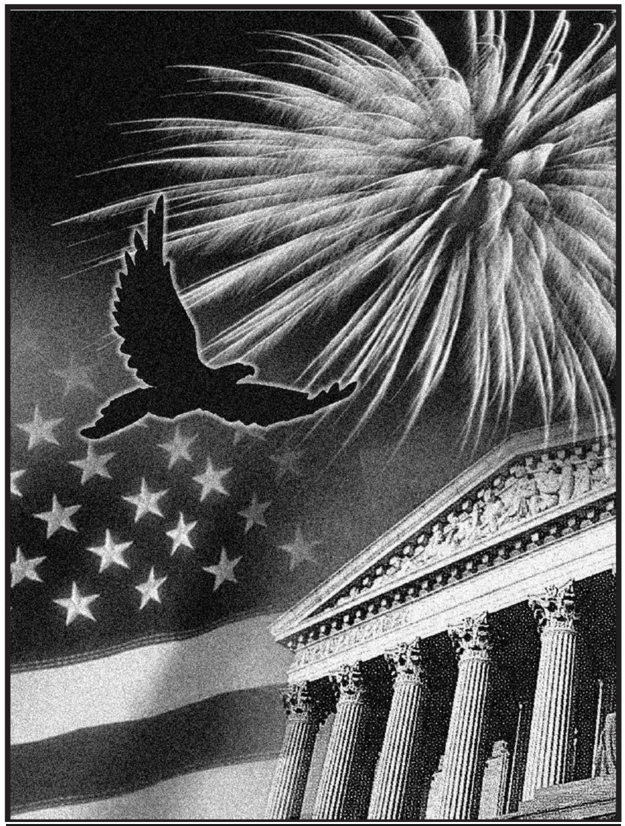
Publication 542

Corparations

(Rev. January 2024)

Volume 1 of 2



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Future Developments

For the latest information about developments related to Pub. 542, such as legislation enacted after it was published, go to *IRS.gov/Pub542*. For changes that may affect the current tax year, see the Instructions for Form 1120 or the applicable instructions for the corporation’s tax return.

What's New

New corporate alternative minimum tax. For tax years beginning after 2022, the Inflation Reduction Act of 2022 amended section 55 of the Internal Revenue Code to impose a new corporate alternative minimum tax (CAMT) based on the adjusted financial statement income (AFSI) of an applicable corporation. See *Corporate Alternative Minimum Tax (CAMT)*, later.

Form 1120-W now historical. Form 1120-W, Estimated Tax for Corporations, and the Instructions for Form 1120-W are now historical. The 2022 revisions were the last revisions of both the form and its instructions. Prior versions are available on *IRS.gov*.

Photographs of Missing Children

The Internal Revenue Service is a proud partner with the *National Center for Missing & Exploited Children® (NCMEC)*. Photographs of missing children selected by the Center may appear in instructions on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 800-THE-LOST (800-843-5678) if you recognize a child.

Introduction

This publication discusses the general tax laws that apply to ordinary domestic corporations. It provides supplemental federal income tax information for corporations. It also supplements the information provided in the Instructions for Form 1120, U.S. Corporation Income Tax Return. However, the information given does not cover every situation and is not intended to replace the law or change its meaning.

Comments and suggestions. We welcome your comments about this publication and suggestions for future editions.

You can send us comments through *IRS.gov/FormComments*. Or, you can write to:

Internal Revenue Service
Tax Forms and Publications
1111 Constitution Ave. NW, IR-6526
Washington, DC 20224

Although we can’t respond individually to each comment received, we do appreciate your feedback and will consider your comments and suggestions as we revise our tax forms, instructions, and publications. **Do not** send tax questions, tax returns, or payments to the above address.

Getting answers to your tax questions. If you have a tax question not answered by this publication or the *How To Get Tax Help* section at the end of this publication, go to the IRS Interactive Tax Assistant page at *IRS.gov/*

Help/ITA where you can find topics by using the search feature or viewing the categories listed.

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Additional forms. A list of other forms and statements that a corporation may need to file is included at the end of this publication. Also, see the instructions for the corporation's tax return for additional forms and statements that may be required.

Useful Items

You may want to see:

Publication

- **510** 510 Excise Taxes (Including Fuel Tax Credits and Refunds)

- **538** 538 Accounting Periods and Methods
- **544** 544 Sales and Other Dispositions of Assets
- **550** 550 Investment Income and Expenses
- **925** 925 Passive Activity and At-Risk Rules
- **946** 946 How To Depreciate Property

Businesses Taxed as Corporations

The rules used to determine whether a business is taxed as a corporation changed for businesses formed after 1996.

Business formed before 1997. A business formed before 1997 and taxed as a corporation under the old rules will generally continue to be taxed as a corporation.

Business formed after 1996. The following businesses formed after 1996 are taxed as corporations.

- A business formed under a federal or state law that refers to it as a corporation, body corporate, or body politic.
- A business formed under a state law that refers to it as a joint-stock company or joint-stock association.

- An insurance company.
- Certain banks.
- A business wholly owned by a state or local government.
- A business specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign businesses.
- Any other business that elects to be taxed as a corporation.

Limited liability company (LLC). An LLC may be classified for federal income tax purposes as either a partnership, a corporation, or an entity disregarded as an entity separate from its owner by applying the rules in Treasury Regulations section 301.7701-3. An LLC can elect to be treated as an association taxable as a corporation by filing Form 8832, Entity Classification

Election. See the Instructions for Form 8832. For more information about LLCs, see Pub. 3402, Taxation of Limited Liability Companies.

S corporations. Some corporations may meet the qualifications for electing to be S corporations. For information on S corporations, see the Instructions for Form 1120-S.

Personal service corporations. A corporation is a personal service corporation if it meets all of the following requirements.

1. Its principal activity during the “testing period” is performing personal services (defined later). Generally, the testing period for any tax year is the prior tax year. If the corporation has just been formed, the testing period begins on the first day of its tax year and ends on the earlier of:

    a. The last day of its tax year, or

b. The last day of the calendar year in which its tax year begins.

2. Its employee-owners substantially perform the services in (1) above. This requirement is met if more than 20% of the corporation's compensation cost for its activities of performing personal services during the testing period is for personal services performed by employee-owners.

3. Its employee-owners own more than 10% of the fair market value of its outstanding stock on the last day of the testing period.

Personal services. Personal services include any activity performed in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and the performing arts.

Employee-owners. A person is an employee-owner of a personal service corporation if both of the following apply.

1. That person is an employee of the corporation or performs personal services for, or on behalf of, the corporation (even if that person is an independent contractor for other purposes) on any day of the testing period.
2. That person owns any stock in the corporation at any time during the testing period.

Other rules. For other rules that apply to personal service corporations, see *Accounting Periods*, later.

Closely held corporations. A corporation is closely held if all of the following apply.

1. It is not a personal service corporation.

2. At any time during the last half of the tax year, more than 50% of the value of its outstanding stock is, directly or indirectly, owned by or for five or fewer individuals. “Individual” includes certain trusts and private foundations.

For rules for determining stock ownership, see section 544 of the Internal Revenue Code.

Other rules. For the at-risk rules that apply to closely held corporations, see *At-Risk Limits*, later.

Property Exchanged for Stock

If you transfer property (or money and property) to a corporation in exchange for stock in that corporation (other than nonqualified preferred stock), and immediately afterward you are in control of the corporation, the exchange is usually not taxable. This rule applies both to individuals and to groups who transfer property to a corporation. It also applies whether the corporation is being formed or is already operating. It does not apply in the following situations.

- The corporation is an investment company.
- You transfer the property in a bankruptcy or similar proceeding in exchange for stock used to pay creditors.

- The stock is received in exchange for the corporation's debt (other than a security) or for interest on the corporation's debt (including a security) that accrued while you held the debt.

See *Property Exchanged for Stock* in chapter 2 of Pub. 544 for more information.

Both the corporation and any person involved in a nontaxable exchange of property for stock must attach to their income tax returns for the year of the exchange, the complete statement of all facts pertinent to the exchange required by Treasury Regulations section 1.351-3.

Control of a corporation. To be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock.

Loss on exchange. If you have a loss from an exchange and own, directly or indirectly, more than 50% of the corporation's stock, you cannot deduct the loss. For more information, see *Nondeductible Loss* under *Sales and Exchanges Between Related Persons* in chapter 2 of Pub. 544.

Basis of stock or other property received. The basis of the stock you receive is generally the adjusted basis of the property you transfer. Increase this amount by any amount treated as a dividend, plus any gain recognized on the exchange. Decrease this amount by any cash you received, the fair market value of any other property you received, and any loss recognized on the exchange. Also decrease this amount by the amount of any liability the corporation or another party to the exchange assumed from you, unless payment of the liability gives rise to a deduction when paid.

Further decreases may be required when the corporation or another party to the exchange assumes from you a liability that gives rise to a deduction when paid, if the basis of the stock would otherwise be higher than its fair market value on the date of the exchange. This rule does not apply if the entity assuming the liability acquired either substantially all of the assets or the trade or business with which the liability is associated.

The basis of any other property you receive is its fair market value on the date of the trade.

Basis of property transferred. A corporation that receives property from you in exchange for its stock generally has the same basis you had in the property, increased by any gain you recognized on the exchange. However, the increase for the gain recognized may be limited. For more information, see section 362 of the Internal Revenue Code.

If property is transferred to a corporation subject to section 362(e)(2) of the Internal

Revenue Code, the transferor and the acquiring corporation may elect, under section 362(e)(2)(C), to reduce the transferor's basis in the stock received instead of reducing the acquiring corporation's basis in the property transferred. Once made, the election is irrevocable. For more information, see section 362(e)(2) and Treasury Regulations section 1.362-4. If an election is made, a statement must be filed in accordance with Treasury Regulations section 1.362-4(d)(3).

Capital Contributions

This section explains the tax treatment of contributions from shareholders and nonshareholders.

Paid-in capital. Generally, contributions to the capital of a corporation, whether or not by shareholders, are paid-in capital. These contributions are not taxable to the corporation. However, after December 22, 2017, the following nonshareholder contributions to the capital of a corporation are not considered nontaxable paid-in capital.

- Any contribution in aid of construction or any other contribution as a customer or potential customer.
- Any contribution by any civic group.
- Any contribution by any governmental entity. However, see the special rule below.

For contributions made after December 31, 2020, a special rule applies to contributions to the capital of water and sewerage disposal utilities. Under the special rule, any amount of money or property received after December 31, 2020, as a contribution in aid of construction or a contribution to the capital of a regulated public utility that provides water or sewerage disposal services is eligible for exclusion from income under section 118 of the Internal Revenue Code.

Basis. The corporation's basis of property contributed to capital by a shareholder is the same as the basis the shareholder had in the property, increased by any gain the shareholder recognized on the exchange. However, the increase for the gain recognized may be limited. For more information, see *Basis of property transferred* above and section 362 of the Internal Revenue Code.

The basis of property contributed to capital by a person other than a shareholder is zero.

If a corporation receives a cash contribution from a person other than a shareholder, the corporation must reduce the basis of any property acquired with the contribution during the 12-month period beginning on the day it received the contribution by the amount of the contribution. If the amount contributed is more than the cost of the property acquired, then reduce, but not below zero, the basis of the other properties held by the corporation on the last day of the 12-month period in the following order.

1. Depreciable property.
2. Amortizable property.
3. Property subject to cost depletion but not to percentage depletion.
4. All other remaining properties.

Reduce the basis of property in each category to zero before going on to the next category.

There may be more than one piece of property in each category. Base the reduction of the basis of each property on the following ratio.

$$\frac{\text{Basis of each piece of property}}{\text{Bases of all properties (within that category)}}$$

If the corporation wishes to make this adjustment in some other way, it must get IRS approval. The corporation files a request for approval with its income tax return for the tax year in which it receives the contribution.

Filing and Paying Income Taxes

The federal income tax is a pay-as-you-go tax. A corporation must generally make estimated tax payments as it earns or receives income during its tax year. After the end of the year, the corporation must file an income tax return. This section will help you determine when and how to pay and file corporate income taxes.

TIP *For certain corporations affected by federally declared disasters such as hurricanes, the due dates for filing returns, paying taxes, and performing other time-sensitive acts may be extended. The IRS may also forgive the interest and penalties on any underpaid tax for the length of any extension. For more information, visit IRS.gov/DisasterTaxRelief.*

Income Tax Return

This section will help you determine when and how to report a corporation's income tax.

Who must file. Unless exempt under section 501 of the Internal Revenue Code, all domestic corporations in existence for any part of a tax year (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income.

Which form to file. A domestic entity electing to be classified as an association taxable as a corporation must generally file Form 1120, U.S. Corporation Income Tax Return, to report its income, gains, losses, deductions, credits, and to figure its income tax liability. Certain organizations and entities must, or may elect to, file special returns. For more information, see *Special Returns for Certain Organizations* in the Instructions for Form 1120.

Electronic filing. Corporations can generally electronically file (*e-file*) Form 1120 and certain related forms, schedules, and attachments. However, for returns filed on or after January 1, 2024, corporations that file 10 or more returns are required to efile. However, these corporations can request a waiver of the electronic filing requirements. For more information on electronic filing, see the Instructions for Form 1120, or the applicable instructions for your income tax return.

When to file. Generally, a corporation must file its income tax return by the 15th day of the 4th month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 4th month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 4th month after the date it dissolved.

However, a corporation with a fiscal tax year ending June 30 must file by the 15th day of the 3rd month after the end of its tax year. A corporation with a short tax year ending anytime in June will be treated as if the short period ended June 30 and must file by the 15th day of the 3rd month after the end of its tax year.

If the due date falls on a Saturday, Sunday, or legal holiday, the due date is extended to the next business day.

Extension of time to file. File Form 7004, Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns, to request an extension of time to file a corporation's income tax return. The IRS will grant the extension if the corporation completes the form properly, files it, and pays any tax due by the original due date for the return.

Form 7004 does not extend the time for paying the tax due on the return. Interest, and possibly penalties, will be charged on any part of the final tax due not shown as a balance due on Form 7004. The interest is figured from the original due date of the return to the date of payment. For more information, see the Instructions for Form 7004.

How to pay your taxes. A corporation must pay its tax due in full no later than the due date for filing its tax return (not including extensions).

Electronic Federal Tax Payment System (EFTPS). Corporations must generally use EFTPS to make deposits of all tax liabilities (including social security, Medicare, withheld income, excise, and corporate income taxes). For more information on EFTPS and enrollment, visit *www.eftps.gov*.

Penalties

Generally, if the corporation receives a notice about interest and penalties after it files its return, send the IRS an explanation and we will determine if the corporation meets reasonable-cause criteria. ***Do not*** *attach an explanation when the corporation's return is filed. See the instructions for your income tax return.*

Late filing of return. A corporation that does not file its tax return by the due date, including extensions, may be penalized 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. If the corporation is charged a penalty for late payment of tax (discussed next) for the same period of time, the penalty for late filing is reduced by the amount of the penalty for late payment. A minimum penalty applies for a return that is over 60 days late. The minimum penalty amount may be adjusted for inflation. See the

Instructions for Form 1120 (or the instructions for your applicable return) for the minimum penalty amount for the current tax year. The penalty will not be imposed if the corporation can show the failure to file on time was due to a reasonable cause.

Note. If the corporation is charged a penalty for late payment of tax (discussed next) for the same period of time, the penalty for late filing is reduced by the amount of the penalty for late payment.

Late payment of tax. A corporation that does not pay the tax when due may be penalized half of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the corporation can show that the failure to pay on time was due to a reasonable cause.

Trust fund recovery penalty. If federal income, social security, or Medicare taxes that a corporation must withhold from employee wages are not withheld or are not deposited or paid to the U.S. Treasury, the trust fund recovery penalty may apply. The penalty is the full amount of the unpaid trust fund tax. This penalty may apply to you if these unpaid taxes cannot be immediately collected from the business.

The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying these taxes, and who acted willfully in not doing so.

A responsible person can be an officer or employee of a corporation, an accountant, or a volunteer director/ trustee. A responsible person may also include one who signs checks for the corporation or otherwise has authority to cause the spending of business funds.

“Willfully” means voluntarily, consciously, and intentionally. A responsible person acts willfully if the person knows the required actions are not taking place or recklessly disregards obvious and known risks to the government’s right to receive trust fund taxes.

For more information on withholding and paying these taxes, see Pub. 15 (Circular E), Employer's Tax Guide.

Other penalties. Other penalties can be imposed for negligence, substantial understatement of tax, reportable transaction understatements, and fraud. See sections 6662, 6662A, and 6663 of the Internal Revenue Code.

Estimated Tax

Generally, a corporation must make installment payments if it expects its estimated tax for the year to be $500 or more. If the corporation does not pay the installments when they are due, it could be subject to an underpayment penalty. This section will explain how to avoid this penalty.

When to pay estimated tax. Installment payments are due by the 15th day of the 4th, 6th, 9th, and 12th months of the corporation's tax year.

Example 1. Your corporation's tax year ends December 31. Installment payments are due on April 15, June 15, September 15, and December 15.

Example 2. Your corporation's tax year ends June 30. Installment payments are due on October 15, December 15, March 15, and June 15.

If any due date falls on a Saturday, Sunday, or legal holiday, the installment is due on the next business day.

How to figure each required installment. The Estimated Tax Worksheet, later, can be used to figure each required installment. Form 1120-W, Estimated Tax for Corporations, is now historical. Prior versions are available on *IRS.gov*

You generally use one of the following two methods to figure each required installment. You should use the method that yields the smallest installment payments. In these discussions, “return” generally refers to the corporation's original return. However, an amended return is considered the original return if it is filed by the due date (including extensions) of the original return.

Method 1. Each required installment is 25% of the income tax the corporation will show on its return for the current year.

Method 2. Each required installment is 25% of the income tax shown on the corporation's return for the previous year.

To use Method 2:

1. The corporation must have filed a return for the previous year,
2. The return must have been for a full 12 months, and

3. The return must have shown a positive tax liability (not zero).

Also, if the corporation is a large corporation, it can use Method 2 to figure the first installment only.

Large corporations. A large corporation is a corporation that had, or whose predecessor had, taxable income of $1 million or more for any of the 3 tax years immediately preceding the current tax year, or if less, the number of years the corporation has been in existence. For this purpose, taxable income is modified to exclude net operating loss and capital loss carrybacks or carryovers.

Annualized income installment method and/or adjusted seasonal installment method. If the corporation's income is expected to vary during the year because, for example, it operates its business on a seasonal basis, it may be able to lower the amount of one or more required installments by using the annualized income installment method and/or the adjusted seasonal installment method. For example, a ski shop, which receives most of its income during the winter months, may be able to benefit from using one or both of these methods in figuring one or more of its required installments. See sections 6655(e)(2) and 6655(e)(3) of the Internal Revenue Code.

Refiguring required installments. If after the corporation figures and deposits its estimated tax it finds that its tax liability for the year will be more or less than originally estimated, it may have to refigure its required installments to see if an underpayment penalty may apply. An immediate catch-up payment should be made to reduce any penalty resulting from the underpayment of any earlier installments.

Underpayment penalty. If the corporation does not pay a required installment of estimated tax by its due date, it may be subject to a penalty. The penalty is figured separately for each installment due date. Therefore, the corporation may owe a penalty for an earlier due date, even if it paid enough tax later to make up the underpayment. This is true even if the corporation is due a refund when its return is filed.

Form 2220. Use Form 2220, Underpayment of Estimated Tax by Corporations, to determine if a corporation is subject to the penalty for underpayment of estimated tax and to figure the amount of the penalty.

If the corporation is charged a penalty, the amount of the penalty depends on the following three factors.

1. The amount of the underpayment.
2. The period during which the underpayment was due and unpaid.
3. The interest rate for underpayments published quarterly by the IRS in the Internal Revenue Bulletin.

A corporation generally does not have to file Form 2220 with its income tax return because the IRS will figure any penalty and bill the corporation. However, even if the corporation does not owe a penalty, complete and attach the form to the corporation's tax return if any of the following apply.

1. The annualized income installment method was used to figure any required installment.
2. The adjusted seasonal installment method was used to figure any required installment.
3. The corporation is a large corporation figuring its first required installment based on the prior year's tax.

How to pay estimated tax. A corporation is generally required to use EFTPS to pay its taxes. See *Electronic Federal Tax Payment System (EFTPS)*, earlier.

Quick refund of overpayments. A corporation that has overpaid its estimated tax for the tax year may be able to apply for a quick refund. Use Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax, to apply for a quick refund of an overpayment of estimated tax. A corporation can apply for a quick refund if the overpayment is:

- At least 10% of its expected tax liability, and
- At least $500.

Use Form 4466 to figure the corporation's expected tax liability and the overpayment of estimated tax.

File Form 4466 after the end of the corporation’s tax year, but before the corporation files its income tax return. Do not file Form 4466 before the end of the corporation's tax year. An extension of time to file the corporation's income tax return will not extend the time for filing Form 4466. The IRS will act on the form within 45 days from the date you file it.

U.S. Real Property Interest

If a domestic corporation acquires a U.S. real property interest from a foreign person or firm, the corporation may have to withhold tax on the amount it pays for the property. The amount paid includes cash, the fair market value of other property, and any assumed liability. If a domestic corporation distributes a U.S. real property interest to a foreign person or firm, it may have to withhold tax on the fair market value of the property. A corporation that fails to withhold may be liable for the tax and any penalties and interest that apply. For more information, see section 1445 of the Internal Revenue Code; Pub. 515, Withholding of Tax on Nonresident Aliens and Foreign Entities; Form 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real

Property Interests; and Form 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests.

Estimated Tax Worksheet

Keep for Your Records

Note. This worksheet may be used as a guide in figuring the required estimated tax installments.

1.	Enter the expected taxable income	1. ______
2.	Multiply line 1 by the maximum tax rate that is in effect for the applicable tax year. For example, in 2023 the maximum rate is 21%.	2. ______
3.	Tax credits. For information on tax credits the corporation can take, see the instructions for Form 1120, Schedule J, Part I, lines 5a through 5e, or the instructions for the applicable lines and schedule of the corporation's income tax return	3. ______
4.	Subtract line 3 from line 2	4. ______
5.	Other taxes. For information on other taxes the corporation may owe, see the instructions for Form 1120, Schedule J, or the instructions for the applicable lines and schedule of the corporation's income tax return	5. ______
6.	**Total tax.** Add lines 4 and 5	6. ______
7.	Enter any credit for federal tax paid on fuels and other refundable credits. For information on other refundable credits, see the instructions for Form 1120, Schedule J, or the instructions for the applicable line of the corporation's income tax return	7. ______
8.	Subtract line 7 from line 6. If the result is less than $500, the corporation is not required to make estimated tax payments	8. ______
9.	Enter the tax shown on the corporation's prior year's tax return. If the tax is zero or the tax year was for less than 12 months, skip this line and enter the amount from line 8 on line 10	9. ______
10.	Enter the **smaller** of line 8 or line 9. If the corporation is required to skip line 9, enter the amount from line 8	10. ______
11.	Required installments. Enter 25% of line 10. If the corporation uses the annualized income installment method, or adjusted seasonal installment method, or is a large corporation, an additional computation may be needed	11. ______

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Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. Taxable income should be determined using the method of accounting regularly used in keeping the corporation's books and records. In all cases, the method used must clearly show taxable income.

Generally, permissible methods include:

- Cash,
- Accrual, or
- Any other method authorized by the Internal Revenue Code.

Accrual method. Generally, a corporation, other than a qualified personal service corporation (as defined in section 448(d)(2) of the Internal Revenue Code), must use an accrual method of accounting if it is not a small business taxpayer (as defined in section

448(c) of the Internal Revenue Code). A corporation engaged in farming operations must also use an accrual method, unless it qualifies as a small business taxpayer.

Under an accrual method of accounting, you generally report income in the year it is earned and deduct or capitalize expenses in the year incurred. The purpose of an accrual method of accounting is to match income and expenses in the correct year.

See Pub. 538 for additional information and special rules.

Expenses. Generally, an accrual basis taxpayer can deduct accrued expenses in the tax year when:

1. All events that determine the liability have occurred,
2. The amount of the liability can be figured with reasonable accuracy, and

3. Economic performance takes place with respect to the expense.

There are exceptions to the economic performance rule for certain items, including recurring expenses. See section 461(h) of the Internal Revenue Code and the related regulations for the rules for determining when economic performance takes place.

Percentage of completion method. Long-term contracts (except for certain real property construction contracts) must generally be accounted for using the percentage of completion method described in section 460 of the Internal Revenue Code.

Mark-to-market accounting method. Generally, dealers in securities must use the mark-to-market accounting method described in section 475 of the Internal Revenue Code. Under this method, any security held by a dealer as inventory must be included in inventory at its fair market value. Any security not held as inventory at the close of the tax year is treated as sold at its fair market value on the last business day of the tax year. Any gain or loss must be taken into account in determining gross income. The gain or loss taken into account is treated as ordinary gain or loss.

Dealers in commodities and traders in securities and commodities can elect to use the mark-to-market accounting method.

Change in accounting method. A corporation can change its method of accounting used to report taxable income (for income as a whole or for the treatment of any material item). The corporation must file Form 3115, Application for Change in Accounting Method. See the Instructions for Form 3115 and Pub. 538 for more information and exceptions.

Section 481(a) adjustment. If the corporation's taxable income for the current tax year is figured under a method of accounting different from the method used in the preceding tax year, the corporation may have to make an adjustment under section 481(a) of the Internal Revenue Code to prevent amounts of income or expense from being duplicated or omitted. The section 481(a) adjustment period is generally 1 year for a net negative adjustment and 4 years for a net positive adjustment. However, exceptions to the general section 481(a) adjustment period may apply. Also, in some cases, a corporation can elect to modify the section 481(a) adjustment period. The corporation may have to complete the appropriate lines of Form 3115 to make an election. See the Instructions for Form 3115 for more information and exceptions.

Accounting Periods

A corporation must figure its taxable income on the basis of a tax year. A tax year is the annual accounting period a corporation uses to keep its records and report its income and expenses. Generally, a corporation can use either a calendar year or a fiscal year as its tax year. Unless special rules apply, a corporation generally adopts a tax year by filing its first federal income tax return using that tax year. For more information, see Pub. 538.

Personal service corporation. A personal service corporation must use a calendar year as its tax year unless:

- • It elects to use a 52-53-week tax year that ends with reference to the calendar year or tax year elected under section 444 of the Internal Revenue Code;

- It can establish a business purpose for a different tax year and obtains approval of the IRS (see the Instructions for Form 1128 and Pub. 538); or
- It elects under section 444 to have a tax year other than a calendar year. Use Form 8716, Election To Have a Tax Year Other Than a Required Tax Year, to make the election.

If a personal service corporation makes a section 444 election, its deduction for certain amounts paid to employee-owners may be limited. See Schedule H (Form 1120), Section 280H Limitations for a Personal Service Corporation (PSC), to figure the maximum deduction.

Change of tax year. Generally, a corporation must get the consent of the IRS before changing its tax year by filing Form 1128, Application To Adopt, Change, or Retain a Tax Year. However, under certain conditions, a corporation can change its tax year without getting the consent. For more information, see Form 1128 and Pub. 538.

Recordkeeping

A corporation should keep its records for as long as they may be needed for the administration of any provision of the Internal Revenue Code. Usually records that support items of income, deductions, or credits on the return must be kept for 3 years from the date the return is due or filed, whichever is later. Keep records that verify the corporation's basis in property for as long as they are needed to figure the basis of the original or replacement property.

The corporation should keep copies of all filed returns. They help in preparing future and amended returns and in the calculation of earnings and profits.

Income, Deductions, and Special Provisions

Rules on income and deductions that apply to individuals also apply, for the most part, to corporations. However, the following special provisions apply only to corporations.

Costs of Going Into Business

When you go into business, treat all eligible costs you incur to get your business started as capital expenses. However, a corporation can elect to deduct a limited amount of start-up or organizational costs. Any costs not deducted can be amortized.

Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Organizational costs are the direct costs of creating the corporation.

For more information on deducting or amortizing start-up and organizational costs, see the instructions for your income tax return.

Related Persons

A corporation that uses an accrual method of accounting cannot deduct business expenses and interest owed to a related person who uses the cash method of accounting until the corporation makes the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied, the rule will continue to apply even if the corporation's relationship with the person ends before the expense or interest is includible in the gross income of that person. These rules also deny the deduction of losses on the sale or exchange of property between related persons.

Related persons. For purposes of this rule, the following persons are related to a corporation.

1. Another corporation that is a member of the same controlled group (as defined in section 267(f) of the Internal Revenue Code).
2. An individual who owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.
3. A trust fiduciary, if the trust or the grantor of the trust owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.
4. An S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
5. A partnership, if the same persons own more than 50% in value of the

outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.

6. Any employee-owner, if the corporation is a personal service corporation (see *Personal service corporation*, earlier), regardless of the amount of stock owned by the employee-owner.

Ownership of stock. To determine whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following apply.

Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries.

An individual is treated as owning the stock owned, directly or indirectly, by or for the individual's family. Family includes only brothers and sisters (including half brothers and half sisters), a spouse, ancestors, and lineal descendants.

Any individual owning (other than by applying (2) above) stock in a corporation, is treated as also owning the stock owned directly or indirectly by that individual's partner.

To apply (1), (2), or (3) above, stock constructively owned by a person under (1) is treated as actually owned by that person. But stock constructively owned by an individual under (2) or (3) is not treated as actually owned by the individual for applying either (2) or (3) to make another person the constructive owner of that stock.

Reallocation of income and deductions. Where it is necessary to clearly show income or prevent tax evasion, the IRS can reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly, or indirectly, by the same interests.

Complete liquidations. The disallowance of losses from the sale or exchange of property between related persons does not apply to liquidating distributions.

More information. For more information about the related person rules, see Pub. 544.

Corporate Preference Items

A corporation must make special adjustments to certain items before it takes them into account in determining its taxable income. These items are known as “corporate preference items” and they include the following.

- • **Gain on the disposition of section 1250 property.** For more information, see Section 1250 Property under Depreciation Recapture in chapter 3 of Pub. 544.

- **Percentage depletion for iron ore and coal (including lignite).**
- **Amortization of pollution control facilities.** For more information, see section 291(a)(4) of the Internal Revenue Code.
- **Mineral exploration and development costs.**

For more information on corporate preference items, see section 291 of the Internal Revenue Code.

Dividends-Received Deduction

A corporation can deduct a percentage of certain dividends received during its tax year. This section discusses the general rules that apply. The deduction is figured on Form 1120, Schedule C, or the applicable schedule of your income tax return. For more information, see the Instructions for Form 1120, or the instructions for your applicable income tax return.

Dividends from foreign corporations. Generally, 100% of the foreign-source portion of dividends (and items treated as dividends) from 10%-owned foreign corporations may be deducted. The stock with respect to which such dividends are received must meet a special 365-day holding period and does not include certain “hybrid” dividend payments. See Form 1120, Schedule C (or the applicable schedule of your income tax return), for details regarding this deduction. Also see the Instructions for Form 1120 or the instructions for your applicable income tax return.

Note. This deduction is not subject to the limit on deduction for dividends related to dividends from domestic corporations, discussed below.

Dividends from domestic corporations. A corporation can deduct, within certain limits, 50% of the dividends received if the corporation receiving the dividend owns less than 20% of the corporation distributing the dividend. If the corporation owns 20% or more of the distributing corporation's stock, it can, subject to certain limits, deduct 65% of the dividends received.

Ownership. For these rules, ownership is based on the amount of voting power and value of the paying corporation's stock (other than certain preferred stock) that the receiving corporation owns.

Small business investment companies. Small business investment companies can deduct 100% of the dividends received from taxable domestic corporations.

Dividends from regulated investment companies. Regulated investment company dividends received are subject to certain limits. Capital gain dividends received from a regulated investment company do not qualify for the deduction. For more information, see section 854 of the Internal Revenue Code.

No deduction allowed for certain dividends. Corporations cannot take a deduction for dividends received from the following entities.

1. A real estate investment trust (REIT).
2. A corporation exempt from tax under section 501 or 521 of the Internal Revenue Code either for the tax year of the distribution or the preceding tax year.
3. A corporation whose stock was held less than 46 days during the 91-day period beginning 45 days before the stock became ex-dividend with respect to the dividend. “Ex-dividend” means the holder has no rights to the dividend.
4. A corporation whose dividends were received on any share of preferred stock that are attributable to periods totaling more than 366 days if such

stock was held for less than 91 days during the 181-day period that began 90 days before the ex-dividend date.

5. Any corporation, if your corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Dividends on deposits. Dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are interest, not dividends. They do not qualify for this deduction.

Limit on deduction for dividends. The total deduction for dividends received or accrued is generally limited (in the following order) to:

1. 65% of the difference between taxable income and the 100% deduction

allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from 20%-owned corporations; then

2. 50% of the difference between taxable income (reduced by total dividends received from 20%-owned corporations) and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from less-than-20%-owned corporations (reducing taxable income by the total dividends received from 20%-owned corporations).

Figuring the limit. In figuring the limit, determine taxable income without the following items.

1. The net operating loss deduction.

2. The deduction under section 199A for income attributable to domestic production activities of specified agricultural or horticultural cooperatives.
3. The deduction allowed by sections 243(a)(1) and 245(a) of the Internal Revenue Code.
4. The deduction allowed by section 250 of the Internal Revenue Code.
5. Any adjustment due to the nontaxable part of an extraordinary dividend (see <u>*Extraordinary Dividends*</u>, later).
6. Any capital loss carryback to the tax year.

Effect of net operating loss. If a corporation has a net operating loss (NOL) for a tax year, the limit of 65% (or 50%) of taxable income does not apply. To determine whether a corporation has an NOL, figure the dividends-received deduction without the 65% (or 50%) of taxable income limit.

Example 1. A corporation loses $75,000 from operations. It receives $100,000 in dividends from a 20%-owned corporation. Its taxable income is $25,000 ($100,000 – $75,000) before the deduction for dividends received. If it claims the full dividends-received deduction of $65,000 ($100,000 × 65%) and combines it with an operations loss of $75,000, it will have an NOL of ($40,000). Therefore, the 65% of taxable income limit does not apply. The corporation can deduct the full $65,000.

Example 2. Assume the same facts as in *Example 1*, except that the corporation only loses $30,000 from operations. Its taxable income is $70,000 before the deduction for dividends received. After claiming the dividends-received deduction of $65,000 ($100,000 × 65%), its taxable income is $5,000. Because the corporation will not have an NOL after applying a full dividends-received deduction, its allowable dividends-received deduction is limited to 65% of its taxable income, or $45,500 ($70,000 × 65%).

Extraordinary Dividends

If a corporation receives an extraordinary dividend on stock held 2 years or less before the dividend announcement date, it must generally reduce its basis in the stock by the nontaxed part of the dividend. The nontaxed part is any dividends-received deduction allowable for the dividends.

Extraordinary dividend. An extraordinary dividend is any dividend on stock that equals or exceeds a certain percentage of the corporation's adjusted basis in the stock. The percentages are:

1. 5% for stock preferred as to dividends, or

2. 10% for other stock.

Treat all dividends received that have ex-dividend dates within an 85-consecutive-day period as one dividend. Treat all dividends received that have ex-dividend dates within a 365-consecutive-day period as extraordinary dividends if the total of the dividends exceeds 20% of the corporation's adjusted basis in the stock.

Disqualified preferred stock. Any dividend on disqualified preferred stock is treated as an extraordinary dividend regardless of the period of time the corporation held the stock.

Disqualified preferred stock is any stock preferred as to dividends if any of the following apply.

1. The stock when issued has a dividend rate that declines (or can reasonably be expected to decline) in the future.

2. The issue price of the stock exceeds its liquidation rights or stated redemption price.
3. The stock is otherwise structured to avoid the rules for extraordinary dividends and to enable corporate shareholders to reduce tax through a combination of dividends-received deductions and loss on the disposition of the stock.

More information. For more information on extraordinary dividends, see section 1059 of the Internal Revenue Code.

Below-Market Loans

If a corporation receives a below-market loan and uses the proceeds for its trade or business, it may be able to deduct the forgone interest as well as any interest the corporation actually paid or accrued.

A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan is generally treated as an arm's-length transaction in which the borrower is considered as having received both the following.

- A loan in exchange for a note that requires payment of interest at the applicable federal rate.
- An additional payment in an amount equal to the forgone interest.

The borrower treats the additional payment as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction.

Foregone interest. For any period, forgone interest is equal to:

1. The interest that would be payable for that period if interest accrued on the

loan at the applicable federal rate and was payable annually on December 31, minus

2. Any interest actually payable on the loan for the period.

More information. For more information on below-market loans, including information on demand loans, gift loans, and term loans, see section 7872 of the Internal Revenue Code, the related regulations, and chapter 1 of Pub. 550, Investment Income and Expenses.

Charitable Contributions

A corporation can claim a limited deduction for charitable contributions made in cash or other property. The contribution is deductible if made to, or for the use of, a qualified organization. For more information on qualified organizations, see Pub. 526, Charitable Contributions. Also, see Tax-Exempt Organization Search at *IRS.gov/Charities,* the online search tool for finding information on organizations eligible to receive tax-deductible contributions.

Note. You cannot take a deduction if any of the net earnings of an organization receiving contributions benefit any private shareholder or individual.

Cash method corporation. A corporation using the cash method of accounting deducts contributions in the tax year paid.

Accrual method corporation. A corporation using an accrual method of accounting can choose to deduct unpaid contributions for the tax year the board of directors authorizes them if it pays them by the due date for filing the corporation’s tax return (not including extensions). Make the choice by reporting the contribution on the corporation's return for the tax year. Attach a declaration stating that the board of directors adopted the resolution during the tax year. The declaration must include the date the resolution was adopted.

Limitations on deduction. A corporation cannot deduct charitable contributions that exceed 10% of its taxable income for the tax year. Figure taxable income for this purpose without the following.

1. The deduction for charitable contributions.
2. The dividends-received deduction.
3. The deduction allowed under section 249 of the Internal Revenue Code for bond premium.
4. Any deduction for income attributable to domestic production activities of specified agricultural or horticultural cooperatives.
5. Any net operating loss carryback to the tax year.
6. Any capital loss carryback to the tax year.