed computation showing how the carryover amount was determined, and (3) any other material facts relevant to the dividend carryover.

### Consent Dividends

To elect to use consent dividends to reduce UPHCI, the shareholder must complete Form 972 (Consent of Shareholder To Include Specific Amount in Gross Income) and provide it to the corporation by the extended due date of the corporate income tax return. This form can be signed only by shareholders who held stock on the last day of the corporation's tax year (i.e., those are the only shareholders allowed to make the consent). By completing Form 972, the shareholder agrees to include the amount of the consent dividend in taxable income for the calendar year in which the corporation's tax year ends. The corporation should attach Forms 972 received from the shareholders to its return.

Form 973 (Corporation Claim for Deduction for Consent Dividends) must be executed by the corporation and filed with its tax return. Form 973 supports the consent dividend deduction shown on Form 1120, Schedule PH [U.S. Personal Holding Company (PHC) Tax], which is also part of the corporation's return.

Although not actually required by the regulations, it is prudent to have a consent dividend documented in the corporate minutes when the actual cash is paid. This is to ensure the consent dividend and cash are considered part of the same distribution.

It may be possible to obtain an extension for making this election if the corporation has acted reasonably and in good faith in failing to make the election in a timely manner. Such a failure will normally arise when a corporation does not realize it is a PHC when it files its return for a particular year and, thus, is not aware of the need to make the consent dividend election. Request for such relief must be made in a letter to the IRS presenting all the facts and circumstances surrounding the failure.

## Computing the PHC Tax and Filing Schedule PH

### Reporting the Status of a Corporation as a PHC

A corporation that meets the definition of a PHC must file Form 1120, Schedule PH [U.S. Personal Holding Company (PHC) Tax] with its income tax return, enter the amount of the PHC tax on line 8 of Schedule J (Tax Computation) of Form 1120, and check box A2 on page 1 of Form 1120.

### Calculating the PHC Tax

Undistributed personal holding company income (UPHCI) is calculated and reported on Part I of Form 1120, Schedule PH [U.S. Personal Holding Company (PHC) Tax].

A PHC's computation of its PHC tax liability is straightforward once UPHCI has been determined. The PHC tax is 15% (for 2003–2010) of UPHCI. No provision is made for any tax credits or other deductions against the tax. The PHC tax is calculated in Part III of Schedule PH.

A personal holding company should attach Schedule PH to its income tax return, Form 1120, for the year, even if no PHC tax is owed. Part II of Schedule PH and the worksheet provided in the instructions can be used to determine if a corporation is a PHC.

#### Example 2G-1 Calculating the PHC tax.

Assume the same facts as in Examples 2C-1 through 2C-4. In 2009, Green paid owner Jim Greenlee a \$3,275 cash dividend. An additional \$3,000 dividend was paid in January 2010. [The deduction for dividends paid after year-end is limited to the lesser of (1) the amount paid (\$3,000) or (2) 20% of the amount actually paid during the tax year—\$655 ( $\$3,275 \times 20\%$ ).]

Green's PHC income for 2009 is as follows:

Dividends	\$ 10,000
Interest income (\$1,000 of which is related to a federal tax refund received during the year)	5,000
Rental income	45,000
Rental expenses (depreciation, taxes, and interest expense)	5,000
Copyright royalties	6,000
Rental income from Jim for corporate property used by him	1,000
Fee received under a contract that specifically required Jim to perform the work	3,000

Green's adjusted ordinary gross income for 2009 is assumed to be \$100,000.

A schedule PH will show a computation of Green's total PHC income. Since Green's PHC income of \$64,000 is more than 60% of the adjusted ordinary gross income, Green is a personal holding

company for 2009. Unless Jim agrees to a consent dividend of at least \$4,345 (undistributed personal holding company income), Green will owe PHC tax of \$652 ( $\$4,345 \times 15\%$ ). Green will need to file this Schedule PH along with its Form 1120. The tax liability shown on Schedule PH is carried to Schedule J, Form 1120.

### Statute of Limitations

If a PHC fails to file the proper information with its income tax return, the statute of limitations period for assessment and collection of PHC tax increases from three to six years.

### Foreign Corporations

A foreign corporation that (1) is a PHC for any tax year and (2) fails to file Form 1120, Schedule PH, must pay a penalty of 10% of its U.S. income tax for the year (including the PHC tax). This penalty is in addition to any other penalties to which the corporation is subject.

## Reducing PHC Tax by Paying Deficiency Dividends

### Deficiency Dividends May Reduce PHC Tax

A deficiency dividend is a distribution paid by a corporation after a determination is made that it is a PHC. For this purpose, a determination includes:

1. a final decision of the Tax Court (generally, a decision becomes final 90 days after an opinion is entered, assuming there is no appeal) or a final decision of another court of competent jurisdiction (e.g., a District Court or Court of Federal Claims);
2. a closing agreement under IRC Sec. 7121; or
3. an agreement between the corporation and the Area Director generally entered into on Form 2198 (Determination of Liability for Personal Holding Company Tax).

The result of a determination under one of these agreements or decisions will be an assessment of the appropriate PHC tax plus interest and penalties on the underpayment of tax. Such an agreement could cover more than one tax period. Therefore, the total amount owed by the corporation could be substantial.

The corporation has one final opportunity to reduce this liability by paying out a deficiency dividend. Such a payment benefits the corporation by reducing or eliminating the 15% penalty tax. The recipient shareholders are taxed on the dividends at a maximum 15% rate for 2009.

If failure to pay the PHC tax was due to fraud with intent to evade tax or willful failure to file a tax return, the corporation may not use a deficiency dividend to avoid PHC tax.

To reduce UPHCI, the deficiency dividend must be paid within 90 days after a determination is made that the corporation is a PHC. Within 120 days of the determination, but after the distribution is made, the corporation must file a claim for the deficiency dividend deduction. The claim is filed on Form 976 (Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust), along with a certified copy of the board of directors' resolution or other authorization of payment of the deficiency dividend. A PHC files Form 976 with the IRS office where the determination of personal holding company status was made. If filing Form 976 results in a tax overpayment, the corporation must also file an amended return to seek a refund.

#### **Example 2H-1 Using deficiency dividends to avoid the PHC tax.**

Kay Bob Jones and Billy Bob Babbit are equal owners of The Bobs Corp. (TBC). TBC's 2006 income tax return was audited and the agent determined the corporation should have been treated as a PHC

for that year. TBC protested the assessment of \$15,000 (before interest and penalties) on \$100,000 of UPHCI and took the matter to Tax Court, but lost. TBC does not appeal the decision. The Tax Court's decision was rendered on July 13, 2009 and becomes final 90 days after that date, October 11, 2009. TBC's deadline for paying a deficiency dividend to its shareholders to avoid the PHC tax is January 9, 2010, which is 90 days after the Tax Court's decision becomes final.

To claim a deduction for the deficiency dividend, TBC must file Form 976 within 120 days of the date the Tax Court decision became final. Therefore, it is due on February 18, 2010. The completed Form 976 for TBC will show distribution of a \$100,000 deficiency dividend paid by January 9, 2010.

Kay and Billy must include the dividend (\$50,000 to each) in their taxable income for the tax year it is received.

### **Determination of PHC Status after Corporation Has Liquidated**

A corporation that has liquidated and filed its final return evidently cannot make a deficiency dividend if the IRS subsequently determines that the corporation was a PHC in its final year.

#### **Example 2H-2 Determination of PHC status after corporation has liquidated.**

ABC liquidated on January 27, 2009 under a plan of liquidation adopted in the preceding year. In May 2009, the IRS determined that the corporation had been a PHC for several years before its liquidation. Two months later, ABC's board of directors passed a resolution retroactively designating the liquidating distribution as a dividend to the extent of undistributed PHC income (UPHCI). The liquidating distribution made in January 2009 does not qualify as a deficiency distribution that will eliminate the PHC tax.

The funds were distributed before ABC was determined to be a PHC. Thus, the distribution was not made within 90 days after the date of the determination. However, since the distribution was made within 24 months after adoption of a plan of liquidation, it is subject to the dividends paid deduction to the extent of ABC's UPHCI for the taxable year ending January 27, 2009.

#### **Example 2H-3 Distributions made after liquidation are not deficiency dividends.**

In 2009, EFG, Inc. made liquidating distributions of all its assets to its shareholders, Jill and Jack. The corporation conducted no business after the distributions were made. In February 2009, the IRS determined that EFG had been a PHC and was liable for PHC tax for 2006. On March 27, 2009, a bank account was opened in EFG's name and Jill and Jack deposited their own funds in that account. On the same day, EFG distributed to Jill and Jack "deficiency dividends" of approximately the same amount as they had deposited in the bank.

The distributions to Jill and Jack do not qualify as deficiency dividends. Under similar facts, the Tax Court ruled in *Callan* (and the Ninth Circuit agreed) that the distributions to the shareholders were not actual corporate distributions. The Tax Court stated, however, that even if the distributions were genuine, distributions made more than 24 months after adoption of a plan of liquidation do not qualify for the dividends paid deduction. Furthermore, since the corporation was dormant (i.e., had no assets and engaged in no business), it could not make distributions that qualify as deficiency dividends.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. If a corporation is classified as a personal holding company, what is the typical method of minimizing the penalty tax?
- a. Paying down debt.
  - b. Declaring dividends.
  - c. Through paying dividends.
28. Sunny Dale is a calendar-year PHC. Prior to any deduction for dividends, SD had \$40,000 of UPHCI. During the year, it paid \$38,000 of dividends qualifying for the UPHCI dividends paid deduction. Therefore, SD's net UPHCI is \$2,000. On March 1 of the following year, SD paid an additional dividend of \$2,500 that meets the rules for the dividends paid deduction. How much of the additional dividend can SD use to reduce its UPHCI to zero by electing to treat dividends paid after the close of the tax year as if paid during the tax year?
- a. \$0.
  - b. \$2,000.
  - c. \$2,500.
29. Which of the following would **not** be eligible to be considered a consent dividend?
- a. A dividend in excess of the larger of a corporation's E&P or remaining UPHCI.
  - b. A dividend, if paid in cash, would be considered a preferential dividend.
  - c. A dividend made with respect to consent stock owned on the first day of the corporation's tax year.
  - d. A dividend paid to a nonforeign shareholder.
30. Which form is filed by the corporation to support the consent dividend deduction?
- a. Form 972.
  - b. Form 973.
  - c. Form 976.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. If a corporation is classified as a personal holding company, what is the typical method of minimizing the penalty tax? **(Page 65)**
- Paying down debt. [This answer is incorrect. Paying down debt of a PHC is not the typical method of minimizing the penalty tax since this will not discourage the PHC from accumulating earnings.]
  - Declaring dividends. [This answer is incorrect. Declaring dividends of a PHC is not the typical method of minimizing the penalty tax since this will not keep the PHC from accumulating earnings.]
  - Through paying dividends. [This answer is correct. PHCs are classified as such because they primarily have investment type earnings. The main purpose of the tax is to discourage the accumulation of earnings from investment-type activities, the distribution of these earnings as dividends will reduce the impact of the PHC tax.]**
28. Sunny Dale is a calendar-year PHC. Prior to any deduction for dividends, SD had \$40,000 of UPHCI. During the year, it paid \$38,000 of dividends qualifying for the UPHCI dividends paid deduction. Therefore, SD's net UPHCI is \$2,000. On March 1 of the following year, SD paid an additional dividend of \$2,500 that meets the rules for the dividends paid deduction. How much of the additional dividend can SD use to reduce its UPHCI to zero by electing to treat dividends paid after the close of the tax year as if paid during the tax year? **(Page 65)**
- \$0. [This answer is incorrect. Sunny Dale can apply some of the March 1 dividend towards the previous year to reduce UPHCI due to an exception to the general rule of UPHCI.]
  - \$2,000. [This answer is correct. Sunny Dale can reduce UPHCI to zero by electing to treat \$2,000 of the dividends paid after the close of the tax year as if paid during the tax year.]**
  - \$2,500. [This answer is incorrect. Sunny Dale should not elect to use all of the March 1 dividend since SD's net UPHCI is not \$2,500 or more.]
29. Which of the following would **not** be eligible to be considered a consent dividend? **(Page 67)**
- A dividend in excess of the larger of a corporation's E&P or remaining UPHCI. [This answer is incorrect. According to consent dividend rules, consent dividend cannot exceed the greater of a corporation's E&P or remaining UPHCI.]
  - A dividend, if paid in cash, would be considered a preferential dividend. [This answer is incorrect. A consent dividend cannot include any amount that, if paid in cash, would be a preferential dividend.]
  - A dividend made with respect to consent stock owned on the first day of the corporation's tax year. [This answer is incorrect. A consent dividend can only be made with respect to consent stock owned on the last day of the corporation's tax year due to the rules governing consent dividends.]
  - A dividend paid to a nonforeign shareholder. [This answer is correct. Consent dividends paid to a foreign shareholder cannot be taken into account for the dividends paid deduction unless the corporation pays an amount equal to the withholding tax that would have been due had an actual cash dividend been paid on the last day of the tax year. Dividends paid to domestic shareholders could be considered consent dividends.]**
30. Which form is filed by the corporation to support the consent dividend deduction? **(Page 71)**
- Form 972. [This answer is incorrect. Form 972, *Consent of Shareholder to Include Specific Amount in Gross Income*, is provided by the shareholder to the corporation. By completing this form, the shareholder agrees to include the amount of the consent dividend in taxable income for the calendar year in which the corporation's tax year ends.]

- b. Form 973. [This answer is correct. Form 973, Corporation Claim for Deduction for Consent Dividends, is executed by the corporation and filed with its tax return. This form supports the consent dividend deduction.]**
  
- c. Form 976. [This answer is incorrect. Form 976, Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust, is filed by a corporation to claim the deficiency dividend deduction.]



**EXAMINATION FOR CPE CREDIT****Lesson 2 (T20TG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

16. What determines personal holding company status?
- At least 60% of the corporation's adjusted ordinary gross income is derived from dividends, interest income, royalties, adjusted rental income, section 1245 gains, or similar income.
  - More than 50% of the value of the corporation's outstanding stock is owned by five or fewer persons on any day during the last half of the corporation's tax year.
  - More than 50% of the value of the corporation's outstanding stock is owned by five or fewer persons on any day during the last half of the corporation's tax year and at least 60% of the corporation's adjusted ordinary gross income is derived from dividends, interest income, royalties, adjusted rental income, section 1245 gains, or similar income.
  - At least 60 % of the corporation's net income must be derived from domestic sources.
17. What is the rate of the PHC tax for tax years 2003-2010?
- 5%.
  - 10%.
  - 15%.
  - 20%.
18. Which of the following types of income is **not** PHC income?
- Royalty income.
  - Gross receipts.
  - Annuities.
  - Section 1245 gains.
19. Match the appropriate type of entity to whether they would be (a) automatically exempt from the PHC tax (b) possibly subject to the PHC tax or (c) not qualifying for PHC status:
- corporations in bankruptcy
  - large publicly & widely held C corporations
  - S corporations
  - corporation 40% owned by 3 individuals
  - surety companies
  - corporation 60% owned by 3 individuals
- 1a, 2c, 3a, 4c, 5a, 6b.
  - 1a, 2c, 3b, 4c, 5b, 6b.
  - 1c, 2a, 3a, 4b, 5a, 6b.
  - 1a, 2c, 3a, 4c, 5a, 6a.

20. A corporation can avoid the classification as a PHC if it does not pass the stock ownership test. Would the following company be classified as a PHC based on the following information?

The common stock is owned equally by 20 individuals, while another individual owns 100% of the preferred stock for a total of 21 shareholders. None of the shareholders are related. The preferred stock represents 60% of the value of the corporation.

<u>Shareholder</u>	<u>Voting Power</u>	<u>Number of Shares</u>
Preferred shareholder	20%	2,000
Any four of the common shareholders	16%	1,600

- Yes, the corporation would be classified as a PHC.
  - No, the corporation would not be classified as a PHC.
  - Do not select this answer choice.
  - Do not select this answer choice.
21. Which of the following accurately defines constructive ownership as it pertains to determining the number of shareholders and shares of stock owned for determining PHC status?
- Shareholders may be deemed to own more stock than they have actually been issued.
  - Shareholders may be deemed to own less stock than they have actually been issued.
  - Shareholders may not sell stock that is constructively received.
  - Shareholders may be deemed to own less stock than they have actually been issued and they may not sell stock that is constructively received.
22. The accumulated earnings tax—
- Is 15% of a PHCs undistributed earnings.
  - Applies to S corporations.
  - Does not apply to PHCs.
  - Is 15% of a PHC's distributed earnings.
23. Which of the following forms is used to calculate and report UPHCI?
- Form 972.
  - Form 1042.
  - Form 1120, Schedule PH.
  - Form 1120, Part I, Schedule PH.

24. Casual Living is a personal holding company. The entity has an accumulation of earnings from investment type activities. What is the best method for reducing the PHC tax?
- Paying operational expenses.
  - Paying dividends.
  - Declaring dividends.
  - Board of director perks.
25. Which of the following dividends would be nondeductible when computing undistributed personal holding company income?
- Deficiency dividends.
  - Preferential dividends.
  - Consent dividends.
  - Liquidating dividends.
26. Tattle Tale is a calendar-year PHC. Prior to any deduction for dividends, TT had \$60,000 of UPHCI. During the year, it paid \$22,000 of dividends qualifying for the UPHCI dividends paid deduction. Therefore, TT's net UPHCI is \$38,000. On March 1 of the following year, TT paid an additional dividend of \$30,000 that meets the rules for the dividends paid deduction. How much of the additional dividend can TT use to reduce its UPHCI by electing to treat dividends paid after the close of the tax year as if paid during the tax year?
- \$4,400.
  - \$4,800.
  - \$22,000.
  - \$30,000.
27. Which of the following dividends can reduce Undistributed PHC Income, increase the shareholder's stock basis, and yet not actually be paid out?
- A dividend.
  - A consent dividend.
  - A liquidating dividend.
  - A preferential dividend.
28. Distributions made \_\_\_\_\_ an adoption of a liquidation plan do not qualify for the dividends paid deduction.
- Less than 10 days before.
  - Less than 12 months before.
  - More than 6 months after.
  - More than 24 months after.

29. Mix It is a calendar-year corporation. It meets the definition of a PHC due to its large amount of rental income. Which of the following items will the PHC tax liability be calculated on?
- a. PHC income.
  - b. Undistributed PHC Income.
  - c. Adjusted Ordinary Gross Income.
  - d. Ordinary Gross Income.
30. A deficiency dividend determination would **not** include—
- a. A resolution made by the board of directors.
  - b. A final decision of the Tax Court.
  - c. A closing agreement under IRC Sec. 7121.
  - d. An agreement between the corporation and the Area Director.

## GLOSSARY

**Accumulated Current Earnings (ACE) Adjustment:** The adjustment used in computing the alternative minimum tax to take account of the difference between earnings reported for financial purposes as opposed to tax purposes.

**Affiliated Group:** A group of includible corporations under sufficient common control to qualify for the privilege of filing a consolidated income tax return. A consolidated return is unavailable to foreign and possession corporations which make the section 336 election(e), regulated investment companies, real estate investment trusts, domestic international sales corporations (DISCs), and former DISCs. There must be one or more chains of includible corporations connected through stock ownership with a common parent corporation "at least 80 percent" of the voting power of all stock and 80 percent or more of the value of all outstanding stock of each corporation (except the common parent) is directly owned by the other corporations. The common parent must own at least 80 percent of the voting power of all outstanding stock and at least 80 percent by value of all outstanding stock of at least one of the other corporations. Convertible preferred and preferred with a higher than market rate yield are both considered stock for these purposes. One disregards preferred stock, meaning nonparticipatory, nonconvertible stock with a reasonable liquidating or redemption preference or premium.

**Alternative Minimum Tax:** An extremely intricate tax designed to flush out income that has been concealed by clever tax planning, by individuals, trusts, estates, and corporations. Its base is the excess of the tentative minimum tax for the taxable year over the regular tax (as modified by § 55(c) with respect to certain tax credits) for the taxable year. § 55(a). The tentative minimum tax is basically 26 percent up to \$175,000 (for married taxpayers) and 28 percent of the excess (20 percent for corporations) of the taxpayer's alternative minimum taxable income (AMTI) minus an exemption amount ranging from \$22,500 to \$45,000, in the case of individuals, from \$31,275 to \$62,550 (for 2006) with a lower exemption amount for Kiddie tax purposes, depending on the taxpayer. § 55(b). Those exemption amounts phase out (i.e., gradually disappear) for high income taxpayers. § 55(d)(3). Adjusted net capital gains are generally taxed at the same rates for AMT purposes as for regular tax purposes. § 55(b)(3)(B) and § 55(c). By far the most difficult aspect of the tax is determining its base, which consists of a series of adjustments to taxable income under § 56 and the inclusion of items of tax preference under § 57. Once the tax is established it becomes the tax for the year if it is higher than the regular tax. Finally, § 53 contains an alternative minimum tax credit which can be carried forward to future years and used as a credit against future years, to the extent that regular tax liability for that year exceeds minimum tax liability for that year; however, it is available only for application against so-called deferral preferences and not exclusion preferences, for example, depreciation as opposed to tax-exempt interest. To make things more complex, for the year the minimum tax might apply, one subtracts all tax credits from regular tax credits, but only reduces alternative minimum taxes by the foreign tax credit and refundable personal tax credits under §§ 21–26. The alternative minimum tax foreign tax credit has its own alternative minimum tax foreign tax credit limitation. To soften the blow, to the extent that any nonrefundable credits are unused as a result of this gyrations, they too are carried forward for application against future regular taxes. See H. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-261 (1986). The 1990 Act added an alternative tax energy preference deduction to encourage domestic oil and gas exploration. Because C corporations get a credit for deferred preferences and exclusion preferences, they can escape the tax completely if they can get into a non-AMT year. Small corporations are exempt from the AMT.

**Alternative Minimum Taxable Income (AMTI):** The base of alternative minimum tax (AMT), i.e., the taxpayer's tentative minimum tax for the taxable year minus the regular tax for the year. § 55(a). The calculation is ornate. Its elements are as follows: (1) taxable income (or the analogous base, such as unrelated business taxable income) less income that qualified for the possessions tax credit; (2) plus or minus adjustments in determining the AMT; (3) plus items of the preference; (4) less an exemption amount (ranging from \$45,000 to \$22,500, depending on the taxpayer). Taxpayers then (5) multiply the resulting number by the applicable tax rate (20 percent for corporations and 21 percent for other taxpayers), (6) subtract the alternative minimum tax foreign tax credit (items 1-6 yield tentative minimum tax), and (7) subtract the regular tax. See § 55(a)–55(b). A portion of the AMT is allowed as a credit against later years' regular income taxes. Only deferral preferences (not exclusion preferences) produce this benefit. § 53(a), (b) and (d). One applies the passive loss rules in modified form (§ 58(b)) and denies tax shelter farm losses (§ 58(a)).

**Alternative Tax Net Operating Loss (ATNOL):** A modified version of the net operating loss deduction (§ 172) used as an adjustment in determining alternative minimum taxable income. It is calculated in the first instance by applying alternative minimum tax concepts (e.g., adding back items of tax preference), denying losses from tax shelter farm

activities and applying the passive loss rules and is further modified by: (1) limiting the deduction to 90 percent of alternative minimum taxable income; and (2) not adding back the items of tax preference to the extent they did not increase the loss for regular tax purposes. § 56(d)(1). There are also minor modifications which are primarily in the nature of transition rules.

**AMT Adjustments:** Adjustments used to increase alternative minimum taxable income. They appear in § 56. Section 57 contains items of tax preference, but the difference between the two is historical and semantic.

**Consent Dividend:** A dividend deemed paid (hence deductible) by personal holding companies and corporations subject to the accumulated earnings tax. This imaginary dividend is made by election, and it is treated as a year-end dividend, followed by an imaginary contribution of such amounts back to the paying corporation. § 565(c). The election calls for shareholder consents, filed with the tax return, and may be made up to the date for filing the corporation's tax return. § 565(a); Reg. § 1.565-1. Such dividends must not be preferential, and amounts that would not have qualified as a dividend if they actually had been paid are not considered part of the consent dividend. § 565(b).

**Deficiency Dividend, Personal Holding Company:** A procedure designed to alleviate the personal holding company tax after liability for the tax has been established. § 547. It permits the corporation to distribute a dividend and to use the dividend to reduce retroactively the corporation's personal holding company tax liability (but not interest and civil tax penalties). The shareholders are taxed in the year of the dividend, but the corporation is entitled to a complete or partial refund of its liability for the tax. The rules are applied strictly; the most treacherous requirement is that there must be a "determination" of the tax (i.e., Tax Court or other court's decree, order, or judgment, or a closing agreement, or other specified agreement between the corporation and the IRS). § 547(c). The dividend qualifies only to the extent it would have been deductible under § 561 if paid in the year for which the tax liability is assessed, and then only if actually paid out within 90 days of the determination. § 547(d)(1). The deficiency dividend procedure tends to render the personal holding company tax a paper tiger. See determination, personal holding company tax.

**Minimum Tax Credit:** A nonrefundable credit against regular income tax liabilities attributable to the portion of the taxpayer's alternative minimum tax liability attributable to timing differences (known as deferral preferences). For most taxpayers the basis for the credit is the "adjusted net minimum tax", which equals the alternative minimum tax paid for the taxable year, less the amount of minimum tax liability that would have arisen if the only items of tax preference and adjustments were exclusion preferences (i.e., preferences and adjustments other than deferral preferences). § 53(d)(1)(B)(i). Corporations can use exclusion preferences also in computing the credit for post-1989 credits. § 53(d)(1).

**Personal Holding Company:** Generally, a closely-held corporation earning excessive amounts of certain types of income. The Code defines it as any corporation: (1) at least 60 percent of whose adjusted ordinary gross income (AOGI) for the taxable year is personal holding company income; and (2) more than 50 percent in value of whose outstanding stock is owned directly or indirectly, actually or constructively, by no more than five individuals at any time during the last half of the taxable year. § 542(a); Reg. § 1.542-1. Corporations excluded from the definition of personal holding company include tax-exempt corporations, banks, building and loan associations, REITs, certain lending or finance companies, surety companies, life insurance companies, foreign personal holding companies, most corporate bankrupts, certain other foreign corporations, and certain small business investment companies that are licensed by the Small Business Administration. § 542(c). For purposes of this provision, the attribution rules set forth in § 544 are applicable; furthermore, certain organizations are deemed individuals: an employee benefit trust under § 401(a); a supplemental unemployment benefits trust described in § 509(a); and a portion of a trust permanently set aside or to be used exclusively for the charitable purposes described in § 642(c). § 542(a)(2). Once characterized as a personal holding company, the corporation is subject to a 50-percent surtax (i.e., in addition to the regular corporate income taxes) on its undistributed personal holding company income. § 541. However, corporations classified as personal holding companies are exempt from the accumulated earnings tax under § 531. § 532(b)(1); Reg. § 1.541-1. Certain other limitations are also applicable to a personal holding company. For example, § 267(a)(1), denying the deduction of losses incurred on sales or exchanges between related taxpayers applies to transactions between two corporations under common control if one corporation is a personal holding company. The Tax Reform Act of 1984 in effect lets personal holding companies become regulated investment companies (mutual funds) if they have no earnings and profits (E & P) or pay out their E & P. Undistributed investment

company income, however, would be taxed at top corporate federal income tax rates. See § 851(a), 852(b)(1) and 852(e).

**Personal Holding Company Income:** Gross income of certain passive investment and personal service varieties that may taint a corporation as a personal holding company, if other tests under § 542(a) are met. Section 543(a) defines the term as that portion of the adjusted ordinary gross income (AOGI) that consists of: (1) dividends, with an exception of certain dividends from qualified bank holding companies; (2) actual and imputed interest, other than certain interest earned by broker-dealers; (3) royalties (other than those described in items (6), (7), and (8) below); (4) annuities; (5) rents (excluding, inter alia, active business software royalties); (6) mineral, oil, and gas royalties; (7) copyright royalties; (8) produced film rents; (9) compensation for use of corporate property by shareholders; (10) income from personal service contracts; and (11) income from estates and trusts. § 543; Reg. § 1.543-1. See Prop. Reg. § 1.543-3 to 1.543-12. This concept is essential in determining the personal holding company status of the corporation. If at least 60 percent of the corporation's AOGI is personal holding company income and if the stock ownership test (more than 50 percent owned by five or fewer individuals, trusts, or exempt organizations) is also satisfied, the corporation is a personal holding company. § 542(a). Distributions in partial liquidation to a corporate shareholder are also personal holding company income if such distributions would otherwise be dividends. § 543(a)(1). See annuities, personal holding company income; compensation for use of corporate property by shareholders, personal holding company income; copyright royalties, personal holding company income; dividend, personal holding company income; interest, personal holding company income; produced film rents; qualified bank holding company, personal holding company income; rents, personal holding company income; royalties, personal holding company income.

**Tentative Minimum Tax:** A building block for calculating the alternative minimum tax. In the case of individuals it is: (1) 24 percent x (alternative minimum taxable income less an exemption amount); (2) minus the foreign tax credit. See § 55(b). One uses a 20 percent rate for corporations. To the extent the tentative minimum tax exceeds the regular tax, (even if that tax is not based on taxable income) there is an alternative minimum tax bill. See alternative minimum tax.

**Undistributed Personal Holding Company Income (UPHCI):** the base on which the personal holding company tax is calculated. The term refers to the taxable income, as adjusted, of a personal holding company less the dividends-paid deduction of § 561. § 545(a). The following are deducted from taxable income: (1) accrued federal income taxes (other than the personal holding company tax and the accumulated earnings tax); (2) net capital gain less associated taxes; and (3) excess charitable contributions beyond the 10-percent limit for corporations (up to the limitations imposed on individuals). The following are added to taxable income: (1) the dividends-received deduction; (2) certain fairly rare deductions allowed corporations in § 241–250 (other than the deduction for organizational expenditures); (3) net operating loss carryovers or carrybacks; and (4) under certain conditions, business expenses and depreciation attributable to nonbusiness property owned by the corporation. § 545(b); Reg. § 1.545-2. There is a special deduction for amounts paid or set aside to amortize certain qualified indebtedness in the case of certain pre-1964 corporations. § 545(c); Reg. § 1.545-2. The dividends-paid deduction of § 561 is the sum of: (1) dividends paid during the taxable year; (2) consent dividends of § 565; and (3) the dividend carryover of § 564. The deficiency dividend of § 547, which is also deductible, may radically mitigate the corporation's personal holding company tax liability. The practical effect of the undistributed income mechanism is to determine the corporation's economic ability to distribute earnings from sources other than capital gains.



# INDEX

## A

### ALTERNATIVE MINIMUM TAX

- Adjusted current earnings (ACE) adjustment
  - Computation of ..... 14
  - Consolidated groups ..... 14
  - Depletion ..... 14
  - Depreciation ..... 14
  - Discharge of indebtedness income ..... 14
  - Dividends received deduction ..... 14
  - Earnings and profits ..... 14
  - Federal tax refunds ..... 14
  - Installment sales ..... 14
  - Intangible drilling costs ..... 14
  - Life insurance ..... 14
  - LIFO recapture ..... 14
  - Organizational costs ..... 14
  - Ownership change, effect of ..... 33
- Adjustment items
  - Basis adjustment ..... 11
  - Bonus depreciation ..... 11
  - Circulation expenses ..... 35
  - Depreciation ..... 11, 35
  - Domestic production activities deduction ..... 11
  - Election to forgo for minimum tax credit ..... 11
  - Long-term contracts ..... 11, 35
  - Mining exploration and development costs ..... 35
  - Passive activity losses ..... 32
  - Table ..... 11
- Alternative tax NOL ..... 24
- Basis adjustment ..... 11
- Carryover of suspended passive losses ..... 32
- Circulation expenses, election to minimize adjustment ..... 35
- Closely held corporation ..... 32
- Computation of ..... 10
- Computing year of change ..... 10
- Consolidated groups ..... 33
- Credits against ..... 22
  - Foreign tax credit ..... 22
  - General business credit ..... 22
  - Specified credits ..... 22
- Deferral of deductions ..... 35
- Depletion ..... 35
- Elections to minimize ..... 35
- Energy preference deduction
  - Calculation of ..... 10, 35
  - IDC preference, defined for purposes of ..... 35
- Exemption
  - Amount ..... 10
  - Phase-out ..... 10
- Insolvent corporation, passive activity loss deduction ..... 32
- Intangible drilling costs ..... 27, 35
- Life insurance, effect of ..... 14
- Long-term contracts ..... 11, 35
  - Worksheet W201 ..... 11, 35
- Minimizing ..... 35
- Minimum tax credit
  - Carryover ..... 27
  - Computation of ..... 27
  - In lieu of bonus depreciation ..... 27
  - Limitation of ..... 27
  - Tax-exempt interest ..... 13
  - Worksheet W202 ..... 27
- Mining exploration and development costs ..... 35
- Net operating loss, alternative tax
  - Limitation on ..... 24
- Organizational costs ..... 14
- Ownership change, effect of ..... 33
- Passive losses ..... 32
- Personal service corporations ..... 32
- Preference items
  - Depreciation ..... 13

- In lieu of bonus depreciation ..... 27
- Table ..... 13
- Tax-exempt interest ..... 13
- Short tax years ..... 33
- Small corporations not subject to
  - Aggregation rules ..... 3
  - New corporations ..... 3
- Wages subject to targeted jobs tax credit ..... 33
- Year of liquidation ..... 24

### AMORTIZATION

- Mining exploration and development costs ..... 35

### ATTRIBUTION OF OWNERSHIP

- Personal holding companies ..... 43

## B

### BASIS

- Alternative minimum tax adjustment ..... 11
- Stock
  - Consent dividends effect on ..... 65

## C

### CAPITAL GAINS

- Deduction for, personal holding company ..... 58

### CARRYBACK

- Alternative tax net operating loss ..... 24

### CHARITABLE CONTRIBUTIONS

- Alternative minimum tax ..... 14, 33
- Personal holding company, increased limit for UPHCI ..... 58

### CIRCULATION EXPENDITURES

- Alternative minimum tax adjustment ..... 11, 35

### CLOSELY HELD CORPORATIONS

- Passive activity loss rules
  - Defined for deductibility of ..... 32

## D

### DEFINITION

- Closely held corporation ..... 43
  - Passive activity losses, for purposes of ..... 32
- Deficiency dividend ..... 72
- Personal holding company ..... 43

### DEPLETION

- Alternative minimum tax
  - Adjusted current earnings ..... 14
  - Preference ..... 13

### DEPRECIATION

- ACE depreciation rules ..... 14
- Alternative depreciation system (ADS) ..... 35
- Alternative minimum tax
  - Adjusted current earnings ..... 14
  - Adjustment ..... 35
  - Allowable depreciation methods ..... 35
  - Election of AMT depreciation ..... 35
- Election
  - Alternative method ..... 35
- Methods
  - AMT depreciation rules ..... 35
- Passive activity loss rules ..... 32
- Qualified property subject to bonus depreciation ..... 11

### DIVIDENDS

- Appreciated property ..... 65
- Consent ..... 65, 71
- Deduction for

- Carryover for personal holding company ..... 69
- Dividends paid for personal holding company tax ..... 65, 69, 71
- Deficiency, undistributed personal holding company income ..... 72
- Earnings and profits ..... 65
- Paid
  - After year-end ..... 65, 71, 72
  - In excess of earnings and profits ..... 65
- Preferential ..... 65
- Property ..... 65
- Reduction of undistributed personal holding company income by
  - Consent dividends ..... 65
  - Deficiency dividends ..... 72
  - Dividend carryover ..... 69
  - Dividends paid after year-end ..... 65, 71, 72
  - Dividends paid during the year ..... 65, 71

**DIVIDENDS RECEIVED DEDUCTION**

- Alternative minimum tax ..... 14
- Personal holding company ..... 58

**E**

**EARNINGS AND PROFITS**

- Dividends paid ..... 65
- Reduction of undistributed personal holding company income by dividends paid out of ..... 65

**ELECTIONS**

- Alternative minimum tax
  - Avoiding ..... 35
  - Circulation expenses ..... 35
  - Depreciation ..... 35
  - IDC ..... 35
  - Mining development cost ..... 35
  - Mining exploration ..... 35
  - Simplified inventory election ..... 35
- Circulation expenses ..... 35
- Consent dividends ..... 65

**EXEMPTION**

- Amount, alternative minimum tax ..... 10

**F**

**FILING AND REPORTING REQUIREMENTS**

- Dividends paid deduction for a PHC ..... 69, 70, 71
- Forms, completed
  - 1120, Schedule PH (U.S. Personal Holding Company Tax) ..... 43, 58
  - 4626 (Alternative Minimum Tax—Corporations) ..... 10
  - 972 (Consent of Shareholders to Include Specific Amount in Gross Income) ..... 65
  - 973 (Corporation Claim for Deduction for Consent Dividends) ..... 65
  - 976 (Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust) ..... 72
- Personal holding company
  - Consent dividends ..... 65, 71
  - Dividend carryover ..... 69
  - Excess rental expenses ..... 58
  - Schedule PH ..... 71
  - Status as ..... 71
  - Statute of limitations, effect on ..... 71
- Rent received by personal holding company ..... 58, 71

**FOREIGN CORPORATION**

- PHC reporting requirement ..... 71

**I**

**INSOLVENT CORPORATIONS**

- Passive activity losses ..... 32

**INTANGIBLE DRILLING COSTS**

- Alternative minimum tax preference ..... 35
- Amortization ..... 35
- Election to minimize preference ..... 35

**L**

**LIFE INSURANCE**

- Adjusted current earnings, include in ..... 14

**LIQUIDATION**

- Distributions by a PHC ..... 70
- Personal holding company ..... 70

**LONG-TERM CONTRACTS**

- Alternative minimum tax ..... 11, 35
- Defined ..... 11

**M**

**MINING EXPLORATION AND DEVELOPMENT COSTS**

- Alternative minimum tax adjustment ..... 35
- Amortization ..... 35
- Election to minimize AMT adjustment ..... 35

**N**

**NET OPERATING LOSSES**

- Alternative tax net operating loss ..... 24
- Carrybacks and carryovers
  - Alternative tax NOLS ..... 24
  - Election to forgo carryback ..... 24
  - Personal holding company ..... 51, 58
- Personal holding company ..... 51, 58

**O**

**OIL AND GAS**

- AMT considerations ..... 14, 35

**ORGANIZATIONAL COSTS**

- Alternative minimum tax adjustment ..... 14

**P**

**PASSIVE ACTIVITY LOSS RULES**

- Alternative minimum tax ..... 32
- Carryover of ..... 32
- Closely held corporation ..... 32, 51
- Corporations subject to ..... 32
- Deduction of ..... 32
- Entities subject to rules
  - Closely held ..... 32
  - Personal service corporations ..... 32
- Entities subject to rules
  - Closely held ..... 51
- Insolvent corporations, AMT deduction for ..... 32
- Personal service corporations ..... 32
- Suspended losses
  - Closely held corporations ..... 32
  - Personal service corporations ..... 32
- Worksheet to track carryover ..... 32

**PENALTIES**

- Failure of foreign PHC to file Form 1120, Schedule PH ..... 71

**PERSONAL HOLDING COMPANY**

- Adjusted income from rents ..... 43

- Adjusted ordinary gross income ..... 43
- Affiliated groups ..... 43
- Alternative minimum tax
  - Circulation expenses as adjustment ..... 35
  - Depreciation as preference ..... 35
- At-risk rules applied to ..... 51
- Attribution of ownership (constructive ownership) ..... 43
- Avoiding or escaping PHC treatment ..... 43
- Capital gains, treatment of ..... 43
- Charitable contributions ..... 58, 71
- Circulation expenses, AMT preference ..... 13
- Consent dividends ..... 65, 71
- Consequences of status as ..... 51
- Constructive ownership ..... 43
- Contracts, personal service ..... 43
- Deficiency dividends ..... 72
- Defined ..... 43
- Dividend carryover ..... 69
- Dividends paid after year-end ..... 65, 71, 72
- Dividends paid deduction ..... 65, 69, 71, 72
- Dividends received deduction ..... 58
- Excluded corporations ..... 43
- Income taxes, deduction for ..... 58
- Income test ..... 43
- Liquidating distributions ..... 69
- Mineral royalties, adjusted ordinary gross income ..... 43
- Net capital gains, deduction for ..... 58, 71
- Net operating loss ..... 51, 58
- Ordinary gross income ..... 43
- Passive activity losses ..... 51
- PHC income ..... 43
- Preferential dividends ..... 65
- Rental expenses, excess ..... 58
- Rental income ..... 43
- Reporting requirement ..... 71
- Schedule PH ..... 70, 71
- S corporation not treated as ..... 43, 51
- Status as ..... 58, 71
- Statute of limitations ..... 71
- Stock ownership test ..... 43
  - Final year ..... 43
- Tax
  - Computation of ..... 71
  - Rate ..... 58, 71
- Tests for status as
  - Affiliated groups ..... 43
  - Income test ..... 43
  - Ownership test ..... 43

- Undistributed personal holding company income ..... 58, 65, 71, 72
- Worksheet for 60% PHC income test ..... 43

**PERSONAL SERVICE CORPORATIONS**

- Passive activity loss rules
  - Alternative minimum tax treatment ..... 32
  - Summary of limitations ..... 32
  - Suspended losses ..... 32

**R**

**RENTALS**

- Excess expenses, personal holding company ..... 58
- Personal holding company income
  - Rentals excluded from and included in ..... 43
- Produced film rents ..... 43

**ROYALTIES**

- Personal holding company income ..... 43

**S**

**STATUTE OF LIMITATIONS**

- PHC, reporting status as ..... 71

**T**

**TANGIBLE PROPERTY**

- Rental income excluded from personal holding company income ..... 43

**TAX-EXEMPT INTEREST INCOME**

- Preference item for AMT ..... 13
- Private-activity bonds ..... 11

**TAX EXPENSE**

- Undistributed personal holding company income ..... 58, 71

**TAX RATES**

- Personal holding company tax ..... 58, 71

**W**

- **WAR PROFITS TAX** ..... 58

**WORKSHEETS, COMPLETED**

- 80% personal holding company income test ..... 43
- Adjusted current earnings ..... 10
- AMT adjustment for long-term contracts ..... 11, 35
- Minimum tax credit carryover ..... 27
- Passive loss carryover ..... 32



**COMPANION TO PPC'S 1120 DESKBOOK**

**COURSE 2**

**ACCUMULATED EARNINGS TAX, CREDITS, AND TAX PAYMENTS (T20TG092)**

**OVERVIEW**

**COURSE DESCRIPTION:** This interactive self-study course covers important aspects of corporate taxation. Lesson 1 explains the accumulated earnings tax (AET) and how and why it is imposed on corporations. Lesson 2 deals with tax credits and how the credits are allowed to offset the regular tax liability of a corporation. Lesson 3 covers how and when income taxes should be paid.

**PUBLICATION/REVISION DATE:** October 2009

**RECOMMENDED FOR:** Users of *PPC's 1120 Deskbook*

**PREREQUISITE/ADVANCE PREPARATION:** Basic knowledge of tax preparation.

**CPE CREDIT:** 6 QAS Hours, 6 Registry Hours  
6 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at [www.nasba.org](http://www.nasba.org) for a listing of states that accept QAS hours.

**Enrolled Agents:** This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

**FIELD OF STUDY:** Taxes

**EXPIRATION DATE:** Postmark by **November 30, 2010**

**KNOWLEDGE LEVEL:** Basic

**Learning Objectives:**

**Lesson 1—Accumulated Earnings Tax**

Completion of this lesson will enable you to:

- Identify corporations subject to the AET, and the advantages and disadvantages of accumulating earnings.
- Describe how to claim the accumulated earnings credit.
- Explain how to report AET to the IRS and shift the burden of proof to the IRS.

**Lesson 2—Credits**

Completion of this lesson will enable you to:

- Explain the concept of the General Business Credit.
- Explain the ordering rules used for carrybacks and carryforwards of General Business Credits.
- Describe how to claim credits arising from passive activities and foreign tax credits.

### **Lesson 3—Tax Payments**

Completion of this lesson will enable you to:

- Explain the details of extending the time to pay income tax.
- Explain how estimated tax payments are calculated.
- Explain how to estimate tax payments for short tax years and members of a controlled group not filing a consolidated return; and explain the general rule to the penalty for underpayment of estimated tax.
- Determine interest on tax underpayments and overpayments.
- Explain how to deposit income tax.

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# Lesson 1: Accumulated Earnings Tax

## INTRODUCTION

The accumulated earnings tax (AET) is a penalty tax imposed on corporations for unreasonably accumulating earnings in the corporation. The tax rate on accumulated earnings is currently at 15%, the rate at which the earnings would be taxed if distributed. For tax years beginning after December 31, 2010, the accumulated earnings tax rate will correspond to the maximum individual tax rate. The tax is in addition to the regular corporate income tax and is assessed by the IRS, rather than being self-assessed by the taxpayer. This means there is no IRS form for reporting the AET.

### Learning Objectives:

Completion of this lesson will enable you to:

- Identify corporations subject to the AET, and the advantages and disadvantages of accumulating earnings and income.
- Describe how to claim the accumulated earnings credit.
- Explain how to report AET to the IRS and shift the burden of proof to the IRS.

Section 4.10.13.2 of the IRS Internal Revenue Manual covers the accumulated earnings tax. That section of the manual was last revised on March 30, 2005.

## Identify Corporations Subject to the Accumulated Earnings Tax (AET)

Corporations with substantial accumulated earnings face exposure to the accumulated earnings tax (AET). The tax is assessed by the IRS, rather than being self-assessed by the taxpayer.

The AET can be imposed on all corporations except the following (1) S corporations, (2) personal holding companies (PHCs), (3) tax-exempt organizations, (4) passive foreign investment companies, and (5) foreign personal holding companies.

If a consolidated return is not filed, corporations are generally treated as independent entities in regard to imposition of the tax. For example, a subsidiary corporation could be subject to the tax even though the parent corporation is not.

Associations taxable as corporations, as well as foreign corporations doing business in the U.S., are subject to the AET. Unlike the personal holding company (PHC) tax, the AET can be assessed regardless of the number of shareholders a corporation has. Thus, publicly held corporations are subject to AET, although the IRS has difficulty successfully asserting the tax against such corporations since their diverse ownership makes it difficult for the shareholders and corporations to agree on a common tax strategy. For example, in *Technalysis Corporation* the Tax Court held that the AET can apply to a publicly held corporation regardless of the concentration of ownership or whether the shareholders are actively involved in the corporation. However, the Tax Court held that the AET did not actually apply to the taxpayer, even though the company had excess accumulations, because the tax avoidance purpose was missing.

## Accumulate Earnings to Avoid Tax at the Shareholder Level

### Tax Avoidance Motive

The accumulated earnings tax (AET) applies when there is intent to avoid income tax at the shareholder level by accumulating earnings in the corporation. AET applies even when tax avoidance is not the dominant reason for the accumulation of income in the corporation, but rather is only one of several reasons.

The fact that a corporation is a mere holding or investment company is automatically considered evidence of the existence of a tax avoidance purpose, unless the corporation can establish to the satisfaction of the Commissioner

that it was not formed or availed of for a tax avoidance purpose. A holding company is a corporation in which there is practically no activity other than the holding of investment property. An investment company is one that buys and sells stock, securities, real estate, and other investment property, in addition to holding investment property. Corporations are generally allowed a \$250,000 accumulated earnings credit. However, holding or investment companies may not consider reasonable business needs (e.g., requirements for working capital and liquidity) to accumulate earnings in excess of \$250,000. Furthermore, they are not allowed an accumulated earnings credit greater than \$250,000. Such corporations are also not allowed to deduct current-year net capital losses from accumulated taxable income.

The tax avoidance motive is considered present if the corporation has accumulated earnings and profits in excess of the reasonable needs of its business unless it can prove otherwise by a preponderance of the evidence. However, when there is no intent to avoid taxes, the courts have occasionally ruled that AET should not be imposed even if earnings are accumulated beyond the reasonable needs of the business.

Whether a corporation has a tax avoidance motive is subjective; it is always a question of facts and circumstances. The following circumstances may indicate that accumulations beyond the reasonable needs of the business exist:

1. Loans to shareholders or related parties.
2. Payments by the corporation that personally benefit the shareholders.
3. Investments in assets having no reasonable relationship to the corporation's business.
4. A weak dividend history.
5. Retention of earnings to provide against unrealistic hazards.

### **Tax Rates as Evidence That Tax Avoidance Motive Is Lacking**

Intent to avoid taxes can exist when a corporation accumulates funds, even if it pays tax at a higher rate than its shareholders. However, an argument that there is no intent to avoid taxes can be found in the following example.

#### **Example 1B-1 No intent to avoid tax when corporate tax rate is higher than individual tax rate.**

Brown Corporation, a closely held corporation, accumulates earnings during the year for what it believes are necessary business reasons. The shareholder-employees agree to reduce their salaries to provide the funds for the accumulation. The shareholder-employees' salaries were considered reasonable before the reduction. The corporation paid tax at a rate of 34% on its accumulation. The individuals would have paid tax on the accumulation at a 28% marginal personal tax rate had it been paid to them as compensation.

Based on these facts, it could be argued that no tax avoidance motive existed, even if the IRS felt the accumulation was beyond the reasonable needs of the business. Grounds for such an argument could be the difference in corporate and individual tax rates. Since the corporation could have deducted the accumulated funds if paid out as salary, leaving the money in the corporation increases the combined tax liabilities of the corporation and its shareholders. This makes it more difficult for the IRS to argue that Brown's motive in accumulating the funds is tax avoidance.

## **Meet Reasonable Business Needs by Accumulating Income**

### **Reasonable Business Needs**

The accumulated earnings tax (AET) is not assessed if earnings are not accumulated beyond reasonable business needs. This subjective test can be satisfied by a variety of business reasons. IRC Sec. 537(a) and Reg. 1.537-1 provide that the reasonable business needs include reasonably anticipated needs of the business (i.e., earnings do not have to be used immediately for a business need).

Reg. 1.537-2(b) provides some broad criteria that can be used to justify that earnings are being accumulated for the reasonable business needs, including the following:

1. provide for bona fide business expansion or plant replacement,
2. acquire a business enterprise through purchasing stock or assets,
3. provide for the retirement of company debt created in connection with its trade or business,
4. provide necessary working capital for the business,
5. provide for investments in or loans to customers or suppliers if necessary to maintain the business of the corporation, and
6. provide for contingencies such as the payment of reasonably anticipated product liability losses, actual or potential lawsuit, loss of a major customer, or self insurance.

### **Stock Redemption**

A normal redemption of stock is generally considered a shareholder need rather than a corporate need. However, if stock is redeemed in order for a deceased shareholder's estate to pay death taxes and state administration expenses, it is considered a reasonable business need of the corporation. Thus, the earnings retained to make such a redemption will qualify for the accumulated earnings credit. Earnings accumulated for other types of shareholder redemptions sometimes have been considered retained for reasonable business needs when the continued existence of the business is at stake. In *Gazette Publishing Co.*, the court ruled the accumulation of earnings was reasonable to redeem a minority shareholder attempting a hostile takeover. The courts held for a corporation that had accumulated earnings to redeem the stock of a group of shareholders who wanted to sell or merge the business and for a corporation that faced the contingent need to redeem the stock of dissenting family shareholders.

### **Business Expansion or Plant Replacement**

Replacing worn-out or obsolete equipment, as well as purchasing or constructing business assets, can be reasonable grounds for retaining earnings in the business. However, vague or general plans to take these actions some time in the future are not sufficient. The plan should be specific, definite, and feasible. A definite plan (coupled with action taken toward its consummation) is essential to justify an accumulation as reasonable. The corporation must do more than refer to the expansion in the corporate minutes, but it is not necessary for the taxpayer to produce meticulously drawn, formal blueprints for action. Such plans should be thoroughly documented. The amount accumulated does not have to be used immediately or within a short period after the close of the tax year, so long as it will be used within a reasonable time depending on all the facts and circumstances relating to the future needs of the business. The accumulation will not be considered reasonable if the future needs of the business are uncertain or vague, or if the execution of the plan is postponed indefinitely.

### **Business Acquisition**

A company is allowed to retain earnings if it has specific plans to acquire another business, either related or unrelated to its present business. However, accumulating funds to acquire mere investment activities, such as personal holding companies, investment companies, or corporations not engaged in the active conduct of a trade or business, is not a reasonable need for retaining earnings.

As with business expansion, such plans must be specific and documented.

### **Debt Retirement**

The mere existence of long-term debt may not justify the accumulation of earnings if it is apparent the debt can be retired using current earnings without adversely affecting the company. However, some loan agreements prohibit the borrower from paying dividends. This could be an important consideration in determining if an unreasonable accumulation exists.

## The Bardahl Formula May Be Used to Determine Working Capital Needs

A widely accepted objective mathematical test is available for use in determining a corporation's working capital needs. The test, known as the Bardahl formula, permits the accumulation of sufficient liquid assets to operate the business for one complete business cycle. For this purpose, a complete business cycle is the period required to acquire raw materials, convert them into inventory, sell the inventory, and collect the resulting accounts receivable; if applicable, a reduction in the operating cycle for accounts payable may be required based on the reasoning that postponement of the expense payment reduces the need for working capital. While the Bardahl formula is not the only method available for determining a corporation's working capital needs, it is frequently used.

### Example 1C-1 Computing working capital needs using the Bardahl formula.

The following financial information applies to Yummy's Christmas Candy, Inc., a calendar-year candy manufacturer.

	<u>12/31/08</u>	<u>12/31/09</u>
Current assets		
Cash	\$ 140,000	\$ 187,000
Accounts receivable	65,000	85,000
Inventory	<u>60,000</u>	<u>50,000</u>
Total current assets	<u>265,000</u>	<u>322,000</u>
Fixed assets		
Building	100,000	100,000
Equipment	125,000	125,000
Accumulated depreciation	<u>(110,000)</u>	<u>(116,000)</u>
Total fixed assets	<u>115,000</u>	<u>109,000</u>
Other assets		
Investments	158,600	326,000
Loans to shareholders	14,000	26,000
Cash surrender value of life insurance	1,500	1,500
Other	<u>2,500</u>	<u>2,500</u>
Total other assets	<u>176,600</u>	<u>356,000</u>
Total assets	<u>\$ 556,600</u>	<u>\$ 787,000</u>
Liabilities		
Accounts payable—current	\$ 42,000	\$ 38,000
Notes payable—long-term	<u>7,000</u>	<u>20,000</u>
Total liabilities	<u>49,000</u>	<u>58,000</u>
Equity		
Common stock	15,000	15,000
Retained earnings:		
Balance at beginning of year	292,600	492,600
Less dividends paid during the year		(20,000)
(see Example 1D-1)		
Net income	<u>200,000</u>	<u>241,400</u>
Total equity	<u>507,600</u>	<u>729,000</u>
Total liabilities and equity	<u>\$ 556,600</u>	<u>\$ 787,000</u>

The following summarizes taxable income for the year ended December 31, 2009.

Gross sales, net of returns and allowances	\$ 1,100,000
Cost of goods sold	<u>(600,000)</u>
Gross profit	500,000
Dividend income	20,000
Net capital gain	
Long-term capital gains	25,000
Short-term capital losses	(10,000)
Capital loss carryover	<u>(5,000)</u>
	10,000

Operating expenses	(16,000)
Depreciation	(6,000)
Other expenses	(144,600)
Dividends received deduction	<u>(14,000)</u>
Taxable income	<u>\$ 349,400</u>

Taxable income reconciles to financial income as follows:

Taxable income	\$ 349,400
Add back	
Dividends received deduction	14,000
Capital loss carryover	5,000
Less	
Nondeductible charitable contribution for tax purposes	(9,000)
Federal income tax estimated payments	<u>(118,000)</u>
Financial income	<u>\$ 241,400</u>

### Lack of Cash to Pay Dividends

Sometimes use of the Bardahl formula or other criteria listed earlier in this lesson will not work to a corporation's advantage when trying to establish that earnings are not accumulated beyond reasonable business needs. In that situation, the practitioner should look for other ways to avoid the AET. One defense against the AET might be lack of available cash to pay dividends.

#### Example 1C-2 Lack of cash to pay dividends as defense against the AET.

Smith, Inc. has computed its working capital needs using the Bardahl formula and has tried to come up with other business reasons to explain its accumulated earnings in an attempt to avoid AET. However, the formula shows that the corporation has accumulated earnings in excess of its working capital needs, and other future business needs for accumulating funds do not appear sufficient to justify the retained earnings.

If application of the Bardahl formula and other efforts to justify accumulated earnings fail, the practitioner should determine if there is a lack of available cash to pay dividends. The courts have held that a corporation should not be required to incur debt, sell business assets, or distribute property used in the business to pay dividends to avoid the AET.

However, in *Northwestern Indiana Telephone Co.*, the court ruled that when a corporation's net liquid assets have been invested in nonbusiness-related assets and payments to personally benefit the shareholders, these expenditures and assets will be taken into consideration in determining the dividend paying capacity. To make this determination of dividend paying capacity, the court increased the corporation's net liquid assets to reflect what the assets would have been if the corporation had not made the payments that failed to further the corporation's business interests and were not of substantial and direct benefit to the corporation.

### To Provide Investments and Loans

A corporation may accumulate earnings to provide for investment in or loans to customers or suppliers if necessary to maintain business. Accumulations to satisfy the business needs of related corporations generally will not qualify. In one case, a closely held corporation purchased stock in a publicly held corporation to which it leased assets in order to prevent a takeover by another company. The Tax Court upheld this as a satisfactory reason to accumulate earnings.

### To Provide for Contingencies

A corporation may accumulate earnings to meet contingencies if such contingencies are both specific and likely to occur. Court cases have revealed some other examples of likely contingencies such as labor strikes that would

affect the supply of a vital raw material; self insurance for casualty or liability losses; no layoff policy for employees; pending or potential litigation losses. Reasons for accumulating earnings should be documented.

Amounts accumulated for the payment of reasonably anticipated product liability losses are considered to be for business needs. Whether such losses are likely to occur is based on the facts and circumstances involved. Factors to consider include the following:

1. The taxpayer's previous product liability experience.
2. The extent of the taxpayer's coverage by commercial product liability insurance.
3. The ability to deduct the product liability losses and related expenses for tax purposes.
4. The taxpayer's potential future liability due to defective products in light of the taxpayer's plans to expand the production of products currently being manufactured (provided such plans are specific, definite, and reasonable).
5. Whether the taxpayer, in accounting for its potential future liability, took into account the reasonably estimated present value of the potential future liability.

The accumulations must be made for products that have been manufactured, leased, or sold. Accumulations for products that have not progressed beyond the development stage are not considered reasonable accumulations.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following entities would automatically be considered as evidence of the existence of a tax avoidance purpose?
  - a. Investment company.
  - b. Personal holding company.
2. Which of the following is considered evidence that accumulations beyond the reasonable needs of a business exist?
  - a. Acquisitions through the purchase of stocks.
  - b. Loans to shareholders.
  - c. Providing loans to suppliers.
3. Which of the following examples does **not** meet reasonable business needs by accumulating income?
  - a. Thomson Inc., has accumulation of earnings to acquire Righters, LLC to help increase production of their products.
  - b. Phillip's Construction has accumulated earnings to replace worn-out bulldozers.
  - c. Cloudy Knights Inc. has accumulated earnings in preparation of a possible takeover by a minority shareholder.
4. The accumulation of funds is **not** considered reasonable under which of the following circumstances?
  - a. Providing for potential lawsuits.
  - b. When the future needs of the business are obscure.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following entities would automatically be considered as evidence of the existence of a tax avoidance purpose? **(Page 93)**
  - a. **Investment company.** [This answer is correct. Unless a corporation can establish, to the satisfaction of the Commissioner, that it was not created or availed of for a tax avoidance purpose, the corporation is a mere investment or holding company which is enough evidence to prove the existence of a tax avoidance purpose.]
  - b. Personal holding company. [This answer is incorrect. According to the IRC, the AET cannot be imposed on a personal holding company. Other entities that are not subject to the AET include foreign personal holding companies, passive foreign investment companies, and S corporations.]
2. Which of the following is considered evidence that accumulations beyond the reasonable needs of a business exist? **(Page 94)**
  - a. Acquisitions through the purchase of stocks. [This answer is incorrect. Acquiring a business enterprise through purchasing stock or assets is an example earnings accumulated for a reasonable need.]
  - b. **Loans to shareholders.** [This answer is correct. Loans to shareholders or related parties are considered a circumstance that may indicate that accumulations beyond the reasonable needs of the business exist. Other indications that provide doubt as to whether accumulations are beyond the reasonable needs of a business include a weak dividend history, retention of earnings to provide against unrealistic hazards, investments in assets having no reasonable relationship to the corporation's business, and payments by the corporation that personally benefit the shareholders.]
  - c. Providing loans to suppliers. [This answer is incorrect. As long as it is necessary to maintain the business of the corporation, providing investments in or loans to customers or suppliers is considered a reasonable business need.]
3. Which of the following examples does **not** meet reasonable business needs by accumulating income? **(Page 95)**
  - a. Thomson Inc., has accumulation of earnings to acquire Righters, LLC to help increase production of their products. [This answer is incorrect. Thomson is allowed to retain these earnings as long as they have specific plans to acquire Righters, LLC.]
  - b. Phillip's Construction has accumulated earnings to replace worn-out bulldozers. [This answer is incorrect. The plan to purchase the bulldozers is justification for the accumulation of earnings as long as the plan is strongly documented.]
  - c. **Cloudy Knights Inc. has accumulated earnings in preparation of a possible takeover by a minority shareholder.** [This answer is correct. Because the threat has not occurred and the takeover is not hostile, the accumulated earnings would not be justified in avoiding AET. For accumulated earnings to be considered justified; the continued existence of the business must be at stake.]

4. The accumulation of funds is **not** considered reasonable under which of the following circumstances?  
**(Page 95)**
- a. Providing for potential lawsuits. [This answer is incorrect. According to the IRC, providing for contingencies such as the payment of reasonably anticipated product liability losses, actual or potential lawsuit, loss of a major customer, or self insurance is considered a justification that earnings are being accumulated for a reasonable business need.]
  - b. When the future needs of the business are obscure. [This answer is correct. The accumulation will not be considered reasonable if the future needs of the business are uncertain or vague, or if the execution of the plan is postponed indefinitely.]**

## Compute the Accumulated Earnings Tax

### AET Applies to Accumulated Taxable Income

The accumulated earnings tax (AET) applies to “accumulated taxable income,” i.e., corporate earnings and profits that have been accumulated during the tax year in excess of the accumulated earnings credit. At times the IRS has attempted to apply the AET against net liquid assets which includes capital contributions. In *Network Systems Corp.*, the Tax Court addressed this issue, stating that the accumulated earnings and profits and net liquid assets are distinct concepts in tax law and the tax is intended to apply only to earnings and profits accumulated beyond reasonable business needs. When net liquid assets exceed accumulated earnings and profits, capital contributions cannot be characterized as profits and are not ordinarily subject to distributions as dividends to shareholders.

### Tax Rate

The tax rate on accumulated earnings is 15%, the rate at which the earnings would be taxed if distributed.

### Adjustments to Accumulated Taxable Income

Accumulated taxable income for the year is the corporation's taxable income adjusted for the following items:

1. Net operating loss deductions are disallowed.
2. The dividends received deduction is disallowed.
3. Capital loss carryforwards and carrybacks are disallowed. However, see below for the treatment of capital loss carryovers.
4. Charitable contributions are recognized in full; that is, the 10% of taxable income limitation is disregarded.
5. Generally, current-year capital losses are allowed in full, reduced however by the lesser of the nonrecaptured capital gains deduction or the corporation's accumulated earnings and profits (E&P) at the close of the prior tax year.
6. Taxable income is reduced by net capital gains (i.e., the excess of capital gains over capital losses) less the income tax related to such gains. When computing this amount, the net gain is determined by treating any net capital loss from the prior year as a short-term capital loss carryover and by ignoring the normal capital loss carryback and carryforward provisions of IRC Sec. 1212.
7. A deduction is allowed for federal and foreign income taxes accrued or deemed paid during the year, other than the accumulated earnings tax, the personal holding company tax, or taxes imposed by corresponding sections of a prior income tax law. Thus, federal income tax for the year is deductible on an accrual basis, regardless of the method of accounting the corporation uses.
8. Dividends paid for the current year are deductible, including all dividends paid within 2<sup>1</sup>/<sub>2</sub> months after year-end and consent dividends. Treatment of dividends paid within 2<sup>1</sup>/<sub>2</sub> months after year-end as being paid during the current year is mandatory for purposes of AET. The dividend carryover allowed under the PHC tax rules is not allowed in computing the AET.
9. The accumulated earnings credit is allowed as a deduction.

The computation of accumulated taxable income can be different for holding or investment companies and foreign corporations.

### Tax-exempt Income

Tax-exempt income is not an adjustment to taxable income in arriving at accumulated taxable income. However, such income is included in determining the reasonableness of earnings and profits.

## Dividends Paid Deduction

Under the AET rules of IRC Secs. 535(a) and 561, the corporation can claim a dividends paid deduction for dividends paid within 2½ months after year-end, and consent dividends.

The dividends paid deduction for AET purposes generally follows the same rules that apply to the personal holding company (PHC) dividends paid deduction. However, differences exist in three basic areas: the dividend carryover rule is not available for AET, Section 547 deficiency dividends apply only for PHC tax purposes, and dividends paid within 2½ months after year-end are allowed in full for purposes of AET, even though limited for purposes of the PHC tax.

## Deduction for Income Taxes

As stated earlier in this lesson, federal income taxes accrued or deemed paid during the year are generally deductible in arriving at taxable income for accumulated earnings tax purposes.

However, in *Metro Leasing and Development Corp.*, the Tax Court agreed with the IRS and held that no part of the taxpayer's paid, but contested, income tax deficiency should reduce its taxable income in arriving at accumulated taxable income under IRC Sec. 535(b)(1). The Tax Court stated that it disagreed with the 5th Circuit's decision in *J.H. Rutter, Rex Manufacturing Co.* In that case, the 5th Circuit ruled that a contested income tax deficiency is deductible under IRC Sec. 535(b)(1) if it has been paid.

## Short Tax Years

The corporation's income does not have to be annualized when calculating the AET for a short tax year.

## Calculation of the AET

The following example illustrates how the AET is calculated.

### Example 1D-1 AET computation.

AET is being computed for Yummy's Christmas Candy, Inc. (see Example 1C-1) for the tax year ending December 31, 2009. In addition to the data set forth in Example 1C-1, the following information applies for the year:

Dividends paid during the year	\$ 20,000
Dividends paid within 2½ months after December 31, 2009	5,000
Accumulated earnings at the beginning of year (note this does not mean retained earnings at the beginning of the year)	400,000

Also, in 2008 the company developed a plan to build a new plant in 2011. The estimated cost of the plant is \$450,000. Yummy's accumulated taxable income for the year is \$25,912, and its accumulated earnings tax is \$3,887.

## Interest on an AET Underpayment

Interest on AET underpayments is computed beginning on the due date of the return (without regard to extensions) for the year the tax is imposed. As a practical matter, a corporation subject to AET cannot avoid interest on the underpayment because the AET is not self-assessed. The only way to avoid interest is to avoid the imposition of the tax.

## Applying Accumulated Earnings Tax to Consolidated Groups

The accumulated earnings tax can apply to a consolidated group of corporations if the group is formed or used to avoid tax of any of its shareholders by accumulating profits beyond its reasonable needs. The rules for the

consolidated group are much the same as those for an individual corporation. However, the following special rules apply:

1. The group's earnings and profits are the aggregate of those of each member of the group at the close of the year.
2. The reasonable needs of the group include the reasonable needs of any of its member corporations at the close of a year. This means that the earnings and profits of one member can be accumulated to meet the reasonable needs of another.

The computation of a group's consolidated accumulated taxable income begins with the group's consolidated taxable income. The same adjustments apply as those that apply to an individual corporation except that these adjustments are based on consolidated amounts, such as the consolidated tax liability, consolidated charitable contributions deduction, and consolidated net operating loss.

Consolidated accumulated taxable income is reduced by the consolidated dividends paid deduction. This deduction is determined by excluding any dividends paid to other members of the group.

#### **Example 1D-2 Computing the consolidated dividends paid deduction.**

Able and Baker Corporations comprise an affiliated group that has elected to file a consolidated income tax return. Able is owned by two individuals, and Able owns 100% of Baker's stock. Neither Able nor Baker is a personal holding company. On December 1, 2009, Baker pays a \$5,000 cash dividend to Able. On January 9, 2010, Able pays a \$10,000 cash dividend to its two shareholders on a prorata basis.

The consolidated dividends paid deduction for 2009 will be \$10,000 for the dividend paid to Able's shareholders on January 11, 2010. The dividend paid by Baker to Able on December 1, 2009 is disregarded in determining the deduction.

A consolidated group is also entitled to a consolidated accumulated earnings credit. The regulations do not prescribe how the consolidated accumulated earnings credit is to be calculated. However, the group would be entitled to only one minimum credit amount of \$250,000.

If a consolidated group is treated as a PHC, it will not be subject to the accumulated earnings tax. If any member of the group is a PHC, that member will be disregarded for all purposes in determining a tax avoidance motive, reasonable needs motive, or any facet of the calculation of consolidated accumulated taxable income.

## **Claim the Accumulated Earnings Credit**

### **Definition and Calculation of the Accumulated Earnings Credit**

A corporation is normally allowed a deduction in computing its accumulated taxable income for an amount called the accumulated earnings credit, which is the greater of:

1. \$250,000 [\$150,000 for a personal service corporation (PSC)] less the accumulated earnings and profits of the corporation at the end of the preceding year (i.e., the minimum credit); or
2. earnings and profits (E&P) for the year retained to meet the reasonable needs of the business, reduced by the after-tax net capital gains. For this purpose, E&P equals E&P for the tax year less the dividends paid deduction allowed in computing accumulated taxable income for such year. This is a limiting factor because the credit cannot result in a negative accumulated taxable income amount.

A corporation that has accumulated E&P of \$250,000 [\$150,000 in the case of a PSC or more at the end of its previous year will not be entitled to any accumulated earnings credit (i.e., it will have a credit of zero) unless it has retained earnings and profits within the corporation to meet a reasonable business need.

## Holding and Investment Companies

Mere holding or investment companies are not allowed an accumulated earnings credit greater than \$250,000. A holding company is a corporation in which there is practically no activity other than the holding of investment property. An investment company is one that buys and sells stock, securities, real estate, and other investment property in addition to holding investment property.

These companies may not consider reasonable business needs (e.g., requirements for working capital and liquidity) to accumulate earnings in excess of \$250,000. Also, such corporations are not allowed to deduct current-year net capital losses from accumulated taxable income.

In *Advanced Delivery & Chemical Systems*, the IRS's assertion that a corporate taxpayer was a mere holding company under IRC Sec. 533 that engaged in no business activities itself was found by the Tax Court to be erroneous. According to the Tax Court, the affiliates' activities were attributable to the taxpayer under Reg. 1.537-3(b). The Tax Court permitted the taxpayer to consider the activities and business needs of its affiliated businesses (including one affiliate operating as a partnership) in determining the reasonableness of accumulated earnings and identifying its reasonably anticipated business needs.

### Example 1E-1 Determining the amount of the accumulated earnings credit.

Yummy's Christmas Candy, Inc., has accumulated earnings and profits at the beginning of the year of \$400,000. Since this amount exceeds \$250,000, the corporation's *minimum credit* is zero. Yummy's *accumulated earnings credit*, however, is \$183,888.

## Component Members of a Controlled Group

When multiple corporations are component members of a controlled group, each corporation is not entitled to the \$250,000 (or \$150,000 for PSCs) amount when calculating the minimum credit. Rather, the component members must be treated as one corporation and are allowed only one \$250,000 (or \$150,000) amount, which is allocated among the component members.

Temp. Reg. 1.1561-2T(c) provides that the group's component members may allocate the credit unequally if the group members have an apportionment plan in effect. The regulation generally applies to any tax year beginning on or after December 22, 2006 and is scheduled to expire on December 21, 2009.

## Avoid Imposition of the Accumulated Earnings Tax

### Documenting Business Needs and Accumulated Earnings Plan

To avoid the accumulated earnings tax (AET) on accumulations in excess of the minimum accumulated earnings credit, a corporation must be able to demonstrate to the IRS that its accumulations are necessary to meet its business needs.

The corporation must have sufficient facts and documentation to substantiate that plans for present and future business needs require additional funds. A determination of whether the accumulation of earnings and profits is a reasonable business need is based on the circumstances of each case. Reg. 1.537-2(b) lists circumstances in which accumulation of earnings will be considered reasonable business needs.

In determining whether a corporation's plans can be used as a defense against a potential IRS argument that earnings have been accumulated to avoid tax, the following should be ascertained for each individual need:

1. It qualifies as a reasonably anticipated future need of the corporation's business.
2. It is a specific plan, rather than a vague generality. In *Haffner's Service Stations*, the court noted that although the Code does not refer to a specific plan, Reg. 1.537-1(b)(1) refers to a specific, definite, and feasible plan. According to the court, dispensing with formality does not create a license for vague,

uncertain, or indefinite plans. In determining whether the plan meets this requirement, the details of the plan, including what information was used in reaching the decision that the plan is viable, who in the corporation is involved in the plan, and what is being done to accomplish the plan's goals should be available. If the information appears consistent with prudent business practices, it is likely that the plan meets this requirement.

3. It is documented. In *Otto Candies, LLC*, the District Court for the Eastern District of Louisiana held that a group of marine transportation companies was not subject to AET because it was able to establish that its earnings were accumulated for reasonable business needs. The taxpayer established this through credible testimony and documents reflecting feasible, cost-specific plans for needs such as fleet replacement, project funding, working capital, and redemption of a minority shareholder's interest. Also, the court rejected the IRS's argument that the redemption in itself reflected a tax avoidance purpose. According to the court, tax avoidance was not indicated by use of some funds for well-documented and secured shareholder loans or for other items that were either immaterial or ultimately helpful to business growth.

The importance of such a contemporaneous plan is clearly illustrated in the *Northwestern Indiana Telephone Co.* case. The court held that the taxpayers offered little more than "vague, unsubstantiated, post-deficiency notice assertions" of business needs that the taxpayer claimed had justified its accumulation of earnings. The 7th Circuit found that the taxpayer "had no written contemporaneous records of specific future business needs or plans."

The following are suggested ways to meet the documentation requirement:

1. Include in the corporate minutes a discussion of why the funds are being accumulated (e.g., plans for plant expansion, debt retirement, inventory increases, etc.). The purpose as outlined in the minutes should be specific, definite, and feasible. The minutes should be prepared in the normal course of the directors' meeting instead of after the fact.

The corporation may not want to refer specifically in the minutes to accumulated earnings since IRS examiners frequently request copies of the minutes as part of routine exams. Frequent references to accumulated earnings may point to an issue the IRS examiners might not raise on their own.

2. Shortly after the end of each tax year, compile written evidence of the business needs for the accumulation of funds, i.e., an accumulated earnings plan. Include in that plan:
  - a. Definitive and verifiable reasons for the accumulation of funds.
  - b. Specific projected dates for the use of the funds. Vague plans that are never carried out or that the company does not plan to carry out in the near future provide little support for an accumulation.
  - c. Specific amounts needed for each purpose for which earnings are being accumulated.
  - d. Copies of appraisals, bills for surveying costs and architectural fees, building estimates, site studies, working capital requirement computations, and other similar materials when applicable and feasible.
3. Update the plan annually.
  - a. Identify in the updated plan all new reasons for accumulations.
  - b. Revise details on previously identified purposes for the accumulations. The IRS will usually consider only factors existing at the time of the accumulation. It does not matter if circumstances later change and make the accumulation unnecessary provided it was reasonable and necessary for the year in question. The plan can be revised annually without affecting the prior year's basis for reasonableness.

A copy of each year's plan should be retained for a minimum of five years.

### **Quantifying Working Capital Needs of a Cash Business**

It is somewhat difficult to quantify working capital needs of a service business that uses the cash method of accounting. In a service business, there is an inventory equivalent represented by the costs of services already

performed but unbilled. An intangible inventory (inventory equivalent) of work-in-process can be created if a service organization has a time lapse between the time services are performed and the time they are billed. This inventory will not appear on the corporation's balance sheet; therefore, it will not be reflected in the computation of the corporation's working capital using the Bardahl formula. However, several courts have permitted the use of a modified Bardahl formula using an equivalent inventory cycle when computing working capital needs for service corporations.

Service corporations using the cash method of accounting encounter another problem when attempting to measure their working capital needs. Their receivables and payables are not shown on the cash-basis balance sheet used to prepare the return nor is their effect on accumulated taxable income reflected in retained earnings. In one case, the corporation's cash-basis balance sheet and income statement were converted to accrual-basis statements. Working capital needs were then computed based on the accrual-basis financial statements.

### **Timing of Judgment on Reasonable Needs**

The regulations state that the reasonableness of anticipated needs is to be judged on the facts existing at the close of the tax year. This means that subsequent events cannot be used to show that the retention of earnings or profits was unreasonable at the close of the tax year if all the elements of reasonable anticipation are present at the close of the year. For example, an accumulation was not unreasonable when expansion plans were abandoned after a manager/shareholder's illness.

However, subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated. In this connection, projected expansion or investment plans should be viewed in light of the facts during each year and as they exist as of the close of the year. If a corporation has justified an accumulation for future needs by plans never consummated, the amount of such an accumulation must be taken into account in determining the reasonableness of subsequent accumulations.

### **Using the Tax Benefit Rule**

The general rule of IRC Sec. 111 provides that gross income does not include income attributable to the recovery of any amount deducted in a prior tax year if that amount did not reduce tax in the prior year. However, IRC Sec. 111(d) provides special rules for the AET and the personal holding company (PHC) tax.

Under IRC Sec. 111(d), if an exclusion of an amount is allowed for regular tax purposes, it is also allowed for AET and PHC tax purposes, whether or not the excluded amount reduced a prior year's AET or PHC tax. In addition, if an excluded amount was not allowable as a deduction for regular tax purposes for a prior year but was for PHC tax or AET, the excluded amount is allowable for PHC tax or AET purposes if it did not result in a reduction of the AET or the PHC tax.

#### **Example 1F-1 Determining the impact of the tax benefit rule on AET and the PHC tax.**

In 2009, Sharp, Inc. recovers \$1,000, which was deducted in 2007. The \$1,000 amount did not reduce the 2007 regular income tax or PHC tax. However, it did reduce the 2007 AET.

Sharp can exclude the \$1,000 from income for regular tax purposes under the tax benefit rule. If an amount is excluded for regular tax purposes, the same exclusion is allowed when computing current-year AET and PHC tax even if the excluded amount reduced the AET or PHC tax for the prior year. Thus, the \$1,000 is also excluded for PHC tax and AET purposes.

If a recovered amount is not excluded from income, it is taxed at the rate in effect in the year of recovery. This may produce a higher current-year tax than the tax benefit received from the original deduction.

### **Report the Accumulated Earnings Tax to the IRS**

AET is not a self-assessed tax, but is assessed by the IRS during the course of an examination of a corporation's income tax return. Therefore, there is no annual tax form to fill out or schedule to attach to the corporate income tax return. For this reason, it is easy to overlook potential imposition of the tax.

Reg. 1.533-2 provides that when the IRS is trying to determine if the AET applies, a corporation may be required to furnish a statement reporting its accumulated earnings and profits; its dividend paying history; name, address, and number of shares owned by each shareholder; the amounts payable to each shareholder if income were distributed; and other information required under IRC Sec. 6042.

## Shifting the Accumulated Earnings Burden of Proof to the IRS

Generally, if the IRS asserts that a corporation has accumulated earnings beyond the reasonable needs of the business and thus is subject to the accumulated earnings tax (AET), the burden of proof rests on the corporation to show the assertion is incorrect. However, if a dispute reaches the Tax Court, IRC Sec. 534 provides some relief to the corporation. If the IRS fails to notify a taxpayer that it intends to propose a deficiency based at least in part on AET, the burden of proof at the Tax Court level is on the IRS.

In a case where the IRS had given a taxpayer notice of a proposed deficiency involving AET, but had failed to specify the tax year involved, the Tax Court ruled that the burden of proof shifted to the IRS even though the taxpayer's ability to prepare and submit a statement showing grounds for accumulated earnings was not harmed.

## Considering the Accumulated Earnings Tax during Busy Season

C corporations with substantial accumulated earnings face exposure to the AET. The tax is assessed by the IRS, rather than being self-assessed by the company. Therefore, there is no annual tax form to fill out or schedule to attach to the return.

Application of the AET is often confusing. Although accumulated earnings from prior years must be considered when determining whether the AET should apply, the AET is assessed only against the portion of the current year's earnings that are accumulated without justification.

Practitioners should focus on the following three general principles:

1. *Determine Whether the AET Applies.* The AET may be assessed if the corporation has earnings accumulated from past-year or current operations, and cannot justify why these earnings were not distributed to its shareholders. If earnings are accumulated for no valid business reason, the IRS can assess the AET.
2. *Understand the Importance of Current-year Earnings.* The AET is assessed only against the portion of the current year's income that is accumulated without justification. For any one tax year, the company's maximum exposure to the AET is based solely on that year's earnings. So, if a company has no taxable income in the current year, there is no exposure to the AET for this year. However, the IRS can go back at least three years and assess the AET separately for each year.
3. *Identify Reasonable Business Needs.* To the extent the company can prove that earnings are being accumulated for a valid business reason, there is no exposure to the AET. As a layer of accumulated earnings is added each year, the company must be able to prove a reasonable business need (perhaps a continuing need) to accumulate those earnings.

### Quick Method to Determine Potential AET Issue

The practitioner can look at Form 1120 taxable income for the year before the net operating loss deduction and special deductions. If it is over \$250,000 (or \$150,000 for personal service corporations), the company has a potential AET issue for that tax year. As previously mentioned, the AET is assessed only against the portion of the current year's income that is accumulated without justification.

If the company has a potential AET issue for the current year, the practitioner should look at prior years (if the statute is still open) since the IRS will probably do the same thing to build a case for the AET issue.

**Paying Dividends to Reduce the AET**

Dividends paid for the current year are deductible, including all dividends paid within 2<sup>1</sup>/<sub>2</sub> months after year-end and consent dividends. Unlike personal holding companies, the corporation gets full credit for all late paid dividends—there is no limitation on the amount that can be included in the preceding year's dividends-paid deduction. In fact, this rule applies even when the recipient of the late paid dividend became a shareholder after the last day of the tax year for which the penalty tax was determined.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Which of the following statements regarding computing the accumulated earnings tax is most accurate?
  - a. In arriving at accumulated taxable income, tax-exempt income should be an adjustment to taxable income.
  - b. One major difference between the dividends paid deduction for AET purposes versus the personal holding company (PHC) dividends paid deduction is the dividend carryover rule is not available for AET.
  - c. A corporation's income must always be annualized when calculating the AET for a short tax year.
6. Which of the following best describes how the accumulated earnings credit and tax applies to consolidated groups?
  - a. Unlike individual corporations, consolidated groups qualify for multiple credit amounts.
  - b. The rules for consolidated groups are similar to those for individual corporations with respect to applying the accumulated earnings tax.
  - c. Consolidated groups are subject to the AET if the group, or any member of the group, is treated as a personal holding company (PHC).
  - d. The consolidated accumulated taxable income is reduced by the after-tax capital gains.
7. When determining if a corporation's plans can be used as a defense against a possible IRS argument that earnings have been accumulated to avoid tax, it is suggested that certain documentation be met. Which of the following is **not** one of the suggested documentation requirements?
  - a. Determine all reasonably anticipated future needs of the corporation's business.
  - b. Collect written evidence of the business needs for the accumulation of funds soon after the end of each tax year.
  - c. Include a summary of why the funds are being accumulated in the corporate minutes.
  - d. Update the plan annually.
8. Select the authoritative literature that establishes specific rules for the AET and the PHC tax.
  - a. IRC Sec. 111.
  - b. IRC Sec. 111(d).
  - c. IRC 537(a).
  - d. IRC Sec. 561.
9. Which of the following IRC Sections provides relief to the corporation by shifting the accumulated earnings burden of proof to the IRS?
  - a. IRC Sec. 535(a).
  - b. IRC Sec. 534.
  - c. IRC 111(d).

10. When considering the accumulated earning during tax busy season, which of the following statements is most accurate?
- a. The AET is only assessed on accumulations from current-year operations.
  - b. Only the part of the current-year's accumulated income can be assessed by AET.
  - c. A corporation can be exposed to AET even if there is proof that the accumulated earnings are for a valid reason.
  - d. C corporations that face AET exposure must complete an annual tax form and attach to the return.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. Which of the following statements regarding computing the accumulated earnings tax is most accurate? **(Page 102)**
- a. In arriving at accumulated taxable income, tax-exempt income should be an adjustment to taxable income. [This answer is incorrect. According to the IRS, tax-exempt income is not an adjustment to taxable income in arriving at accumulated taxable income. However, such income is included in determining the reasonableness of earning and profits.]
  - b. One major difference between the dividends paid deduction for AET purposes versus the personal holding company (PHC) dividends paid deduction is the dividend carryover rule is not available for AET. [This answer is correct. The dividends paid deduction for AET purposes generally follows the same rules that apply to the PHC dividends paid deduction. Other differences are Section 547 deficiency dividends apply only for PHC tax purposes, and dividends paid within 2<sup>1</sup>/<sub>2</sub> months after year-end are allowed in full for purposes of AET, even though limited for purposes of the PHC tax.]**
  - c. A corporation's income must always be annualized when calculating the AET for a short tax year. [This answer is incorrect. According to the IRS, the corporation's income does not have to be annualized when calculating the AET for a short tax year.]
6. Which of the following best describes how the accumulated earnings credit and tax applies to consolidated groups? **(Page 103)**
- a. Unlike individual corporations, consolidated groups qualify for multiple credit amounts. [This answer is incorrect. Per IRS regulations, a consolidated group is entitled to a consolidated accumulated earnings credit. The regulations do not prescribe how the consolidated accumulated earnings credit is to be calculated. However, the group is entitled to only one minimum credit amount of \$250,000.]
  - b. The rules for consolidated groups are similar to those for individual corporations with respect to applying the accumulated earnings tax. [This answer is correct. The accumulated earnings tax can apply to a consolidated group of corporations if the group is formed or used to avoid tax of any of its shareholders by accumulating profits beyond its reasonable needs. The rules for consolidated groups are much the same as those for an individual corporation. However, the group's earnings and profits are the aggregate of those of each member of the group at the close of the year; and the reasonable needs of the group include the reasonable needs of any of its member corporations at the close of a year.]**
  - c. Consolidated groups are subject to the AET if the group, or any member of the group, is treated as a personal holding company (PHC). [This answer is incorrect. If a consolidated group is treated as a PHC, it will not be subject to the accumulated earnings tax. If any member of the group is a PHC, that member will be disregarded for all purposes in determining a tax avoidance motive; reasonable needs motive, or any facet of the calculation of consolidated accumulated taxable income.]
  - d. The consolidated accumulated taxable income is reduced by the after-tax capital gains. [This answer is incorrect. Consolidated accumulated taxable income is reduced by the consolidated dividends paid deduction. This deduction is determined by excluding any dividends paid to other members of the group.]
7. When determining if a corporation's plans can be used as a defense against a possible IRS argument that earnings have been accumulated to avoid tax, it is suggested that certain documentation be met. Which of the following is **not** one of the suggested documentation requirements? **(Page 106)**
- a. Determine all reasonably anticipated future needs of the corporation's business. [This answer is correct. According to the IRS, this is not one of the suggested ways to meet the documentation requirement.]**

- b. Collect written evidence of the business needs for the accumulation of funds soon after the end of each tax year. [This answer is incorrect. This is a suggested method of meeting the documentation requirement. Shortly after the end of each tax year, compile written evidence of the business needs for the accumulation of funds, i.e., an accumulated earnings plan. The plan should include definitive and verifiable reasons for the accumulation of funds; specific projected dates for the use of the funds. Vague plans that are never carried out or that the company does not plan to carry out in the near future provide little support for an accumulation; specific amounts needed for each purpose for which earnings are being accumulated; and copies of appraisals, bills for surveying costs and architectural fees, building estimates, site studies, working capital requirement computations, and other similar materials when applicable and feasible.]
  - c. Include a summary of why the funds are being accumulated in the corporate minutes. [This answer is incorrect. One suggestion is to include in the corporate minutes a discussion of why the funds are being accumulated (e.g., plans for plant expansion, debt retirement, inventory increases, etc.). The purpose as outlined in the minutes should be specific, definite, and feasible. The minutes should be prepared in the normal course of the directors' meeting instead of after the fact.]
  - d. Update the plan annually. [This answer is incorrect. This is a suggested method of meeting the documentation requirement. When updating the plan, the corporation should identify in the updated plan all new reasons for accumulations, and revise on previously identified purposes for the accumulations. The IRS will usually consider only factors existing at the time of the accumulation. It does not matter if circumstances later change and make the accumulation unnecessary provided it was reasonable and necessary for the year in question.]
8. Select the authoritative literature that establishes specific rules for the AET and the PHC tax. **(Page 107)**
- a. IRC Sec. 111. [This answer is incorrect. The general rule of IRC Sec. 111 provides that gross income does not include income attributable to the recovery of any amount deducted in a prior tax year if that amount did not reduce tax in the prior year.]
  - b. IRC Sec. 111(d). [This answer is correct. IRC Sec. 111(d) provides special rules for the AET and the personal holding company (PHC) tax. Under IRC Sec. 111(d), if an exclusion of an amount is allowed for regular tax purposes, it is also allowed for AET and PHC tax purposes, whether or not the excluded amount reduced a prior year's AET or PHC tax.]**
  - c. IRC 537(a). [This answer is incorrect. IRC Sec. 537(a) provide that the reasonable business needs include reasonably anticipated needs of the business (i.e., earnings do not have to be used immediately for a business need).]
  - d. IRC Sec. 561. [This answer is incorrect. Under IRC Sec. 561, the corporation can claim a dividends paid deduction for dividends paid within 2<sup>1</sup>/<sub>2</sub> months after year-end and consent dividends.]
9. Which of the following IRC Sections provides relief to the corporation by shifting the accumulated earnings burden of proof to the IRS? **(Page 108)**
- a. IRC Sec. 535(a). [This answer is incorrect. Under the AET rules of IRC Sec. 535(a), the corporation can claim a dividends paid deduction for dividends paid within 2<sup>1</sup>/<sub>2</sub> months after year-end, and consent dividends.]
  - b. IRC Sec. 534. [This answer is correct. Generally, if the IRS asserts that a corporation has accumulated earnings beyond the reasonable needs of the business and thus is subject to the accumulated earnings tax (AET), the burden of proof rests on the corporation to show the assertion is incorrect. However, if a dispute reaches the Tax Court, IRC Sec. 534 provides some relief to the corporation. If the IRS fails to notify a taxpayer that it intends to propose a deficiency based at least in part on AET, the burden of proof at the Tax Court level is on the IRS.]**
  - c. IRC 111(d). [This answer is incorrect. Under IRC Sec. 111(d), if an exclusion of an amount is allowed for regular tax purposes, it is also allowed for AET and PHC tax purposes, whether or not the excluded amount reduced a prior year's AET or PHC tax.]

10. When considering the accumulated earning during tax busy season, which of the following statements is most accurate? **(Page 108)**
- a. The AET is only assessed on accumulations from current-year operations. [This answer is incorrect. The AET may be assessed if the corporation has earnings accumulated from past-year or current operations, and cannot justify why these earnings were not distributed to its shareholders. If earnings are accumulated for no valid business reason, the IRS can assess the AET.]
  - b. Only the part of the current-year's accumulated income can be assessed by AET. [This answer is correct. The AET is assessed only against the portion of the current year's income that is accumulated without justification. For any one tax year, the company's maximum exposure to the AET is based solely on that year's earnings. So, if a company has no taxable income in the current year, there is no exposure to the AET for the year.]**
  - c. A corporation can be exposed to AET even if there is proof that the accumulated earnings are for a valid reason. [This answer is incorrect. To the extent the company can prove that earnings are being accumulated for a valid business reason, there is no exposure to the AET. As a layer of accumulated earnings is added each year, the company must be able to prove a reasonable business need to accumulate those earnings.]
  - d. C corporations that face AET exposure must complete an annual tax form and attach to the return. [This answer is incorrect. C corporations with substantial accumulated earnings face exposure to the AET. The tax is assessed by the IRS, rather than being self-assessed by the company. Therefore, there is no annual tax form to fill out or schedule to attach to the return.]



**EXAMINATION FOR CPE CREDIT**

**Lesson 1 (T20TG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Properly match the type of corporation with the tax treatment as either subject to AET or **not** subject to AET.

Type of Corporation	Tax Treatment
i. Corporations with minimal accumulated earnings	A. Subject to AET
ii. Personal holding companies	B. Not subject to AET
iii. S corporations	
iv. Foreign corporations doing business in the U.S.	
v. Associations taxable as corporations	
vi. Publicly held corporations	

- a. A (i, ii, and iv); B (iii, v, and vi).
  - b. A (iv, v, and vi); B (i, ii, and iii).
  - c. A (i, ii, and iii); B (iv, v, and vi).
  - d. A (iv, v, and i); B (ii, iii, and vi).
2. What is the maximum accumulated earnings credit for holding or investment companies?
    - a. \$100,000.
    - b. \$150,000.
    - c. \$200,000.
    - d. \$250,000.
  3. House Corporation, a closely held corporation, accumulates earnings during the year for what it believes are necessary business reasons. The shareholder-employees agree to reduce their salaries to provide the funds for the accumulation. The shareholder-employees' salaries were considered reasonable before the reduction. The corporation paid tax at a rate of 35% on its accumulation. The individuals would have paid tax on the accumulation at a 28% marginal personal tax rate had it been paid to them as compensation.

This is an example of which of the following?

- a. Adjustments to accumulated taxable income.
- b. Accumulated earnings to avoid tax at the corporate level.
- c. No intent to avoid tax when the corporate tax rate is higher than the individual tax rate.
- d. Accumulated earnings to avoid tax at the shareholder level.

4. What is the purpose of the Bardahl formula?
  - a. Determine a corporation's working capital need.
  - b. Determine the maximum accumulated taxable income.
  - c. Determine the interest on AET underpayment.
  - d. Do not select this answer choice.
5. A labor strike that may influence the reserve of vital raw material is an example of which of the following?
  - a. Timing of judgment of a reasonable need.
  - b. A likely contingency as a reason to accumulate earnings.
  - c. Quantifying working capital needs.
  - d. Do not select this answer choice.
6. Flowers and Steele Corporations comprise an affiliated group that has elected to file a consolidated income tax return. Flowers is owned by two individuals, and Flowers owns 100% of Steele's stock. Steele is not a personal holding company. On December 1, 2009, Steele pays a \$5,000 cash dividend to Flowers. On January 9, 2010, Flowers pays a \$10,000 cash dividend to its two shareholders on a prorata basis.

What is the amount of the consolidated dividends paid deduction for 2009?

- a. \$0.
  - b. \$5,000.
  - c. \$10,000.
  - d. \$15,000.
7. What is one deduction a personal service corporation is entitled to when computing its accumulated taxable income for the accumulated earnings credit?
    - a. The greater of \$100,000 less the accumulated earnings and profits (E&P) of the corporation at the end of the preceding year.
    - b. The greater of \$150,000 less the accumulated E&P of the corporation at the end of the preceding year.
    - c. The greater of \$250,000 less the accumulated E&P of the corporation at the end of the preceding year.
    - d. The greater of \$300,000 less the accumulated E&P of the corporation at the end of the preceding year.
  8. How long should a corporation retain a copy of each year's accumulated earnings plan?
    - a. Three years.
    - b. Minimum of three years.
    - c. Five years.
    - d. Do not select this answer choice.

9. According to the regulations, when should the reasonableness of anticipated needs be determined?
- a. Close of the tax year.
  - b. Beginning of the tax year.
  - c. Return due date.
  - d. Do not select this answer choice.
10. How many years can the IRS go back and assess the AET separately for each year?
- a. One.
  - b. Three.
  - c. Five.
  - d. Seven.



# Lesson 2: Credits

## INTRODUCTION

Tax credits are allowed to offset the regular tax liability of a corporation. However, credits generally cannot reduce regular tax liability below the alternative minimum tax (AMT).

Generally, for tax years beginning after 1986, a corporation is allowed a credit for the amount of AMT incurred in a prior year. Thus, corporations may use a minimum tax credit to offset their regular tax liability.

### Learning Objectives:

Completion of this lesson will enable you to:

- Explain the concepts of General Business Credit.
- Explain the ordering rules used for carrybacks and carryforwards of General Business Credits.
- Describe how to claim credits arising from passive activities and foreign tax credits.

## How to Claim the General Business Credit

### Credits Included in the General Business Credit

The general business credit (GBC) is composed of a number of separate credits that are computed on various federal tax return forms and then summarized on Form 3800 (General Business Credit). These separate credits are combined and a tax liability limitation is applied to the overall GBC. The GBC is the sum of the following credits determined for the tax year:

1. *The Section 46 Investment Credit.* This credit is the sum of the following credits [all of which are computed on Form 3468 (Investment Credit)]:
  - a. The Section 47 Rehabilitation Credit.
  - b. The Section 48(a) Energy Credit.
  - c. The Section 48A qualifying advanced coal project credit.
  - d. The Section 48B qualifying gasification project credit.

The coal project and gasification project credits are not covered in this lesson because of their limited applicability.

  - e. The Section 48C qualifying advanced energy project credit.
2. *The Section 51 Work Opportunity Credit.*
3. *The Section 40 Alcohol Fuels Credit.* This credit is available to certain producers, sellers, and users of alcohol-based fuels suitable for use in an internal combustion engine. It is computed on Form 6478 Alcohol and Cellulosic Biofuel Fuels Credit.
4. *The Section 41 Research Credit.*
5. *The Section 42 Low-income Housing Credit.*
6. *The Section 43 Enhanced Oil Recovery Credit.*
7. *The Section 44 Disabled Access Credit.*

8. *The Section 45 Renewable Electricity Production Credit.* This credit is available (during the ten-year period beginning on the placed-in-service date) for electricity produced by a company from wind-energy or a closed-loop biomass in a facility placed in service after 1992 and before 2014 (for a closed-loop biomass facility) or after 1993 and before 2013 (for a facility using wind energy). This credit is also available for electricity produced at open-loop biomass facilities, geothermal or solar energy facilities, small irrigation power facilities, landfill gas facilities, trash combustion facilities, and electricity produced at refined coal production facilities placed in service after October 22, 2004 and before January 1, 2014. Electricity produced at hydroelectric and Indian coal facilities placed in service after August 8, 2005, and before 2014 (for hydropower facility), also qualifies for the credit. The credit is claimed on Form 8835 (Renewable Electricity, Refined Coal, and Indian Coal Production Credit). The IRS publishes annually an IRS notice announcing the current-year inflation adjustment factors and reference prices.
9. *The Section 1396 Empowerment Zone Employment Credit and the Section 1400H Renewal Community Employment Credit.*
10. *The Section 45A Indian Employment Credit.* This credit is available to business owners who employ members of an Indian tribe on an Indian reservation. The credit applies to certain wages and health insurance costs paid or incurred after 1993 for qualified employees in tax years beginning before 2010. The credit is claimed on Form 8845 (Indian Employment Credit).
11. *The Section 45B Employer Credit for Social Security Taxes Paid on Employee Tip Income (FICA Tip Credit).* This credit is for owners of food and beverage establishments who are required to report employees' tips in excess of those treated as wages for purposes of the Fair Labor Standards Act. The credit is available to employer payments for taxes on tip income—whether or not reported by employees and regardless of when the services were actually performed. The credit also applies to taxes on tips earned from delivery and take-out orders. The Section 45B credit limits the employer's social security tax liability to the amount that would be due if an employee received only the minimum wage, no matter how much the employee actually earns. The employee's earnings record and income tax liability are not affected.  
  
The credit is claimed on Form 8846 (Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips). An election may be made not to have this credit apply. If this election is made, the employer can deduct the employer portion of the social security tax on the tips. Employers should use the federal minimum wage when computing the credit in cases where the state minimum wage is different than the federal minimum wage. The FICA tip credit is allowed to offset 100% of AMT liability.
12. *The Section 45C Orphan Drug Credit.* This credit applies to qualified expenses incurred in the testing of drugs to cure rare diseases or conditions (drugs termed generally as "orphan drugs"). Form 8820 (Orphan Drug Credit) is used to compute this credit.
13. *The Section 45D New Markets Tax Credit.*
14. *The Section 45E Small Employer Pension Plan Start-up Costs Credit.* The credit equals 50% of the qualified costs incurred in the first three years.
15. *The Section 45F Employer Child Care Assistance Credit.*
16. *The Section 30B Alternative Motor Vehicle Credit.*
17. *Section 30C Alternative Fuel Vehicle Refueling Property Credit.* This credit is available to taxpayers who place property in service that is used to store or dispense clean-burning fuel into a fuel tank, or to recharge motor vehicles propelled by electricity. The volume of the clean-burning fuel must be at least 85% ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, or at least 20% biodiesel. Except for hydrogen property, the property must be placed in service by December 31, 2010. This credit is computed on Form 8911 (Alternative Fuel Vehicle Refueling Property Credit).

18. *Section 45O Agricultural Chemicals Security Credit.* The 2008 Farm Act created a new general business credit category under which an eligible agricultural business can take a 30% credit for qualified chemical security expenditures for the tax year. The credit is subject to both a \$100,000 limitation per facility and an annual \$2 million limitation per taxpayer. The credit is designed to encourage expenditures to safeguard agricultural chemicals from theft and use for illegal purposes (e.g., illicit drug manufacturing or acts of terrorism). If an eligible agricultural business pays or incurs qualified chemical security expenditures to increase the security of specified agricultural chemicals, the credit will help offset these expenses. The credit is effective for amounts paid or incurred after May 22, 2008 and before January 1, 2013.
  
19. *Section 45P Differential Wage Payment Credit.* The 2008 Heroes Act provides to an eligible small business employer a differential wage payment credit equal to 20% of the sum of the eligible differential wage payments for each of the employer's qualified employees during the tax year. An eligible small business employer is one that (a) employed an average of less than 50 employees on business days during the tax year and (b) provided, under a written plan, eligible differential wage payments to each of its qualified employees. A *qualified employee* is a person who has been an employee of the taxpayer for the 91-day period immediately before the period for which any differential wage payment is made. Eligible differential wage payments are, for each qualified employee, so much of the differential wage payments paid to the employee for the tax year that do not exceed \$20,000. Thus, a *differential wage payment* is any payment that (a) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days and (b) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing service for the employer. The credit is effective for amounts paid or incurred after June 17, 2008 and before January 1, 2010.
  
20. *Section 30D Qualified Plug-in Electric Drive Motor Vehicles Credit.* This credit is available for four-wheeled vehicles propelled to a significant extent by an electric motor that draws electricity from a battery that has a capacity of at least four kilowatt hours and is rechargeable from an external source. The credit applies to vehicle purchases beginning in 2009 and expires in 2014.

**Computation of Credits**

A corporation claiming more than one of these business credits, a carryback or carryforward of any of these credits, or having credits from a passive activity must summarize them on Form 3800 (General Business Credit). The following examples illustrate the computation of two of these credits.

**Example 2A-1 Claiming the disabled access credit.**

Ace Containers, Inc. (ACI) incurs costs of \$20,250 during 2009 to make its factory accessible to disabled employees. ACI has gross receipts of less than \$1 million, and has fewer than 30 full-time employees. Therefore it qualifies as an "eligible small business" for purposes of the Section 44 disabled access credit. ACI may claim a 2009 credit of \$5,000 computed as follows:

1. Total eligible disabled access expenditures	\$ 20,250
2. Minimum amount	_____ (250)
3. Subtract line 2 from line 1	<u>\$ 20,000</u>
4. Maximum amount allowed	<u>\$ 10,000</u>
5. Smaller of line 3 or line 4	<u>\$ 10,000</u>
6. Current year credit (50% of line 5)	<u>\$ 5,000</u>

ACI claims this credit by completing Form 8826 (Disabled Access Credit). ACI must decrease the basis of the assets by the amount of the credit claimed.

**Example 2A-2 Claiming the rehabilitation investment credit.**

ACI (see Example 2A-1) purchased a historic building in 2007 to renovate and use for the corporate administration offices. Renovation began on March 1, 2007 when the building's adjusted basis was \$100,000 and was completed on February 28, 2009. Qualified rehabilitation expenditures incurred during the 24-month period beginning March 1, 2007 and ending February 28, 2009 were \$120,000. The rehabilitation has been certified by the National Parks Service (NPS) as being consistent with the historic character of the structure.

The Section 47 rehabilitation investment credit equals 20% of the qualified rehabilitation expenditures for a certified rehabilitation of a historic structure. Thus, ACI's rehabilitation investment credit is \$24,000 ( $\$120,000 \times 20\%$ ).

ACI claims the credit by completing Form 3468 (Investment Credit). ACI also must attach to its return a copy of the NPS certification of completed work or the request for final NPS certification, evidence that the building is a certified historic structure, and a statement indicating:

1. the beginning and ending date of the chosen measuring period,
2. the adjusted basis of the building at the beginning of the measuring period, and
3. the qualified rehabilitation expenditures incurred during the measuring period.

In addition, since ACI also has an additional business credit in the form of the disabled access credit computed in Example 2A-1, it must complete Form 3800 to claim both the rehabilitation investment credit and the disabled access credit. Assume ACI has a regular tax liability of \$100,000 before tax credits.

**Limitations**

IRC Sec. 38(c) limits the credit that can be claimed in any one year. The total general business credit allowed for any tax year cannot exceed the excess of the taxpayer's net income tax (sum of the regular tax liability and the Section 55 alternative minimum tax reduced by specified credits) over the greater of:

1. the tentative minimum tax (AMT increased by the "regular" tax subtracted in arriving at AMT) for the year,  
or
2. 25% of the taxpayer's net regular tax (net income tax as above less AMT and specified credits) liability in excess of \$25,000 for the year.

Example 2B-1 provides an example of the computation of this limitation. Unused credits can be carried to other years under the rules discussed later in this lesson. The limitation rules are different for the empowerment zone credit and the renewal community employment credit than for other credits.

**How to Handle General Business Credit Carrybacks and Carryforwards****In General**

Unused general business credits may be carried back one year and carried forward for 20 years. Any unused credits for a year must be carried back to the preceding tax year before being carried forward. There is no election to forgo the carryback period.

**Using Business Credit Carrybacks and Carryforwards**

Business credit carryforwards are used to offset tax liability before any current-year credit or carryback. Carrybacks are used after all carryforwards from earlier years and all current-year credits are used. Carryforwards from two or more separate unused credit years are to be used on a FIFO basis.

**Example 2B-1 Using business credit carrybacks and carryforwards.**

ABC, Inc. has \$200,000 of tax liability for 2009 that can be offset by the general business credit. It has no minimum tax liability for 2009. Its business credit for 2009 is \$30,000. ABC has business credit carryforwards from earlier years as follows:

<u>Year</u>	<u>Unused Credit</u>
2006	\$ 40,000
2007	100,000
2008	<u>50,000</u>
	<u>\$ 190,000</u>

The credit carryforwards are applied in the following order against ABC's 2009 tax liability:

<u>Order of Use</u>	<u>Amount</u>
2009 tax liability	\$ 200,000
First—2006 credit carryforward	(40,000)
Second—2007 credit carryforward	(100,000)
Third—2008 credit carryforward	<u>(16,250)</u>
Remaining 2009 tax liability	<u>\$ 43,750<sup>a</sup></u>

**Note:**

<sup>a</sup> Only \$16,250 of the \$50,000 credit carryforward from 2008 can be used due to the IRC Sec. 38(c)(1) limitation.

The credit cannot exceed the excess of the taxpayer's net income tax over the greater of its tentative minimum tax or 25% of its net regular tax liability in excess of \$25,000.

(1) 2009 net income tax		\$ 200,000
Net income tax in excess of \$25,000	175,000	
	× 25%	
	<u>43,750</u>	
(2)	<u>\$ 43,750</u>	
(3) Tentative minimum tax	<u>\$ -0-</u>	
(4) Greater of (2) or (3)		<u>\$ (43,750)</u>
Limitation of credit [(1) – (4)]		<u>\$ 156,250</u>

How much credit remains from 2009?

Total credit carryforward remaining from 2008	\$ 33,750
Credit carryforward from 2009	<u>30,000</u>
	<u>\$ 63,750</u>

**Ordering Rules**

Under the ordering rules of IRC Sec. 38(d), the credits listed within the general business credit, including credits under prior law, are to be used in the following order:

1. The Section 46 investment credit:
  - a. The rehabilitation credit under IRC Sec. 47.

- b. The energy credit under IRC Sec. 48(a).
  - c. The Section 48A qualifying advanced coal project credit.
  - d. The Section 48B qualifying gasification project credit.
  - e. The Section 48C qualifying advanced energy project credit.
2. The Section 51 work opportunity credit.
  3. The Section 40 alcohol fuels credit.
  4. The Section 41 research credit.
  5. The Section 42 low-income housing credit.
  6. The Section 43 enhanced oil recovery credit.
  7. The Section 44 disabled access credit.
  8. The Section 45 renewable electricity production credit.
  9. The Section 1396 empowerment zone employment credit.
  10. The Section 45A Indian employment credit.
  11. The Section 45B employer social security credit.
  12. The Section 45C orphan drug credit.
  13. The Section 45D new markets tax credit.
  14. The Section 45E small employer pension plan start-up costs credit.
  15. The Section 45F employer-provided child care credit.
  16. The Section 45G(a) railroad track maintenance credit.
  17. The Section 40A(a) biodiesel fuels credit.
  18. The Section 45H(a) low sulfur diesel fuel production credit.
  19. The Section 45I(a) marginal oil and gas well production credit.
  20. The Section 5011(a) distilled spirits credit.
  21. The Section 45J(a) advanced nuclear power facility production credit.
  22. The Section 45K(a) nonconventional source production credit.
  23. The Section 45L(a) new energy efficient home credit.
  24. The Section 45M(a) energy efficient appliance credit.
  25. The portion of the alternative motor vehicle credit to which IRC Sec. 30B(g)(1) applies.
  26. The portion of the alternative fuel vehicle refueling property credit to which IRC Sec. 30C(d)(1) applies.

27. The Section 1400P(b) Hurricane Katrina housing.
28. The Section 1400R(a) Hurricane Katrina employee retention credit.
29. The Section 1400R(b) Hurricane Rita employee retention.
30. The Section 1400R(c) Hurricane Wilma employee retention credit.
31. The Section 45N(a) mine rescue team training credit.
32. The Section 45O agricultural chemicals security credit.
33. The Section 45P differential wage payment credit.
34. The Section 45Q carbon dioxide sequestration credit.
35. The Section 30D qualified plug-in electric drive motor vehicle credit.

**Example 2B-2 Application of the credit ordering rules.**

XYZ, Inc., a calendar-year taxpayer, began business January 1, 2008 and incurred a general business credit in 2008 of \$15,000 (\$5,000 of the energy credit and \$10,000 of the low-income housing credit). XYZ was unable to use any of this credit in 2008 as it had no tax liability. XYZ has a \$12,000 tax liability for 2009.

Under the Section 38(d) ordering rules, XYZ must first use the energy credit and then the low-income housing credit. Thus, all of the \$5,000 energy credit carryforward and \$7,000 of the low-income housing credit carryforward are used to offset the 2009 \$12,000 tax liability. The remaining \$3,000 of the low-income housing credit (\$10,000 – \$7,000) is available for carryforward.

**Deducting Unused Business Credits**

If a taxpayer's qualified business credit carryforward has not been used in any tax year, the entire unused credit is allowed to the taxpayer as a *deduction* (not a credit) for the year following the last tax year in which the credit could be taken under IRC Sec. 39. Normally, this would be the 21st year after the credit is earned. However, the unused credit can be deducted in the year a taxpayer ceases to exist.

For this deduction, the term "qualified business credits" refers to (1) the investment credit, (2) the work opportunity credit, (3) the alcohol fuels credit, (4) the research credit, (5) the enhanced oil recovery credit, (6) the empowerment zone employment credit, (7) the Indian employment credit, (8) the employer Social Security credit, (9) the new markets tax credit, (10) the small employer pension plan start-up cost credit, (11) the biodiesel fuels credit, (12) the low sulfur diesel fuel credit, and (13) the new energy efficient home credit. For the investment credit and research credit, only 50% of the unused amount can be deducted.

**Example 2B-3 Deducting unused business credits.**

Grantcorp is liquidating in 2009. It has a \$5,000 unused work opportunity credit. If a taxpayer ceases to exist before taking all available qualified business credits, certain unused credits can be taken as a deduction in the year following the last tax year for which they could be taken (i.e., the 21st year) or in the final year of a taxpayer's existence (i.e., for death or liquidation). Therefore, Grantcorp may take a *deduction* (not a credit) for the \$5,000 in unused credits on its final Form 1120.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Green With Energy, Inc., (GWE) is a construction company that is clearing land to begin the development of qualified new energy-efficient homes. The project will be complete in the fall of 2009. Assume that GWE is eligible for the Energy Credit under Section 48(a). What form should GWE use to claim the energy credit?
  - a. Form 3468.
  - b. Form 6478.
  - c. Form 8911.
  - d. Form 8845.
12. According to the Section 45P Differential Wage Payment Credit, which of the following statements is most accurate?
  - a. Eligible small business employers should employ no more than 45 employees on any business day.
  - b. Eligible small business employer must provide, under a written plan, eligible differential wage payments to all of its qualified employees.
13. Which of the following statements regarding general business carrybacks and carryforwards is most accurate?
  - a. Most general business credits that have not been used may be carried forward for 15 years, but can only be carried back one year.
  - b. Business credits that have not been used must be carried back to the previous tax year before being carried forward.
  - c. Taxpayers should use all current-year carrybacks to offset tax liability before using any business credit carryforwards.
14. Plaxico Inc. (PXI) is liquidating in 2009. It has \$3,000 of unused research credit. If PXI liquidates before taking all available qualified business credits, it can deduct certain unused credits during all of the following **except**:
  - a. The year following the last tax year in which the credit can be taken under IRC Sec. 196(b).
  - b. The year following the last tax year for which the tax credit could be taken.
  - c. The year of PXI's liquidation.

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. Green With Energy, Inc., (GWE) is a construction company that is clearing land to begin the development of qualified new energy-efficient homes. The project will be complete in the fall of 2010. Assume that GWE is eligible for the Energy Credit under Section 48(a). What form should GWE use to claim the energy credit? **(Page 117)**
  - a. **Form 3468. [This answer is correct. The sum of the credits under the Section 46 Investment credit is computed on Form 3468. GWE is eligible to claim the Section 48(a) Energy Credit which is included in Section 46.]**
  - b. Form 6478. [This answer is incorrect. The Section 40 Alcohol Fuels Credit is computed on Form 6478 (Alcohol and Cellulose BioFuels Credit).]
  - c. Form 8911. [This answer is incorrect. Form 8911 is used to compute the Alternative Fuel Vehicle Refueling Property Credit.]
  - d. Form 8845. [This answer is incorrect. The Section 45A Indian Employment Credit is claimed on Form 8845.]
12. According to the Section 45P Differential Wage Payment Credit, which of the following statements is most accurate? **(Page 119)**
  - a. Eligible small business employers should employ no more than 45 employees on any business day. [This answer is incorrect. An eligible small business employer is one that employed on average less than 50 employees on business days during the tax year.]
  - b. **Eligible small business employer must provide, under a written plan, eligible differential wage payments to all of its qualified employees. [This answer is correct. Eligible small business employers must provide, under a written plan, eligible differential wage payments to each of its qualified employees. A qualified employee is a person who has been an employee of the taxpayer for the 91-day period immediately before the period for which any differential wage payment is made. Eligible differential wage payments are, for each qualified employee, so much of the differential wage payments paid to the employee for the tax year that does not exceed \$20,000.]**
13. Which of the following statements regarding general business carrybacks and carryforwards is most accurate? **(Page 120)**
  - a. Most general business credits that have not been used may be carried forward for 15 years, but can only be carried back one year. [This answer is incorrect. Unused general business credits may be carried back one year and carried forward for 20 years.]
  - b. **Business credits that have not been used must be carried back to the previous tax year before being carried forward. [This answer is correct. According to the IRC, any unused credits for a year must be carried back to the preceding tax year before being carried forward.]**
  - c. Taxpayers should use all current-year carrybacks to offset tax liability before using any business credit carryforwards. [This answer is incorrect. Business credit carryforwards are used to offset tax liability before any current-year credit or carryback.]
14. Plaxico Inc. (PXI) is liquidating in 2009. It has \$3,000 of unused research credit. If PXI liquidates before taking all available qualified business credits, it can deduct certain unused credits during all of the following **except**: **(Page 123)**
  - a. **The year following the last tax year in which the credit can be taken under IRC Sec. 196(b). [This answer is correct. According to IRC Sec. 196(b), the unused credit can be deducted in the year a**

**taxpayer ceases to exist. Under IRC Sec. 196(a), if a taxpayer's qualified business credit carryforward has not been used in any tax year, the entire unused credit is allowed to the taxpayer as a *deduction* (not a credit) for the year following the last tax year in which the credit could be taken under IRC Sec. 39.]**

- b. The year following the last tax year for which the tax credit could be taken. [This answer is incorrect. According to the IRC, PXI can deduct specific unused credits during the 21<sup>st</sup> year after the credit is earned.]
- c. The year of PXI's liquidation. [This answer is incorrect. According to the IRC, PXI can deduct certain unused credits in the final year of existence.]

## How to Claim Credits Arising from Passive Activities

### In General

In the corporate setting, passive activity rules apply to personal service corporations (PSCs) and closely held corporations. When the passive activity rules apply, credits arising with respect to passive activities are treated similarly to losses from those activities. Passive activity credits are not additional credits, but are regular tax credits arising from a passive activity. A passive activity credit is defined as the excess of the taxpayer's credits from passive activities allowable under the Code over the taxpayer's regular tax liability allocable to all passive activities.

1. *Personal Service Corporations (PSCs)*. Credits attributable to passive activities by PSCs can be used only to offset regular tax that is attributable to passive income. Credits are thus limited much the same as passive activity losses—unused credits arising with respect to passive activities are suspended and can be carried forward indefinitely if they are not allowable under the passive loss rules. The character of a passive activity credit changes when it becomes allowable under the passive loss rules. At that point, the credits are aggregated with credits relating to nonpassive activities for purposes of determining whether they are subject to the general business credit limitations under IRC Sec. 38(c)(1).
2. *Closely Held Corporations (CHCs)*. Essentially the same rules apply to CHCs except they are allowed to offset credits against tax attributable to their net active income.

Investors claiming the low-income housing credit (LIHC) through a pass-through entity (partnership) need not file Form 8609. The investor's LIHC is taken from the "Credits" section of Schedule K-1 to Form 8586.

If there is a general business credit (GBC) in addition to the LIHC (or a carryback or carryforward of the GBC), or if the LIHC is from a passive activity, the LIHC is carried to Form 3800 (General Business Credit), then to Form 8810 (Corporate Passive Activity Loss and Credit Limitations) if from a passive activity.

#### **Example 2C-1 Low-income housing credit from partnership interest.**

Scott Corporation owns a 5% interest in Fulton, Ltd., a limited partnership that it invested in seven years ago. The partnership rents residential property to low-income families. Scott does not participate in the partnership's business, so the passive activity rules apply. The LIHC is the only business credit the corporation is eligible to claim.

The Schedule K-1 from Fulton shows a flow-through LIHC of \$3,000. The \$3,000 is shown on Schedule K on line 15a (Low-income housing credit). It is reported to Scott on Schedule K-1, line 15, code A.

The partnership (i.e., the owner of the property) attaches the following forms to its Form 1065:

Form 8586	Low-Income Housing Credit
Form 8609	Low-Income Housing Credit Allocation Certification
Form 8609, Schedule A	Annual Statement

While preparing Scott's Form 1120, the practitioner enters \$3,000 on Scott's Form 8586. The rules allow the credit to be carried directly from Form 8586 to Form 1120 if there are no other business credits and if the credits are not subject to the passive activity limitations.

### Calculating the Credit on Form 8810

The credit calculations are made on Form 8810 (Corporate Passive Activity Loss and Credit Limitations). Any suspended losses related to a passive activity are fully allowable if a corporation disposes of its entire interest in the activity in a fully taxable transaction. Reg. 1.469-4(g) allows a disposition of "substantially all of an activity" to be treated as a separate activity. However, any suspended passive activity credits related to the activity are not triggered by such a disposition. Suspended credits from disposed activities continue to be subject to the rules of IRC Sec. 469. Consequently, if no tax is generated by the disposition, or not enough tax is generated (for example,

because of the use of suspended losses related to the activity), any unused suspended credits continue to be carried forward until they are used to offset tax on income from other passive activities. Example 2C-2 illustrates how the unused credits can be utilized.

### Applying the Basis Adjustment Rule

A special basis adjustment rule applies if a corporation made a property basis adjustment as a result of claiming a tax credit (e.g., a corporation reduces the basis of property for which a rehabilitation credit is claimed) and it makes a fully taxable disposition of the entire interest in an activity. When the property is disposed of, the corporation can elect to increase its basis by the amount of the suspended credit through operation of the passive activity rules. However, the basis adjustment cannot exceed the amount of the original basis adjustment resulting from the unused credit. The adjustment applies immediately before disposition of the property. Thus, the corporation's gain may be minimized or loss increased as a result of the election. However, the election may not be advantageous to a corporation with sufficient passive income from other activities to allow full use of the credit. Example 2C-3 shows how the election is made.

#### Example 2C-2 Claiming credits upon the dispositions of a passive activity.

Lossco, Inc. (LI), a calendar-year PSC, has an investment in a passive activity it disposes of during the current year. LI has a suspended passive activity loss of \$10,000 carried into the current year, a current-year passive activity loss of \$8,000, a taxable gain from the disposition of the passive activity of \$25,000, and a carryover rehabilitation investment credit from the passive activity of \$5,000. LI is a PSC subject to a flat 35% corporate tax rate. The corporation's taxable income is \$350,000.

The net gain from the disposition of the activity is computed as follows:

Gain on sale	\$ 25,000
Suspended losses	(10,000)
Current-year passive loss	<u>(8,000)</u>
Net gain on sale (net passive income from the activity)	<u>\$ 7,000</u>

The regular tax attributable to the net passive income from this activity is \$2,450 (35% of \$7,000). LI can only use the passive activity credit equal to the amount of the regular tax attributable to the net passive income. Thus, LI can only use \$2,450 of the available passive activity credit of \$5,000. The unused credit of \$2,550 is carried forward until it can be used to offset tax on income from other passive activities.

### Electing the Special Basis Adjustment for Property after a Fully Taxable Disposition

The following example illustrates how to elect the special basis adjustment after a fully taxable disposition.

#### Example 2C-3 Electing the special basis adjustment for property after a fully taxable disposition.

Assume the same facts as in Example 2C-2. LI decides to elect the basis adjustment rule and increase the basis of the property by the amount of the unused rehabilitation investment credit.

When the credit was claimed, the basis of the property was reduced by the entire amount of the credit, which was \$8,000. LI can increase the basis by the remaining unused credit of \$5,000 because it is less than the original basis adjustment. The net gain from the disposition of the activity is computed as follows:

Gain on sale (\$25,000 less increased basis of \$5,000)	\$ 20,000
Suspended losses	(10,000)
Current-year passive loss	<u>(8,000)</u>
Net gain on sale	<u>\$ 2,000</u>

The regulations specify that LI should make the election on Form 8810. The election is made on Part III of Form 8810.

## How to Claim the Foreign Tax Credit

A U.S. corporation is subject to U.S. taxation on its worldwide income. If foreign-source income is also taxed by a foreign country, the corporation could be subject to double taxation. A corporation may be entitled to a deduction or a tax credit for the foreign tax paid. If the deduction is taken, it is reported as a part of taxes on line 17 of Form 1120. If the credit is taken, Form 1118 (Foreign Tax Credit—Corporations) is used to calculate and report the credit.

Generally, it is more advantageous to take the credit for qualified foreign taxes paid rather than a deduction for those taxes. However, the credit is limited to the U.S. tax attributable to the foreign-source income. Thus, if the corporation has no U.S. tax liability, the deduction of the foreign tax may be more advantageous in limited circumstances (rather than the dollar-for-dollar effect of a foreign tax credit). The amount of the foreign tax a corporation can use as a credit is computed (as well as limited) based on the following formula:

$$\text{U.S. tax (before credit)} \times \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}}$$

The U.S. tax liability considered is the regular tax liability minus the possessions corporation tax credit determined under IRC Sec. 936. The tax amount does not include AMT, PHC tax, or recapture of ITC. As a result of this formula, the foreign tax credit may not exceed the portion of the U.S. tax liability attributable to income from foreign sources. The limitation is calculated on Form 1118.

If the foreign taxes paid or accrued in the current year exceed the limitation, the excess eligible taxes are first carried back for one year and then forward to the 10 succeeding years. The excess taxes are considered paid in the year to which they are carried and can be used only when the overall limitation for that year exceeds the foreign taxes actually paid or accrued.

### Example 2D-1 Calculation of limitation on credit.

Hot Tamales, Inc. (HTI) has foreign-source taxable income for the current year of \$200,000. The foreign tax paid on that income is \$40,000. HTI has worldwide income of \$3,000,000 for the current year (including the \$200,000 of foreign income) and a U.S. regular tax liability of \$1,020,000. The current year limitation on the use of the foreign tax credit by HTI is calculated as follows:

$$\$1,020,000 \times \frac{\$200,000}{\$3,000,000} = \$68,000 \text{ available credit}$$

In this instance, the amount determined by the formula (\$68,000) is more than the actual foreign tax paid (\$40,000). Therefore, the foreign tax credit for the current year is limited to \$40,000.

A separate limitation of the foreign source income must be calculated for two categories (also referred to as "baskets") of foreign-source income.

The two baskets are—

1. *The passive income basket* includes passive income and specified passive income, which is defined as (a) dividends from a DISC or former DISC to the extent the dividends are treated as foreign source income; (b) taxable income attributable to foreign trade income; and (c) distributions from a FSC or a former FSC out of earnings and profits attributable to foreign trade income or interest or carrying charges from a transaction that results in foreign trade income.
2. *The general income basket* includes income other than passive income. For example, shipping income usually will be considered general income, while, depending upon the circumstances, high withholding tax interest could be considered either passive or general income. Dividends from a DISC or former DISC, FSC

or former FSC will all be considered passive income. The basket classification does affect the separate computation of foreign tax credit limitations under special Code provisions relating to treaty-based sourcing rules or specified countries under IRC Sec. 901(j).

In determining the limitation, the source of all income must be established using the general source rules of IRC Sec. 861 through 865, the specific source rules of IRC Sec. 904(g), and any applicable source rules contained in various tax treaties. In addition, the deductions applicable to the various categories of income must be determined. Some deductions that cannot be definitely allocated to a specific category of income must be apportioned in accordance with IRC Sec. 864. Schedule H of Form 1118 is used for making these apportionments.

A corporation can claim the foreign tax credit for any income, war profits, and excess profits taxes paid or accrued to any foreign country or U.S. possession, and for certain taxes deemed paid on dividends from foreign subsidiaries under IRC Secs. 902 and 960. IRC Sec. 901(f) through (j) lists various types of payments that are not considered foreign taxes for the foreign tax credit.

The foreign tax credit is also available for use against a corporation's alternative minimum tax liability. The regular tax foreign tax credit claimed for each separate limitation category of income must be refigured by taking the corporation's AMT adjustments and preferences into consideration to determine U.S. and foreign-source income. However, taxpayers may elect to use foreign-source regular taxable income to substitute for their AMT foreign-source income when computing their AMT foreign tax credit limitation.

IRC Sec. 904(g) provides that taxpayers who sustain an overall domestic loss can recharacterize that loss as foreign source income for succeeding tax years in an amount equal to the lesser of:

1. The full amount of the loss not carried back to prior tax years.
2. 50% of the taxpayer's U.S. source taxable income for the succeeding tax year.

The result is that parity is achieved in the treatment of overall foreign losses and overall domestic losses and, thus, the double taxation of foreign source income is mitigated.

## **Claiming Credit Carryover against S Corporation Built-in Gains Tax**

An S corporation that has converted from C status may be subject to a corporate-level built-in gains tax. The built-in gains tax can be offset by unused business credit carryforwards from prior C corporation tax years, but only to the extent they could be used under the C corporation rules.

Business credit carryovers are entered on the appropriate lines of Part III of Schedule D (Form 1120S). Form 3800 (General Business Credit) should be completed when a business credit carryover is claimed.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. What happens when no tax is generated by a disposition?
  - a. The unused credit is deducted in the corporation's final year of existence.
  - b. The unused credits are continually carried forward until used to offset tax on income from other passive activities.
16. How can a corporation's suspended losses related to passive activities become fully allowable?
  - a. A corporation must create a property basis adjustment.
  - b. A corporation must dispose of its entire interest in the activity in a complete, taxable transaction.
17. Aquarius Aquariums Inc., (AAI) is an international corporation who is subject to double taxation. If AAI is entitled to a tax credit for the foreign tax, which of the following forms would AAI use to calculate and report the credit?
  - a. Form 1118.
  - b. Line 17 of Form 1120.
  - c. Form 1120S.
  - d. Form 8810.
18. Select the Internal Revenue Code(s) a corporation can use to claim the foreign tax credit for income paid to any foreign country.
  - a. IRC Sec. 861.
  - b. IRC Sec. 902.
  - c. IRC Sec. 901(f) through (j).
  - d. IRC Sec. 904(g).

## SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. What happens when no tax is generated by a disposition? **(Page 128)**
- The unused credit is deducted in the corporation's final year of existence. [This answer is incorrect. The practitioner should review IRC Sec. 196 whenever a corporate client liquidates to determine if any unused credits can be deducted in the final year of the corporation's existence.]
  - The unused credits are continually carried forward until used to offset tax on income from other passive activities. [This answer is correct. Suspended credits from disposed activities continue to be subject to the rules of IRC Sec. 469. Consequently, if no tax is generated by the disposition, or not enough tax is generated (for example, because of the use of suspended losses related to the activity), any unused suspended credits continue to be carried forward until they are used to offset tax on income from other passive activities.]**
16. How can a corporation's suspended losses related to passive activities become fully allowable? **(Page 128)**
- A corporation must create a property basis adjustment. [This answer is incorrect. A special basis adjustment rule applies if a corporation made a property basis adjustment as a result of claiming a tax credit and it makes a fully taxable disposition of the entire interest in an activity. When the property is disposed of, the corporation can elect to increase its basis by the amount of the suspended credit through operation of the passive activity rules.]
  - A corporation must dispose of its entire interest in the activity in a complete, taxable transaction. [This answer is correct. Any suspended losses related to a passive activity are fully allowable if a corporation disposes of its entire interest in the activity in a fully taxable transaction.]**
17. Aquarius Aquariums Inc., (AAI) is an international corporation who is subject to double taxation. If AAI is entitled to a tax credit for the foreign tax, which of the following forms would AAI use to calculate and report the credit? **(Page 129)**
- Form 1118. [This answer is correct. A U.S. corporation is subject to U.S. taxation on its worldwide income. If foreign-source income is also taxed by a foreign country, the corporation could be subject to double taxation. A corporation may be entitled to a deduction or a tax credit for the foreign tax paid. If the credit is taken, Form 1118 (Foreign Tax Credit—Corporations) is used to calculate and report the credit.]**
  - Line 17 of Form 1120. [This answer is incorrect. A U.S. corporation is subject to U.S. taxation on its worldwide income. If foreign-source income is also taxed by a foreign country, the corporation could be subject to double taxation. A corporation may be entitled to a deduction or a tax credit for the foreign tax paid. If the deduction is taken, it is reported as a part of taxes on line 17 of Form 1120.]
  - Form 1120S. [This answer is incorrect. Business credit carryovers are entered on the appropriate lines of Part III of Schedule D (Form 1120S).]
  - Form 8810. [This answer is incorrect. The credit calculations are made on Form 8810 (Corporate Passive Activity Loss and Credit Limitations).]
18. Select the Internal Revenue Code(s) a corporation can use to claim the foreign tax credit for income paid to any foreign country. **(Page 130)**
- IRC Sec. 861. [This answer is incorrect. The general source rules of IRC Sec. 861 through 865 also apply to foreign source income and this is not the correct IRC Section for claiming the foreign tax credit.]
  - IRC Sec. 902. [This answer is correct. A corporation can claim the foreign tax credit for any income, war profits, and excess profits taxes paid or accrued to any foreign country or U.S. possession, and for certain taxes deemed paid on dividends from foreign subsidiaries under IRC Secs. 902 and 960.]**

- c. IRC Sec. 901(f) through (j). [This answer is incorrect. IRC Sec. 901(f) through (j) lists various types of payments that are not considered foreign taxes for the foreign tax credit.]
- d. IRC Sec. 904(g). [This answer is incorrect. The specific source rules of IRC Sec. 904(g) and any applicable source rules contained in various tax treaties also apply to foreign source income and this is not the IRC Section for claiming the foreign tax credit.]



**EXAMINATION FOR CPE CREDIT**

**Lesson 2 (T20TG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

11. Match the following statements with the appropriate credits. (Note: some statements may not be applicable to either of the credits.)

Statement	Credit
i. The credit is claimed on Form 8846.	A. Section 45B Employer Credit for Social Security Taxes Paid on Employee Tip Income
ii. The credit is effective for amounts paid or incurred after June 17, 2008 and before January 1, 2010.	B. Section 45P Differential Wage Payment Credit
iii. The credit is claimed on Form 8911.	
iv. Applies to specific wages and health insurance costs paid or incurred after 1993 for qualified employees in tax years beginning before 2008.	

- a. A (iii); B (iv).
  - b. A (ii); B (i).
  - c. A (iv); B (iii).
  - d. A (i); B (ii).
12. The Container Club, Inc. (TCC) incurs costs of \$10,000 during 2009 to make its factory accessible to disabled employees. TCC has gross receipts of less than \$1 million, and has fewer than 30 full-time employees. Therefore it qualifies as an “eligible small business” for purposes of the Section 44 disabled access credit. What credit amount can TCC claim for 2009?
- a. \$4,000.
  - b. \$4,875.
  - c. \$5,000.
  - d. \$5,875.
13. What happens to unused general business credits?
- a. They are carried forward to the next tax year.
  - b. They are carried back to the preceding tax year and then carried forward for 20 years.
  - c. They are carried back one year and carried forward for 15 years.
  - d. Do not select this answer choice.

14. When deducting unused business credits, which of the following credits are considered "qualified credits?"

i. Research credit	v. Orphan drug credit
ii. Indian employment credit	vi. Biodiesel fuels credit
iii. Work opportunity credit	vii. Low-income housing credit
iv. New markets tax credit	viii. Renewable electricity production credit

- a. i., ii., iii., iv., and vi.
- b. ii., vi., vii., and., viii.
- c. iv., v., vi., and vii.
- d. v., vi., vii., and viii.
15. Under which of the following rules can a corporation choose to increase its basis by the amount of the suspended credit when disposing of property?
- a. Limitation rules.
- b. Ordering rules.
- c. Passive activity rules.
- d. Passive loss rules.
16. Salt of the Earth, Inc. (SOE) has foreign-source taxable income for the current year of \$100,000. In 2009, the foreign tax paid on that income is \$50,000. SOE has worldwide income of \$2,000,000 for the current year (including the \$100,000 of foreign income) and a U.S. regular tax liability of \$1,020,000. What is SOE's available foreign tax credit?
- a. \$51,000.
- b. \$68,000.
- c. \$81,600.
- d. \$85,000.
17. In the example above, what is SOE's foreign tax credit limitation for 2009?
- a. \$40,000.
- b. \$50,000.
- c. \$51,000.
- d. \$68,000.

18. The foreign source income separate limitation must be calculated for both categories of foreign-source income referred to as baskets. Match the following income with the appropriate basket. (Note: some income may be included in both baskets.)

i. Shipping income	A. Passive income basket
ii. Dividends from a DISC	B. General income basket
iii. Distributions from a FSC	
iv. High withholding tax	

- a. A (i, ii, and iv); B (iii, iv).  
 b. A (ii, iv); B (iii, iv).  
 c. A (ii, iii, and iv); B (i, iv).  
 d. A (ii, iv); B (i, ii, and iii).



# Lesson 3: Tax Payments

## INTRODUCTION

Income taxes generally must be paid when they are due. However, the IRS may extend the time for payment of tax in limited situations. Taxpayers must pay the IRS interest if they do not pay (or if they underpay) tax when it is due. The failure of a corporation to pay tax when it is due generally subjects it to a penalty of 0.5% per month on the amount of unpaid tax for each month of the delinquency, up to a maximum of 25%.

Corporations are normally required to make estimated tax payments. Underpaying or failing to make timely estimated tax payments subjects the corporation to a penalty. Alternatively, if a corporation discovers after its tax year that it has overpaid its estimated tax payments, it may be eligible to file for a quick refund of those payments.

IRC Sec. 6302(h) requires certain taxpayers to use electronic fund transfer (EFT) for total tax deposits (for payroll taxes, corporate income tax, back-up withholding, etc.). Failure to deposit by EFT will subject the taxpayer to a penalty even if a timely deposit is made by other means.

### Learning Objectives:

Completion of this lesson will enable you to:

- Explain the details of extending the time to pay income tax.
- Explain how estimated tax payments are calculated.
- Explain how to estimate tax payments for short tax years and members of a controlled group not filing a consolidated return; and explain the general rule to the penalty for underpayment of estimated tax.
- Determine interest on tax underpayments and overpayments.
- Explain how to deposit income tax.

## Extend the Time for Paying the Tax

### Hardship Situations

The IRS continually reminds taxpayers that are having difficulty paying their income taxes in full to file their returns on time and pay as much as they can with the return. They can then consult with the IRS or their practitioner to see if they qualify for one of the following payment alternatives.

The time for payment of income tax may be extended by the IRS for a reasonable period not exceeding six months. This extension is available only if the taxpayer demonstrates that paying the tax when it is due will result in an undue hardship. Undue hardship is defined as a substantial financial loss to the taxpayer, such as a sale of property at a sacrifice price to pay the tax owed. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in undue hardship.

An application for the extension of time to pay income tax is made on Form 1127 (Application For Extension of Time For Payment of Tax) and must provide evidence showing the undue hardship that would result to the corporation if the extension were refused. The application must also be accompanied by a statement of the assets and liabilities (showing book and market values) of the taxpayer and an itemized statement showing all receipts and disbursements for each of the three months immediately preceding the due date of the tax. The application must be filed with the IRS on or before the due date for the tax payment. The IRS will examine the application and, if possible, grant or deny (or grant subject to specified conditions) the application within 30 days.

### Installment Agreements

The IRS has statutory authority to enter into a written installment agreement that enables the corporation to pay its tax liability over a period of time if the arrangement will facilitate full or partial collection of the tax. The civil penalties authorized by Chapter 68 of the Code (in particular, the Section 6662 accuracy-related penalties) can be included in the agreement. The corporation can submit Form 9465 (Installment Agreement Request) with its tax return, or it

can file the form in response to a bill from the IRS. While Form 9465 allows the corporation to avoid a late filing penalty, it will still be liable for interest and a late payment penalty on the unpaid amount.

The IRS collects a \$105 fee for entering into an installment agreement. A \$52 fee applies when the taxpayer pays via direct debit from a bank account, while the fee for restructuring or reinstating an agreement is \$45.

IRC Sec. 6159 authorizes the use of partial payment installment agreements. However, taxpayers entering into a partial payment agreement are subject to a financial review every two years and must understand that their payments may increase or the agreement may be terminated if the taxpayer's financial condition improves.

Under current administrative procedures, all IRS offices can approve installment agreements up to \$25,000 when the taxpayer agrees to pay the amount due in five years or less. No managerial approval is required, a Collection Information Statement is not required, and if the taxpayer adheres to the payment schedule a federal tax lien will not be filed. These agreements can be secured in person, by telephone, or by correspondence. However, the corporation must have filed all tax returns that are due prior to entering into the agreement.

Once the taxpayer and the IRS agree on the amount of the monthly payment, the IRS will prepare Form 433-D (Installment Agreement). Form 433-D is not required to have a valid installment agreement. The installment agreement can be a written confirmation of an agreement proposed by the taxpayer and accepted by the IRS, or an oral agreement between the taxpayer and the IRS.

### **Extensions of Time to Pay**

The IRS can grant an additional period of time to make full payment of the tax. Extensions of time to pay provide a specific date by which the full payment of taxes is expected, and can be granted for up to 30 days for business. Since the extension is not an installment agreement, a user fee is not payable.

### **Corporation Expecting an NOL Carryback**

A corporation expecting a current-year NOL that it can carry back to the immediately preceding tax year can obtain an extension of time to pay the income tax for that year. The extension is only good for payments (including estimated tax payments) due after the request is filed. Thus, an extension is not available for payments already made or due.

The extension request is made on Form 1138 (Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback) and is filed with the Service Center where the corporation files its income tax return. The request must be filed after the beginning of the year for which the NOL is expected but before the due date for paying the previous year's income taxes. It may be filed with Form 7004 (Application for Automatic Extension of Time to File Corporation Income Tax Return). If the forms are filed together, Form 1138 reduces or eliminates the amount of tax to be deposited when Form 7004 is filed.

Because estimates upon which the extension application is based may change during the year (resulting in an increase or decrease in the expected NOL for that year), corporations may file more than one Form 1138 during the year. The additional statement is considered an original statement and not an amendment of a prior statement. The new statement may thus extend the time for payment of a greater or lesser amount of tax than was extended under any prior statement(s).

The extension for paying the tax expires at the end of the month that the return for the tax year of the expected NOL is required to be filed (including extensions). If the corporation has filed Form 1139 (Corporation Application for Tentative Refund) before the extension period ends, it expires on the date the IRS mails by either registered or certified mail a notice to the corporation that it has allowed or disallowed the application for tentative refund. If the extension to pay covers only part of the tax, the time for payment of the remainder is the original due date of the tax.

Interest is payable on the full amount of the unpaid tax including the amount postponed with the extension. Interest begins to accrue on the dates that payments would have been required if the extension had not been filed. To the extent any part of the postponed payment is offset by the NOL, interest on such part ceases to accrue on the due date of the return (without regard to extensions) for the tax year the NOL arises. To the extent that any part of the postponed payment is not offset by an NOL, interest on that portion continues to accrue until paid.

**Example 3A-1 Corporations expecting an NOL carryback.**

Mega Loss, Inc. (MLI), a calendar-year corporation, will file its 2009 return on March 15, 2010. The return showed a tax liability of \$100,000 with a balance due of \$97,000. (MLI paid \$3,000 as estimated tax payments in 2009 based on 100% of the preceding year's tax liability.) MLI anticipates a \$400,000 NOL in 2010 that it will carry back to 2009 to offset the entire \$100,000 tax liability.

MLI can file a Form 1138 on or before March 15, 2010 requesting that the time for payment of the remaining tax be extended due to MLI's anticipated NOL. Generally, that extension will expire on March 31, 2011 unless the 2010 return is extended.

In early April 2010, MLI estimates that the NOL for that year will result in an offset of only \$70,000 of the 2009 tax liability. In this case, MLI should file a new statement indicating that the reduction of 2009 tax due to the 2010 NOL will be \$70,000. Under the new statement, only \$70,000 of the 2009 tax liability will be offset with the 2010 NOL. Thus, \$27,000 of the \$97,000 2009 tax due is payable. Since the due date for such tax payment has passed (March 15, 2010), the full \$27,000, plus interest, is due immediately.

**Federally Declared Disasters or Terroristic or Military Actions**

Under IRC Sec. 7508A, the IRS has authority to postpone certain tax deadlines, including the deadlines for filing returns or paying tax, for up to one year for taxpayers affected by a federally declared disaster or a terroristic or military action. Additionally, the IRS may abate any interest on underpaid income tax for the period of the postponement.

**How to Compute Estimated Tax Payments**

Estimated tax payments for corporations are normally made in four installments on the 15th day of the 4th, 6th, 9th, and 12th months of the tax year. For calendar-year corporations, those dates are April 15, June 15, September 15, and December 15. If a due date falls on a legal holiday or weekend, the next business day is used instead.

Corporations are not subject to the penalty for underpayment of estimated tax payments if the tax shown on the return for the tax year (or, if no return is filed, the tax) is less than \$500. Some corporations are required to deposit taxes by electronic funds transfer.

**Applying Tax Overpayments to Estimated Taxes**

In lieu of receiving a refund, a corporation can elect to apply all or any portion of a tax overpayment shown on its income tax return as a payment of estimated tax for its next tax year. The election is made on line 36 on page 1 of Form 1120 (U.S. Corporation Income Tax Return). The overpayment will be applied to unpaid installments of estimated tax due on or after the date(s) the overpayment arose in the order they are required to be paid to avoid an estimated tax penalty.

**General Rule**

Each required installment is 25% of the "required annual payment." The term "required annual payment" means the lesser of the following two amounts:

1. 100% of the tax on the return for the tax year, or, if no return is filed, 100% of the tax for such year, or
2. 100% of the tax shown on the return of the corporation for the preceding tax year.

As noted later in this lesson, large corporations cannot use 100% of the preceding year's tax to compute estimated tax payments. Furthermore, the required annual payment cannot be based on 100% of the preceding year's tax if that year was less than 12 months or if the corporation did not file a return for that year showing a tax liability.

**Example 3B-1 Estimated tax payments for corporation showing zero liability in preceding year.**

ABC, Inc., a calendar year corporation, filed its 2009 tax return on March 15, 2010. The return showed no tax liability as a result of a large net operating loss incurred in that year. ABC filed an NOL carryback claim to previous years and utilized the entire NOL. For 2010, ABC expects to have an income tax liability of \$24,000.

ABC will need to pay \$6,000, one-fourth of what it expects to owe for 2010, on or before April 15, 2010 (and on each quarter thereafter if the estimated tax remains at \$24,000). Although ABC's tax return for 2009 covered a full 12 months, the return showed no tax liability. Thus, ABC cannot use the 100% safe harbor exception.

If an amended return is filed for the previous year after the due date for filing the original return (including extensions), the tax shown on the *original* return is used as the preceding year's tax for purposes of determining the subsequent year estimated tax payments, regardless of the amount of the ultimate tax liability reported on the amended return. However, the tax on an amended return filed on or before the original due date (including extensions) is used as the preceding year's tax.

Definition of Tax. To compute estimated tax payments, the term *tax* is the excess of the sum of the following over the corporation's tax credits:

1. the corporate income tax, the alternative tax on corporate gains (i.e., the maximum tax on corporate capital gains), or the tax imposed on insurance companies, whichever applies;
2. the alternative minimum tax (AMT); and
3. the tax on gross transportation income of foreign corporations.

Form 1120-W. Corporations may use Form 1120-W (Estimated Tax for Corporations) to help in calculating their estimated tax payments.

**Treatment of Section 338(h)(10) Election**

If a Section 338(h)(10) election is made, the tax attributable to the target corporation as a result of such a transaction must be taken into consideration when determining the target's estimated tax for the year.

**Large Corporations**

A *large corporation* may not use the 100% prior year safe harbor except when determining its first quarter payment. A large corporation is any corporation having taxable income of \$1 million or more during any of the three immediately preceding tax years. For this purpose, taxable income is determined without regard to any NOL or capital loss carryback or carryforward. If the corporation had a short tax year for any of the three tax years immediately preceding the current tax year, the taxable income for the short tax year is computed by (1) multiplying the taxable income for the short tax year by 12, and (2) dividing the resulting amount by the number of months in the short year.

Large corporations using 100% of the preceding year's tax to determine their first installment must recapture any savings by increasing the amount of the next required installment (based on 100% of the current year's tax) by the amount of that savings.

**Example 3B-2 Estimated tax payments for large corporations.**

ABC, Inc., a calendar-year corporation, had taxable income of \$1.5 million two years ago. ABC had a tax liability of \$40,000 on its 2009 return. The corporation is not a member of a controlled group. What is ABC's required installment of estimated tax payable on April 15, 2010?

ABC is a large corporation since it had taxable income of at least \$1 million during one of the three years immediately preceding the current tax year. ABC can base only its first required installment on the preceding year's tax. Therefore, ABC can make a first quarter estimated tax payment of \$10,000 ( $\$40,000 \times 25\%$ ).

Because ABC is a large corporation, it must base its remaining estimated tax payments on 100% of its current-year tax. The corporation estimates its tax for 2010 will be \$80,000. Since the combined first and second estimated payments should equal 50% of the estimated tax for the year (\$40,000), ABC must make an estimated tax payment of \$30,000 ( $\$40,000 - \$10,000$ ) by June 15. If the estimated tax remains unchanged through the end of the year, the final two estimated payments will be \$20,000 each, so ABC will have paid the full amount of estimated tax (\$80,000) when the fourth estimated tax payment is made.

**Exceptions to the General Rule**

A corporation may also compute its required quarterly installments using one of two alternative methods: (1) the annualized income method or (2) the adjusted seasonal income method. (Normally, a corporation will benefit from one of these methods if it earns most of its taxable income during part of the tax year.) If the required quarterly installment determined under one of these methods is less than 25% of the required annual payment under the general rule (described earlier) the corporation can pay the lesser amount for that quarter.

**Annualized Income Method**

Annualized income installments of estimated tax are computed by the following steps:

- Step 1** Place the corporation's taxable income, alternative minimum taxable income (AMTI), and modified AMTI on an annualized basis based on the following periods:
1. First three months of the tax year for the first installment.
  2. First three months of the tax year for the second installment.
  3. First six months of the tax year for the third installment.
  4. First nine months of the tax year for the fourth installment.

A corporation also can elect to use either of two alternative annualization periods (shown in the following table) to determine its estimated income tax payments for the year. The election to use one of the alternative periods is made by filing Form 8842 (Election to Use Different Annualization Periods for Corporate Estimated Tax) with the IRS Service Center where the corporation files its income tax return by the 15th day of the fourth month of the tax year for which the election is to apply. Form 8842 must be filed annually to elect Option 1 or 2 even if the same option is elected each year. The election applies only to the tax year for which it is made. Once the election is made, it cannot be revoked for that tax year. The instructions to Form 8842 state that the form can only be signed by a qualified officer of the corporation or a receiver, trustee or assignee, if applicable.

<u>Installment</u>	<u>Option 1</u>	<u>Option 2</u>
1st quarterly installment	First 2 months of year	First 3 months of year
2nd quarterly installment	First 4 months of year	First 5 months of year
3rd quarterly installment	First 7 months of year	First 8 months of year
4th quarterly installment	First 10 months of year	First 11 months of year

Income is annualized by multiplying the taxable income for the period by 12 and dividing by the number of months in the period.

- Step 2** Calculate the tax on the annualized income.

- Step 3** Multiply the Step 2 amount by the applicable percentage (25% for first required installment, 50% for the second, 75% for the third, and 100% for the fourth).
- Step 4** Subtract from the amount determined in Step 3 the total of any previously required installments for the tax year. The remainder is the annualized income installment.

**Example 3B-3 Computing the annualized income installment.**

ABC, Inc., a calendar-year corporation, has not had taxable income in excess of \$1 million during any of its three preceding tax years. ABC filed a return for 2009 showing a tax liability of \$100,000. As of March 31, 2010, ABC has taxable income of \$50,000. The corporation cannot estimate with any great accuracy what its total income for 2010 will be, but it does anticipate having net income.

Based on the general rule, each required installment of estimated tax is 25% of the required annual payment. For 2010, ABC's required annual payment is the lesser of 100% of its 2009 tax or 100% of its tax shown on the 2010 return. On March 31, 2010, ABC cannot accurately estimate what its current year's tax will be, so its required annual payment should be based on 100% of the preceding year's tax (\$100,000). ABC's required installment is \$25,000 ( $\$100,000 \times 25\%$ ).

ABC may pay the lesser of the required installment or the annualized income installment. ABC does not elect to use an alternative annualization period by filing Form 8842. Therefore, its annualized income installment due on April 15, 2010 will be based on the default periods under IRC Sec. 6655(e)(2)(A):

- Step 1** ABC annualizes its income for the first quarter.

$$\frac{\$50,000 \times 12}{3} = \$200,000$$

- Step 2** ABC computes tax on \$200,000 (\$61,250).

- Step 3** ABC computes the annualized income installment payment.

$$\$61,250 \times 25\% \text{ (applicable percentage for first required installment)} = \$15,313$$

- Step 4** This step is not applicable because the payment being computed is for the first quarter.

Since ABC's \$15,313 annualized income installment payment is lower than the \$25,000 required installment under the general rule, ABC may make its April 15 payment based on the lower amount.

The estimated tax installment for June 15, 2010 will be the lesser of the required installment of \$25,000 or the annualized income installment computed by annualizing income for three months:

- Step 1** ABC annualizes its income for three months. (The second quarter payment is also based on taxable income through March.)

$$\frac{\$50,000 \times 12}{3} = \$200,000$$

- Step 2** ABC computes tax on \$200,000 (\$61,250).

- Step 3** ABC computes the annualized income installment payment.

$$\$61,250 \times 50\% \text{ (applicable percentage for second required installment)} = \$30,625$$

- Step 4** Since the annualized income installment for the payment period is the excess, if any, of the amount determined in Step 3 over the amount of any prior installment for the tax year, ABC's estimated tax payment for June 15 is \$15,312 ( $\$30,625 - \$15,313$ ).

**Example 3B-4 Using different annualization periods.**

Salmon, Inc., a calendar-year C corporation, operates a seasonal sport fishing business in Alaska. During the preceding year, the corporation sold a fully depreciated float plane and a parcel of real estate, and incurred an unusually large tax liability. For 2010, the anticipated corporate tax will be lower since its only activity will be the normal sport fishing revenues. The corporation generates most of its sales in June and September during the two salmon runs and tends to incur losses during the other months. The corporation elects annualization periods Option 2 as this allows its most profitable months to be reduced by the maximum number of loss months before calculation of the required estimated tax payment. To make this election the corporation must file Form 8842 by April 15, 2010.

**Example 3B-5 Use of a net operating loss carryforward with the annualized income method.**

Geaux Corporation, a calendar-year corporation, has a \$100,000 net operating loss carryforward from the preceding year. Geaux is required to base its 2010 estimated tax payments on 100% of its current year taxable income. Geaux does not file Form 8842 by April 15, 2010 and must use the default annualization periods when using the annualized installment method. Geaux's taxable income through its third, sixth, and ninth months is \$50,000, \$99,000, and \$125,000, respectively. Its taxable income for the year is \$200,000.

Without regard to the net operating loss carryforward, Geaux's annualized taxable income for each of the periods would exceed \$100,000. However, the full amount of the NOL can be used to offset taxable income before it is converted to an annualized basis. Geaux's first and second estimated tax payments are zero, based on its income for the first three months, less the NOL carryforward (\$50,000 – \$100,000). Its third estimated tax payment is also zero, based on the income for the first six months of the tax year (\$99,000 – \$100,000). The fourth installment is based on income of \$33,333, the annualized income for the first nine months of the tax year ( $\$125,000 - \$100,000 \times \frac{12}{9}$ ). Thus, Geaux is required to make an estimated tax payment of \$5,000 ( $\$33,333 \times 15\%$ ) on December 15, 2010. Although Geaux's tax liability for 2010 will be \$22,250, it is able to defer payment of \$17,250 ( $\$22,250 - \$5,000$ ) of that tax until March 15, 2011.

**Adjusted Seasonal Installments**

A corporation may use an adjusted seasonal installment as its required installment if its *base period percentage* for any six consecutive months of the tax year equals or exceeds 70%. The *base period percentage* is the average percent of the taxable income for the three preceding tax years derived from the corresponding period of months for those years (i.e., the same six-month period).

**Example 3B-6 Computing the base period percentage for adjusted seasonal installments.**

Dot, Inc. (DI) uses a calendar tax year. Its income for the three years preceding 2010 is as follows:

<u>Year Ending</u>	<u>Taxable Income for Year</u>	<u>Taxable Income for Apr.–Sept.</u>
December 31, 2007	\$ 65,000	\$ 50,000
December 31, 2008	67,000	43,000
December 31, 2009	<u>80,000</u>	<u>60,000</u>
Total	<u>\$ 212,000</u>	<u>\$ 153,000</u>

DI's base period percentage is greater than 70% ( $\$153,000 \div \$212,000 = 72\%$ ). Therefore, DI can use the adjusted seasonal installment method for the year ending December 31, 2010.

The adjusted seasonal installment amount is computed as follows:

- Step 1** Divide the taxable income for all months during the tax year preceding the month in which the installment is due (referred to as the filing month) by the base period percentage for those months.

- Step 2** Compute the tax due on the amount determined in Step 1.
- Step 3** Multiply the tax computed in Step 2 by the base period percentage for the filing month and all months during the tax year preceding the filing month.
- Step 4** Subtract all previous required installments from the Step 3 amount. The resulting amount equals the adjusted seasonal installment.

**Example 3B-7 Computing the adjusted seasonal installment.**

Assume the same facts as Example 3B-6. DI's first quarterly estimated tax payment is due April 15, 2010. DI's taxable income for the period January 1–March 31, 2010 (the income for all months in the year preceding the filing month) is \$10,000. For the three preceding years, its total taxable income for the period January–March is \$44,520. Thus, the base period percentage for these months is 21% ( $\$44,520 \div \$212,000$ ).

For the three preceding years, its total taxable income for January–April (for the filing month plus all preceding months in the tax year) is \$74,200. The base period percentage for these months is 35% ( $\$74,200 \div \$212,000$ ).

DI's adjusted seasonal installment for April 15, 2010 is computed as follows:

- Step 1**  $\$10,000 \div 21\% = \$47,619$
- Step 2**  $\$47,619 \times 15\% = \$7,143$  tax
- Step 3**  $\$7,143$  tax  $\times 35\% = \$2,500$
- Step 4** There are no previous required installments to subtract as this is the first estimated tax payment of the year. Therefore, the adjusted seasonal installment is \$2,500.

This example illustrates the computation of an adjusted seasonal installment. However, the use of another method could be preferable. For example, use of the annualized income installment method would result in a required payment of only \$1,500 ( $\$10,000 \div 3 \times 12 = \$40,000 \times 15\% = \$6,000 \times 25\%$ ).

**Increasing Subsequent Required Installments**

The amount of any reduction in a required installment resulting from use of the annualized income or the adjusted seasonal installment is added to the next required installment that is not an annualized income or adjusted seasonal installment (i.e., it is recaptured). This prevents the corporation from selecting the best method on a quarter-by-quarter basis and requires a total year approach to estimating tax payments.

**Example 3B-8 Increasing subsequent required installments.**

For 2010, calendar-year corporation Moonrock, Inc. (MI) has required quarterly estimated tax installments of \$20,000 each, based on the preceding year's tax. On April 15, 2010, rather than paying \$20,000, MI makes an annualized income installment of \$17,000. For the second 2010 payment due on June 15, MI's annualized income installment and adjusted seasonal installment amounts both exceed the required installment of \$20,000. How much must MI pay for the second installment of estimated tax?

MI must add the \$3,000 ( $\$20,000 - \$17,000$ ) reduction from its first installment to its second required installment. MI's second installment is \$23,000 ( $\$20,000 + \$3,000$ ).

**Applying the Regulations**

An extensive set of regulations govern the amount due with each quarterly installment as well as rules for computing estimated tax during a short tax year in August 2007.

**Recapture of Tax Credit.** Unless the Code and regulations provide otherwise, a recapture of tax under Chapter 1 of the Code, such as recapture under the investment tax credit rules of IRC Sec. 50(a)(1), is not included within the definition of “tax” for estimated tax purposes.

**Preceding Year Safe Harbor.** Under the regulations, the “return of the corporation of the preceding taxable year” includes an amended return if filed before the applicable installment due date. If an amended return is filed on or after that date, the “return for the preceding taxable year” does not include the amended return when figuring installments due before the time the amended federal income tax return is filed.

**Annualized Income Installment Method.** For annualized income installment method purposes, the regulations recognize that items that are incurred once (or otherwise infrequently) during the tax year or are subject to special exceptions should not be annualized because doing so distorts the estimate of annualized taxable income. The regulations also provide special rules for specific deductions that are incurred on an annual basis or for which a special exception to the general accounting rules exists, such as real property taxes, employee and independent contractor bonus deductions, deductions under IRC Sec. 404 (deferred compensation) and IRC Sec. 419 (welfare benefit funds), charitable contributions by accrual method corporations, the recurring item exception in Reg. 1.461-5, and the 12-month rule in Reg. 1.263(a)-4(f).

**NOL Deduction.** The regulations treat a net operating loss (NOL) deduction as an extraordinary item that occurs on the first day of the tax year and is taken into account after annualization. (See Example 3B-5, and the discussion preceding that example.)

**Section 481(a) Adjustment.** A taxpayer is allowed to treat a Section 481(a) adjustment as an extraordinary amount arising on the first day of the tax year for which the adjustment is taken into account, or on the date the Form 3115 requesting the change in accounting method was filed with the IRS.

**Example 3B-9 Use of a Section 481(a) adjustment with the annualized income method.**

Alliance Corp. is a calendar-year corporation using the annualized income installment method. On June 1, 2009, Alliance files Form 3115 to request permission to change its method of accounting. This change results in a \$300,000 positive Section 481(a) adjustment of which \$75,000 ( $1/4$ ) would be recognized in 2009.

The IRS approves the requested change effective for the year ending December 31, 2009. Alliance is allowed to recognize the Section 481(a) adjustment on January 1, 2009 (the first day of the first tax year in which the change takes effect) or June 1, 2009 (the date Alliance filed the Form 3115). Alliance chooses to recognize the \$75,000 positive adjustment as an extraordinary item occurring on June 1, 2009. Thus, the \$75,000 Section 481(a) adjustment is not taken into account in determining Alliance's first and second annualized income installments (which are based on income for the first three months of the year). However, in future years, any part of the Section 481(a) adjustment applicable to that year will be treated as an extraordinary item occurring on the first day of that year.

For 2009, Alliance is required to use its new method of accounting as of June 1, 2009 for estimated tax purposes. Therefore, Alliance will be required to use the new method of accounting 2009 to determine taxable income when computing its third and fourth annualized income installments for 2009 (which are based on annualization periods that include June 1). If Alliance's annualized taxable income for the third installment period is estimated to be \$200,000 [without regard to the Section 481(a) adjustment], Alliance will be allowed to reduce this amount by the full \$75,000 Section 481(a) adjustment. Alliance would also be allowed to reduce the annualized income amount for the fourth installment period by the full \$75,000 adjustment.

**Depreciation Expense.** Under the regulations, taxpayers generally estimate their annual depreciation expense and include a proportionate amount of that expense for annualization purposes. When determining the estimated annual depreciation expense, the taxpayer may take into account purchases, sales or other dispositions, changes in use, additional first-year depreciation, and similar events and provisions that, based on the relevant information available as of the last day of the annualization period (such as capital spending budgets or financial statement

projections) are reasonably expected to occur or apply during the tax year. The regulations also provide two safe harbors as an alternative to these general rules.

**Example 3B-10 Calculation of depreciation for annualized income method.**

Ellsworth, Inc. began business on January 20, 2008 and adopted the accrual method of accounting based on a calendar year. Ellsworth will use the annualized income installment method to calculate its estimated tax payments for 2009.

On January 20, 2008, Ellsworth placed in service tangible MACRS five-year property costing \$80,000, which it depreciates under the 200% DB method using the half-year convention. On January 20, 2009, Ellsworth placed in service a new machine, qualifying for bonus depreciation costing \$50,000 that is tangible MACRS five-year property. Ellsworth will depreciate this 2009 property using the 200% DB method and the half-year convention, and will deduct the 50% bonus depreciation allowed under IRC Sec. 168(k).

For 2008, Ellsworth takes a depreciation deduction of \$16,000 ( $\$80,000 \times 20\%$ ). Ellsworth does not anticipate being subject to the mid-quarter convention or taking a Section 179 deduction for 2009. Ellsworth also does not anticipate selling or disposing of any depreciable assets, but an additional tangible asset will be purchased in mid-2009 costing \$40,000. Ellsworth intends to take 50% bonus depreciation on this asset.

In estimating its depreciation expense for the first quarterly installment of 2009, Ellsworth can use the general rule, or one of the safe harbor methods provided in Reg. 1.6655-2(f)(3)(iv)(B). Under the general rule, Ellsworth may consider assets placed in service prior to the end date for the installment period as well as other relevant information available such as capital spending budgets or financial statement projections. Based on this method, Ellsworth computes an estimated depreciation deduction for the first three months of 2009 of \$19,900 ( $\$79,600 \times \frac{3}{12}$ ) computed as follows:

**Estimated annual depreciation expense for 2009**

First year bonus depreciation ( $\$90,000 \times 50\%$ )	\$ 45,000
Depreciation of 2008 asset ( $\$64,000 \times 40\%$ )	25,600
Depreciation of 2009 assets ( $\$45,000 \times 20\%$ )	<u>9,000</u>
Total 2009 estimated annual depreciation	<u>\$ 79,600</u>

Under the first safe harbor method (*proportionate depreciation allowance*), Ellsworth can estimate a depreciation deduction based on assets placed in service as of the end of the previous year and by the end of the installment period (March 31). Thus, an estimated depreciation deduction for the first installment period of \$13,900 ( $\$55,600 \times \frac{3}{12}$ ) is computed as follows:

First year bonus depreciation ( $\$50,000 \times 50\%$ )	\$ 25,000
Depreciation of 2008 asset ( $\$64,000 \times 40\%$ )	25,600
Depreciation of 2009 asset placed in service before March 31, 2009 ( $\$25,000 \times 20\%$ )	<u>5,000</u>
Total 2009 estimated annual depreciation	<u>\$ 55,600</u>

Under the second safe harbor method (*90% of preceding year's depreciation*), Ellsworth can use an estimated depreciation expense amount equal to 90% of the \$16,000 depreciation actually taken for 2008. The amount for the first installment would be \$3,600 [ $(\$16,000 \times 90\%) \times \frac{3}{12}$ ].

If Ellsworth uses the general rule to compute depreciation expense for its first 2009 installment, it will be allowed to switch to either of the safe harbor methods in computing depreciation for the second, third, and fourth installments. Likewise, if it uses a safe harbor method, it may switch to the general rule for subsequent quarters, but it may not switch between the safe harbor methods.

**Section 199 Deduction.** The Section 199 domestic production activities deduction is computed before annualizing taxable income for the annualization period. But since the various Section 199 limits may not be known at the end

of any particular annualization period, taxpayers can make a reasonable estimate of their deduction when determining the amount to include in their annualized taxable income.

Adjusted Seasonal Installment Method. Under Reg. 1.6655-3(d)(4), the amount of an installment determined using the adjusted seasonal installment method must take into account any alternative minimum tax (AMT) that would apply for the period of the computation. This amount is determined by applying to alternative minimum taxable income, tentative minimum tax, and AMT, the rules in Reg. 1.6655-3(c) for determining the amount of an installment using the adjusted seasonal installment method.

The regulations also provide guidance in allocating other income and expense items, such as real property taxes, employee bonuses and deferred compensation, and advance payments. Also covered are the treatment of credits, distributive share items, and the AMT exemption.



**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Alton is selling property at fire sale prices to obtain enough cash to pay his income tax. Does Alton qualify as a hardship situation?
  - a. Yes.
  - b. No.
  
20. The IRS has the authority to approve installment agreements under which of the following circumstances?
  - a. Only after a manager's approval.
  - b. Only after a Collection Information Statement has been received.
  - c. Only after the agreement has been finalized in person.
  - d. Only after the IRS has collected a \$105 fee for engaging in the agreement.
  
21. Which of the following statement regarding taxable income for large corporations is most accurate?
  - a. The IRS requires large corporations to use the 100% prior-year safe harbor when determining each quarter installment payment.
  - b. Large corporations are defined as any corporation having taxable income of \$1 million or more during any of the three immediately preceding tax years.
  - c. If a large corporation has a short tax year for any of the three tax years immediately preceding the current tax year, the taxable income for the short tax year is calculated by interpolating the taxable income as though the corporation had a full tax year.
  
22. There are four steps to computing the annualized income estimated tax income installments. Calculating the tax on the annualized income is which of the followings steps?
  - a. Step 1.
  - b. Step 2.
  - c. Step 3.
  - d. Step 4.
  
23. When computing estimated tax payments, the alternative minimum tax is taken into account under which of the following methods?
  - a. Adjusted seasonal installment method.
  - b. Annualized income installment method.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Alton is selling property at fire sale prices to obtain enough cash to pay his income tax. Does Alton qualify as a hardship situation? **(Page 137)**
- Yes. [This answer is correct. Since Alton is selling property at below market prices, the corporation has demonstrated a substantial financial loss in order to pay the taxes due.]**
  - No. [This answer is incorrect. If Alton had been selling property at current market price, this would not be considered an undue hardship.]
20. The IRS has the authority to approve installment agreements under which of the following circumstances? **(Page 138)**
- Only after a manager's approval. [This answer is incorrect. Under current administrative procedures, the IRS has the authority to approve installment agreements without a manager's approval.]
  - Only after a Collection Information Statement has been received. [This answer is incorrect. According to the IRS, a Collection Information Statement is not required for the IRS to approve an installment agreement.]
  - Only after the agreement has been finalized in person. [This answer is incorrect. According to the IRS, an installment agreement can be secured in person, by telephone, or by correspondence. However, the corporation must have filed all tax returns that are due prior to entering into the agreement.]
  - Only after the IRS has collected a \$105 fee for engaging in the agreement. [This answer is correct. The IRS collects a \$105 fee for entering into an installment agreement. A \$52 fee applies when the taxpayer pays via direct debit from a bank account, while the fee for restructuring or reinstating an agreement is \$45.]**
21. Which of the following statement regarding taxable income for large corporations is most accurate? **(Page 140)**
- The IRS requires large corporations to use the 100% prior-year safe harbor when determining each quarter installment payment. [This answer is incorrect. According to IRC Sections, a large corporation may not use the 100% prior year safe harbor except when determining its first quarter payment.]
  - Large corporations are defined as any corporation having taxable income of \$1 million or more during any of the three immediately preceding tax years. [This answer is correct. A large corporation is any corporation having taxable income of \$1 million or more during any of the three immediately preceding tax years. For this purpose, taxable income is determined without regard to any NOL or capital loss carryback or carryforward.]**
  - If a large corporation has a short tax year for any of the three tax years immediately preceding the current tax year, the taxable income for the short tax year is calculated by interpolating the taxable income as though the corporation had a full tax year [This answer is incorrect. According to IRS regulations taxable income is determined without regard to any NOL or capital loss carryback or carryforward. If the corporation had a short tax year for any of the three tax years immediately preceding the current tax year, the taxable income for the short tax year is computed by (1) multiplying the taxable income for the short tax year by 12, and (2) dividing the resulting amount by the number of months in the short year.]
22. There are four steps to computing the annualized income estimated tax income installments. Calculating the tax on the annualized income is which of the followings steps? **(Page 141)**
- Step 1. [This answer is incorrect. The first step in calculating the tax on the annualized income estimated tax income installments is to place the corporation's taxable income, alternative minimum taxable income (AMTI), and modified AMTI on an annualized basis based on the following periods:

First three months of the tax year for the first installment.

First three months of the tax year for the second installment.

First six months of the tax year for the third installment.

First nine months of the tax year for the fourth installment.]

- b. Step 2. [This answer is correct. The second step in calculating the tax on the annualized income estimated tax income installments is to calculate the tax on the annualized income.]**
- c. Step 3. [This answer is incorrect. The third step in calculating the tax on the annualized income estimated tax income installments is to multiply the Step 2 amount by the applicable percentage (25% for first required installment, 50% for the second, 75% for the third, and 100% for the fourth).]
- d. Step 4. [This answer is incorrect. The fourth step in calculating the tax on the annualized income estimated tax income installments is to subtract from the amount determined in Step 3 the total of any previously required installments for the tax year. The remainder is the annualized income installment.]
23. When computing estimated tax payments, the alternative minimum tax is taken into account under which of the following methods? **(Page 147)**
- a. Adjusted seasonal installment method. [This answer is correct. Under Reg. 1.6655-3(d)(4), the amount of an installment determined using the adjusted seasonal installment method must take into account any alternative minimum tax (AMT) that would apply for the period of the computation. This amount is determined by applying to alternative minimum taxable income, tentative minimum tax, and AMT, the rules in Reg. 1.6655-3(c) for determining the amount of an installment using the adjusted seasonal installment method.]**
- b. Annualized income installment method. [This answer is incorrect. For annualized income installment method purposes, the final regulations recognize that items that are incurred once (or otherwise infrequently) during the tax year or are subject to special exceptions should not be annualized because doing so distorts the estimate of annualized taxable income. AMT is not considered when using this method.]

## Make Estimated Payments for Short Tax Years

The due date and amount of estimated tax payments for short tax years are addressed in Reg. 1.6655-5. Estimated tax payments are not required if the short tax year is a period of less than four full calendar months, or the tax shown on the return for the tax year (or, if no return is filed, the tax) is less than \$500. If the tax year is four or more full calendar months but less than 12 full calendar months, the due dates in Reg. 1.6655-1(f)(2) apply, which means that payment is due on the 15th day of the 4th, 6th, 9th, and 12th months of the tax year (April 15, June 15, September 15, and December 15 for a calendar-year corporation). But if the due date of the first required installment is earlier than the 15th day of the 4th month, the first required installment is due on the first due date on or after that date.

The amount due for any required installment determined for a short tax year under IRC Sec. 6655(d)(1)(B)(i) (100% of tax for the current tax year) is 100% of the required annual payment for the short tax year divided by the number of required installments due for the short tax year. The amount due for any required installment determined under IRC Sec. 6655(d)(1)(B)(ii) (100% of tax shown on the return for preceding tax year) is determined by dividing 100% of the tax shown on the return for the preceding tax year by 12, then dividing that amount by the number of required installments due for the current short year.

### **Example 3C-1 Initial short year with four required installments.**

Binger Corp. is a calendar-year corporation that began business on February 12. It computes its required installments based on 100% of the tax shown on the return for the year. While the normal due dates of Binger's required installments would be April 15, June 15, September 15, and December 15, the first required installment is due on June 15 because April 15 is earlier than the 15th day of the 4th month of its tax year. Binger's second required installment is due on September 15, and its third (and last) installment is due on December 15.

The amount due with each required installment is 33.33% of the required annual payment for Binger's first required installment, 66.67% of the required annual payment for the second required installment, and 100% of the required annual payment for the third (and final) required installment.

### **Tax Year Ends Early**

If the tax year ends early (e.g., due to an acquisition or a change in tax year), the due date of the final required installment is the date of the next required installment if the event that gave rise to the short tax year had not occurred. If this date is within 30 days of the last day of the short tax year, the due date for the final required installment is the 15th day of the second month following the month that includes the last day of the short year.

### **Example 3C-2 Short termination year with three required installments.**

Paschal, Inc. is a calendar-year taxpayer that computes its required installments based on 100% of the tax shown on the return for the tax year in accordance with IRC Sec. 6655(d)(1)(B)(i). It computes its required installments based on a projected tax liability of \$600,000. On July 31, Paschal is acquired by another corporation, creating a short tax year from January 1 through July 31 with a \$350,000 tax liability.

Paschal's first and second required installments of \$150,000 each are due on April 15 and June 15, respectively. Its third (and final) required installment of estimated tax is due on September 15, with 100% of the required annual payment due with the installment. Accordingly, Paschal is required to pay \$50,000 with its final required installment on September 15 (\$350,000 total tax liability for the short tax year less prior installment payments of \$300,000).

Variation: Now assume that Paschal is acquired on August 31. Paschal's third (and final) required installment of estimated tax is due on October 15 because September 15 (the date that would have been the due date of the next required installment if the acquisition had not occurred) is within 30 days of the last day of the short tax year, and 100% of the required annual payment is due at that time.

Regardless of the corporation's tax year (calendar year or fiscal tax year), it can use the annualized income installment method described in Reg. 1.6655-2 or the adjusted seasonal installment method described in Reg. 1.6655-3 to compute its required installments of estimated tax for a short year.

## Make Estimated Tax Payments for Members of a Controlled Group Not Filing a Consolidated Return

All rules pertaining to estimated tax payments discussed earlier in this lesson apply to members of a controlled group not filing a consolidated return except for the large corporation rule of IRC Sec. 6655(g)(2). A large corporation is one that reports taxable income of \$1 million or more during any of the three immediately preceding tax years.

In determining whether corporations that are component members of a controlled group are large corporations, the \$1 million is divided among all the members of the group under rules similar to those limiting the use of tax benefits among the corporations. This means the \$1 million will be divided equally among the controlled group members unless they have agreed to a different apportionment arrangement. Members of a controlled group must also apportion the lower income tax brackets among themselves when estimating their tax liability for estimated tax payment purposes.

## How to Deal with the Penalty for Underpayment of Estimated Tax

### General Rule

A nondeductible penalty is imposed under IRC Sec. 6655(a) for a corporation that underpays an installment of its estimated tax. The amount of the penalty is determined by applying the "underpayment rate" to the "amount of the underpayment" for the "period of underpayment."

1. *Underpayment Rate.* The underpayment rate is generally the rounded federal short-term rate under IRC Sec. 1274(d) plus three percentage points. The rate is adjusted quarterly. The IRS issues a revenue ruling every three months setting forth the applicable interest rate. The interest rate is not compounded when computing the estimated tax penalty.

A special underpayment rate applies to large corporate underpayments, i.e., an underpayment of tax that for any tax period exceeds \$100,000.

2. *Amount of the Underpayment.* The amount of the underpayment is the excess of the smallest required installment computed under the available alternatives, i.e., the required installment, over the amount, if any, of the installment paid on or before the last date prescribed for payment. The payments of estimated tax are credited against unpaid installments in the order they are required to be paid. Thus, payments in excess of the required installment are applied against subsequent installments.
3. *Period of Underpayment.* The period of underpayment for any portion of the underpayment begins on the due date of the required installment and ends on the earlier of the 15th day of the third month following the close of the tax year (the unextended due date for Form 1120), or the date the portion of the underpayment is paid.

The penalty is calculated on Form 2220 (Underpayment of Estimated Tax by Corporations).

### Example 3E-1 Computing the underpayment of estimated tax penalty.

Yellow Inc. is a calendar-year corporation that reported a tax liability of \$90,000 on its prior-year return and estimates a current-year tax liability of \$70,000. It is not a "large corporation" and so can use the 100% prior-year safe harbor. Yellow made no installment payments on April 15, June 15, or September 15, but did pay \$63,000 on December 15. It timely filed its current-year return, which showed tax due of \$70,000. Of the \$63,000 paid on December 15, \$17,500 ( $\$70,000 \div 4$ ) is applied to each of the first three installments, and the remaining \$10,500 is applied to the fourth installment. Therefore, Yellow has

a \$17,500 underpayment of estimated tax for each of the first three installments, and a \$7,000 underpayment for the fourth installment.

Assuming that the underpayment rate is 8%, Yellow's addition to tax would be \$2,125, computed as follows:

- First installment (underpayment period of April 16 through December 15):  $244 \div 365 \times \$17,500 \times 8\% = \$936$ .
- Second installment (underpayment period of June 16 through December 15):  $183 \div 365 \times \$17,500 \times 8\% = \$702$ .
- Third installment (underpayment period of September 16 through December 15):  $91 \div 365 \times \$17,500 \times 8\% = \$349$ .
- Fourth installment (underpayment period of December 16 through March 15 of the following year):  $90 \div 365 \times \$7,000 \times 8\% = \$138$ .

### Exceptions to the Penalty

No penalty is imposed if the tax shown on the return for the tax year (or, if no return is filed, the tax) is less than \$500. Furthermore, no penalty is imposed on the debtor or trustee in bankruptcy under Title 11 of the U.S. Code, to the extent the bankruptcy case precludes such payment.

There is no reasonable cause exception to the penalty for underpayment of estimated tax.

## How to Apply for a Quick Refund of an Overpayment of Estimated Tax

Corporations can apply for a quick refund of estimated tax overpayments by filing Form 4466 (Corporation Application for Quick Refund of Overpayment of Estimated Tax). To qualify for a quick refund, the overpayment must be 10% or more of the expected tax liability and must exceed \$500.

Form 4466 must be filed after the close of the corporation's tax year but before the earlier of the unextended due date of the corporate return or the date the corporation actually files its return. The original of the form must be filed with the Service Center where the corporation files its income tax return. A copy of the form should be attached to Form 1120 when it is filed.

The IRS must act upon an application filed on Form 4466 within 45 days from the date it is filed. During this time, the IRS may make a limited examination of the form to determine the amount of the adjustment.

### Example 3F-1 Filing Form 4466 for a quick refund of estimated tax.

Four Square, Inc. (FSI), a calendar-year corporation, made four timely estimated tax payments of \$6,000 each during 2009 for a total of \$24,000. In early January 2010, FSI determines its 2009 tax liability is \$10,000.

FSI can file a quick refund claim since the amount of the overpayment exceeds \$500 and the corporation has overpaid its tax by 10% or more.

### Penalty for Excessive Adjustments

A nondeductible addition to tax is imposed if an adjustment for estimated tax payments is subsequently determined to be excessive. The penalty is computed at the underpayment rate established under IRC Sec. 6621 on the excessive amount from the date the adjustment credit was allowed or refund was paid to the 15th day of the third month after the end of the tax year.

The excessive amount is equal to the lesser of:

1. the amount of the Section 6425 adjustment (the adjustment of overpayment of estimated income taxes), or
2. the amount by which the income tax liability for the tax year as shown on the return exceeds the estimated income tax paid during the tax year, reduced by the amount of the adjustment.

**Example 3F-2 Penalty for excessive adjustments.**

ABC, Inc., a calendar-year taxpayer, made three quarterly estimated payments during 2009 of \$10,000 each on April 15, June 15, and September 15. It did not make its December estimated payment. In early January 2010, ABC filed Form 4466 requesting a refund of \$15,000. On February 16, 2010, the IRS approved the application and refunded \$15,000. On March 16, 2010, ABC filed its 2009 return showing a total tax of \$40,000 of which it had paid only \$15,000 (three \$10,000 estimated tax payments less the \$15,000 quick refund).

ABC is subject to the penalty for underpayment of estimated tax with regard to the \$10,000 underpayment of its fourth installment under IRC Sec. 6655(a). Also, ABC is subject to the penalty for an excessive adjustment under IRC Sec. 6655(h). The excessive adjustment equals the lesser of:

1. the amount of the Section 6425 adjustment (\$15,000), or
2. the amount by which the income tax liability for the tax year as shown on the return (\$40,000) exceeds the estimated income tax paid, reduced by the adjustment (\$30,000 – \$15,000 = \$15,000) or \$25,000.

The penalty is computed by multiplying the underpayment rate by the excessive amount (\$15,000) for the number of days from the date the refund is paid (February 16, 2010) until the 15th day of the third month following the close of the tax year (March 15, 2010). If the appropriate underpayment rate for this period is 9%, the penalty is \$104 [ $9\% \times \$15,000 \times (28 \div 365)$ ].

The computation of the penalty for an excessive adjustment of estimated tax is made independently and does not affect the computation of any penalty for the underpayment of estimated tax.

**Reasonable Cause for an Excessive Adjustment**

There is no reasonable cause exception, which means that the penalty is imposed whether or not there was reasonable cause for the excessive adjustment.

**How to Calculate Interest on Tax Underpayments and Overpayments**

**Underpayment and Overpayment Rates**

Corporations must pay the IRS interest if they do not pay tax when it is due without regard to extensions for payment. The interest must be paid for the period that begins with the last date prescribed for payment (usually the due date of the return determined without regard to extensions) and runs until the date payment is made.

Interest on underpayments accrues at the “underpayment rate,” while interest on overpayments accrues at the “overpayment rate.” For corporations, the *underpayment rate* equals the federal short-term rate plus three percentage points, while the *overpayment rate* equals the federal short-term rate plus two percentage points. Furthermore, interest payable on corporate overpayments of tax in excess of \$10,000 equals the federal short-term rate plus half a percentage point.

A special underpayment rate equal to the federal short-term rate plus five percentage points applies if a corporation underpays its income tax by more than \$100,000. *Underpayment* means the excess of tax for the period without regard to interest, penalties, and additions to tax, over the amount of tax paid by the last date prescribed for

payment. Interest begins to accrue on the 30th day after the corporation receives a 30-day or 90-day letter (notice of deficiency). If the \$100,000 threshold is exceeded, the higher rate applies not only to the tax but also to interest and penalties.

The computation of interest on an underpayment is made on a quarter-by-quarter basis by updating the computation through the end of a quarter, then using the updated balance to begin the next quarter's computation. Interest on underpayments is computed under Tables 7–54 of Rev. Proc. 95-17 for nonleap years and Tables 55–102 for leap years. Because IRC Sec. 6621 originally required the redetermination of interest rates semiannually, the effective daily rates for 184 days are published.

### **Deducting Interest on Tax Deficiency**

Temp. Reg. 1.163-9T allows corporations to deduct interest on all underpayments of federal, state, and local taxes. However, IRC Sec. 163(m) bars a deduction for interest paid or incurred on any portion of an underpayment attributable to an undisclosed listed transaction or an undisclosed reportable avoidance transaction.

### **Net Zero Interest Rate on Equivalent Overpayments and Underpayments**

According to IRC Sec. 6621(d), a net interest rate of zero is charged when interest is payable and allowable by the same taxpayer on equivalent overpayments and underpayments of federal tax that exist for any period. Each overpayment and underpayment is considered only once in determining whether equivalent amounts of overpayment and underpayment exist. The rules that provide for an increased interest rate on large corporate underpayments and a decreased interest rate on corporate overpayments in excess of \$10,000 do not prevent the application of the net zero interest rate provisions.

For the zero net interest rate rules to apply, the same taxpayer must be liable for the underpayment and must also be entitled to the overpayment. In FSA 199924017, the IRS reviewed a claim by a consolidated group that overpayment interest paid to one subsidiary for excise taxes could be netted against underpayment interest on the group's income taxes. The IRS concluded that it can net overpayment and underpayment interest on different types of taxes, but it cannot net interest for different taxpayers. In CCA 200212028, the IRS illustrated how the same taxpayer requirement applies to different situations involving multiple corporations:

- In one example, newly created subsidiaries were not liable for the affiliated group's Year 1 underpayment of tax. Therefore, it was not possible to net interest owed on the Year 1 underpayment against interest owed to the subsidiaries because of their Year 3 overpayments.
- In another example, A and B merged, with B surviving. If B assumed A's liabilities and was entitled to A's overpayment from Year 1, and B was also liable for a Year 3 underpayment, it could file a claim for interest netting. On the other hand, if A remained in existence, B would not be entitled to interest netting because A would be entitled to its Year 1 overpayment and B would be liable for its Year 3 underpayment.

Rev. Proc. 2000-26 states that the IRS will take reasonable steps to identify overlapping periods of tax overpayments and underpayments and apply the net interest rate of zero. In such cases, it will provide a copy of the interest computation to the taxpayer. But there may be instances when it does not identify periods of overlap. In that event, taxpayers should request a net interest rate of zero (or ask the IRS to recompute interest if the taxpayer disagrees with the IRS's computation).

Requests for a net interest rate of zero should normally be made on Form 843 (Claim for Refund and Request for Abatement).

### **Deposits Made to Suspend Running of Interest**

Taxpayers can make a deposit with the IRS to suspend the running of interest on a disputed underpayment of tax. The underpayment of tax must not have been assessed prior to the time the deposit is made. For interest purposes, to the extent that the deposit is ultimately used to pay tax, the payment is deemed to have been made on the date the taxpayer made the deposit.

Upon written request by the taxpayer, the IRS will return the requested amount unless it has previously been used to pay tax or the IRS determines returning the deposit would jeopardize the collection of tax. The IRS will pay interest on the returned deposit, to the extent it is attributable to a disputed tax, at the federal short-term rate. The payment must have been specified at the time of deposit as being a reasonable estimate of the maximum amount of tax that is likely to be due as the result of a disputable item. Both the taxpayer and the IRS must have a reasonable basis for disputing the item in question.

### **Applicable Interest Rate**

The IRS issues a revenue ruling every three months setting forth the applicable interest rate.

## **How to Deposit Income Tax**

A corporation must pay the tax due on Form 1120 in full no later than the original due date of the return to avoid penalties and interest. If the due date falls on a Saturday, Sunday, or legal holiday, payment can be made on the next business day.

### **Using the Depository Method to Pay Income Taxes**

A corporation that owes tax when it files its income tax return must deposit the tax payment. (The tax payment is not included with the return.) Estimated income tax payments are deposited in a similar manner.

A corporation not required to deposit income taxes electronically (see the discussion later in lesson) must deposit its income tax payment along with Form 8109 (Federal Tax Deposit Coupon) in an authorized depository for federal taxes. An authorized depository is a financial institution (e.g., a commercial bank) that is authorized to accept federal tax deposits. Checks or money orders should be made payable to that depository. For businesses that do not want to use an authorized financial institution, the Treasury Department has authorized a financial agent to process federal tax deposit payments through the mail. The address for this mail-in alternative is Financial Agent, Federal Tax Deposit Processing, P.O. Box 970030, St. Louis, Missouri, 63197.

The company should write its employer identification number, the tax period to which the deposit applies, and Form 1120 on the check or money order being deposited. Also, the 1120 box on Form 8109 should be darkened.

Absent reasonable cause, the failure-to-deposit penalty can be imposed if deposits are mailed with the return or delivered to an IRS office rather than to an authorized depository. Furthermore, a deposit with an incorrect form is not a proper payment. The IRS is slow to correct misapplied deposits; therefore, each deposit coupon should be inspected to verify that the preprinted and taxpayer-entered information are correct.

### **Hints for Making Proper Tax Deposits**

Circular E (Employer's Tax Guide 2009) provides these tips for complying with the deposit rules:

- *Deposits at Depositories.* Authorized depositories accept cash, a postal money order drawn to the order of the depository, or a check or draft drawn on and to the order of the depository. The company can deposit taxes with a check drawn on another financial institution if the depository accepts that form of payment.
- *Depositing on Time.* To be timely, the funds must be available to the depository on the deposit due date before the institution's cutoff deadline. The company should contact the local depository for the check clearance and cutoff schedules. While a deposit received by the authorized depository after the due date will be timely if it was properly mailed within the U.S. at least two days before the due date, if the company is required to deposit tax more than once per month, any deposit of \$20,000 or more must be received by the due date to be timely.
- *Depositing without an Employer Identification Number (EIN).* If the corporation has applied for but not yet received an EIN, the deposit should be sent to the local IRS office or Service Center where the return for that deposit will be filed. The company should attach an explanation, including the date it applied for an EIN.

- *Depositing without Form 8109.* Companies that do not have a preprinted Form 8109 can use Form 8109-B, which is an over-the-counter tax deposit coupon.
- *Proof of Deposit.* The FTD coupon is not returned to the company. However, the (completed) stub provided with each FTD coupon, along with the canceled check, bank receipt, or money order, can establish timely payment.

### Using Electronic Funds Transfer to Pay Income Taxes

Certain corporations are required to make all tax deposits electronically using the Electronic Federal Tax Payment System (EFTPS). Tax deposits must be made by the EFTPS if the corporation has aggregate annual tax deposits of more than \$200,000 for a calendar year. Aggregate tax deposits include corporate income taxes, estimated taxes, FICA taxes (both employer and employee halves), and federal withholding taxes during the year. Corporations not subject to these requirements can continue depositing funds with a qualified banking institution using Form 8109 (Federal Tax Deposit Coupon).

A business that exceeds the \$200,000 threshold for the first time will be required to make electronic tax deposits after a one-year grace period (i.e., it must begin making electronic tax payments in the second succeeding year following the year it exceeded the threshold).

#### Example 3H-1 First year that electronic deposits are required.

Lever, Inc., incorporated on January 1, 2007. For 2007, it made tax deposits of \$45,000. For 2008, it made tax deposits of \$210,000. It has a one-year grace period (2009) from the year it exceeded the \$200,000 threshold and must make tax deposits via the EFTPS beginning January 1, 2010.

Once the use of the EFTPS is required because aggregate annual tax deposits exceed \$200,000 in a calendar year, a business cannot resume making deposits with Form 8109, even if its tax deposits fall below \$200,000 in a subsequent year. However, a taxpayer who voluntarily uses the EFTPS can switch back to using Form 8109.

### Failure to Deposit Taxes

IRC Sec. 6656(a) imposes a civil penalty when the taxpayer fails to make a required tax deposit with an authorized government depository (or, as explained later in this lesson, by electronic funds transfer). This failure to deposit (FTD) penalty uses a four-tier rate (from 2% to 15%) that increases the amount of the penalty the longer the required amount remains undeposited. It can apply when the taxpayer sends a deposit to an unauthorized depository (such as the IRS), and extends to any employment tax form where the filer is required to deposit the reported taxes. As with the failure to file and failure to pay penalties, the FTD penalty is waived if the failure is due to reasonable cause and not willful neglect.

#### Failure to Deposit Penalty for First-time Depositors

The Secretary of the Treasury has the authority to abate the penalty for first-time depositors who inadvertently send the deposit to the IRS rather than the proper depository.

#### Concurrent Penalty Application for Failure to Deposit and Failure to Pay Estimated Tax

The IRS is not required to assert both the addition to tax under IRC Sec. 6655(a) for failure to pay corporate estimated income tax and the penalty under IRC Sec. 6656 for failure to deposit corporate estimated income tax concurrently if they are both applicable. However, it is within the discretion of the Commissioner to assess both penalties.

### Penalties and Related Waiver Procedures

A corporation required to participate in the EFTPS will be subject to the 10% failure to deposit penalty under IRC Sec. 6656 if its tax deposits are not filed electronically by the respective due date of those deposits (unless it can show the failure was based on reasonable cause). Once the electronic funds transfer (EFT) deposit rules apply to

a taxpayer, any payments made by means other than EFT are generally subject to the late deposit penalty, even if those payments are timely made. However, a corporation that voluntarily participates in the EFTPS is not subject to the penalty if it makes a timely tax deposit with an authorized depository using Form 8109.

An Ohio District Court found an employer liable for the Section 6656 failure-to-deposit penalty for not paying its payroll taxes via the EFTPS. In so holding, the District Court noted that: "It is uncontested that [taxpayer] remitted the proper amounts of employment taxes. Furthermore, it is accepted that [taxpayer] submitted the taxes to its bank, which then made payment to an authorized government depository on or before the dates said taxes were due. The . . . penalties were not assessed, however, for late payments or for payments less than that which was required, but were imposed because the deposits were made other than as required by Section 6656(a) (*F. E. Schumacher Co.*; also see *Fallu Productions*). Nevertheless, corporations in this situation should at least attempt to get penalties removed by the IRS (e.g., based on the financial hardship this would impose on the taxpayer).

### **Enrolling in the EFTPS**

Before depositing taxes using EFTPS, employers must enroll either online at [www.eftps.gov](http://www.eftps.gov) or by completing Form 9779 (EFTPS-Business Enrollment Form) and mailing it to the EFTPS enrollment center. Form 9779 can be obtained by calling (800) 945-8400 or (800) 555-4477. Enrolling online is more convenient and much quicker than filing Form 9779 (taxpayers receive online confirmations much sooner).

When the enrollment process is completed, the corporation will receive a confirmation package that includes a step-by-step payment instruction booklet and information on how to obtain an Internet password. A personal identification number (PIN) will be mailed to the corporation separately from the enrollment confirmation package. Upon receiving the PIN, the corporation can begin making payments by phone. Corporations wanting to make payments online must first follow the instructions in the confirmation package and obtain an Internet password.

Applicants for employer identification numbers (EINs) that expect to have federal tax obligations will be automatically pre-enrolled in the EFTPS. In addition to receiving their EIN, taxpayers also receive a separate mailing containing an EFTPS personal identification number and instructions for activating their enrollment. New business taxpayers activate their enrollment by calling an 800-number, entering their banking information, and completing an authorization for EFTPS to transfer funds from their account to Treasury's account for tax payments per their instructions.

### **Failure to Pay**

IRC Sec. 6651 imposes a civil penalty if a taxpayer does not timely pay tax that is due. This failure to pay (FTP) penalty has two components—the failure to pay tax shown as due on a return on the date prescribed for payment, and the failure to pay tax within 21 calendar days (10 business days if the amount demanded is \$100,000 or more) of the date of notice and demand for the tax. The first component can apply to the late payment of tax shown as due on the return, while the latter can apply to deficiencies resulting from an examination of the return or a mathematical error on the return. As with the failure to file penalty, the FTP penalty does not apply if the failure was due to reasonable cause and not willful neglect.

#### **Amount of the Penalty**

The FTP penalty equals half of 1% (0.5%) of the net tax shown on the return for each month or fraction of a month the tax remains unpaid, up to a maximum of 25%. (The definition of a month is the same as that for the failure to file penalty.)

The penalties for failure to pay tax shown on the return and failure to pay following notice and demand are both increased from 0.5% to 1% per month (subject to the same 25% maximum) after the IRS issues a notice of levy. This increased FTP penalty rate begins at the beginning of the month after the earlier of (1) 10 days after notice of levy is given, or (2) the day on which notice and demand for immediate payment is made when the IRS believes that collection of the tax is in jeopardy.

When both the FTP and failure to file penalties apply to the same month, the failure to file penalty (5%) is reduced by the FTP penalty (0.5%). Because of the 25% maximum that independently applies to each penalty, the failure to

file penalty stops at five months. However, the FTP penalty can be imposed for another 45 months (beyond the first five months) until the 25% maximum is reached. When both penalties are imposed for their respective maximum periods, the combined total can reach 47.5% (22.5% for the failure to file penalty and 25% for the FTP penalty).

### **Computation of the Penalty**

The penalty under IRC Sec. 6651(a)(2) applies if the tax shown on the return is not paid by the due date, excluding any extensions of time to file. For penalty computation purposes, the tax shown on the return is reduced by (1) any part of the tax paid on or before the beginning of the month, and (2) any credit against the tax that may be claimed on the return. If the amount of tax shown on the taxpayer's return is more than the amount required to be shown, the penalty applies only against the smaller amount.

The separate FTP penalty under IRC Sec. 6651(a)(3) applies to tax not shown on the return if not paid within 21 calendar days (10 business days if the amount demanded is \$100,000 or more) of the date of notice and demand for the tax. (The notice and demand informs the taxpayer that an assessment has been made, and makes demand upon the taxpayer to pay the amount assessed.) The amount subject to penalty is the tax stated in the notice and demand, reduced by payments made before the beginning of that month.

### **Reasonable Cause for Failure to Pay**

The regulations state that reasonable cause for failure to pay exists to the extent the taxpayer can satisfactorily show ordinary business care and prudence were exercised in providing for the payment of the tax liability, but the taxpayer was nevertheless either unable to pay the tax or would have suffered undue hardship if the tax was paid on the due date. In determining whether reasonable cause exists, consideration is given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could reasonably have expected, at the time he made the expenditures, to receive before the tax payment due date.

Examples of reasonable cause include: (1) death or serious illness of the taxpayer, a relative, or someone affecting the taxpayer's business; (2) the unavoidable absence of the taxpayer or another person; (3) the destruction of the taxpayer's place of business or records (i.e., casualty loss, theft, accidental loss); and (4) civil disturbances impairing the taxpayer's ability to pay.

To claim the reasonable cause exception, the taxpayer must make an affirmative showing of all facts alleged to constitute reasonable cause in a written statement, signed under penalties of perjury, that is filed with the IRS office where the return is filed.

**SELF-STUDY QUIZ**

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. Tax payments are not required in a short tax year when which of the following occurs?
- The tax shown on the return for the tax year is less than \$1,000.
  - The short year is four or more complete calendar months.
  - The short year is less than four complete calendar months.
25. Which of the following statements regarding the penalty for underpayment of estimated tax is most accurate?
- The underpayment rate is adjusted quarterly.
  - The penalty for underpayment of estimated tax is determined by applying the underpayment rate to the amount of the overpayment for the period of underpayment.
  - The underpayment period for any part of the underpayment begins with the last date prescribed for payment and runs until the date payment is made.
  - Large corporations are required to pay a special underpayment rate for any tax period exceeding \$500,000.
26. When calculating the interest on tax underpayments, the underpayment rate for corporations equals the federal short-term rate plus which of the following?
- Half of a percentage point.
  - Two percentage points.
  - Three percentage points.
  - Five percentage points.
27. Which of the following statements regarding net zero interest rate on equivalent overpayments and underpayments is most accurate?
- Overpayments and underpayments are considered multiple times when determining if equal amounts of overpayment and underpayment exists.
  - Specific rules exist that provide for an increased interest rate on large corporate underpayments and a decreased interest rate on corporate overpayments in excess of \$20,000 which prevent the application of the net zero interest rate provisions.
  - Net zero interest rates rules only apply if the same taxpayer is liable for the underpayment.
  - Net zero requests are made on Form 9779.
28. The IRS can suspend the running of interest on a disputed underpayment of tax if the taxpayer makes a deposit with the IRS. The taxpayer must follow which of the following procedures when making the deposit?
- The taxpayer must designate that the deposit is a reasonable estimate of the maximum tax amount that is likely to be due as a result of a questionable item.

- b. The payment must be believed to have been made on after the date the taxpayer made the deposit.
  - c. The tax underpayment must be assessed prior to making the deposit.
29. Tree's Tees, Inc. (TTI), a calendar-year taxpayer, is preparing to deposit its income tax payment along with Form 8109 (Federal Tax Deposit Coupon). Which of the following statements regarding how TTI should make the deposit is most accurate?
- a. TTI should make the check payable to the IRS.
  - b. TTI can have an authorized financial agent process the deposit via the mail.
  - c. TTI can mail the deposit along with the return to the IRS.
30. What is the first step employers must take before depositing taxes using EFTPS?
- a. Receive an employer identification number (EIN).
  - b. Obtain an Internet password.
  - c. Enroll online.

**SELF-STUDY ANSWERS**

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

24. Tax payments are not required in a short tax year when which of the following occurs? **(Page 152)**
- a. The tax shown on the return for the tax year is less than \$1,000. [This answer is incorrect. Estimated tax payments are not required if the tax shown on the return for the tax year (or, if no return is filed, the tax) is less than \$500.]
  - b. The short year is four or more complete calendar months. [This answer is incorrect. If the tax year is four or more full calendar months but less than 12 full calendar months, the due dates in Reg. 1.6655-1(f)(2) apply, which means that payment is due on the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.]
  - c. **The short year is less than four complete calendar months. [This answer is correct. According to IRS regulations, estimated tax payments are not required if the short tax year is a period of less than four full calendar months.]**
25. Which of the following statements regarding the penalty for underpayment of estimated tax is most accurate? **(Page 153)**
- a. **The underpayment rate is adjusted quarterly. [This answer is correct. The underpayment rate is generally the rounded federal short-term rate under IRC Sec. 1274(d) plus three percentage points and is adjusted quarterly.]**
  - b. The penalty for underpayment of estimated tax is determined by applying the underpayment rate to the amount of the overpayment for the period of underpayment. [This answer is incorrect. A nondeductible penalty is imposed under IRC Sec. 6655(a) for a corporation that underpays an installment of its estimated tax. The amount of the penalty is determined by applying the "underpayment rate" to the "amount of the underpayment" for the "period of underpayment."]
  - c. The underpayment period for any part of the underpayment begins with the last date prescribed for payment and runs until the date payment is made. [This answer is incorrect. According to the IRC, the period of underpayment for any portion of the underpayment begins on the due date of the required installment and ends on the earlier of the 15th day of the third month following the close of the tax year (the unextended due date for Form 1120), or the date the portion of the underpayment is paid.]
  - d. Large corporations are required to pay a special underpayment rate for any tax period exceeding \$500,000. [This answer is incorrect. Per the IRC, a special underpayment rate applies to large corporate underpayments, i.e., an underpayment of tax that for any tax period exceeds \$100,000.]
26. When calculating the interest on tax underpayments, the underpayment rate for corporations equals the federal short-term rate plus which of the following? **(Page 155)**
- a. Half of a percentage point. [This answer is incorrect. According to the IRC, interest payable on corporate overpayments of tax in excess of \$10,000 equals the federal short-term rate plus half a percentage point.]
  - b. Two percentage points. [This answer is incorrect. According to the IRC, the overpayment rate equals the federal short-term rate plus two percentage points.]
  - c. **Three percentage points. [This answer is correct. According to the IRC, interest on underpayments accrues at the underpayment rate, while interest on overpayments accrues at the overpayment rate. For corporations, the underpayment rate equals the federal short-term rate plus three percentage points.]**

- d. Five percentage points. [This answer is incorrect. According to the IRC, a special underpayment rate equal to the federal short-term rate plus five percentage points applies if a corporation underpays its income tax by more than \$100,000.]
27. Which of the following statements regarding net zero interest rate on equivalent overpayments and underpayments is most accurate? **(Page 156)**
- a. Overpayments and underpayments are considered multiple times when determining if equal amounts of overpayment and underpayment exists. [This answer is incorrect. Each overpayment and underpayment is considered only once in determining whether equivalent amounts of overpayment and underpayment exist per the IRS.]
- b. Specific rules exist that provide for an increased interest rate on large corporate underpayments and a decreased interest rate on corporate overpayments in excess of \$20,000 which prevent the application of the net zero interest rate provisions. [This answer is incorrect. According to the IRS, the rules that provide for an increased interest rate on large corporate underpayments and a decreased interest rate on corporate overpayments in excess of \$10,000 do not prevent the application of the net zero interest rate provisions.]
- c. Net zero interest rates rules only apply if the same taxpayer is liable for the underpayment. [This answer is correct. For the zero net interest rate rules to apply, the same taxpayer must be liable for the underpayment and must also be entitled to the overpayment. In FSA 199924017, the IRS reviewed a claim by a consolidated group that overpayment interest paid to one subsidiary for excise taxes could be netted against underpayment interest on the group's income taxes. The IRS concluded that it can net overpayment and underpayment interest on different types of taxes, but it cannot net interest for different taxpayers.]**
- d. Net zero requests are made on Form 9779. [This answer is incorrect. According to the IRS, employers must complete Form 9779 before depositing taxes using EFTPS. Requests for a net interest rate of zero should normally be made on Form 843 (Claim for Refund and Request for Abatement). Rev. Proc. 2000-26 provides the rules for how, where, and when to file the form.]
28. The IRS can suspend the running of interest on a disputed underpayment of tax if the taxpayer makes a deposit with the IRS. The taxpayer must follow which of the following procedures when making the deposit? **(Page 156)**
- a. The taxpayer must designate that the deposit is a reasonable estimate of the maximum tax amount that is likely to be due as a result of a questionable item. [This answer is correct. The payment must have been specified at the time of deposit as being a reasonable estimate of the maximum amount of tax that is likely to be due as the result of a disputable item. Both the taxpayer and the IRS must have a reasonable basis for disputing the item in question.]**
- b. The payment must be believed to have been made on after the date the taxpayer made the deposit. [This answer is incorrect. For interest purposes, to the extent that the deposit is ultimately used to pay tax, the payment is deemed to have been made on the date the taxpayer made the deposit according to the IRC.]
- c. The tax underpayment must be assessed prior to making the deposit. [This answer is incorrect. Taxpayers can make a deposit with the IRS to suspend the running of interest on a disputed underpayment of tax. The underpayment of tax must not have been assessed prior to the time the deposit is made according to the IRC.]
29. Tree's Tees, Inc. (TTI), a calendar-year taxpayer, is preparing to deposit its income tax payment along with Form 8109 (Federal Tax Deposit Coupon). Which of the following statements regarding how TTI should make the deposit is most accurate? **(Page 157)**
- a. TTI should make the check payable to the IRS. [This answer is incorrect. An authorized depository is a financial institution (e.g., a commercial bank) that is authorized to accept federal tax deposits. Checks or money orders should be made payable to that depository, according to the IRC.]

- b. **TTI can have an authorized financial agent process the deposit via the mail. [This answer is correct. For businesses that do not want to use an authorized financial institution, the Treasury Department has authorized a financial agent to process federal tax deposit payments through the mail. The address for this mail-in alternative is Financial Agent, Federal Tax Deposit Processing, P.O. Box 970030, St. Louis, Missouri, 63197.]**
  - c. TTI can mail the deposit along with the return to the IRS. [This answer is incorrect. Absent reasonable cause, the failure-to-deposit penalty can be imposed if deposits are mailed with the return or delivered to an IRS office rather than to an authorized depository. Furthermore, a deposit with an incorrect form is not a proper payment.]
30. What is the first step employers must take before depositing taxes using EFTPS? **(Page 158)**
- a. Receive an employer identification number (EIN). [This answer is incorrect. Applicants for employer identification numbers (EINs) that expect to have federal tax obligations will be automatically pre-enrolled in the EFTPS. In addition to receiving their EIN, taxpayers also receive a separate mailing containing an EFTPS personal identification number and instructions for activating their enrollment.]
  - b. Obtain an Internet password. [This answer is incorrect. This is the second step. When the enrollment process is completed, the corporation will receive a confirmation package that includes a step-by-step payment instruction booklet and information on how to obtain an Internet password.]
  - c. **Enroll online. [This answer is correct. Before depositing taxes using EFTPS, employers must enroll either online at [www.eftps.gov](http://www.eftps.gov) or by completing Form 9779 (EFTPS-Business Enrollment Form) and mailing it to the EFTPS enrollment center. Enrolling online is more convenient and faster than filing Form 9779.]**



**EXAMINATION FOR CPE CREDIT****Lesson 3 (T20TG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

19. How long does the IRS have to grant or deny an application for extension of time to pay income tax?
- a. 30 days.
  - b. 60 days.
  - c. 90 days.
  - d. 120 days.
20. In 2010, Javabucks Inc. (JBI) had to reduce its staff and close three of its seven locations because of undue hardship. JBI applied for an extension of time to pay income tax on Form 1127. If JBI anticipates a current-year NOL and can carry back to the immediately preceding tax year and apply for an extension of time to pay the income tax for that year; which of the following forms should JBI use to request this extension?
- a. Form 433-D.
  - b. Form 1138.
  - c. Form 1139.
  - d. Form 7004.
21. Blue Moon Roofing, Inc. (BMR), a calendar-year corporation, filed its 2009 tax return on March 15, 2010. The return showed no tax liability as a result of a large net operating loss incurred in that year. BMR filed an NOL carryback claim to previous years and utilized the entire NOL. For 2010, BMR expects to have an income tax liability of \$32,000.
- BMR must make its first installment on or before April 15, 2010 and on each quarter thereafter if the estimated tax remains at \$32,000. What amount will BMR have to pay each quarter?
- a. \$4,000.
  - b. \$8,000.
  - c. \$12,000.
  - d. \$16,000.
22. Crenshaw's Trucking, Inc. (CTI), a calendar-year corporation, had taxable income of \$2 million two years ago. CTI had a tax liability of \$50,000 on its 2009 return. The corporation is not a member of a controlled group. What is CTI's required installment of estimated tax payable on April 15, 2010?
- a. \$12,000.
  - b. \$12,500.
  - c. \$25,000.
  - d. \$25,500.

23. For 2010, calendar-year corporation Moonstruck, Inc. (MI) has required quarterly estimated tax installments of \$25,000 each, based on the preceding year's tax. On April 15, 2010, rather than paying \$25,000, MI makes an annualized income installment of \$20,000. For the second 2010 payment due on June 15, MI's annualized income installment and adjusted seasonal installment amounts both exceed the required installment of \$25,000. How much must MI pay for the second installment of estimated tax?
- a. \$10,000.
  - b. \$15,000.
  - c. \$20,000.
  - d. \$30,000.
24. According to IRC Sec. 6655(d)(1)(B)(ii), how is the amount due determined for any required installment?
- a. Dividing the entire amount of the required annual payment for the short tax year by the number of required installments due for the short tax year.
  - b. Dividing the entire amount of the tax shown on the return for the preceding tax year by 12, then dividing that amount by the number of required installments due for the current short year.
  - c. Multiplying the taxable income for the short tax year by 12, and then dividing the resulting amount by the number of months in the short year.
  - d. Multiplying the taxable income for the period by 12 and dividing by the number of months in the period.
25. Blue Inc. is a calendar-year corporation that reported a tax liability of \$90,000 on its prior-year return and estimates a current-year tax liability of \$75,000. It is not a "large corporation" and so can use the 100% prior-year safe harbor. Blue made no installment payments on April 15, June 15, or September 15, but did pay \$63,000 on December 15. It timely filed its current-year return, which showed tax due of \$75,000. Of the \$63,000 paid on December 15, \$18,750 is applied to each of the first three installments, and the remaining \$6,750 is applied to the fourth installment.

What are Blue's underpayment of estimated tax for each of the first three installments and the underpayment for the fourth installment?

- a. \$15,750; \$7,000.
  - b. \$17,500; \$7,000.
  - c. \$18,750; \$4,688.
  - d. \$18,750; \$12,000.
26. In the example above, which of the following forms is used to calculate the underpayment of taxes?
- a. Form 1120.
  - b. Form 1127.
  - c. Form 2220.
  - d. Form 7004.

27. The IRS will take reasonable steps to identify overlapping period of tax underpayments and overpayments and apply the net interest rate of zero according to which of the following?
- a. IRC Sec. 6655(a).
  - b. Rev. Proc. 2000-26.
  - c. Rev. Proc. 2005-18.
  - d. Temp. Reg. 1.163-9T.
28. Which of the following statements regarding deposits made to suspend the running of interest is true?
- a. The taxpayer can send a written request to the IRS to return the requested amount if not previously used to pay tax.
  - b. If the IRS determines returning the deposit would jeopardize the tax collection the taxpayer cannot send a written request to the IRS to return the requested amount.
  - c. Do not select this answer choice.
  - d. Do not select this answer choice.
29. Corporations that have aggregate annual tax deposits of more than \_\_\_\_\_ for a calendar year must make all tax deposits via the EFPTS.
- a. \$100,000.
  - b. \$200,000.
  - c. \$300,000.
  - d. \$500,000.
30. Which of the following statements regarding penalties and related waiver procedures is most accurate?
- a. According to IRC Sec. 6656, corporations are subject to a 5% penalty for failing to electronically deposit tax deposits in a timely manner.
  - b. All payments made by means other than the EFT are subject to the late deposit penalty once the EFT rules apply to the taxpayer.
  - c. If a corporation volunteers to participate in the EFTPS it will not be subject to the deposit penalty if the tax deposit is timely filed with an authorized depository using Form 9779.
  - d. Do not select this answer choice.



## GLOSSARY

**Accumulated Earnings Tax (AET):** The accumulated earnings tax is a penalty tax imposed on corporations for unreasonably accumulating earnings in the corporation.

**Bardahl Formula:** The Bardahl formula permits the accumulation of sufficient liquid assets to operate the business for one complete business cycle.

**General Business Credit:** The general business credit (GBC) is composed of a number of separate credits that are computed on various federal tax return forms and then summarized on Form 3800 (General Business Credit). These separate credits are combined and a tax liability limitation is applied to the overall GBC.

**Holding Company:** A corporation in which there is practically no activity other than the holding of investment property.

**Investment Company:** A company that buys and sells stock, securities, real estate, and other investment property, in addition to holding investment property.

**Large Corporation:** A large corporation is any corporation having taxable income of \$1 million or more during any of the three immediately preceding tax years.

**Passive Activity Credit:** A passive activity credit is defined as the excess of the taxpayer's credits from passive activities allowable under the Code over the taxpayer's regular tax liability allocable to all passive activities.

**Period of Underpayment:** The period of underpayment for any portion of the underpayment begins on the due date of the required installment and ends on the earlier of the 15th day of the third month following the close of the tax year (the unextended due date for Form 1120), or the date the portion of the underpayment is paid.

**Tax Avoidance Motive:** The tax avoidance motive is considered present if the corporation has accumulated earnings and profits in excess of the reasonable needs of its business unless it can prove otherwise by a preponderance of the evidence.

**Underpayment Rate:** The underpayment rate is generally the rounded federal short-term rate under IRC Sec. 1274(d) plus three percentage points.



# INDEX

## A

### ACCUMULATED EARNINGS CREDIT

- Bardahl formula . . . . . 94
- Computation of . . . . . 104
- Controlled group . . . . . 104
- For personal service corporation . . . . . 104
- Holding and investment companies . . . . . 104
- Limitations on . . . . . 104
- Maximum amount
  - Bardahl formula worksheet . . . . . 94
  - Based on earnings retained to meet reasonable needs of business . . . . . 104
  - Consideration of prior years' earnings . . . . . 104
- Minimum credit amount . . . . . 104

### ACCUMULATED EARNINGS TAX

- Accumulated taxable income . . . . . 102
- Assessed
  - Based on accumulations of income in excess of reasonable business needs . . . . . 93, 94, 105
  - Regardless of number of shareholders . . . . . 93
- Burden of proof . . . . . 108
- Busy season considerations . . . . . 108
- Computation of . . . . . 102, 104
- Consolidated groups . . . . . 104
- Corporations subject to . . . . . 93, 104
- Deduction for federal income taxes . . . . . 102
- Determining and substantiating reasonable needs . . . . . 94, 105
- Dividends paid deduction . . . . . 102
- Electing S status to avoid . . . . . 105
- Interest on underpayment of . . . . . 102
- Personal holding company not subject to . . . . . 93
- Reasonable business needs . . . . . 93, 94, 105
  - Bardahl formula . . . . . 94
  - Cash business . . . . . 105
  - Dividends paid deduction . . . . . 102
  - Documenting . . . . . 105
  - Timing of decision . . . . . 105
- Reporting requirements . . . . . 105, 107
- S corporations not subject to . . . . . 93, 105
- Short tax year, effect of . . . . . 102
- Strategies for corporations . . . . . 105, 108
- Tax avoidance motive . . . . . 94
- Tax benefit rule . . . . . 105
- Tax-exempt income . . . . . 102
- Tax rate . . . . . 102

### ALCOHOL FUELS

- Credit for . . . . . 121

### ALTERNATIVE MINIMUM TAX

- Estimated tax payments . . . . . 147

### ALTERNATIVE MOTOR VEHICLE CREDIT

- Computation for . . . . . 121

### ANNUALIZING SHORT-YEAR INCOME

- Estimated tax payments . . . . . 160

## C

### CAPITAL GAINS

- Accumulated earnings computations . . . . . 102

### CAPITAL LOSSES

- Accumulated earnings tax computation . . . . . 102

### CARRYBACK

- Foreign tax credit . . . . . 134
- General business credit . . . . . 124

### CARRYOVER

- Foreign tax credit . . . . . 134
- General business credit . . . . . 124

### CHARITABLE CONTRIBUTIONS

- Accumulated earnings tax computation, allowed in . . . . . 102

### CONSOLIDATED RETURNS

- Accumulated earning tax, applying . . . . . 104

### CONTROLLED GROUP OF CORPORATIONS

- Estimated tax payments . . . . . 161

### CREDITS

- Foreign tax credit . . . . . 134
- General business credits . . . . . 121
- Passive activity credits . . . . . 132

## D

### DISABLED ACCESS

- Credit for . . . . . 121

### DIVIDENDS

- Accumulated earnings tax computation . . . . . 102
- Deduction for
  - Dividends paid for accumulated earnings tax . . . . . 102

### DIVIDENDS RECEIVED DEDUCTION

- Accumulated earnings tax computation . . . . . 102

## E

### EARNINGS AND PROFITS

- Accumulated earnings credit, for purposes of . . . . . 104

### ELECTRONIC FUNDS TRANSFER

- Definition . . . . . 165
- Requirements . . . . . 165
- Voluntary participation . . . . . 165
- Waiver of penalties . . . . . 165

### EMPLOYER-PROVIDED CHILD CARE

- Credit for . . . . . 121

### EMPOWERMENT ZONE EMPLOYMENT

- Credit for . . . . . 121

### ENERGY CREDIT

- Computation of . . . . . 121

### ENHANCED OIL RECOVERY

- Credit for . . . . . 121

### ESTIMATED TAX PAYMENTS

- Adjusted seasonal installment . . . . . 147
- Alternative minimum tax included in determination of . . . . . 147
- Annualized income installment . . . . . 147
  - Depreciation calculation for . . . . . 147
  - NOL, treatment of . . . . . 147
  - Section 199 deduction, treatment of . . . . . 147
  - Section 481(a) adjustment, treatment of . . . . . 147
- Applying for quick refund . . . . . 162
- Applying tax overpayment to . . . . . 147
- Computation of . . . . . 147
- Controlled groups . . . . . 161
- Election for alternative annualization method . . . . . 147
- Electronic funds transfers, payment by . . . . . 165
- Exceptions to general rule . . . . . 147
- General rule . . . . . 147
- Initial tax year . . . . . 160
- Large corporations . . . . . 147
- Penalty for underpayment . . . . . 161
- Required installment . . . . . 147
- Short tax years . . . . . 160

- Treatment of Section 338(h)(10) election . . . . . 147

**F**

**FILING AND REPORTING REQUIREMENTS**

- Accumulated earnings tax . . . . . 107
- Forms, completed
  - 1138 (Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback) . . . . . 145
  - 3468 (Investment Credit) . . . . . 121
  - 3800 (General Business Credit) . . . . . 121
  - 4466 (Corporation Application for Quick Refund of Overpayment of Estimated Tax) . . . . . 162
  - 6765 (Credit for Increasing Research Activities) . . . . . 121
  - 8810 (Corporate Passive Activity Loss and Credit Limitations) . . . . . 132
  - 8842 (Election to Use Different Annualization Periods for Corporate Estimated Tax) . . . . . 147

**G**

**GENERAL BUSINESS CREDIT**

- Alcohol fuels credit . . . . . 121
- Carryback and carryforward . . . . . 124
- Computation of . . . . . 121
- Disabled access credit . . . . . 121, 124
- Employer FICA credit on tip income . . . . . 121
- Employer-provided child care credit . . . . . 121
- Empowerment zone employment credit . . . . . 121
- Energy credit . . . . . 121
- Enhanced oil recovery credit . . . . . 121
- From passive activities . . . . . 132
- Indian employment credit . . . . . 121
- Investment credit . . . . . 121
- Limitations . . . . . 121
- Low-income housing credit . . . . . 121
- New market credit . . . . . 121
- Ordering rules . . . . . 124
- Orphan drug credit . . . . . 121
- Qualified plug-in electric drive credit . . . . . 121
- Reforestation credit . . . . . 121
- Rehabilitation credit . . . . . 121, 124
- Renewable electricity production credit . . . . . 121
- Research credit . . . . . 121
- Targeted jobs credit . . . . . 121
- Unused credit . . . . . 124
- Work opportunity credit . . . . . 121

**I**

**INCREMENTAL RESEARCH CREDIT**

- Computation of . . . . . 121

**INDIAN EMPLOYMENT**

- Credit for . . . . . 121

**INTEREST EXPENSE**

- Deposits to avoid . . . . . 163
- Large corporate underpayments . . . . . 163
- Net zero interest rates . . . . . 163
- Tax underpayments and overpayments . . . . . 163

**L**

**LIQUIDATION**

- Accumulated earnings tax, avoidance of . . . . . 105

**LOW-INCOME HOUSING**

- Credit for . . . . . 121

**N**

**NET OPERATING LOSSES**

- Deduction disallowed for accumulated earnings tax computation 102

**NEW MARKET INVESTMENT**

- Credit for . . . . . 121

**O**

**ORPHAN DRUGS**

- Credit for . . . . . 121

**OVERPAYMENT**

- Interest on overpayment . . . . . 163
- Quick refund . . . . . 162

**P**

**PASSIVE ACTIVITY LOSS RULES**

- Basis adjustments rule . . . . . 132
- Credits . . . . . 132
- Tax credits arising from . . . . . 132

**PASSIVE FOREIGN INVESTMENT COMPANIES**

- Exempt from accumulated earnings tax . . . . . 93

**PENALTIES**

- Failure to deposit electronically . . . . . 165
- Underpayment of estimated tax . . . . . 161

**PENSION PLAN COSTS**

- Credit for . . . . . 121

**PERSONAL HOLDING COMPANY**

- Exempt from accumulated earnings tax . . . . . 93

**PERSONAL SERVICE CORPORATIONS**

- Accumulated earnings credit . . . . . 104
- Passive activity loss rules
  - Tax credits arising from . . . . . 132

**Q**

**QUICK REFUND**

- Penalty for excess, estimated tax . . . . . 162

**R**

**REFORESTATION**

- Credit for . . . . . 121

**REHABILITATION CREDIT**

- Computation of . . . . . 121

**RENEWABLE ELECTRICITY PRODUCTION**

- Credit for . . . . . 121

**RENEWAL COMMUNITY EMPLOYMENT CREDIT**

- Computation of . . . . . 121

**RESEARCH CREDIT**

- Computation of . . . . . 121

**S**

**S CORPORATION BUILT-IN GAINS TAX**

- Credit carryovers . . . . . 121

**S CORPORATIONS**

- Election, advantages of . . . . . 105
- Exempt from accumulated earnings tax . . . . . 93, 105

**SHAREHOLDERS**

- Accumulation of income for loans to . . . . . 93

**SMALL EMPLOYER PENSION PLAN START UP COSTS**

- Credit for . . . . . 121

**T**

**TABLES**

- Credits ..... 121

**TAX AVOIDANCE**

- Accumulated earnings tax ..... 93, 104

**TAX-EXEMPT ORGANIZATIONS**

- Exempt from accumulated earnings tax ..... 93

**TAX PAYMENTS**

- Extension of time to pay ..... 145
- Form 9465 (Installment Agreement Request) ..... 145
- Interest on underpayment ..... 102, 163
- NOL carryback ..... 145
- Payment agreements ..... 145
- Presidentially declared disaster areas ..... 145

**TAX YEARS**

- Short year
  - Estimated tax payments ..... 160

**W**

**WORKING CAPITAL**

- Bardahl formula for computation of working capital needs ..... 94
- Cash business ..... 105

**WORK OPPORTUNITY CREDIT**

- Computation of ..... 121

**WORKSHEETS, COMPLETED**

- Accumulated earnings tax ..... 102
- Bardahl formula ..... 94



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### Companion to PPCs 1120 Deskbook—Course 1—Alternative Minimum Tax and Personal Holding Company Tax (T20TG091)

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	<b>Page</b>
<b>CPE Examination Questions (Lesson 1)</b> .....	<b>39</b>
<b>CPE Examination Questions (Lesson 2)</b> .....	<b>79</b>

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8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.  
 (Please print legibly):

### Additional Comments:

1. What did you find **most** helpful? \_\_\_\_\_
2. What did you find **least** helpful? \_\_\_\_\_
3. What other courses or subject areas would you like for us to offer? \_\_\_\_\_
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? \_\_\_\_\_
5. How many employees are in your company? \_\_\_\_\_
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No**

For more information on our CPE & Training solutions, visit [trainingcpe.thomson.com](http://trainingcpe.thomson.com). Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here \_\_\_\_\_

## TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

### Companion to *PPC's 1120 Deskbook—Course 2—Accumulated Earnings Tax, Credits, and Tax Payments (T20TG092)*

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

**ONLINE GRADING.** Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

**PRINT GRADING.** If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters  
Tax & Accounting—R&G  
T20TG092 Self-study CPE  
36786 Treasury Center  
Chicago, IL 60694-6700**

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

Please allow a minimum of three weeks for grading.

**Note:** The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of \$79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$336 (a 15% discount on all five courses or more).
4. To receive CPE credit, completed answer sheets must be postmarked by **November 30, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.
5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS**. Be sure to keep a completed copy for your records.
6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

### EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

	<b>Page</b>
<b>CPE Examination Questions (Lesson 1)</b> .....	<b>117</b>
<b>CPE Examination Questions (Lesson 2)</b> .....	<b>141</b>
<b>CPE Examination Questions (Lesson 3)</b> .....	<b>175</b>

**EXAMINATION FOR CPE CREDIT ANSWER SHEET**

**Companion to PPC's 1120 Deskbook—Course 2—Accumulated Earnings Tax, Credits, and Tax Payments (T20TG092)**

**CTEC Course No. 3039-CE-0228  
Price \$79**

First Name: \_\_\_\_\_

Last Name: \_\_\_\_\_

Firm Name: \_\_\_\_\_

Firm Address: \_\_\_\_\_

City: \_\_\_\_\_ State /ZIP: \_\_\_\_\_

Firm Phone: \_\_\_\_\_

Firm Fax No.: \_\_\_\_\_

Firm Email: \_\_\_\_\_

Express Grading Requested:  Add \$24.95

CTEC No.: \_\_\_\_\_

Signature: \_\_\_\_\_

Credit Card Number: \_\_\_\_\_ Expiration Date: \_\_\_\_\_

Birth Month: \_\_\_\_\_ Licensing State: \_\_\_\_\_

**ANSWERS:**

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊙.

- | a    | b | c | d | a     | b | c | d | a     | b | c | d | a     | b | c | d |
|------|---|---|---|-------|---|---|---|-------|---|---|---|-------|---|---|---|
| 1. ○ | ○ | ○ | ○ | 9. ○  | ○ | ○ | ○ | 17. ○ | ○ | ○ | ○ | 24. ○ | ○ | ○ | ○ |
| 2. ○ | ○ | ○ | ○ | 10. ○ | ○ | ○ | ○ | 18. ○ | ○ | ○ | ○ | 25. ○ | ○ | ○ | ○ |
| 3. ○ | ○ | ○ | ○ | 11. ○ | ○ | ○ | ○ | 19. ○ | ○ | ○ | ○ | 26. ○ | ○ | ○ | ○ |
| 4. ○ | ○ | ○ | ○ | 12. ○ | ○ | ○ | ○ | 20. ○ | ○ | ○ | ○ | 27. ○ | ○ | ○ | ○ |
| 5. ○ | ○ | ○ | ○ | 13. ○ | ○ | ○ | ○ | 21. ○ | ○ | ○ | ○ | 28. ○ | ○ | ○ | ○ |
| 6. ○ | ○ | ○ | ○ | 14. ○ | ○ | ○ | ○ | 22. ○ | ○ | ○ | ○ | 29. ○ | ○ | ○ | ○ |
| 7. ○ | ○ | ○ | ○ | 15. ○ | ○ | ○ | ○ | 23. ○ | ○ | ○ | ○ | 30. ○ | ○ | ○ | ○ |
| 8. ○ | ○ | ○ | ○ | 16. ○ | ○ | ○ | ○ |       |   |   |   |       |   |   |   |

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

**Expiration Date: November 30, 2010**

# Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1120 Deskbook—Course 2—Accumulated Earnings Tax, Credits, and Tax Payments Course Acronym: T20TG092

Your Name (optional): \_\_\_\_\_ Date: \_\_\_\_\_

Email: \_\_\_\_\_

Please indicate your answers by filling in the appropriate circle as shown:  
 Fill in like this  not like this   .

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.  
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### Additional Comments:

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2. What did you find **least** helpful? \_\_\_\_\_
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5. How many employees are in your company? \_\_\_\_\_
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No**

For more information on our CPE & Training solutions, visit [trainingcpe.thomson.com](http://trainingcpe.thomson.com). Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here \_\_\_\_\_