CORPORATE OWNERSHIP ENTITY RECONSIDERED

by Gaylon E. Greer and Michael D. Farrell

Real estate investors face a major decision in selecting a legal form of ownership. They must choose from an array of alternatives, each having a different impact on profits, taxes and risk. Entity decisions involve issues such as limitation of investor liability, flexibility in management decision-making, ease in transferring ownership interests, and legal restrictions imposed by state and federal laws.

Corporations have generally-acknowledged advantages with regard to many of these considerations, but the opinion that income tax disadvantages outweigh nontax benefits is widely held, and corporations usually are not viewed as acceptable ownership vehicles for real estate investment. But recent legislation has reduced the corporate income tax rate while stripping away many of the tax shelter opportunities traditionally associated with individual ownership of investment property. As a consequence, tax advantages in many cases may favor the corporate form of ownership.

Traditional Objections To Incorporation

Numerous nontax arguments for incorporation have been intensively examined elsewhere.[1] The most widely publicized is limited liability for corporate shareholders. Ease in transferring ownership interests is also included — though somewhat unpersuasively, for small privately held corporations — in the catalogue of benefits. Although continuity of life is usually included in these arguments, it may be the least compelling reason to choose a corporate entity.

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These and other acknowledged benefits notwithstanding, most investors reject the corporate entity because of anticipated unfavorable income tax consequences such as "double taxation" and lack of "conduit" treatment. Both merit reexamination in the context of contemporary income tax law.

Profit-making corporations are liable for both state and federal income taxes; and shareholders are liable for taxes on any corporate earnings in excess of the dividend exclusion remitted to them as dividends. Thus, tax collectors take a "double serving" from corporate earnings before permitting investors access to the residual.

The "double taxation" objection rests upon two presumptions:

1. That investors wish to withdraw earnings rather than permit the corporation to reinvest; and

2. That they do so only by receiving dividends.

Neither presumption is necessarily valid. If a corporation never declares a dividend in excess of shareholders' dividend exclusions, "double taxation" is not an issue. Investor-shareholders who wish to withdraw cash from their corporations may employ a number of strategies other than dividend declarations.

Real estate is frequently considered tax-advantaged due to the provision for tax deductible depreciation allowances. Because depreciation allowances reduce taxable income without affecting actual pretax cash flow from an investment, net cash receipts may far outstrip taxable income.

Investors who employ financial leverage wisely in connection with investment in depreciable assets may be able to realize significant pretax cash flow and yet report legitimate losses for tax purposes. Additional tax savings result from offsetting these "artificial accounting losses" against taxable income

from other sources.

Because corporations are taxable entities and not "tax conduits," their losses cannot be offset against shareholder-investors' other taxable income. This lack of "conduit" treatment leads many investors to view the corporate entity as fatally flawed.

Lack of "conduit" treatment is less serious when the corporation has other taxable income to offset "artificial accounting losses." A corporation that acquires property at staggered intervals will always have some taxable income from more mature investments to use to offset losses from recent acquisitions, thus benefiting from depreciation deductions.

Special tax rules permit corporations to recompute as many as three years of prior tax liability, offsetting profits of earlier years against current losses. Any remaining current losses not offset against profits of earlier years may be carried over and offset against future income for as many as seven years.[2]

Tax Advantages For Corporations

Critics of the corporate organizational form have written vociferously about its income tax disadvantages, but little has been said about offsetting tax benefits. All entities suffer some relative disadvantages under the Internal Revenue Code, and no single tax factor should be considered by itself. Rather, relative tax consequences in conjunction with nontax consequences over the entire life of an estate-building plan should be considered.

The tax code favors corporations over noncorporate taxpayers. Corporations are permitted to deduct items that individuals must capitalize. Tax preference items result in less additional tax for corporations than for individuals. Corporations pay less tax than individuals who have the same net taxable income.

Real estate developers are in a good position to benefit from incorporation. Corporations are permitted the option of reporting construction-period property taxes and interim interest as a currently deductible operating expense, or of amortizing these expenditures over a number of years.[3] Noncorporate taxpayers are denied this option, and must amortize such outlays over periods ranging from four to ten years.[4]

Certain available tax deductions dubbed "preference items" may subject the investor to additional tax liability. The surtax or add-on preference tax on preference items equals 15 percent of the amount that preference items exceed a determinable statutory exemption. This obviously reduces the tax savings associated with deductions included in the definition of tax preferences.[5]

Preference items include all depreciation deductions on real estate, to the extent that the deductions exceed what would have resulted from using the straight-line depreciation method. Consequently, real estate investors who take advantage of allowable accelerated depreciation methods may incur a preference tax obligation in addition to their regular income tax liability.

Noncorporate taxpayers are allowed an add-on preference tax exemption that equals either $10,000 or one-half their regular income tax obligation, whichever is greater. Corporations may exempt either $10,000 or 100 percent of their regular income tax obligation, whichever is greater. Thus, the potential maximum exemption for corporations is *twice* that of noncorporate taxpayers.

Chief among the advantages for corporate taxpayers is lower marginal tax rates. Corporations pay a flat 17 percent on the first $25,000 of taxable income, after which marginal rates move in steps to a maximum of 46 percent. Unmarried individuals are assessed at an incremental rate exceeding 17 percent on income above $4,400, and exceeding 50 percent on income greater than $41,500. Compared with this 17 percent for corporations, the average rate paid by single taxpayers earning $25,000 is almost 25 percent.

Married taxpayers who file joint returns and those qualifying as heads of households fare a little better than single taxpayers. Regardless of filing status, marginal tax rates for individuals exceed those for corporations at all levels of income above $7,600, as illustrated in the Figure.

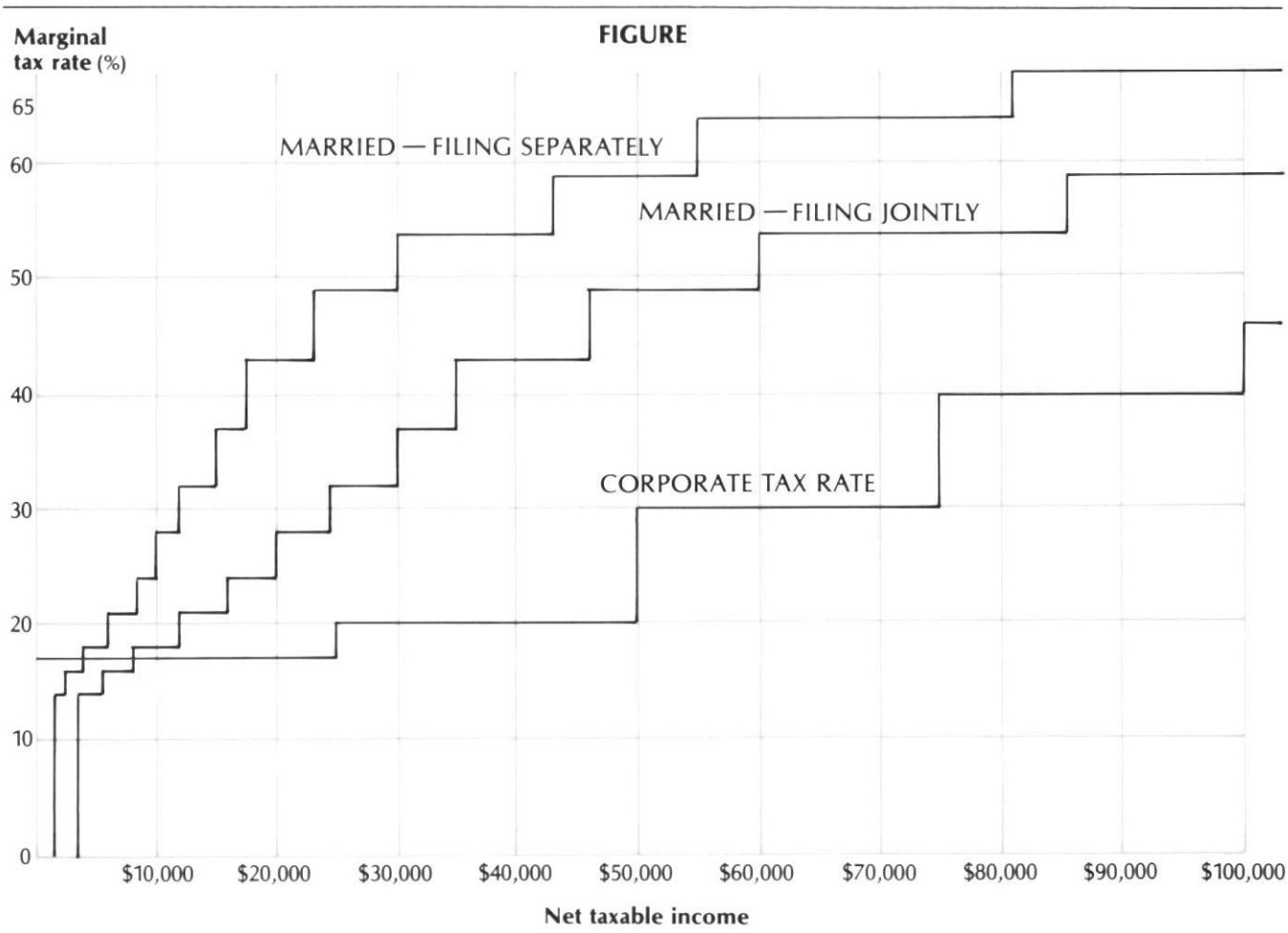
Incorporation Provides Tax-Planning Opportunities

Investors create a number of tax-planning opportunities by incorporating. Delaying incorporation or incorporating only a portion of a venture enables an investor to enjoy the best of both corporate and noncorporate tax environments. Multiple corporations may enhance tax-planning flexibility by providing opportunities to exploit investment tax credit and accelerated depreciation rules, and they may also facilitate property disposal.

Real estate investments that generate tax losses to offset income from other sources present a situation where immediate incorporation might be unwise. If the investor is in a higher income tax bracket than his investment corporation, then a noncorporate entity might be more appropriate.

Tax shelter from real estate is temporary. Annual deductions from accelerated depreciation drop off quickly after the first few years of ownership. The portion of debt service that comprises tax-deductible interest expense declines more slowly.

When investments do begin to generate taxable income, investors may benefit from transferring ownership to a wholly-owned or at least a controlled corporation. If properly structured, an exchange of realty for securities of a controlled or at least 80 percent owned corporation is not a taxable event.[6] To avoid income tax liability, consideration for the trans-



fer must consist solely of stock and other securities issued by the corporation. Immediately after the exchange, the taxpayer-investor must own at least 80 percent of the voting and 80 percent of the nonvoting stock of the corporation.[7]

After the transfer the corporation is in the same position with respect to the property as the investor was before the exchange. Because the corporation is in a lower income tax bracket, less tax liability will be incurred.

Delayed incorporation can enhance the tax benefit associated with rehabilitation of nonresidential income property. A tax credit equaling 10 percent of the cost of rehabilitating qualifying nonresidential real estate is available.[8] If an investor-rehabilitator claims the full credit and then disposes of property within the ensuing seven years, a portion of the credit must be repaid in the years of disposal.[9]

Transferring rehabilitated property to a wholly-owned or controlled corporation does not require that the investment tax credit be repaid.[10] Investors may benefit from holding title in their own name during the rehabilitation period, and then transferring ownership to their investment corporation, thereby offsetting the tax credit against their personal income tax liability and retaining income from the property taxed at the lower corporate income tax rates.

Incorporation does not need to be immediate nor complete. Wherever tax planning objectives are better served, only a portion of an investor's ownership interest needs to be transferred to a corporate entity.

For example, upon initial acquisition an investor might choose to have land title vest in a corporation and hold title to improvements in his own name, thereby offsetting his personal income by depreciation allowances and a reasonable land rental paid to his corporation. Because corporate income is taxed at lower rates, his personal tax reduction due to land rental expense will more than offset the corporate income tax on land rental income. One should be

sure that operations divided this way are actually separable and separate; otherwise income and expense items may be reallocated to reflect the IRS's vision of economic reality.[11]

Forming separate corporations to own each major property interest enhances tax planning flexibility. Since incorporation is inexpensive, as many separate organizations as necessary to benefit financial objectives and a personal income tax position can be formed.

Multiple corporations will not reduce the tax rate applicable to corporate income when the corporations are in related businesses but will form the foundation for disposing of properties without triggering recapture of investment tax credit or excess depreciation. As each property is to be marketed, one sells the owning corporation, carefully avoiding running afoul of the Collapsible Corporation rules of Code Section 341.

Investors who consider using accelerated depreciation to amplify the income tax benefits or to reduce adverse tax consequences of investing find the advantages reduced or eliminated by the potential for additional taxes when property is sold. Under most circumstances, any gain on disposal will be taxed as ordinary income to the full extent of accumulated depreciation deductions in excess of those generated by the straight-line method.[12] Because lump-sum recapture may catapult an investor into a high income tax bracket, potential recapture problems rate high among issues that determine whether accelerated depreciation is worthwhile.

Delayed incorporation may solve the recapture dilemma, permitting investors to benefit from accelerated depreciation deductions and avoid this "back-end" cost. Having held a property in their own or a partnership name while claiming accelerated depreciation, taxpayers may transfer ownership to a controlled corporation without recapture.[13]

Potential recapture continues to exist with respect to property transferred to a controlled corporation in a nontaxable transaction. If the corporation sells the depreciable property, the sale will trigger the same recapture problem as a sale by the investor.

Recapture is avoided if the investor sells the corporation, instead of the corporation selling property that is subject to recapture rules. If the investor holds corporate stock for a sufficient length of time and establishes his motive for acquisition as investment-oriented rather than tax avoidance, recapture is not triggered by sale of the corporation. Under these circumstances the entire gain from sale of the corporation is a long-term capital gain. This strategy must be carefully planned and executed to avoid difficulty with Collapsible Corporation rules.[14]

Extracting Cash From The Corporation

After lack of "conduit" treatment, the main objection to incorporation is double taxation. Critics observe correctly that earnings are taxed first to the corporation, and again to shareholders when cash is distributed as dividends. The problem can be circumvented by structuring cash withdrawals as other than dividend payouts.

Interest paid on corporate indebtedness to shareholders represents taxable income to the shareholder (after provision for the allowable exclusion), but it is deductible by the corporation. Principal payments are not a taxable event.

This strategy is subject to limitations imposed by provisions associated with "thinly capitalized" corporations. If shareholder loans do not represent prudent business practice, they may be construed by the IRS as capital contributions. In that event, interest and principal payments to shareholders are considered as dividend payouts — taxable to the shareholder but not deductible by the corporation.[15]

An appealing opportunity to apply this strategy occurs when property is transferred to a controlled corporation solely in exchange for corporation securities. Qualifying transactions are nontaxable under provisions of Section 351 of the Internal Revenue Code. The Code defines qualifying securities as both stock and certificates of indebtedness. Investors planning periodic cash withdrawals from corporate entities may avoid the "double taxation" problem by including sufficient evidence of indebtedness, that is, intermediate or long-term notes to generate interest payments totalling the amount of the desired periodic withdrawals.

Employee salaries paid by corporations are tax deductible if the amount paid is a "reasonable and necessary business expense." Like any employee, controlling shareholders may receive reasonable compensation for their services. Such compensation is taxable to the employee-shareholder and deductible to the corporation.

Salary payments not justified by the value of services performed, however, may be construed as "constructive dividends." If this occurs, the payment would be taxable as dividend income to the shareholder-recipient and will not be deductible by the corporation.

If only depreciable property is deeded to the corporation, cash may be extracted as rental charges for the land that has corporate-owned buildings. These charges are taxable to the shareholder-landlord and deductible by the corporation.

As emphasized earlier, the corporation must be operating a separate business; otherwise the corporation may be treated as a sham and corporate income will be taxable directly to the shareholders.

Summary

The corporate form of ownership provides real estate investors attractive tax planning opportunities despite widely-cited disadvantages such as "double taxation" and lack of tax "conduit" treatment. Neither of these two reasons for rejecting the corporate form needs to be a serious issue for investors intent upon building an estate through realty.

A number of income tax considerations favor use of the corporate form. Corporations pay taxes at lower marginal rates than do individuals at income levels above approximately $7,600. Corporations are favored with respect to the add-on preference tax and deduction of construction-period interest and property taxes.

Advantages of incorporation can be amplified by judicious tax strategy planning. Tax consequences can be divided advantageously between corporation and shareholder-owners, with shareholder-owners often withdrawing large sums from the corporation without consequence of "double taxation."

Tax rules applicable to corporations are extremely complicated and somewhat different from those applicable to individuals. A number of tax traps await the unwary investor who uses a corporate entity. Since failure to avoid these traps can be disastrous, competent tax counsel is advised in decisions having income tax implications.

NOTES

1. For example, see David G. McGrady and William C. Weaver, "Why Set Up a Corporation to Own Real Estate?", *Real Estate Review*, Vol. 10, No. 3 (Fall 1980), 89-93.
2. Internal Revenue Code, Section 172(b).
3. *Ibid*, Sections 189 and 266.
4. *Ibid*, Section 189(b).
5. *Ibid*, Section 56(a).
6. *Ibid*, Section 351.
7. *Ibid*, Section 368(c).
8. *Ibid*, Section 48(g).
9. *Ibid*, Section 47(a).
10. *Ibid*, Section 47(b).
11. *Ibid*, Section 482.
12. *Ibid*, Section 1250.
13. *Ibid*, Section 1250(d).
14. See Gaylon E. Greer, *The Real Estate Investor and the Federal Income Tax* (New York, Wiley-Interscience, 1979), 247-248.
15. *Op. cit.*, Section 385.