

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



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:

	<u>Asset Tax Basis</u>	<u>Fair Mkt. Value</u>
Cash	\$10,000	\$10,000
Furniture & Fixtures	20,000	60,000
Other Assets	<u>40,000</u>	<u>100,000</u>
Total	<u>\$70,000</u>	<u>\$170,000</u>

- *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

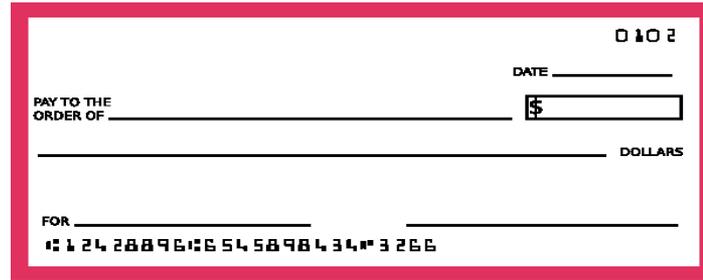
- **Dividends** *to the extent* of Earnings and Profits (E&P) of the C-Corporation
 - Taxed at ordinary income rates *unless* qualified dividends, then taxed at long-term capital gain rates
- **Return of Invested Capital**
 - Any part of a corporate distribution not from E&P
 - *Reduces* the adjusted 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



A blank check form with the following fields and text:

- Top right: 0 1 0 2
- DATE _____
- PAY TO THE ORDER OF _____ \$ _____
- _____ DOLLARS
- FOR _____
- Bottom left: 1 2 4 2 8 8 9 6 1 2 6 5 4 5 8 9 8 4 3 4 * 3 2 6 6

- 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”**