CORPORATE REAL ESTATE - A NO-NO

Contributed By: Martin H. Abo, CPA/ABV/CVA/CFF October 27, 2017

A frequent mistake made by small business owners is to have the operating corporation own the real estate, or to have a separate C corporation own the property and lease it to the business. The reason is that when the company eventually disposes of the property, usually after it has significantly appreciated and been substantially depreciated, a double tax bill will result. First, the corporation will be taxed on the appreciation upon the disposition of the real estate, and then, the shareholder(s) will be taxed on the proceeds of the disposition when they are distributed to them as a dividend or through liquidation. The tax traps are not limited to C corporations. Holding real estate in an S corporation has its own pitfalls. Mortgage debt does not constitute "basis" for tax losses when the accompanying real estate is owned in an S corporation. As most real estate investments yield potentially deductible losses after factoring depreciation on the structure, this could eliminate the tax benefits for a great deal of investors.

A better approach is for the business owners to own the real estate personally in a limited liability company or in a partnership with other investors, and then lease it to the operating business. Among the advantages:

- The business owner can sell the real estate interest for his or her own account, avoiding tax at the corporate level.
- The owner can refinance the property for his or her own benefit.
- Lease payments received by the property owner are not subject to employment taxes and are deductible by the company as a business expense.
- If the property owner dies while still owning the property, heirs will get it at its stepped-up basis, eliminating tax on all of the gain resulting from appreciation.

It's particularly important for small business owners to engage in careful tax planning with respect to real estate being acquired for use by their business, and we receive frequent requests for assistance with appropriate tax strategies.

While we're talking real estate and hopefully that which is not titled in corporate form, do you own a property that has appreciated considerably and that you want to sell? Are you concerned about incurring a large capital gains tax liability? One option is to structure the sale as an installment sale. Here the buyer pays the cost of the property plus interest in regular installments, frequently for a period of 5 years, enabling the seller to reflect the capital gain for tax purposes over the entire payment period. Sellers who decide on this strategy are cautioned, however, that an installment sale carries more risk than an outright sale of the property. Thus, the seller needs to:

- Carefully assess the creditworthiness of the buyer and possibly obtain personal guarantees, if the purchaser is a business.

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- Evaluate the future income producing capability of the property to make sure it provides sufficient cash flow to enable the buyer to make the payments.
- Use an interest rate that is competitive with current market rates in the area so as not to squash the deal.
- Obtain a down payment of at least 20% to have a cushion in the event of buyer default, and to cover the expenses if foreclosure becomes necessary.

Similarly, a topic for another alert is our frequently suggested use of Section 1031 which provides an alternative strategy for deferring the capital gains tax that may arise from a business/investment property sale. As of the writing of this Abo and Company Tip-of-the Month, we've read that the days of deferring 100% of gain via like-kind exchanges of real-estate could be numbered if the much talked about tax reform occurs in this particular arena does take place. Republican lawmakers are seeking tax breaks to trim or scrap to offset the cost of significantly cutting the income tax rate for businesses. We've seen tax-free real estate exchanges/swaps targeted before nixing like-kind swaps, immediately taxing the full amount of gain or in President Obama's proposal to cap the deferral at $1 million. If the deferral is curbed, we don't think the break will be axed retroactively but who really knows at this point.

Business property transactions are often complex, and the services of a knowledgeable CPA (hopefully we at Abo and Company) can be vital in developing strategies that make it possible to bring a contemplated transaction to a successful conclusion.

FOR MORE INFORMATION:

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