FIGURE 2-3
Completed Form 1120, Schedule C—Gamma Corporation

Schedule C	Dividends and Special Deductions (see instructions)	(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)	870	70	609
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Total.** Add lines 1 through 8. See instructions for limitation			
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	609
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on page 1, line 4 ▶	870		
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			609

In other words, the DRD is the lesser of two amounts:

1. the regular DRD (70% of the dividends received); or
2. the taxable income limitation (70% of the line 28, page 1 taxable income).

The taxable income limitation is waived if the corporation reports a tax loss, rather than taxable income. The limitation is discussed in greater detail in IRS Publication 542, *Corporations*. Also, the instructions for Forms 1120 and 1120-A provide a special "Worksheet for Schedule C, Line 9" that gives a step-by-step procedure for calculating the amount of the limitation.

Examples 2 and 3 illustrate the taxable income limitation of the DRD.

EXAMPLE 2: North Corporation received $1,000 of dividend income from <20%-owned domestic corporations. The dividend is reported on line 1 of Schedule C and is eligible for the 70% DRD. North's taxable income on line 28, page 1 is $800. The DRD is the lesser of:

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Completed Form 1120, Schedule C—Gamma Corporation

Schedule C	**Dividends and Special Deductions** (see instructions)	**(a)** Dividends received	**(b)** %	**(c)** Special deductions **(a)** × **(b)**
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2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructions	
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9	**Total.** Add lines 1 through 8. See instructions for limitation			
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	609
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
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Examples 2 and 3 illustrate the taxable income limitation of the DRD.

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Section 3

SALES OF BUSINESS PROPERTY

Introduction

Many IRC provisions encourage investment in productive capacity—property, plant, and equipment. One of these provisions, IRC Section 1231, extends favorable tax treatment on gains and losses from the sale of depreciable property and land used in the corporation's business.

When an asset is sold, the gain or loss must be characterized, or classified, for tax purposes as *ordinary* or *capital*, or a combination of both. Because the tax treatmet of ordinary gains and losses differs from that of capital gains and losses, the correct characterization is important.

- As a general rule, ordinary losses are deductible in full when calculating a corporation's taxable income.
- However, capital losses are deductible only against capital gains; they are not deductible against ordinary income.

Consequently, corporations generally prefer ordinary losses to capital losses because ordinary losses are easier to deduct.

Conversely, corporations may prefer capital gains to ordinary income for two reasons:

1. If a corporation has capital losses, it cannot deduct the losses unless it has capital gains. Capital gains are therefore an insurance policy of sorts. If the corporation has capital losses, the capital gains help make them deductible.
2. Capital gains have historically been taxed at preferential rates. At present, capital gains and ordinary income are taxed at the same rates on corporate returns. However, tax rates are subject to congressional whim; they may change again tomorrow.

To summarize, corporations generally prefer ordinary losses to capital losses, but they may prefer capital gains to ordinary income.

when preparing corporate returns. The material in this text is limited to an introductory overview to assist preparers in identifying these special situations. Preparers working with controlled corporate groups must acquire the additional tax expertise necessary to properly serve these clients.

Tax Credits for Corporations

A tax credit is a dollar for dollar offset against a corporation's income tax.

> **EXAMPLE 8:** Ralph Corporation's income tax before credits is $1,000. The corporation has $220 of tax credits. The corporation's income tax is decreased by $1 for each $1 of tax credit. The corporation's income tax after credits is $780 ($1,000 – $220).

As indicated on Schedule J, there are many tax credits, including the foreign tax credit and the general business credit.

If a corporation pays foreign tax, it can elect to claim a foreign tax credit. This credit is calculated on Form 1118, "Foreign Tax Credit—Corporations." See the instructions to Form 1118 for additional information.

The general business credit is the sum of several tax credits, including:

- various employment credits;
- research activities credit;
- disabled access credit;
- low-income housing credit;
- several energy-related credits.
- small employer pension plan startup costs credit; and
- employer-provided child care facilities and services credit.

Each credit is specialized and has limited applicability. The general business credit is reported on Form 3800. See the instructions to Form 3800 for additional information.[6]

Other Taxes

In addition to regular income tax, a corporation may be subject to one or more other taxes reported on Schedule J, including the personal holding company tax, the recapture tax, and the alternative minimum tax (AMT).

QUIZ 1 COMPUTING INCOME TAX

Problem I.

Mark each statement True or False.

1. In general, a corporation is taxed at 35% on all of its taxable income.

a. True b. False

2. A tax credit is a dollar-for-dollar offset against tax.

a. True b. False

3. The alternative minimum tax is designed to ensure that corporations with significant economic income pay at least a minimum amount of tax.

a. True b. False

4. Each member of a controlled corporate group is entitled to its own tax rate schedule for the computation of corporate tax.

a. True b. False

5. A corporation is generally required to make quarterly estimated payments of its current year tax.

a. True b. False

6. If a corporation overpays its tax, it may elect to have the overpayment credited to its estimated tax for the succeeding tax year.

a. True b. False

7. A brother-sister group is an example of a controlled corporate group.

a. True b. False

8. A parent-subsidiary group may elect to file a consolidated Form 1120.

a. True b. False

The proposed revenue procedure provides detailed information on eligible and ineligible businesses. Please see Revenue Procedure 2002-28 for additional information, special rules, examples, and procedures for qualifying small business taxpayers who want to change from the accrual to the cash method of accounting.

Summary of tax methods allowed

Under Section 448, "Limitation on Use of Cash Method of Accounting," C corporations are generally prohibited from using the cash method of accounting. Exceptions apply to qualified personal service corporations and corporations that satisfy the $5 million gross receipts test.

Taxpayers engaged in the production, purchase, or sale of inventory are generally required to account for inventory and use the accrual method for sales and purchases. Exceptions apply to certain small businesses that satisfy the requirements of either Revenue Procedure 2001-10 or 2002-28.

Cash-Basis Method of Accounting—General Rules

The cash-basis method of accounting is preferred by many small businesses, including corporations, for two major reasons. First, it is simple. As a general rule, income is taxed in the year received, and expenses are deducted in the year paid. Second, it provides considerable opportunity for the manipulation of taxable income. If a cash-basis corporation wants to keep its taxable income down, it can defer revenue by slowing down the billing and collection process and accelerate deductions by paying bills prior to year end. Conversely, if the corporation wants to increase its taxable income, it can accelerate the billing and collection process and defer paying bills until after year end.

In general, the IRS does not quarrel with taxpayers attempting to increase taxable income; higher taxable income generally means higher tax revenues. However, the government does limit the corporation's ability to decrease taxable income by imposing three significant exceptions to the general rules for the recognition of income and deductions by cash-basis taxpayers.