Understanding the Formation of a C-Corporation and the Preparation of IRS Form 1120

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Formation of a Corporation

• A corporation is created as a result of State law
• Subjected to formal requirements of each State
• Ownership is witnessed through the issuance of stock certificates to shareholders
• Shareholders have legal rights to the distribution of corporate profits
• Shareholders do not own the assets of the entity
• Observation of the formalities ensures that the entity is treated separately from the owners
§351 Formation of a Corporation

• §351 provides a general rule that the act of incorporating is not a taxable event to the entity or the shareholders, if 3 specific conditions are met:

  1. Shareholders transfer *property* to the corporation
  2. The transfer is *solely* in exchange for *stock of the corporation, and*
  3. *Immediately after* the transfer, the transferors are in *control* of corporation
§351 Formation Issues

• In order to have control, the transferors must own:
  • 80% of total combined voting power of all classes of stock entitled to vote, plus
  • 80% of total number of shares of all other classes of stock
§351 Corporate Formation Transaction

Shareholders

Cash or Other Property

Corporate Stock

Corporate charter

Corporation

Control required: shareholders must own 80% after the transfer
Required Attachments to Returns

- Both the corporation and each shareholder involved in a §351 transaction must attach to their tax returns, a complete statement of all the facts pertinent to the exchange including:
  - Property given up and received
  - Type of stock transferred and received
  - Number of shares involved
  - Voting vs. non-voting stock
  - Common vs. preferred stock
  - Par Values, etc.
§351 Formation Example

Taxpayer decided to incorporate a business:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Tax Basis</th>
<th>Fair Mkt.</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Furniture &amp; Fixtures</td>
<td>20,000</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Other Assets</td>
<td>40,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$70,000</strong></td>
<td><strong>$170,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

• **Without §351**: gain of $100,000.
• **With §351**: no gain or loss. Economic status has not changed.
Exceptions to Non-recognition

• There are 3 exceptions to the no gain or loss rule:
  1) Boot received exception
  2) Services exchanged exception
  3) Debt greater than basis exception

• **Boot Exception:** If *property other than stock* is received by the shareholder then gain is recognized by the shareholder in an amount up to the *lesser of*:
  • Boot received or
  • Realized gain
  • A loss is never recognized
Exceptions to Non-recognition

• **Services Exception:** if a shareholder receives *stock* in exchange *for services* provided to the corporation then *gain* is recognized by the shareholder because “*services*” is not “*property*”

• If the *other* shareholders do not own 80% of the remaining stock then they will also have a recognition transaction, and *gain or loss* will be recognized by all parties involved in the exchange.
Exceptions to Non-recognition

• Debt Greater Than Basis Exception: If a shareholder transfers *property* to the corporation *in exchange for stock* and there is *debt* attached to the property which is *greater than* the *adjusted basis* of the property given up then that individual shareholder will have *gain* recognition

• Debt > Basis = Gain
§351 Formation Issues

• Transfers for property and services:
  • May result in the service provider being treated as a member of the 80% control group, but will be taxed on value of stock issued for services
  • Not taxed on value of stock received for property contributed
  • Service provider should transfer property having more than “a relatively small value”
Shareholder Stock Basis After §351 Exchange

- Shareholder’s *basis of stock received* in exchange for *property given up*:

  Adjusted basis of *assets transferred* to corporation
  + Gain recognized on exchange by shareholder (if any)
  - Boot received
  - Liabilities transferred to corporation

  = Basis of Stock Received by Shareholder
Corporation’s Basis in Assets Received From Shareholder After §351 Exchange

• **Corporation’s basis** in assets received from the shareholder under §362:

  Adjusted basis of transferred assets by shareholder
  + Gain recognized by shareholder (if any)
  = §362 Basis of Assets to the Corporation
C Corporation Filing Requirements

• IRS Form 1120 “U.S. Corporation Income Tax Return”

• Must file Form 1120 if in existence on any day during the tax year even if corporation had no activity

• Due date: 15th day of 4th month after the close of the tax year
  • Exception for C Corporations with a June 30 year end: 15th day of 3rd month until years ending after June 30, 2025

• Automatic 5 month extension: file IRS Form 7004
C Corporation Filing Requirements

• Penalty for *late filing* of tax return: 5%* per month, maximum 5 month period = 25%

• *Note: Reduced by ½ of 1% for any month when there is also a “failure to pay” penalty imposed, therefore nets to 4.5% for that month

• Penalty for *late payment* of tax: ½ of 1% per month for a maximum period of 50 months = 25%

• Minimum penalty imposed for a return over 60 days late: *smaller of* the tax due or $205**
  • ** indexed to inflation
§6655 Estimated Tax Payments

• Estimated payments required if corporate tax is $500 or more

• If not paid then subjected to underpayment penalty for failure to pay estimated taxes

• §6655(c) installment payments due by the 15th day of the 4th, 6th, 9th and 12th months of the tax year

• Next business day if Saturday, Sunday or legal holiday

• Calculate estimated payments on IRS Form 1120-W
§6655 Estimated Tax Payments

• Corporation must use Electronic Federal Payments System (EFTPS) to make installment payments

• Deposit on time: submit by 8:00 PM Eastern Time the day before the date the deposit is due

• Same-Day Wire Option: If corporation fails to submit via EFTPS then the Federal Tax Collection Service (FTCS) is available

• These are third party financial institutions that have different cut off times and charge a fee (www.irs.gov/payments) click on “Same-day-wire”
§6655(d) Required Installments

• Quarterly 25% deposits of the “required annual payment”

• “Required annual payment” means the lesser of:
  • 100% of the tax reported on the current year return, or
  • 100% of the tax reported on the prior year’s return*

*The prior year test will not apply if the prior taxable year was less than 12 months or no return was filed in the prior year
§11(b)(1) Graduated Corporate Tax Rates

• 15% on first $50,000 of taxable income
• 25% on next $25,000 of taxable income
• 34% on next $25,000 of taxable income
• 39% on any amount in excess of $100,000 up to $335,000*

* Phases out the benefit of the 15% and 25% rates on the first $100,000
Flat Rate on Personal Service Corporations (PSC)

• §11(b)(2) provides an exception to graduated rates
• Certain PSC subjected to a flat 35% rate on each dollar of taxable income if the trade or business is in the fields of:
  • Health
  • Law
  • Engineering
  • Architecture
  • Accounting
  • Performing arts
  • Actuarial Sciences
  • Consulting
Corporate Tax Issues

Corporate Transactions

• Corporate Revenue
• (Minus deductions)
• = Net Profit
• (Minus Corp. Tax)
• = Profits to Shareholders*

  • *Dividend Distributions

Shareholder Transactions

• Dividend from Corporation included in gross income on Form 1040
• Taxed as ordinary income
• Taxed at long-term capital gain rates if qualified dividends
Distributions to Shareholders

• **Dividends** *to the extent of* Earnings and Profits (E&P) of the C-Corporation
  • Taxed at ordinary income rates *unless* qualified dividends, then taxed at long-term capital gain rates

• **Return of Invested Capital**
  • Any part of a corporate distribution **not** from E&P
  • *Reduces* the adjusted basis of the shareholder’s stock and **not** includible in the shareholder’s gross income

• **Capital Gain**
  • *Distributions* **not** from E&P and **more than** the adjusted basis of the shareholder’s stock
Distributions to Shareholders

• **Cash Dividends:** declared by the Board of Directors to shareholders of record on a specified date

• **Property Dividends:** Distributions of corporate assets resulting in a “deemed sale” at the corporate level resulting in *income to the corporation* and a *dividend* to the shareholder

• **Constructive Dividends:** (disguised dividends) *favorable treatment* to shareholders made in a form *other than, declared* dividends and *property* dividends
Cash Dividend

• Corporation pays dividends in the form of money

• Dividends are **not** deductible expenses on the Form 1120
Property Distribution

- FMV of corporate asset on the date of distribution
- (Less: Adjusted basis of the corporate asset)
- Equals: Gain at the Corporate Level*  

*Dividend to shareholder
Constructive Dividends

• Below-market Loans:
  • Corporation gives *shareholder loans* at rates *less than* the “Applicable Federal Rate” (AFR) or at no rate at all

• Cancelled Debts:
  • Corporation *cancels shareholder debts* for money borrowed from the corporation

• Transfer of property at less than FMV:
  • *sale of assets* by corporation to shareholders at a price *below* the market price
Constructive Dividends

• **Unreasonable Rents:**
  • Corporation pays an amount for rent *unreasonably greater than* the going rate

• **Unreasonable Salaries:**
  • Corporation *compensates* a shareholder-employee for *services* provided at an unreasonably *excessive* amount *to avoid the corporate level income tax*

• **Above-market Loans:**
  • Shareholders paid interest on *loans to corporation* at an *unreasonably high* rate
Special Issues Pertaining to Form 1120

• **Net Operating Losses:**
  • Locked in the entity level: automatic *carryback* of 2 years with an *election* to forego; *carryforward* 20 years

• **Capital Losses:**
  • Locked in the entity level: automatic *carryback* of 3 years and *carryforward* 5 years

• **Charitable Contribution Deductions:** Limited to 10% of the taxable income *before* the charitable contribution
  • No *carryback* period allowed
  • Limited 5 year *carryforward only*
Special Issues Pertaining to Form 1120

• **Schedule L**: Balance Sheet: Assets & Liabilities

• **Schedule M-1**: Reconciliation of Income per Books with Income per Return:
  - Items that have different treatment for book vs. tax

• **Schedule M-2**: Analysis of Unappropriated Retained Earnings per books:
  - Amount *available for distribution to shareholders* per books:
    Not designated for special appropriations determined by Board of Directors

• *Page 4 Schedule K Question 13 Total Receipts & Total Assets < $250,000*
National Society of Tax Professionals

• Come to the booth for the handout on this presentation and on NSTP’s other 2 presentations which are:

• “Tax Professional’s Guide to Understanding the Importance of the Substantiation of Business Expense Deductions”

• “Schedule C Issues Facing the Tax Professional”