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## Chapter 6: Federal Income Tax Returns and Filings

Entities subject to franchise and excise tax file on a variety of different federal income tax forms, as discussed previously. For example:

- Corporations and business trusts file on Form 1120.
- S-corporations file on Form 1120-S.
- REITs file on Form 1120-REIT.
- LLCs generally file on Form 1065.
- SMLLCs owned by individuals file on Form 1040, GPs and LPs file on Form 1065.
- Foreign corporations file on Form 1120-F.

The discussion in this chapter is limited to federal forms and does not address state tax issues, but it may be especially helpful to auditors reviewing federal tax returns and forms. *Although this information may also be helpful to franchise and excise tax filers (because federal taxable income is generally the starting point for calculating the franchise and excise tax liability), this information is not intended as an interpretation of federal tax law.*

All IRS forms and related instructions can be accessed at <http://www.irs.gov/Forms-&-Pubs>. REITs filing Form 1120-REIT are discussed in Addendum 2.

### Corporations

#### 1. Consolidated Group Election, Form 851 & Subsidiary Statements

Corporations filing on Form 1120 must file individually unless they have made a federal election to file as a consolidated group. Many large corporations with subsidiaries make this election. One advantage in making the election is that the losses of certain subsidiaries will offset the gains of others. Taxpayers attach Form 1122 – Authorization and Consent of Subsidiary Corporation To Be Included in a Consolidated Income Tax Return – to the parent’s consolidated return the first year a subsidiary corporation is included in a consolidated return. The taxpayer will check a box on the first page of the consolidated Form 1120 to indicate that the return was

prepared on a consolidated basis. Also, Form 851 – Affiliations Schedule – must be attached to the consolidated federal return.

A consolidated federal return includes a parent corporation and an affiliated group of corporations that have at least 80% direct or indirect common ownership with a common parent corporation. Affiliated groups may include numerous subsidiaries. They are identified on federal Form 851. Note that federally disregarded LPs or LLCs are not listed on Form 851, as this form only lists corporations.

Information found on the federal Form 851 includes:

- The names and addresses of each of the filing group members;
- The federal identification numbers of all members of the filing group;
- Corporate organization/ownership structure;
- The principal business activity (PBA) code of each entity; and
- Group members who left the group during the tax year (sold, etc.).

The common parent corporation listed on Form 851 must directly own stock that represents at least 80% of the total voting power and at least 80% of the total value of the stock of at least one of the other corporations. 80% of each of the other corporations (except for the common parent corporation) must be owned directly by one or more of the other includible corporations.

Consolidated returns must include statements for each corporation included in the return. The supporting statements will have *columns for each corporation* that show the following, both before and after adjustments:

- Items of gross income, gain, loss, and deductions;
- A computation of taxable income;
- Balance sheets as of the beginning and end of the tax year;
- A reconciliation of income per books with income per return; and
- A reconciliation of retained earnings

The supporting statement will have eliminating entries so that intercompany transactions between corporations within the consolidated group are eliminated. The sum of each item of income and deduction, net of eliminations, is entered on the consolidated Form 1120. Note, the last three items listed above are not required if the group's total receipts and its total assets at the end of the tax year are less than \$250,000.

## 2. Capital Loss

A capital loss occurs when a capital asset is sold or disposed of at a loss. Property held by a corporation (whether or not connected with its trade or business) is generally a capital asset except for the following:

- Stock in trade or other property included in inventory or held mainly for sale to customers.
- Accounts or notes receivable acquired in the ordinary course of the trade or business for services rendered or from the sale of stock in trade or other property included in inventory or held mainly for sale to customers.
- Depreciable or real property used in the trade or business, even if it is fully depreciated.
- For dispositions after December 31, 2017, certain patents, inventions, models or designs (whether or not patented), secret formulas or processes, or similar property.
- Supplies regularly used in the trade or business.

For a corporation, capital losses are allowed in the current tax year *only to the extent of capital gains*. A net capital loss may be carried back 3 years and forward up to 5 years as a short-term capital loss. A capital loss may be carried back to the extent it does not increase or produce a net operating loss in the tax year to which it is carried.<sup>1</sup> Capital gains and losses are reported on Schedule D (Form 1120). This schedule is necessary because capital losses may not offset ordinary business income.

## 3. Capital Gain Net Income

Form 1120, Line 8 "Capital gain net income" reflects *net* capital gain income. It is the current year capital gains less current and/or prior year capital losses. The gain and loss amounts, before being netted, are reported on Schedule D (Form 1120) and the *net* gain is carried to Form 1120.

#### **4. Dividends and Inclusions**

Dividends and inclusions are reported on Form 1120, Line 4; the total comes from Schedule C (page 2 of Form 1120). Dividends from corporations more than 20% owned and less than 20% owned are segregated on Schedule C, but the specific percentage of ownership is not reported on this schedule. Corporations filing a consolidated return do not report as dividends on Schedule C any amounts received from corporations within the consolidated group because such dividends are eliminated in consolidation.

#### **5. Exempt Interest Income**

Interest earned on tax-exempt state or municipal bonds is federally exempt from taxation. It is disclosed on Form 1120, Schedule K and Schedule M-1 or M-3.

#### **6. Other Income**

Corporations with an ownership interest in a partnership report their share of the partnership's ordinary income from trade or business activities on Form 1120, Line 10, "Other income." Note that ordinary partnership losses passed through to a corporation are not reported as a negative on the "Other income" line, but are reported on Form 1120, Line 26, "Other deductions."

A statement is attached to the federal return that shows the name, address, and EIN of each partnership that is owned by the corporation, along with the related pass-through amounts.

#### **7. Charitable Contributions**

The charitable contribution deduction amount claimed on a corporate return cannot be more than 10% of taxable income computed without regard to any deduction for charitable contributions and certain other deductions and losses. Charitable contributions over the 10% limitation can be carried over to the next 5 tax years.

In addition, if contributions of property (not cash) are made, the corporation will attach a statement to the return describing the kind of property contributed and the method used to determine its fair market value on Form 8283 – Noncash Charitable Contributions.

#### **8. Balance Sheet**

The Form 1120, Schedule L – Balance Sheet per Books – should agree with the corporation's books and records. Generally, the accounting method used is accrual, but it could be cash or another method. Some corporations are not required to complete Schedule L; for example, corporations that have total receipts and total assets at the end of the tax year of less than

\$250,000 are not required to complete Schedule L. Consolidated returns report on Schedule L the total consolidated assets, liabilities, and shareholders' equity for all affiliates in the consolidated group. Also, the balance sheets of each corporate affiliate are attached to the return unless the \$250,000 receipts/assets exception is met.

## **9. Reconciliation of Income (Loss) per Books with Income per Return**

All corporations reconcile net income (loss) per books with income (loss) per return by completing either Schedule M-1 (for smaller corporations) or M-3 (for larger corporations). All items of income and expense are reconciled on these schedules. On the expanded Schedule M-3, there are specific lines for many types of income and expense, such as dividends, Subpart F, sale versus lease, gain or loss on sale, capital loss limitation, interest expense, charitable contributions, depletion, depreciation, and more. The "Other income" and "Other expense" lines are used to report items not specifically listed; amounts reported on these lines must be supported by detailed statements that show the book to tax reconciliation.

Multiple Schedule M-3s may be completed (consolidated group, parent, consolidated eliminations, subsidiary corporations, mixed 1120/L/PC group). If a taxpayer files a consolidated Form 1120 and Schedule M-3, then the book to tax reconciliation is completed for each member of the consolidated group. The first page of Schedule M-3 discloses whether audited financial statements exist, if the corporation filed SEC Form 10-K, and if the income statement has been restated in the last five years or more.

## **S-corporations**

Subchapter S-corporations and qualified subsidiaries file a single Form 1120-S. An S-corporation is a corporation that has made the federal election to be an S-corporation on Form 2553 – Election by a Small Business Corporation. A non-corporate entity, such as an LP or LLC, may also use this form to make an election to be taxed as an S-corporation.<sup>2</sup> S-corporation shareholders are limited to individuals, certain estates and trust, and other S-corporations.

S-corporation income is not taxed at the corporate level. Income, gains, losses, deductions, credits, and other items are passed through to the S-corporation shareholders to report on their individual income tax returns. Shareholders are liable for tax based on their share of the corporation's earnings, regardless of the amount actually distributed to the shareholders in cash or property. Form 1120-S, Schedule K is a summary schedule of the corporation's income, deductions, credits, etc. In addition, Schedule K-1 is prepared for each shareholder and shows each shareholder's portion of the items listed on Schedule K.

**⚠ Page 1 of Form 1120-S does not report the entity's total net income/loss. The tax basis net income/loss is found on the last line of Form 1120-S, Schedule K. The book basis income is found on Schedule M-3, Part 1, Line 11.**

S-corporations are pass-through entities, but they differ from partnerships in the following ways:

- S-corporations are true corporations and corporate rules regarding disregarded entities apply.
- S-corporation income is not subject to federal self-employment tax.
- S-corporations cannot have more than 100 shareholders and may not be owned by a corporation.
- S-corporations pay salaries and wages to shareholders and not guaranteed payments.
- S-corporations with 100% owned corporate subsidiaries may use Form 8869 to elect to treat one or more of its eligible subsidiaries as a qualified subchapter S subsidiary (QSub).<sup>3</sup>
  - An S-corporation and its QSubs file together on one Form 1120-S. They do not file Form 851 Affiliations Schedule, so the inclusion of QSubs is not readily apparent on the face of the return.

S-corporations are true corporations, but they differ from C-corporations in the following ways:

- S-corporations segregate income by type (ordinary, passive, capital gain/loss) whereas C-corporations net all types of earnings to arrive at one "taxable income" amount.
- S-corporations pass through to shareholders certain expense items that may be limited at the shareholder level. Each shareholder calculates their own limitation. For example, charitable contributions, Section 179 depreciation, capital losses, and items subject to passive activity limitations may be limited on the shareholder's return.
- S-corporations cannot have more than 100 members.
- S-corporations file Schedule M-3 (Form 1120-S), not Schedule M-3 (Form 1120).

**⚠ The Form 1120-S may include subsidiaries, but these inclusions may not be apparent. Franchise and excise tax audits begin by determining if any QSubs were erroneously included in the franchise and excise tax return of the parent.**

## Corporations Chartered Outside the United States

Corporations chartered outside of the United States file Form 1120-F – U.S. Income Tax Return of a Foreign Corporation – in which they report their income, gains, losses, deductions, and credits and compute their United States income tax liability. Form 1120-F is filed:

- If the corporation was engaged in a trade or business in the United States, regardless of whether it had United States source income from that trade or business or if income from such trade or business is exempt from United States tax under a tax treaty.
  - If the corporation does not have any gross income for the tax year because it is claiming a treaty or Code exemption, it must still file Form 1120-F to show that the income was exempted by a treaty.
- As a *protective return* when the foreign corporation conducts limited activities in the United States that the foreign corporation determines do not give rise to gross income that is effectively connected with the conduct of a trade or business within the United States. It files the return as a protective measure to safeguard its right to receive certain IRC deductions and credits if its original tax liability determination was incorrect.
- If the corporation was not engaged in a trade or business in the United States, but had income from any United States source, if its tax liability has not been fully satisfied by the withholding of tax at source.<sup>4</sup>
- If the corporation was, or had a branch that was, a Qualified Derivatives Dealer.

A foreign corporation may not belong to an affiliated group of corporations that files a consolidated return.<sup>5</sup>

## Partnerships

In their default classification, LLCs, LPs, and GPs file Form 1065 – U.S. Return of Partnership Income. Owners of a partnership are called partners, whereas owners of an LLC are called members. Like the Form 1120-S, Form 1065 reports ordinary business income (or loss) on page



1 and distributive share items on Schedule K (page 4 of Form 1065). Each partner's share of the partnership's tax attributes are reported on Schedule K-1s that the partnership issues to each partner, so that all items of income, deductions, credits, and other items pass through to the partners, who then report these tax attributes on their individual income tax returns (subject to any loss limitations at the individual level).

Pass-through entities filing on Form 1065 do not net short-term capital gains and losses with long-term capital gains and losses, but report each on a separate line on Form 1065, Schedule K to maintain their character when included in the owner's individual income tax return. The capital loss limitation (capital losses can only offset capital gains) is applied at the owner level. Income and expense items reported on Form 1065 do not lose their character when distributed to owners via Schedule K-1. For example, tax-exempt income is not netted with other types of income and expense but retains its character as tax-exempt income when reported on the owner's K-1, and eventually, the owner's tax return.

There are limits to the amount of losses, deductions, and credits that partners can claim from "passive activities." This limitation does not apply to the partnership, but instead applies to each partner's share of any income or losses and credits attributable to a passive activity. Because the treatment of pass-through items depends on the nature of the activity that generated them, the partnership must report income or loss and credits separately for each activity. Generally, passive activities include activities that involve the conduct of a trade or business if the partner does not materially participate in the activity, and all rental activities regardless of the partner's level of participation.

The passive activity rules provide that losses and credits from passive activities can generally be applied only against income and tax resulting from passive activities. In reporting the partnership's income or losses and credits from rental activities, the partnership separately reports rental real estate activities and rental activities other than rental real estate activities. Rental real estate activity income (loss) is reported on Form 8825 – Rental Real Estate Income and Expenses of a Partnership or an S Corporation – and the total from this form is carried to Line 2 of Schedule K and Box 2 of Schedule K-1, rather than to page 1 of Form 1065. Each real estate property rented by the entity is listed on Form 8825 along with the gross rents and expense items (such as depreciation, wages, utilities, repairs, etc.) that are attributable to each rental property listed.

A partnership could be disregarded for federal income tax purposes if it has common ownership (i.e., it is owned by two affiliated corporations that file a consolidated Form 1120). In this case, there would be no reason to file Form 1065 and issue Schedule K-1s because the distributed

items all ultimately flow to the same consolidated Form 1120. Instead, such partnership would be disregarded and included in the consolidated Form 1120. However, if the partnership's owners file different federal returns, then the partnership would file a Form 1065 and issue Schedule K-1s to the respective owners to include the tax attributes in their federal returns.

## **Limited Liability Company (LLC)**

An LLC is a type of entity created by state statute. They became common starting in 1990. The IRS did not create a new tax classification for the LLC when it was created by the states. Instead, the IRS will classify an LLC either as a corporation, partnership, or disregarded entity. Generally, an LLC will file a partnership return on Form 1065 unless it has made an election to be treated as a corporation.

## **Single Member LLC**

By default, an LLC that has two or more members will be classified as a partnership for federal income tax purposes. An LLC with only one member is known as a single-member limited liability company (SMLLC). By default, an SMLLC is disregarded to its owner for federal income tax purposes. However, an SMLLC can elect on Form 8832 to be recognized as a taxpaying entity, such as a corporation. An SMLLC that is owned by an individual is a disregarded entity and its activity is reported on Schedule C of the individual's Form 1040. Similarly, an SMLLC owned by a corporation is treated as a branch (or division) of its corporate owner and is included in the corporation's Form 1120.

## **Other Federal Forms**

There are numerous federal forms and schedules that are required for the purpose of making various federal tax elections or to show in greater detail how a particular taxable income or deduction amount was calculated. Thus far, we have discussed federal Forms 851, 1122, 2553, 8283, 8825, 8832, 8869, and federal Schedules C, D, K, K-1, M-1, and M-3. This section provides a brief overview of additional forms that support the various federal income tax returns (Forms 1120, 1120-S, 1065, and 1040).

### **1. Form 940**

Employers file the federal unemployment Form 940 annually. This return reports the total wage payments to all employees and calculates the federal unemployment tax. Also, this form indicates on Schedule A the states in which the employer paid state unemployment tax.

## 2. Form 1125-A

The first section of Forms 1065, 1120, and 1120-S is where income is reported by type and totaled. Note that the total is reduced by cost of goods sold (CGS) items like depreciation, labor expense, rent expense, intangible expense, etc. CGS is reported on Form 1125-A and the total is carried, as a reduction, to the income section of the first page of the corporate and partnership tax returns. CGS is any direct cost related to the production of goods that are sold or the cost of inventory that an entity acquires to sell to consumers.

The second section of Forms 1065, 1120, and 1120-S is where overhead expenses related to the general operation of the business are reported. The same *type* of expense may be reported as CGS in the income section of the form and as a general operating expense in the deduction section. For example, wages, rent, and intangible expenses could be CGS or they could be general, operating expenses.

## 3. Form 4562

Most entities file Form 4562 – Depreciation and Amortization – to report:

- Section 179 expense currently deducted and any related carryover;
- Special (bonus) depreciation;
- MACRS depreciation for assets added in the current year and in previous years;
- Depreciation on listed property; and
- Amortization of intangible expenses.

The *Section 179* election to expense certain property is made by many taxpayers. For tax years beginning in 2018, the maximum section 179 expense deduction was \$1,000,000. This limit is reduced by the amount by which the cost of section 179 property placed in service during the tax year exceeds \$2,500,000.

*Special (bonus)* depreciation is also claimed by many taxpayers because of the ability to accelerate their depreciation expense. The rate of special (bonus) depreciation depends on when the qualified property was placed into service. Certain qualified property acquired after September 27, 2017, and before January 1, 2023, is eligible for a special depreciation allowance of 100% of the depreciable basis of the property. Qualified property includes tangible property depreciated under MACRS with a recovery period of 20 years or less.

The last section of Form 4562 is where *amortization* is reported. Even though amortization is reported on this form, it is not carried to a depreciation expense line on Forms 1120, 1120-S, or 1065. Instead, amortization expense generally will be included in the amount reported on the “Other deductions” line of the return. A schedule must be attached to the return to list the type and amount of expenses that make up this deduction.

#### **4. Form 4797**

Form 4797 provides details regarding sales of business property. This form lists the gross sales price, cost basis, depreciation allowed, dates of acquisition and sale, and the resulting gain or loss on the sale. The net gain or loss from Form 4797 is reported on page 1 of Forms 1120, 1065, and 1120-S. Note, the disposition of capital assets is not reported on this form, but instead are reported on Schedule D.

#### **5. Form 6252**

Form 6252 – Installment Sale Income – is used to report gains from an installment sale. An installment sale is a disposition of property where at least one payment is received after the end of the tax year in which the disposition occurs. The installment method taxes the gain in the periods in which proceeds are received, instead of when the contract was signed. For example:

- A building is sold under an agreement in which payments are to be received in installments over the next three years.
- Form 6252 is filed in the year of sale and each year thereafter until all proceeds have been received.
- Form 6252 reports the selling price, acquisition and sale dates, calculation of the gain, gross profit percentage, and payments received.

This form calculates the gain subject to income tax each year; the gain is transferred to Schedule D or Form 4797. Taxpayers are not required to use the installment method. They may elect out by not filing Form 6252, but instead reporting the full amount of the gain on Form 4797 or Schedule D.

#### **6. Form 7004**

Form 7004 – Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns – must be filed on or before the due date of the applicable tax

return. This form shows the taxpayer's identifying information, the form number of the tax return (Form 1041, 1065, 1120, 1120-S, etc.), and the beginning and end dates of the applicable tax year or short tax year. Generally, all members of a consolidated group must use the same taxable year as the common parent corporation. If, however, a member of a consolidated group is required to file a separate income tax return for a short period and seeks an extension of time in which to file the return, that member must file a separate Form 7004 for that period.

## **7. Form 8594**

When a group of assets that makes up a trade or business is sold, Form 8594 – Asset Acquisition Statement – is completed by both the seller and purchaser if there is goodwill or a going concern value relating to the assets and the purchaser's basis in the assets is determined solely by the amount paid for the assets. This form reports the names of the parties, date of sale, total sale price, allocation of sale price, including any amount allocated to goodwill. Also, the form discloses if there are any contractual agreements associated with the sale such as, covenants not to compete, lease agreements, management contracts, employment contracts, and similar arrangements.

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<sup>1</sup> Foreign expropriation capital losses cannot be carried back, but are carried forward up to 10 years. Also, a net capital loss of a regulated investment company (RIC) incurred in tax years beginning before December 23, 2010, is carried forward up to 8 years. There is no limit on the number of tax years a RIC is allowed to carry forward a net capital loss incurred in tax years beginning after December 22, 2010.

<sup>2</sup> An LLC electing classification as an S-corporation generally is not required to file Form 8832 to elect classification as a corporation before filing Form 2553. By filing Form 2553, an LLC is deemed to have elected classification as a corporation in addition to the S-corporation classification. S-corporation shareholders cannot include non-resident aliens, partnerships, or corporations.

<sup>3</sup> This QSub election results in a deemed liquidation of the subsidiary into the parent. Following the deemed liquidation, the QSub is not treated as a separate corporation and all of the subsidiary's assets, liabilities, and items of income, deduction, and credit are treated as those of the parent.

<sup>4</sup> Under Chapter 3 of the Internal Revenue Code.

<sup>5</sup> A Canadian or Mexican corporation described in IRC § 1504(d), maintained solely for complying with the laws of Canada or Mexico for title and operation of property, may elect to be treated as a domestic corporation and thereby file as part of an affiliated group.