Corporations

Tab C Topics

Basics of Corporations

Form 1120; see also IRS Pub. 542

Filing Requirements

Every corporation (except exempt—although exempt organizations that are corporations could be required to file other forms such as 990 and 990-T) must file regardless of the amount of income or loss. A corporation must continue to file until it is dissolved.

Filing deadline. For most C corporations, by the 15th day of the fourth month following the close of the tax year.

Note: For tax years beginning in 2016 or later, C corporation returns are due April 15 (or the 15th day of the fourth month following the close of a fiscal year). For tax years beginning before 2016, the deadline was the 15th day of the third month following the close of the tax year. For corporations with a June 30 year end, the due date change will be effective for tax years beginning after 2025.

Electronic filing of Form 1120 is required for C corporations that have $10 million or more in assets and annually file 250 or more returns of any type (including information returns such as Forms W-2 and 1099). However, these corporations can request a waiver of the electronic filing requirements (Notice 2010-13).

Extension deadline and form number. Form 7004 extends the deadline (1) six months for calendar year C corporations, (2) seven months for June 30 year end C corporations or (3) six months for other fiscal year C corporations (Reg. 1.6081-3). An extension to file does not extend the time for paying tax.

Penalties:

- Estimated tax underpayment: see *Estimated Tax* on Page C-2.
- Failure to make tax payments utilizing authorized methods: see *Tax Payments* on Page C-2.
- Late filing penalty: 5% of the unpaid balance per month or part of a month, up to a maximum of 25% (plus any underpayment and/or late payment penalties and interest) [IRC Sec. 6651(a)(1)].
- Minimum penalty for late filing in 2022 (including 2021 tax year returns due in 2022): if a return is more than 60 days late (including extensions), lesser of $435 or 100% of the amount of tax required to be shown on the return [IRC Sec. 6651(a)].

  Note: The statutory penalty amount is indexed by a cost-of-living adjustment (COLA).
- Late payment penalty: tax not paid by due date of a return is subject to a penalty of one half of one percent per month or part of a month, up to a maximum of 25% [IRC Sec. 6651(a)(2)].

If the corporation is assessed a penalty for late payment of tax for the same period in which a late filing penalty applies, the penalty for late filing is reduced by the amount of penalty for late payment, but not below the amount of the minimum penalty for late filing discussed earlier. Penalties for late filing and late payment will not be imposed if the corporation can show the failure was due to reasonable cause. A statement explaining the reasonable cause should be attached to the tax return. For reasonable cause exceptions, see Section 20.1.1.3—Criteria for Relief From Penalties, of the Internal Revenue Manual (available at **www.irs.gov/irm**).

Tax Rates on Taxable Income

The Tax Cuts and Jobs Act of 2017 (TCJA) changed the corporate tax rate to a flat 21%. This rate also applies to personal service corporations (PSCs) [see *Personal Service Corporation (PSC)* on Page F-12]. For tax years beginning prior to January 1, 2018, graduated tax rates applied, with a top rate of 35% if taxable income exceeded $10 million. PSCs were taxed at a flat rate of 35%.

Tax rate exceptions. Personal holding companies (PHCs) are subject to a 20% tax on undistributed PHC income [see *Personal Holding Company (PHC)* on Page F-15]. C corporations may also be subject to a 20% accumulated earnings tax on accumulated taxable income (see *Accumulated Earnings Tax* on Page C-12).

Corporation Defined

For federal tax purposes, corporations include the following:

1) Businesses organized under a federal or state law that identifies the entity as a corporation.
2) Joint stock companies.
3) Insurance companies.
4) Certain banks.
5) Business entities wholly owned by a state or any political subdivision thereof.
6) Certain foreign business entities.

Other entities, such as publicly traded partnerships, may be treated as corporations by other Code sections.

***Check-the-box* rules.** Noncorporate entities, such as sole proprietorships and partnerships, may elect to be taxed as corporations by filing Form 8832 (Entity Classification Election).

Note: Corporations cannot elect out of corporate tax treatment. If an entity is classified as a corporation under IRS regulations, the entity must file as a corporation.

Caution: Some states have rules that classify entities for tax purposes. Not all states recognize reclassification of an entity under the check-the-box rules.

See *Check-the-Box Rules—Entity Classification Election (Form 8832)* on Page F-2 for more information.

Limited Liability

A corporation formed under state law shields owners from liability for the corporation's actions. A shareholder's risk of loss is limited to the amount invested in stock. This is in contrast to sole proprietors or general partners in partnerships, who are personally liable for debts of the business.

State laws determine an entity's liability status. A proprietor or partnership cannot receive limited liability status simply by electing to be taxed as a corporation under the check-the-box rules.

Courts have disregarded the limited liability status of corporate shareholders in the following circumstances:

- Fraud.
- Bad faith.
- Failure to observe corporate formalities.
- Need to accomplish substantial justice.

A shareholder owning 100% of the stock of a corporation is particularly susceptible to having the corporate veil pierced. Incorporating a business is not a substitute for liability insurance.

Other shareholder liability. A corporation will not protect a shareholder from liability directly linked to the individual. For example, a shareholder who personally guarantees a corporate loan is liable for repayment. Similarly, if a shareholder performs services using his own vehicle and is involved in an accident, he may be liable for damages because he owns the vehicle.

Tax Treatment of C Corporations

For federal income tax purposes, a C corporation is a separate taxpaying entity. A corporation conducts business, realizes net income or loss, pays taxes, and distributes profits to shareholders. Income is taxed to the corporation when earned, and taxed again when distributed to the shareholders as dividends. The corporation does not receive a tax deduction for the dividends paid.

Example: Lookback Corporation is taxed at a flat 21% and its sole shareholder is in the highest individual bracket. The corporate tax on $1,000 of profits equals $210. The remaining $790 dividend will incur tax of $188 to the shareholder since he is in the highest bracket (20% individual tax rate on dividends plus 3.8% net investment income tax). This leaves $602 in after-tax profits for the shareholder and results in an effective combined tax rate of 39.8%.

Unlike S corporations and partnerships, various types of income do not retain their character as they pass from a C corporation by dividends to shareholders.

Example: The BCA Corporation received tax-exempt interest and distributed it to shareholders as taxable dividends. The fact that the money was originally tax-exempt interest is of no consequence to a shareholder. However, if the company was an S corporation or a partnership, the tax-exempt interest would retain its character as it passed through to shareholders or partners.

Schedule M-3 (Form 1120)—Reconciliation of Books With Tax Return

Domestic corporations with total assets of $10 million or more on the last day of the tax year must complete Schedule M-3 [Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More]. The schedule requires detailed explanations of the transactions that create book-tax differences, and is filed in place of Schedule M-1. Schedule M-3 is filed as an attachment to Form 1120. In addition, Form 8916-A (Supplemental Attachment to Schedule M-3) is filed to reconcile cost of goods sold and interest income and expense reported on Schedule M-3. Mixed consolidated return groups (those including certain insurance companies) must also file Form 8916 (Reconciliation of Schedule M-3 Taxable Income with Tax Return Taxable Income for Mixed Groups) to reconcile Schedule M-3 with their returns (Forms 1120, 1120-L, and 1120-PC).

A corporation filing Form 1120 that is not required to file Schedule M-3 may voluntarily file Schedule M-3 in place of Schedule M-1. For these corporations, and for those that are required to file Schedule M-3 but have less than $50 million in total assets at the end of the tax year, there is an option concerning how Schedule M-3 is completed. In lieu of completing all parts of Schedule M-3, these corporations may complete the schedule only through Part I, and then complete Schedule M-1 of Form 1120 (or Form 1120-C, if applicable) instead of completing Parts II and III of Schedule M-3. In addition, these filers are not required to file Schedule B (Form 1120) or Form 8916-A. If this option is selected, make sure line 1 of Schedule M-1 equals line 11 of Part I of Schedule M-3.

A corporation filing Schedule M-3 must check the box on Form 1120, page 1, item A(4), indicating that Schedule M-3 is attached (whether required or voluntary). For IRS website information on Schedule M-3, search for "Schedule M-3*"* at **www.irs.gov**.

Schedule UTP—Uncertain Tax Position Statement

A corporation must file Schedule UTP with Form 1120 if it (1) has assets equal to or exceeding $10 million, (2) issued or is included in audited financial statements for all or part of the tax year, and (3) has one or more tax positions that must be reported on Schedule UTP. A tax position must be reported if (1) the corporation has taken a tax position on its return for the current or a prior tax year and (2) either the corporation or a related party has recorded a reserve in an audited financial statement for that position or expects to litigate the position. A corporation required to file Schedule UTP also must check "Yes" to Form 1120, Schedule K, Question 14.

Tax Payments

Estimated tax payments and any tax due on Form 1120 are required to be deposited electronically using EFTPS. See *Electronic Federal Tax Payment System* on Page I-9 for EFTPS rules.

The corporation is subject to a failure to deposit penalty if required procedures are not followed, unless the failure was due to reasonable cause and not willful neglect (IRC Sec. 6656).

Estimated Tax

- No penalty for underpaying estimates if tax is less than $500 [IRC Sec. 6655(f)].
- No penalty will be assessed if each quarterly installment is at least 25% of the corporation's current-year income tax.
- No underpayment penalty will be assessed if each installment is at least 25% of the income tax on the prior-year return. This provision does not apply if:
  1) The prior tax year was less than 12 months,
  2) The corporation did not file a return for the prior year,
  3) The prior-year return did not show a liability for tax, or
  4) The corporation had at least $1 million of modified taxable income (disregarding NOL and capital loss carrybacks and carryovers) in any of the last three tax years.

  A corporation that had at least $1 million of taxable income in any of the last three years can use prior-year tax liability for the first installment and current-year tax liability for installments two, three, and four.
- Instead of four equal installment payments, estimates can be based on an annualized income method or the adjusted seasonal installment method. See *Annualized Income Methods* on Page C-2. For more on the adjusted seasonal installment method, see the instructions to Form 2220 and IRS Pub. 542.
- Estimated payments must be made by the following dates:

  First payment.................. 15th day of the fourth month
  Second payment............. 15th day of the sixth month
  Third payment................. 15th day of the ninth month
  Fourth payment .... 15th day of the 12th month

- For calendar-year corporations, those dates are April 15, June 15, September 15, and December 15.
- If the 15th of the month due date falls on a Saturday, Sunday or legal holiday, the installment is due on the next business day.

Annualized Income Methods

Corporations can compute current-year tax for each estimated tax installment under one of three annualized income methods: (1) Standard, (2) Option 1, and (3) Option 2 [IRC Sec. 6655(e)].

An election to use either of the optional periods is effective only for the tax year for which it is made. The election must be made on or before the date required for paying the first installment for the tax year.

Corporate Annualization Methods and Periods						
Methods		Form 8842 Required	Installment Periods			
Number	Name		First	Second	Third	Fourth
1	Standard	No	3	3	6	9
2	Option 1	Yes	2	4	7	10
3	Option 2	Yes	3	5	8	11

Note: Each installment is based on annualized income for the number of months given the method. For example, if using the Standard method the third installment is based on annualized income from the first six months.

Related forms:

- *Form 8842* (Election To Use Different Annualization Periods for Corporate Estimated Tax) is filed to make the election to use optional methods 1 or 2.
- *Form 1120-W*. Used by corporations to estimate amount of required payments. This form is retained in the corporation's records and not filed with the IRS.
- *Form 2220*. Used to figure underpayment penalty or to show exception to penalty under the annualized income method.

Quick Refund of Estimated Tax

A corporation that has overpaid its estimated tax may apply for a quick refund if the overpayment is:

1) At least 10% of its expected income tax liability and
2) At least $500.

To apply for a quick refund, complete Form 4466 (Corporation Application for Quick Refund of Overpayment of Estimated Tax). Mail Form 4466 to the IRS service center specified in the instructions of Form 4466 before the 16th day of the fourth month after the end of the tax year, and before the tax return is filed. Attach a second copy to the corporation's tax return. An extension of time to file the tax return will not extend the time to file Form 4466.

Capital Contributions

Contributions to capital of a corporation are called paid-in capital.

- A corporation does not recognize gain or loss when it issues stock in exchange for cash or property (IRC Sec. 1032).
- Shareholders do not recognize gain or loss upon contribution of cash in exchange for stock. Shareholders may recognize gain or loss upon exchange of property for stock.
- When services are performed in exchange for stock, the fair market value (FMV) of the service is taxable compensation. The amount included in income becomes the shareholder's stock basis.

Contributions to capital by nonshareholders. The basis of property contributed to a corporation by a nonshareholder is zero. For example, if a municipality gives land to a corporation as inducement to locate there, the corporation accounts for the property as a contribution to capital with zero basis. If cash is contributed by a nonshareholder, basis in the corporation's assets is reduced by the amount of the contribution.

Note: Contributions made by a customer or potential customer are taxable income to the corporation, not capital contributions. After December 22, 2017, any contribution made by a governmental entity or civic group also is taxable to the corporation.

See IRS Pub. 542 for more information about contributions from nonshareholders.

Transfers of Property

Generally, when property is transferred to a corporation in exchange for stock, the transaction is treated as if the property were sold to the corporation at FMV.

Example: Ed exchanges property with FMV of $10,000 and adjusted basis of $4,000 for 70% of PIE Corporation's stock. Ed recognizes $6,000 gain on the transaction. His basis in stock received is $10,000.

Nontaxable Exchange of Property for Stock—Section 351 Transfers

In a nontaxable Section 351 exchange, the corporation takes the transferor's basis in the transferred property. No gain or loss is recognized if one or more persons transfer cash or property to a corporation solely in exchange for stock if the person or persons control the corporation immediately after the exchange. Control is defined as owning at least 80% of the voting stock and 80% of all other classes of stock.

Example: Mr. Bean owns a sole proprietorship, which contains assets with FMV of $10,000 and basis of $2,000. He changes the business entity to a corporation, and transfers the assets from the sole proprietorship to the corporation in exchange for 100% of the corporation's stock. The exchange qualifies under IRC Sec. 351, and no gain is recognized on the transaction.

Note: Nonrecognition treatment under IRC Sec. 351 does not apply to: (1) transfer of property to an investment company, (2) transfer of property in a bankruptcy in exchange for stock used to pay creditors, or (3) stock received in exchange for the corporation's debt or for interest on the corporation's debt that accrued while the transferor held the debt.

Basis. See *Basis of Property Exchanged for Corporate Stock* on Page C-4. Generally, a corporation's basis in property received under IRC Sec. 351 is equal to the transferor's basis. However, IRC Sec. 362(e) includes a carryover basis limitation to prevent (1) the importation of built-in losses into the U.S. by transferors who are not subject to U.S. tax, and (2) the double deduction of a single economic loss by transferring built-in loss property to a corporation in a carryover basis transaction with the transferee deducting a loss on the sale of the property and the transferor deducting a loss on the sale of stock.

Group transfers. The 80% control test may be met by a group of investors, and the group can include current shareholders. However, a transfer from a current shareholder is not recognized for purposes of the 80% rule if (1) a small amount is transferred, and (2) the purpose is to qualify the other transferors for nonrecognition treatment [Reg. 1.351-1(a)(1)(ii)]. The amount transferred will not be considered a small amount if the amount transferred equals or exceeds 10% of the FMV of stock already owned or to be received for services by the transferor (Rev. Proc. 77-37, Sec. 3.07).

Example: Al owns 100% of Offline, Inc., which has stock valued at $25,000. Bob wants to purchase a 50% ownership interest in the corporation by means of contributing equipment with a FMV of $25,000 in exchange for stock. Bob's basis in the equipment is $5,000.

Al and Bob want the transaction to qualify for nonrecognition treatment under IRC Sec. 351 so that Bob will not have a taxable gain. Al contributes $2,500 in cash for additional stock. It is necessary for Al (the existing shareholder) to transfer an asset with a FMV of at least 10% of the FMV of the corporation in order to include his stock in the 80% control test and have the transaction be recognized under IRC Sec. 351. As a group, Al and Bob meet the 80% ownership rule, and the transaction qualifies for nonrecognition treatment.

If Al does not make a capital contribution in exchange for stock, or if he purchases only a small amount, the 80% control test will not be met and Bob will recognize a $20,000 gain on the transaction.

Solely in exchange for stock. Nonrecognition of gain applies only to amounts transferred solely in exchange for stock. If the shareholder receives cash or other property, gain is recognized up to the amount of cash or FMV of other property received. Securities are considered property for purposes of IRC Sec. 351.

Example: Shelly transfers property with FMV of $20,000 and adjusted basis of $12,000 to Magnolia Corporation in exchange for 80% of its stock. In addition to stock, she receives $3,000 in cash. Although the transfer qualifies under IRC Sec. 351, Shelly recognizes gain of $3,000. Her basis in the stock is $12,000 (adjusted basis of property transferred, plus gain, less cash received). The corporation's basis in the property is $15,000 (transferor's basis plus gain recognized by transferor).

Immediately after the exchange. The phrase *immediately after the exchange* does not necessarily require simultaneous exchanges as long as the transfers are made pursuant to a predetermined agreement [Reg. 1.351-1(a)(1)].

> **Example:** Wilbur and Orville enter into an agreement to purchase 100% of the stock of Wright Corporation. Wilbur agrees to contribute $6,000 cash on July 31 in exchange for 50 shares of stock. Orville agrees to contribute property with a FMV of $6,000 and an adjusted basis of $2,000 on October 31 in exchange for 50 shares of stock. Since Wilbur and Orville control Wright Corporation immediately after the transfer and since the exchanges were made in accordance with a predetermined agreement, Section 351 treatment applies. Neither shareholder recognizes gain on the exchange. Wilbur's basis in stock is $6,000. Orville's basis in stock is $2,000.

Holding period. A corporation's holding period for an asset received in a Section 351 transfer includes the time the asset was held by the transferor. Likewise, a shareholder's holding period for stock acquired in a 351 transfer includes the period the shareholder held the property before the exchange (IRC Sec. 1223).

Property Subject to Liabilities

In a Section 351 exchange, if a shareholder contributes property subject to liabilities, the shareholder's basis in the stock received is reduced by the amount of liability relief (IRC Sec. 358). If liabilities exceed the shareholder's adjusted basis in the property, gain is recognized on the excess, and the shareholder's basis in the stock is zero. *Exception:* Under IRC Sec. 357(c)(3), liability relief is not included in the computation if the payment of the liability "would give rise to a deduction."

> **Court Cases:** Although the Code does not specifically address whether liability payment deductibility must apply to the transferor or the transferee, court cases have affirmed that deductibility by either the transferor or transferee is sufficient to remove the liabilities from the basis computation. In *Black & Decker* [97 AFTR 2d 2006-841 (4th Cir. 2006)], the 4th Circuit upheld the District Court's finding on this specific issue. See *Coltec Industries Inc.* [98 AFTR 2d 2006-5249 (Fed. Cir. 2006)] for a similar decision.

> **Example:** Scott and Mikaela contribute the following property to Swing Corporation in exchange for 100% of the stock:

Scott's Property			*Mikaela's Property*		
FMV	Basis	Liability	FMV	Basis	Liability
$8,000	$4,000	$5,000	$8,000	$6,000	$1,000

> Since the liability on Scott's property exceeds his adjusted basis, he recognizes gain of $1,000 on the transaction. His stock basis is zero.
>
> Mikaela's basis is reduced by the amount of liability relief, bringing her stock basis to $5,000. She does not recognize gain on the transaction.

Attempts to avoid gain under IRC Sec. 357(c). There is disagreement among courts and the IRS with regard to the effect of personal liability on computing gain under IRC Sec. 357(c).

> **Court Case #1:** *Gain recognized even though taxpayers were not relieved of liability.* Taxpayers transferred property that was subject to liabilities to a corporation. The corporation assumed the debt. However, the taxpayers remained personally liable as guarantors. The IRS stated that even though the taxpayers' personal liability was not relieved when the corporation assumed the debt, the debt assumption was sufficient to create gain on the transaction. The Tax Court agreed with the IRS, as did the 7th Circuit Court of Appeals [*Seggerman Farms, Inc.*, 90 AFTR 2d 2002-6981 (7th Cir. 2002)].

> **Court Case #2:** *Court allows avoidance of gain from promissory note.* A taxpayer contributed real estate to a corporation that was subject to liabilities approximately $500,000 greater than the property's basis. To avoid recognition of gain under IRC Sec. 357(c), the taxpayer also contributed a personal promissory note in the amount of $1 million. The basis of the note, when added to the basis of the real estate, exceeded the liabilities assumed by the corporation. The taxpayer reported no gain on the transaction.
>
> The Tax Court ruled that the basis of the taxpayer's promissory note was zero. The Court ruled that the taxpayer must recognize gain for the excess of the liabilities over the basis of the real estate equal to $500,000.
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> The 9th Circuit reversed the Tax Court, calling the promissory note an "ordinary, negotiable, recourse obligation which must be treated as genuine debt for tax purposes," since the taxpayer had the ability to repay and considered the note a bona fide debt. The Court determined that the note had a basis equal to its face amount. Therefore no gain was recognized on the transaction [*Peracchi,* 81 AFTR 2d 98-1754 (9th Cir. 1998)]. For a similar result, based on different reasoning, see *Lessinger,* 63 AFTR 2d 89-1055 (2nd Cir. 1977).
>
> **Caution:** The IRS maintains that a personal promissory note contributed by a shareholder in a Section 351 exchange has a basis of zero (Rev. Rul. 68-629). The IRS is not likely to follow the reasoning in *Peracchi* or *Lessinger* outside of the 9th Circuit or 2nd Circuit, respectively. Other court decisions agree with the IRS on this issue.

Services Not Treated as Property

Services that are performed in exchange for stock do not qualify for nonrecognition treatment under IRC Sec. 351.

> **Example:** Sharice, Dirk, and Aleah enter into an agreement to become equal shareholders in a corporation. Sharice and Dirk will each contribute cash of $10,000 in exchange for stock, and Aleah will perform services worth $10,000 in exchange for stock. Since services performed do not qualify as property under IRC Sec. 351, the transfer of property (cash) only amounts to 66⅔% of the corporation's stock. The transaction does not qualify for nonrecognition treatment. Aleah's $10,000 of compensation is taxable income.

Basis of Property Exchanged for Corporate Stock

Tax-Free Exchanges Under Section 351 —Transferors have at least 80% control after the exchange—		**Taxable Exchanges That Do Not Qualify Under Section 351**	
Shareholder's basis in stock received equals [IRC Sec. 358(a)]:	Corporation's basis in property received equals [IRC Sec. 362(a)]:	Shareholder's basis in stock received equals FMV of stock received which is measured by:	Corporation's basis in property received equals FMV of the property received, which is measured by:
+ Adjusted basis of property transferred + Recognized gain + Cash paid + Liabilities assumed – Cash received – FMV of property received – Liabilities transferred	+ Adjusted basis of the property in the hands of the transferor + Gain recognized by the transferor	+ FMV of property transferred (adjusted basis plus or minus gain or loss recognized by the transferor) + Cash paid **Note:** The general rule of Section 1001 (gain or loss equals difference between amount realized and adjusted basis) applies.	+ Adjusted basis of the property in the hands of the transferor + Gain recognized by the transferor – Loss recognized by the transferor
Note: Shareholders who transfer property to a corporation in a Section 351 exchange recognize gain only up to the amount of boot received (money or property other than the corporation's stock). Liability relief is not considered boot for determining gain under these rules [IRC Sec. 357(a)]. However, gain may be recognized if liabilities exceed basis of the contributed property [IRC Sec. 357(c)]. See *Property Subject to Liabilities* on Page C-4.		**Notes:** • Shareholders who are not in control of a corporation immediately after a transfer recognize gain or loss as if they sold the property at its FMV to the corporation. • Corporations never recognize gain or loss on the receipt of money or property in exchange for their own stock (IRC Sec. 1032).	