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The Real Estate Tax Mistake

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Do you want to know what makes tax attorneys cringe? It is when we see real estate held by a C corporation. In most cases, this creates unnecessary adverse tax implications which could be easily avoided with tax planning. There are some cases, because of particular circumstances, that a C corporation is the only viable option such as subsidiaries of foreign corporations and widely held corporations. However, for most closely held operating corporations, adverse tax consequences of owning real estate can be avoided.

C corporations are regular corporations that are required to pay corporate income tax on income and gains. Corporations then pay out earnings to its shareholders in the form of dividends which are nondeductible to the corporation and taxable to the shareholder. This is known as the double system of taxation. Many closely held corporations do not pay dividends on a regular basis as the owners are typically involved in the business and are able to take out earnings through salaries which are deductible to the corporation.

Typically, real estate in a C corporation is used in connection with the corporation's business operations. Therefore, it does not itself generate earnings and profits that would create a dividend. However, upon sale of the assets of the business, any gain attributable to the real estate will be taxed inside the corporation and then upon liquidation of the sale proceeds, the shareholders will pay tax a second time as capital gain on the redemption of their shares. Thus, the gain on the real estate will be subject to the corporate tax which is as high as 35% plus the capital gains rate at the individual level of 15% plus any state income taxes at the corporate and individual levels.

Another situation that causes a problem is when a buyer wants to buy the stock of a corporation but does not want the real estate. The shareholders are then faced with the prospect of distributing the real estate out to them. A distribution of the real estate in a cashless transaction still triggers corporate tax and individual tax. For instance, assume Conglomerate wants to buy the stock of Target C corporation but does not want the real estate owned by Target. The real estate is worth $3,000,000 and was previously purchased and over time depreciated down to $1,000,000. The corporation would be forced to distribute out the real estate prior to the purchase by Conglomerate triggering gain of $2,000,000 creating a Federal corporate tax of $700,000. The shareholders would recognize a dividend or a capital gain equal to $3,000,000. Currently the rates for dividends and capital gains are the same so the character is not important at this time, although when the law changes, it may be significantly important. The result is there is a 15% tax on the $3,000,000, or $450,000 (assuming nominal basis stock). So, between the corporation and the shareholders, tax of $1,150,000 results without any cash consideration paid for the real estate.

The best method to avoid this adverse tax consequence is to have an affiliated limited liability company (LLC) purchase the real estate. But if the real estate is already in a corporation, this is not an option.

However, there are remedial measures that may be available so if you hear of situations where the C corporation owns the real estate, then you should make an inquiry of why that is and whether there should be an exploration into removing the real estate from the C corporation. Maybe there is not a viable remedy, although we would rather ask and explore before there is a sale of the business pending.

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