When to Put Real Estate in a Corporation–Tax Considerations

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WHEN TO PUT REAL ESTATE IN A CORPORATION—TAX CONSIDERATIONS

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EDITOR'S NOTE: After this article was sent to press, Congress enacted the Installment Sales Revision Act of 1980. See note 15 *infra*. Please note that this act is discussed throughout this article as *proposed* legislation.

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I. INTRODUCTION

When a client asks his lawyer to handle a real estate acquisition, he sometimes informs the lawyer that title will be taken in the name of a corporation. This should raise a red flag in the lawyer's mind, because corporate ownership of real estate often leads to undesirable tax consequences. The lawyer should raise the tax planning issue at an early stage, since permanent damage may result once title is taken.

This article is a simplified discussion of the tax advantages and disadvantages of putting real estate in a corporation. The first half describes the general principles, and the second half applies these principles to the following common situations: an investment in rental property, use of real estate by an operating business, real estate and the hotel or motel, raw land held for speculation, raw land to be subdivided, and apartments to be converted to condominiums.

II. CORPORATE VS. OTHER FORMS OF OWNERSHIP

A. *Tax Comparison*

1. *Two Levels of Taxation.*—The most obvious, and also the most important, tax difference between corporations and other forms of ownership is that a corporation pays income tax on its net income, and the shareholders pay a second tax if the corporation distributes income to them. In a partnership, tenancy in common, or proprietorship, on the other hand, there is a single tax directly on the owners. Although a Subchapter S corporation usually avoids the corporate level tax, this corporate

form cannot be used for many real estate investments.[1]

Because there are two levels of taxation in a corporation, taxable income from real estate may be taxed twice. The corporate level tax sometimes can be reduced by payment of salaries to the shareholders, however, because "reasonable" salaries are deductible by the corporation[2] and, therefore, reduce its net income. In an active business, such as subdividing and developing residential lots, a substantial salary may be justified, but in passive enterprises, such as mere rental of property, substantial salaries are not usually warranted.

Real estate frequently produces cash flow in excess of taxable income. This tax-sheltered cash flow is tax-free to the owner. When a corporation distributes this cash flow to its shareholders, however, they may be taxed, because any distribution in excess of the corporation's earnings and profits[3] is treated as a tax-free return of capital to the extent of the shareholders' basis in their stock, but then as capital gain income to the extent it exceeds their basis.[4] Thus, a corporation can create taxable income

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1. See notes 55-70 and accompanying text *infra*.

2. I.R.C. § 162(a)(1). The Treasury Regulations define a "reasonable salary" as follows:

> Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

Treas. Reg. § 1.162-7(b)(1) (1958).

3. "Earnings and profits" is a tax concept used to determine how much of a corporate distribution to a shareholder is a dividend and is therefore taxed as ordinary income. The amount of a corporation's "earnings and profits" is its taxable income with certain adjustments and is often close to its current and retained earnings for accounting purposes. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.03 (4th ed. 1979).

4. Distributions are considered to be ordinary income dividends to the extent of the corporation's earnings and profits, then a tax-free return of capital to the extent of the shareholder's basis in his stock, then capital gain. I.R.C. §§ 301(c), 316. If the corporation uses accelerated depreciation, although it may have no taxable income, it can have earnings and profits and thereby subject its shareholders to ordinary income on distributions. See I.R.C. § 312(k); note 3 *supra*. If the corporation has no earnings and profits, distributions will reduce the shareholders' basis in their stock, see I.R.C. § 301(c)(2), which can lead to a higher tax on sale, corporate liquidation, or other disposition of the stock. Worst of all, once the shareholders' basis is exhausted, any further distribution is treated

where none need exist.

Real estate also frequently produces tax losses that offset the owner's other income, as well as sheltering cash flow from the real estate itself. These losses pass directly through to partners in a partnership, but not to shareholders of a corporation. Losses can be trapped in a corporation and be available only to offset the corporation's later income.[5] It is usually better to offset *current* income of the shareholders themselves, who are often in higher brackets than the corporation.

The tax consequences of refinancing also can be affected adversely by the two levels of corporate taxation. When real estate is refinanced, the proceeds are tax-free to the owner. If a corporation owns the real estate, however, and distributes these proceeds to its shareholders, then, as in the case of tax-sheltered cash flow,[6] there are usually tax consequences to the shareholders.[7]

Finally, the two levels of taxation can apply to a sale of corporate property. If a partnership, tenancy in common, or proprietorship sells property, any gain on the sale is taxed only once, directly to the owners. If a corporation makes the sale, however, the corporation may have income, and the shareholders also may have income when the sale proceeds are distributed to them either as a dividend or as a liquidating distribution.[8]

The problem of two-level taxation on sale of property usually can be avoided under section 337 of the Internal Revenue Code, which protects a corporation against recognition of any gain at the corporate level if, within twelve months, it resolves to liquidate, makes sales of its property, and distributes its assets (including sale proceeds) to its shareholders. The shareholders, of course, will recognize their gain or loss on liquidation, but the second tax at the corporate level will be avoided.

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as capital gain (assuming the stock is a capital asset in the shareholders' hands and assuming the corporation is not "collapsible" under I.R.C. § 341). I.R.C. § 301(c)(3).

5. Net operating losses may be carried back three years and forward seven years. I.R.C. § 172(b).

6. See notes 3 & 4 and accompanying text *supra*.

7. See note 4 *supra*.

8. If the distribution is a dividend on their stock, it may be treated partly as ordinary income, partly as a tax-free return of basis in their stock, and partly as capital gain. *See* note 4 *supra*. If the distribution is in liquidation of the corporation, it normally will be a capital gain to the extent it exceeds their basis in their stock. *See* I.R.C. § 331(a).

Unfortunately, a section 337 liquidation can have serious drawbacks. First, the liquidation must be a complete one.[9] Even if only some of the corporation's property is sold, all its assets must be distributed to the shareholders and they must recognize their entire gain, including appreciation in any property not sold, even though they have "cashed in" only part of their investment.[10]

A second drawback of a section 337 liquidation is that, under present law, installment tax treatment is difficult to obtain. If a corporation sells its property on the installment basis, it still must liquidate within twelve months and distribute the installment note to the shareholders, whose entire gain from the liquidation usually will be recognized immediately, rather than on the installment basis.[11] This creates a serious problem when the buyer insists on paying in installments or when the owners would save taxes by using the installment method.

One solution is to persuade the buyer to purchase the shareholders' stock. The corporation then would have no gain (not having sold any property), and the shareholders could report their gain on the installment basis. The buyer could immediately liquidate the corporation without gain[12] (since his cost for the stock, and therefore his tax basis, would equal the value of the corporate assets) and obtain a stepped-up basis in the corporate assets after liquidation.[13] The difficulty lies in persuading the

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9. I.R.C. § 337(a).

10. Liquidation of a corporation is treated as a taxable exchange by the shareholders of their stock for the corporation's assets. *See* I.R.C. § 331(a)(1). A shareholder's gain is the value of the assets he receives, minus his basis in his stock. *See* Treas. Reg. § 1.331-1(b) (1955).

11. The installment method may be used only if payments in the year of sale are no more than 30% of the selling price. I.R.C. § 453(b)(2)(A). For that purpose, "payments" do not include the note of the other party to the transaction, but do include a third party's note. Since a liquidation is treated as a transaction between the shareholders and the corporation, see note 10 *supra*, the buyer of the corporation's assets is a third party whose installment note, when distributed by the corporation to the shareholders, is a "payment" to them in its full amount. Because the amount of this "payment" usually exceeds 30% of the shareholders' selling price (the amount to be received from the liquidating corporation for their stock), installment reporting is usually unavailable. *See, e.g.*, Simpson v. Commissioner, 35 T.C.M. (CCH) 710 (1976). A bill to change this rule is pending in Congress. See text accompanying note 15 *infra*.

12. The liquidation may not be tax-free to the corporation itself because of depreciation recapture, investment credit recapture, or other problems beyond the scope of this article. *See* B. Bittker & J. Eustice, *supra* note 3, ¶ 11.61-.62.

13. *See* I.R.C. § 334(a), (b)(2).

buyer to buy stock rather than assets, since a stock purchaser may succeed to unknown corporate liabilities. The buyer may consent to buy stock if the sellers indemnify him against any liability and if he can enforce the indemnity by reducing his payments on the installment note. Many buyers are hesitant to get involved in these complications, however.

Creative taxpayers have found ways to claim installment treatment even when the buyer insists on buying assets rather than stock. The device generally used is an installment sale of stock to a related person, who then makes the sale to the ultimate buyer.[14] Because proper tax treatment of such devices is still unsettled, they must be viewed as somewhat risky.

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14. The devices used to obtain installment treatment typically work as follows: *Step 1*—The shareholders sell their stock on the installment method to an accommodation party, such as a trust for their children's benefit. The shareholders report this sale on the installment method for tax purposes. *Step 2*—The corporation sells its assets for an installment note and then liquidates. No gain is realized by the trust because it paid fair value for the stock and no gain is recognized to the corporation if the liquidation is begun and completed within a twelve-month period. *See* I.R.C. § 337. *Alternative Step 2*—The trust liquidates the corporation (no gain because the trust paid fair value for the stock), and the trust thereby gets a stepped-up basis for the assets equal to its cost basis for the stock. The trust then sells the assets for an installment note (no gain to the trust). *Step 3*—The trust uses the installment receipts to pay off its installment obligation to the original shareholders.

Using such devices to qualify for the installment method of reporting income is risky, but has been approved by the courts in certain fact situations. *See, e.g.*, Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971); Nye v. United States, 407 F. Supp. 1345 (M.D.N.C. 1975); Goodman v. Commissioner, 74 T.C. (CCH) No. 53 (1980); Weaver v. Commissioner, 71 T.C. 443 (1978); Roberts v. Commissioner, 71 T.C. 311 (1978); Pityo v. Commissioner, 70 T.C. 225 (1978). The position of the Internal Revenue Service (I.R.S.) does not comport with these decisions:

> "The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."

Rev. Rul. 73-157, 1973-1 C.B. 213, 213 (quoting Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945)). Thus, the I.R.S. may try to characterize the above transaction as a liquidation of the corporation in the hands of the original shareholders—triggering the entire gain to them immediately—followed by a sale of assets to the purchaser. *See* Rev. Rul. 73-157, 1973-1 C.B. 213, 213. *See also* Lustgarten v. Commissioner, 71 T.C. 303 (1978); Wrenn v. Commissioner, 67 T.C. 576 (1976).

Legislation now pending in Congress would solve this problem by giving installment treatment to shareholders in a section 337 liquidation if the corporation sells property on the installment basis and distributes the installment obligation to them.[15] The proposed legislation also would prohibit use of the risky devices[16] discussed above to obtain installment treatment, at least when a related person participates in the transaction.[17]

The third problem with a section 337 liquidation is that South Carolina tax law has no equivalent of section 337. To prevent South Carolina taxation at both the corporate and shareholder levels, the corporation first must liquidate, distributing its assets to the shareholders and causing immediate gain to them, and then the shareholders must sell the property themselves. The results are the following: no gain to the corporation because it made no sale, a gain to the shareholders on the liquidation, but no further gain to the shareholders on the sale of the assets because they take a stepped-up basis in the assets after the liquidation.[18]

There are numerous problems with this approach. First, the entire gain is recognized by the shareholders even if only part of

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15. S. 2451, 96th Cong., 2d Sess. (1980); HOUSE WAYS AND MEANS COMM., REPORT ON THE INSTALLMENT SALES REVISION ACT OF 1980 (H.R. 6883), H.R. REP. No. 96-1042, 96th Cong., 2d Sess. 1 (1980) [hereinafter cited as I.R.C. § 453 (proposed)]. This bill would make numerous other changes in the installment sale rules.

16. See note 14 *supra*. See notes 148-60 and accompanying text *infra* for a discussion of the impact of these proposed rules on an installment sale of subdivision land by an individual to his controlled corporation.

17. *See* I.R.C. § 453(e)(proposed), *supra* note 15. "Related person" would include family members and entities such as trusts, estates, partnerships, and corporations in which the taxpayer or his family has a certain interest. *See id.* § 453(f)(1) (incorporating the rules of I.R.C. § 318). If an *unrelated* person serves as the accommodation party, the proposed legislation would not apply. It could be difficult, however, to arrange such a transaction with an unrelated person, without making the risky device even more risky. The taxpayer probably would not want an unrelated party to have the right to keep the property. The unrelated party probably would not accept the risk of being stuck with the property if the resale fell through. Both, therefore, would want the resale binding on all concerned, which the courts view as undercutting the *bona fides* of the installment sale to the unrelated person. *See* Rushing v. Commissioner, 441 F.2d 593, 593 (5th Cir. 1971). If the unrelated party's own finances would not permit him to make the purchase without soon reselling, the transaction looks even more like a sham.

18. *See* I.R.C. § 334(a); S.C. Tax Comm'n. R., S.C. CODE ANN. (R. & REG.) 117-87.52(D) (Cum. Supp. 1979). The latter provides: "If property is exchanged in a taxable transfer, the property acquired takes the fair market value on the date of the exchange." *Id.*

the property is sold.[19] Second, installment treatment will be impossible to obtain unless one of the risky devices discussed above[20] is used. The proposed federal legislation would not only prohibit use of such devices, but apparently would make it very difficult to obtain installment treatment for federal purposes and, at the same time, avoid two levels of South Carolina tax. Federal installment treatment would require that the installment obligation arise from a sale of assets *by the corporation* and be distributed to the shareholders as part of the liquidation.[21] Avoidance of the South Carolina tax at the corporate level, on the other hand, requires liquidation first, then sale of assets *by the shareholders.*[22]

A third problem with the "liquidate first, then sell" method of avoiding South Carolina tax on the corporation is that the shareholders' sale of the assets may nevertheless be attributed back to the corporation for tax purposes if the corporation itself arranged the sale.[23] Two levels of South Carolina taxation would result: tax on the corporation's gain on the sale attributed to it and tax on the shareholders' gain in liquidation. Under section 337, however, there would be no danger of double federal taxation.[24] Fourth, this method may not be practical if a large number of shareholders must join in the sale of assets, if a judgment is on record against any shareholder, or if any shareholder would have difficulty obtaining a renunciation of dower.

In summary, the seemingly harmless decision to transfer or take title to real estate in a corporation's name can cause double taxation on the sale of property, as well as the loss of tax shelter benefits and tax-free refinancing. Avoiding double taxation on

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19. *See* note 10 *supra.*

20. *See* note 14 *supra.*

21. *See* I.R.C. § 453(h)(i)(A)(proposed), *supra* note 15.

22. See text preceding and accompanying note 18 *supra.* The shareholders' only hope would be with a "risky device" sale to an *unrelated* person. *See* note 17 *supra.* The stakes in such a gamble would be high, since both federal and South Carolina installment treatment would depend on the "risky device." The shareholders would have to forego the certainty of federal installment treatment under proposed I.R.C. § 453(h) in exchange for a chance to get South Carolina installment treatment.

23. *Compare* Commissioner v. Court Holding Co., 324 U.S. 331 (1945) *with* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950). *See generally* B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 11.63.

24. The corporation should adopt a plan of complete liquidation and distribute all its assets, and the shareholders should make their sale of assets within twelve months, to be sure § 337 will apply if the sale is attributed back to the corporation.

the sale of property also can be difficult. These drawbacks to taking title in a corporate name are the result of the two levels of corporate taxation—the most significant tax difference between corporations and other forms of ownership.

2. *Stepped-Up Basis at Death.*—When a property owner dies, his estate usually obtains a fair-market-value basis in the property.[25] If property is held by a corporation, however, the basis of the property does not change when a shareholder dies.[26] When a partner dies, the partnership, unlike a corporation, can increase the basis for its assets just as an individual can.[27] The partnership's increase in basis does not benefit all the partners, but only the deceased partner's successor. This allows the successor to claim higher depreciation, if depreciable assets are involved, and a lower gain on any later sale of assets by the partnership.

3. *Sale of Part Interest—Buyer's Basis.*—A similar problem with corporate ownership is that a sale of a part interest in a corporation does not permit an increase in the corporation's basis for its assets. A partnership, on the other hand, can adjust its basis for its assets when a partner sells his interest, in the same manner as when a partner dies.[28] The purchaser of corporate stock ultimately bears the burden of the corporation's tax on the sale of its assets even though the purchase price for his stock was based on the appreciated value of the assets. For example, if a corporation had purchased for $10,000 land that appreciated to $100,000, and a new shareholder then bought half the stock for $50,000, the corporation still has a $10,000 basis in its land. If the land is sold, the corporation will have to pay tax on the

25. *See* I.R.C. § 1014(a).

26. The basis adjustment provided in I.R.C. § 1014(a) applies generally to property owned by the decedent, *e.g.*, his stock in the corporation, but not to property owned by the corporation. Because the shareholder's stock does get a stepped-up basis, a corporate liquidation after the shareholder's death may be possible with little or no gain, unless there are other shareholders who will not agree to liquidate because they would face a gain on their stock.

27. *See* I.R.C. §§ 743, 754. The partnership must make an election on its tax return for the year of the partner's death. This election applies to all future years unless the I.R.S. permits the partnership to change it. *Id.* § 754. The election would require a downward adjustment in the partnership's basis for its assets if the deceased partner would have had to reduce his basis if he had held the property individually. These adjustments to basis also apply when a partner sells his interest in the partnership. *Id.* § 743(b).

28. *See* note 27 *supra*.

entire gain, and the new shareholder ultimately will bear the burden of half that tax even though he bought in at fair market value. This may make it difficult for the original shareholder to sell his stock.[29]

4. *Use of Corporation as Tax Shelter.*—Corporations often have substantially lower federal income tax rates than do individuals, as shown in the following table:

FEDERAL INCOME TAX RATES

Taxable Income	Corporate Rate[30]	Married Individual Rate[31]
first $ 25,000	17%	14-32%
next $ 25,000	20%	32-49%
next $ 25,000	30%	49-54%
next $ 25,000	40%	54-59%
above $100,000	46%	59-70%

Because of these lower rates, a corporation can be used as a temporary tax shelter for nonsheltered income from, for example, a ground lease or a subdivision development. The income can be accumulated in the corporation. (If paid out, the income would be subjected to two levels of taxation, except for reasonable salaries.) The accumulated income could be used in some future business to be conducted in corporate form or eventually could be withdrawn by the shareholders. A second tax would have to

29. The following actual fact situation is illustrative: Two subdivision developers purchased raw land for development as residential lots, their corporation taking title. Shortly thereafter, an interstate highway bordering the property was announced, making the land too valuable for residential use. Several years later, when the corporation still owned the land, one of the shareholders suffered financial reverses and needed to sell his stock. The prospective buyer was informed that no increase in basis for the land would be possible and that he would bear half the tax burden when the land was sold. As a result, no sale was made.

The basis problem could have been solved by liquidating the corporation and selling a half interest in the land to the buyer, who would then have a "cost" basis in his half equal to his purchase price. *See* I.R.C. § 1012. The other shareholder refused to liquidate, however, because he did not want to trigger his entire gain before selling the land. Nor would he agree to a liquidation under § 333, see notes 89-92 and accompanying text *infra*, since South Carolina then had no equivalent of § 333, and he would therefore have had to recognize his gain for South Carolina tax purposes.

30. I.R.C. § 11(b). The tax rates for both corporations and indivduals would be decreased slightly by H.R. 5829, 96th Cong., 2d Sess. (1980) (the "Tax Reduction Bill of 1980"), as revised and reported by the Senate Finance Committee on September 15, 1980.

31. *Id.* § 1(a). The rate shown is for a joint return. See note 30 *supra* for proposed changes in the tax rates.

be paid upon withdrawal, of course, but the tax at that time could be fairly low for several reasons. First, the corporation could be liquidated and the shareholders would pay tax at the lower capital gain rates.[32] Second, the original shareholders may have given their stock to their children, who may be in lower tax brackets. Third, the shareholder may have died and his estate may have a stepped-up basis[33] for his stock, so that the liquidation produces little or no gain.

When a corporation is used to accumulate income and temporarily avoid tax at the shareholder level, the possibility of penalty taxes in two forms arises: the accumulated earnings tax[34] and the personal holding company tax.[35] A corporation holding real estate can frequently avoid these taxes to a large degree. The accumulated earnings tax will not apply until $150,000 of earnings has been accumulated in the corporation.[36] Above that level, however, the earnings must be distributed to avoid the twenty-seven and one-half percent tax (thirty-eight and one-half percent on accumulated taxable income for the year in excess of $100,000) that is added to the regular corporate tax.[37]

The other penalty tax, the personal holding tax, will not apply if the corporation's income is primarily rent and if a small dividend is paid.[38] Nor would the tax apply to the income from an active subdivision business, because receipts of principal from lot sales would not be personal holding company income (although interest on installment sales would be).[39]

Income accumulated in the corporation without a penalty tax should be reinvested with the objective of further accumulation without a penalty tax. An alternative would be a reinvest-

32. The Code provides preferential tax treatment to capital gains: "[i]f for any taxable year a taxpayer other than a corporation has a net capital gain, 60 percent of the amount of the net capital gain shall be a deduction from gross income." *Id.* § 1202(a). If the corporation is "collapsible," the shareholders' gain from the sale or exchange of the stock does not receive the preferential treatment but is deemed to be ordinary income. *See id.* § 341. The 60% deduction would be increased to 70% under H.R. 5829, 96th Cong., 2d Sess. (1980). See note 30 *supra*.

33. *See* note 26 and accompanying text *supra*.

34. I.R.C. § 531.

35. *Id.* § 541.

36. *Id.* § 535(c)(3). The permitted accumulation would be increased to $250,000 under H.R. 5829, 96th Cong., 2d Sess. (1980). See note 30 *supra*.

37. *Id.* § 531(1), (2).

38. *See id.* § 543(a)(2).

39. *See id.* § 543(a).

ment, producing income that is subject to little or no corporate-level tax and that can be distributed to the shareholders. Examples are tax-free municipal bonds and either common or preferred stocks. Because a corporation can deduct eighty-five percent of its dividend income from stocks,[40] it will pay federal tax only on the remaining fifteen percent. South Carolina, however, will impose its corporate tax on one hundred percent of the dividend income.

5. *Use of Corporation for "Dealer" Property.*—When real estate is to be sold as "dealer" property,[41] such as subdivision lots, incorporation usually is advisable because then the corporation, and not the individual, will be tainted as a "dealer." The sale of such property produces ordinary income[42] rather than capital gain, and the seller who deals in such property will find it difficult, though not impossible, to obtain capital gain treatment on sales of other property.[43] Avoiding dealer taint is a legitimate reason for incorporating. Subdivision tax strategy is discussed more thoroughly in subsection III.*E.* below.

6. *Accelerated Depreciation—Original User.*—Only the "original user" of property may take accelerated depreciation deductions.[44] If the owners of a building transfer it to a corporation in return for the corporation's stock, the transaction is tax-free and the transferees' basis in the building carries over to the

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40. *See id.* § 243.

41. Capital gain treatment under I.R.C. § 1202 is available only upon disposition of a "capital asset" or "property used in the trade or business," both of which are defined to *exclude* "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business[,]" which is commonly referred to as "dealer" property. *Id.* §§ 1221(1), 1231(b)(1)(B).

42. *Id.* § 64.

43. It is possible for real estate dealers to hold investment property and later sell it at capital gain rates. *See* Cousins Properties, Inc. v. United States, 215 Ct. Cl. 897 (1977); Estate of Dean v. Commissioner, 34 T.C.M. (CCH) 631 (1975); Maddux Constr. Co. v. Commissioner, 54 T.C. 1278 (1970); Eline Realty Co. v. Commissioner, 35 T.C. 1 (1960). Subdivision developers may be denied capital gain treatment on the sale of commercial sites in their subdivisions, however. *See, e.g.,* Herzog Bldg. Corp. v. Commissioner, 44 T.C. 694 (1965), *acq. on another point;* Grant v. Commissioner, 22 T.C.M. (CCH) 771 (1963), *aff'd per curiam,* 333 F.2d 603 (4th Cir. 1964). *See also* Tibbals v. United States, 362 F.2d 266, 272 (Ct. Cl. 1966) (taxpayer held to have received ordinary income on sales of subdivision land to his controlled corporation, but was allowed capital gain treatment on the sale of adjacent lots in bulk to an unrelated developer).

44. *See* I.R.C. § 167(c). A proposed change in the federal tax law would allow faster depreciation for all structures. The fastest method would be reserved for owner-occupied business structures. See note 121.1 and accompanying text *infra.*

corporation. The corporation is not entitled to accelerated depreciation, however, unless it is the original user of the building, as would be the case if construction were incomplete when it took title.[45] This inability to accelerate depreciation is a pitfall whenever property is transferred to or from a corporation or a partnership, or to an investor taking title to a recently constructed building.[46]

"Component" depreciation means separate depreciation of building components, such as the roof, wiring, painting, and shell over different useful lives. Because component depreciation is not a form of accelerated depreciation, there is no original user requirement. The purchaser of used property, however, must obtain an appraisal of the fair market value of each component in order to use component depreciation.[47]

7. *Estate Planning.*—Real estate may be transferred to a corporation for estate planning purposes. Farm operations, for example, are frequently incorporated to create separate interests (stock and debt) in a single asset (the farm). The separate interests facilitate transfer during life and at death and reduce taxes on farm income by dividing the income among the family members and the corporation.[48]

Investment property, such as raw land, may be put in a corporation to facilitate the transfer of part interests to children to reduce the parent's estate. Incorporation may also reduce the gift tax value of the children's stock, and sometimes even the estate tax value of the parent's remaining stock, since the value of a minority interest usually can be discounted.[49] These advan-

45. Treas. Reg. § 1.167(c)-1(a)(6) (1956).

46. For example, assume that an investor agrees to purchase a building when construction is completed. A tenant signs a lease during construction and moves in immediately on completion of construction. A few days later, the investor closes his purchase of the building. The investor is not the original user, since use began a few days before he took title, and therefore he is not entitled to accelerated depreciation. *See* Rev. Rul. 66-372, 1966-2 C.B. 67.

47. *See id.* 73-410, 1973-2 C.B. 53.

48. This type of estate planning is beyond the scope of this article, but is discussed thoroughly in other publications. *See, e.g.,* Hines, *Estate Planning for the Family Farmer and Rancher,* in 10 UNIVERSITY OF MIAMI INSTITUTE ON ESTATE PLANNING ¶¶ 300-08 (1976), and articles cited therein.

49. A minority stock interest may be entitled to a discount in value. *See* Treas. Reg. § 20.2031-2(f); Rev. Rul. 59-60, § 4.02(g), 1959-1 C.B. 237. Depending on the facts, a parent may or may not be able to obtain discounts for transfers to children (*e.g.,* one-third interest to each of two children) and also for the minority interest retained by him

tages must be weighed against the potential income tax disadvantages of incorporation.[50]

An alternative to incorporation is creation of a family partnership, either general or limited, and a transfer of percentage partnership interests as gifts to the children. The transfer of partnership interests is not complicated if permitted by the partnership agreement, and the tax value of a minority partnership interest, like a minority interest in a corporation, may be eligible for a discount.[51]

8. *Nominee or Straw Corporation.*—Straw corporations may be used as temporary title holding agents to obtain anonymity, to protect against liability on a mortgage, or to obtain mortgage loans that would be usurious if made to a noncorporate borrower.[52] Because the straw corporation may be

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at his death. *See* Richardson v. Commissioner, 151 F.2d 102 (2d Cir. 1945), *cert. denied,* 326 U.S. 796 (1946); Estate of Heppenstall v. Commissioner, 8 T.C.M. (CCH) 136 (1949); Phipps v. Commissioner, 43 B.T.A. 1010 (1941), *aff'd,* 127 F.2d 214 (10th Cir. 1942), *cert. denied,* 317 U.S. 645 (1942); Whittemore v. Fitzpatrick, 127 F. Supp. 710 (D. Conn. 1954). *But see* Blanchard v. United States, 291 F. Supp. 348 (S.D. Iowa 1968) (family attribution applied to prohibit a discount for the gift of a minority interest). *See generally* J. KRAHMER & T. HENDERER, *Valuation of Shares of Closely Held Corporations,* 221 Tax Management Portfolios A-52 to -62. The Internal Revenue Service continues to oppose discounts for minority interests when all the stock is owned, before and after the gift, by members of one family. *See* Private Letter Ruling 8010017 (Dec. 6, 1979).

50. See text accompanying notes 2-29 *supra.*

51. There is very little authority concerning the propriety of discounting the value of a minority partnership interest. According to the Regulations, the fair market value of a partnership interest is what a willing purchaser would pay a willing seller for the interest. Treas. Reg. § 20.2031-3 (1958). Presumably, the purchaser of a minority interest in a partnership would discount the underlying value of the business because of his lack of control. The Regulations also provide that it is proper to consider the factors used to value corporate stock, which include the degree of control of the business. *Id. See also* Friedman v. Commissioner, 10 T.C. 1145 (1948)(court discounted the underlying value of a capital interest in a partnership transferred to children because the parents retained a controlling interest and provided personal services to the business that were more important in earning the profits than was the business capital in which the children were given an interest).

In principle, therefore, a discount often should be proper for a minority partnership interest since a minority partner may have little control over the business, and sale of his interest may be restricted. These factors may depend in part on the partnership agreement, particularly the provisions concerning control and management of the business, transfer of interests to third parties, and waiver of the right to partition real property owned by the partnership. The use of a limited partnership, with the children as limited partners, may make it easier to obtain a discount and to keep control in the hands of the parents.

52. Under South Carolina law, for example, usury limitations do not apply to loans to corporations with an issued capital of at least $40,000 par value or stated value. S.C.

taxed as the owner of the property, rather than as a mere agent, it may suffer from all the tax drawbacks discussed.[53] If the straw corporation's status as a mere agent is respected for tax purposes, and its principals are treated as the true owners of the property, then the principals still may want to use some entity other than themselves, *e.g.*, a partnership, as the true owner.

Anyone contemplating the use of a straw corporation should clearly establish the agency relationship.[54] The slightest business activity by the corporation may make it taxable as the true owner. An unrelated accommodation party—not the "real owners" themselves—should be the shareholder of the corporation. Otherwise, the corporation could be interpreted either as a mere agent for the "real owners" or as their investment vehicle that owns beneficial, as well as legal, title.

9. Subchapter S Corporations.—A Subchapter S corporation[55] usually pays no corporate income tax. The income or loss flows directly through to the shareholders pro rata.[56] A Subchapter S corporation, therefore, avoids two problems caused by the two levels of ordinary corporate taxation. First, income of the Subchapter S corporation is taxed only once. Second, property can be sold without a corporate level tax on the gain, since the shareholders will report the gain instead.[57]

Unfortunately, under present law, Subchapter S status is unavailable to many corporations owning real estate, because only twenty percent of a Subchapter S corporation's gross receipts may consist of rents and certain other passive investment income.[58] Typical rental property usually would violate this twenty-percent limit on rents.[59] Other kinds of real property,

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CODE ANN. § 34-31-80 (1976).

53. See text accompanying notes 2-29 *supra*.

54. For guidelines in this area, see B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 2.10; G. ROBINSON, FEDERAL INCOME TAXATION OF REAL ESTATE ¶ 8.06 (Rev. ed. 1973); Greenberg, *Forms of Organization for Holding and Developing Real Estate*, in 29 NEW YORK UNIVERSITY ANNUAL INSTITUTE ON FEDERAL TAXATION 1129, 1156-57 (1971).

55. A Subchapter S corporation, or "electing small business corporation," is defined at I.R.C. § 1371.

56. For a general discussion of Subchapter S corporations, see B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 6.01-.10.

57. The corporation avoids tax on capital gain only if it has elected Subchapter S status for the preceding three taxable years or, if recently formed, since its incorporation. *See* I.R.C. § 1378(c).

58. *Id.* § 1372(e)(5).

59. *See, e.g.*, Bramlette Bldg. Corp. v. Commissioner, 424 F.2d 751 (5th Cir.

such as raw land, may not violate the twenty-percent limit while being held, but could do so if sold on the installment method, since interest income might then exceed twenty percent of all receipts.

The twenty-percent limit on passive income, along with certain other Subchapter S restrictions, would be eliminated by changes recently proposed by the staff of the Joint Committee on Taxation.[60] If adopted, these changes would authorize Subchapter S status for many corporations owning rental property. The choice of a Subchapter S corporation as the entity to own rental property would then have certain tax[61] and nontax[62] advantages.

A major tax disadvantage would remain, however, if the real estate is expected to produce tax shelter for the shareholders, either in the form of tax losses or tax-sheltered cash flow, *i.e.*, cash flow greater than taxable income. Real estate tax losses depend on depreciating the entire cost of the property. Even though most of the cost is financed by mortgage loans, the owner's basis for depreciation is his full cost, not just his equity investment.[63] A Subchapter S corporation benefits from depreciation as much as other owners, but the resulting corporate losses may or may not pass through to the shareholders, since Subchapter S shareholders may deduct corporate losses[64] only to the extent of their actual investment in the corporation.[65] Mortgage

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1970)(office building); City Mkts., Inc. v. Commissioner, 433 F.2d 1240 (6th Cir. 1970)(farmers' market leasing space to varied tenants). Unlimited rental income is permitted, however, if significant services are rendered by the owner in addition to mere occupancy. Examples are charges for hotel rooms with maid service, and warehousing charges and parking lot fees if significant services are rendered. *See* Treas. Reg. § 1.1372-4(b)(5)(vi) (1959); Rev. Rul. 65-91, 1965-1 C.B. 431.

60. STAFF OF JOINT COMM. ON TAXATION, 96TH CONG. 2D SESS., REPORT ON SIMPLIFICATION OF TAX RULES RELATING TO SUBCHAPTER S CORPORATIONS (Comm. Print 1980) [hereinafter cited as JOINT COMM. REPORT].

61. See text accompanying notes 55-57 *supra*.

62. See text accompanying notes 79-85 *infra*.

63. Crane v. Commissioner, 331 U.S. 1 (1947).

64. Capital, as opposed to ordinary, losses do *not* pass through to the shareholders. B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 6.07. If the proposals cited in note 60 *supra* are enacted, capital losses would pass through.

65. Code § 1374(c)(2) limits the shareholder's deduction of losses to his adjusted basis in his stock plus his adjusted basis in any debt owed to him by the corporation. Any losses in excess of these amounts can never be used, even if the shareholder later contributes or lends money to the corporation, thereby increasing his basis. *See* Treas. Reg. § 1.1374-1(b)(4)(i) (1959). *Compare id. with* notes 75 & 76 and accompanying text

loans to the corporation from third parties do not increase the amount of losses that the shareholders can take.[66] This severely limits the tax benefits of real estate.

Even when property produces no losses, Subchapter S is undesirable if the property's cash flow is tax sheltered in whole or in part. As with ordinary corporations, the distribution to shareholders of tax-sheltered cash flow can create taxable income at the shareholder level although there was none at the corporate level.[67] Similarly, the corporation, like any owner, can refinance or borrow against its property tax-free, but the proceeds cannot be distributed to the shareholders without creating taxable income to them.[68] The proposed Subchapter S changes do not appear to eliminate these disadvantages.[69]

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infra (discussion of mortgage loans in the case of limited partnerships). If the proposals cited in note 60 *supra* are enacted, a shareholder could later increase his basis and take a delayed loss. Because taking the loss immediately is preferable, however, a partnership will still be better than a Subchapter S corporation, even under the proposed changes.

66. Corporate debts to third parties do not count to increase deductible losses, even if guaranteed by the shareholders. Perry v. Commissioner, 47 T.C. 159 (1966), *aff'd*, 392 F.2d 458 (8th Cir. 1968). Such loans do count to increase deductible losses if and when the shareholders have to pay the creditor on their guaranty. Rev. Rul. 71-228, 1971-1 C.B. 53; *id.* 70-50, 1970-1 C.B. 178.

67. See note 4 *supra* concerning the taxation of distributions from ordinary corporations. The same rules apply to Subchapter S corporations except when explicitly modified in Subchapter S of the Code. Though the modifications are extensive, *see* B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 6.05-6.08, they normally do not protect tax-sheltered cash flow or other nontaxable receipts from taxation when distributed to shareholders.

68. *See* note 67 *supra.*

69. The report of the staff of the Joint Committee states: "The character and source (U.S. or Foreign) of items of income, deduction, and loss, as well as items of credit, would pass through to shareholders in the same general manner as they pass through partnerships." JOINT COMM. REPORT, *supra* note 60, at III.D. The report then lists tax-exempt interest income, capital losses, and other items that would pass through, retaining their character.

Until the proposals are reduced to legislation, it may not be clear how these principles would apply to tax-sheltered cash flow and to nontaxable receipts by the corporation, such as proceeds of refinancing. Such items seem unlikely to pass through without tax effect unless the eventual legislation goes beyond the apparent main concern of the report of the Joint Committee staff, which is passing through to the shareholders the "character and source (U.S. or Foreign)" of items of income and deduction. Taxation of tax-sheltered cash flow or proceeds of refinancing does not result from changing its "character," but from such distributions being in excess of the shareholders' basis in their stock, which causes taxation in all corporations, regardless of the source of the funds distributed. See note 4 *supra*. One possible cure for this problem would be to accord partnership treatment to Subchapter S shareholders by increasing their basis in their stock by their pro rata share of the corporation's liabilities. The report does not suggest such a sweeping change, however.

In addition, Subchapter S corporations do not avoid the problem of the corporation retaining a low basis in its property when a shareholder dies or sells his stock.[70] South Carolina tax law creates still another problem with Subchapter S corporations, since it has no equivalent to Subchapter S and, therefore, treats Subchapter S corporations as ordinary corporations.

10. Trust as Investment Vehicle.—Formation of a trust to own real property initially may appear advisable. A trust offers limited liability and centralized management, and trust income normally passes directly through to the beneficiaries for tax purposes in much the same manner as the income of a partnership. South Carolina even has a "business trust" statute.[71]

The use of a business trust may be extremely unwise from a tax standpoint, however. Trusts and other noncorporate entities can be taxed as corporations (technically "associations") if they have certain corporate characteristics.[72] When investors associ-

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70. See text accompanying notes 25-30 *supra*. Although Subchapter S corporations pay no corporate level tax, the amount of income passed through to the shareholders when the corporation sells an asset depends on the corporation's basis for the asset.

71. S.C. CODE ANN. §§ 33-53-10 to -50 (1976).

72. Treas. Reg. § 301.7701-2 (1967). These characteristics include "(i) [a]ssociates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests." *Id.* As the Regulation explains,

> [s]ome of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations. Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association, and characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. For example, since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom. On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.
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> (3) An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered.

ate themselves to carry on business through a trust (including a passive investment in rental property), the trust usually will be taxable as a corporation, unless its functions are so severely limited that it would be of little value as an investment vehicle.[73]

11. General Partnership vs. Limited Partnership.—Investment property frequently is held in a partnership rather than a corporation for the tax reasons discussed.[74] The choice between a general and a limited partnership depends on several factors, including limited liability and the lack of management power for limited partners. Two tax considerations are particularly important. Losses will pass through to partners (and tax-sheltered cash flow can be distributed to them without tax) to the extent of their actual contributions to the partnership plus their pro rata share of loans to the partnership from third parties, but in the case of limited partners the loans must be nonrecourse, meaning that no partner has personal liability.[75] A limited partnership must, therefore, obtain nonrecourse loans if the limited partners are to enjoy maximum tax benefits.[76]

Id. § 301.7701-2(a)(2), (3).

73. The trust's functions apparently must be limited to holding title, conserving the trust property, collecting and distributing income, and taking other limited actions at the direction of the beneficiaries, with no power to manage, buy, sell, improve or demolish property, or to borrow money. *Compare* Rev. Rul. 78-371, 1978-2 C.B. 344 *with* Rev. Rul. 79-77, 1979-1 C.B. 448.

74. See text accompanying notes 2-29 *supra.*

75. I.R.C. §§ 704(d), 731(a)(1), 752(a); Treas. Reg. § 1.752-1(e) (1956). The losses that can pass through to a partner are limited to his basis in his partnership interest, *i.e.*, his contributions plus his share of the partnership's liabilities. *Id.* § 1.704-1(d)(1) (1956). If a partner runs out of basis and cannot deduct his share of the losses, he can later increase his basis, *e.g.*, by contributing more to the partnership, and then deduct the past losses. *Id. Compare id. with* note 65 and accompanying text *supra.*

76. When the lender insists on some recourse, it is unclear whether personal liability of the general partners on, for example, 20% of the loan leaves the remaining 80% as a nonrecourse debt for tax purposes. Since the Regulations provide that a nonrecourse loan is one on which no partner has "any" personal liability, *see* Treas. Reg. § 1.752-1(e) (1956), the I.R.S. may take the position that the entire loan is a recourse loan. This result would be harsh since 80% of the loan is repayable only from profits (in which the limited partners share) rather than increasing the partners' potential liability for losses (in which only the general partners share), but there is no authority on this question. The safest approach is to arrange two loans—a 20% recourse loan and an 80% nonrecourse loan—from two different lenders, if possible.

When construction financing is obtained prior to permanent financing, the construction loan can be recourse if the permanent loan is nonrecourse. Any losses which could not be passed through during construction because of the recourse loan can be passed through when the permanent nonrecourse loan is closed, since that will increase the limited partners' basis. *See* Treas. Reg. § 1.704-1(d)(1), (4) (*Example* (2)) (1956). Since

The second tax danger for limited partnerships is the possibility of being classified as an "association" taxable as a corporation—the same problem as is faced by a business trust.[77] Most limited partnerships avoid "association" status unless the only general partner is a corporation, a straw man, or someone who has only a nominal interest in the partnership.[78]

B. *Nontax Comparison of Forms of Ownership*

Nontax considerations are often important in choosing the best form for real estate ownership. Dower is a potential problem in a proprietorship or a tenancy in common, but not in a partnership or a corporation.[79] Bankruptcy, death, or incompetency cause fewer title problems in a corporation or partnership than in a proprietorship or tenancy in common.[80]

Partial interests can be transferred more easily if title to real estate is in a corporation. Rather than preparing a deed to a fractional interest, the transferor simply assigns some of his stock to the transferee. The ease of transfer assumes greater importance if transfers will be made every year—to one's children, for example. A partnership may provide the same advantage as a

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1976, however, interest and property taxes during construction have had to be capitalized and then amortized over a statutory period of approximately 10 years for most property. *See* I.R.C. § 189. Thus, losses during construction may be small enough to be covered by the partners' actual contributions and, therefore, pass through to them immediately.

77. See notes 72 & 73 and accompanying text *supra*.

78. *See generally* Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159 (1976); Treas. Reg. § 301.7701-2 (1967); Rev. Rul. 79-106, 1979-1 C.B. 448; Rev. Proc. 74-17, 1974-1 C.B. 438; Rev. Proc. 72-13, 1972-1 C.B. 735. For a recent discussion of the problem of a partnership being classified as an "association," see Katz, *Service Agrees to Follow the Tests of Partnership Recognition as Stated in Larson,* 51 J. TAX. 12 (1979).

79. *See* S.C. CODE ANN. § 33-41-720(e) (1976).

80. When a proprietor or tenant in common dies, his real estate may pass to a minor, a trustee, or a large number of beneficiaries, possibly making the real estate more difficult to deal with. In addition, if the decedent's personal property is insufficient to pay debts, real estate can be subjected to claims of creditors. *Id.* § 21-15-920. When title is in a corporation or a partnership, on the other hand, the death or bankruptcy of a shareholder or partner does not affect ownership of the real estate, but only ownership of the stock or partnership interest. Even in a partnership, a creditor of a partner has no rights against the assets of the partnership, but can only require that the partnership distribute to him any distributions that would have been made to the debtor-partner. *See id.* § 33-41-750(1).

corporation,[81] but without the tax disadvantages.[82]

Centralized management can be an important feature of the corporate and limited partnership forms of ownership. These forms work well when some owners will run the business and others will be inactive. If all owners want participation in management, on the other hand, the limited partnership form would not be available, since limited partners cannot take part in control of the business without exposing themselves to personal liability as general partners.[83]

Potential liability to creditors can be a crucial consideration and may dictate the use of a corporation or limited partnership. Often, however, the importance of limited liability is exaggerated. Proper insurance protects against most tort liability. Personal liability to lenders is often unavoidable even in a corporation or limited partnership, since the lender may require personal guarantees.[84] A lender who is willing to lend to a corporation or limited partnership without personal guarantees would probably be equally willing to lend to an individual or general partnership on a nonrecourse basis.

In an "operating" business, potential liability to trade creditors may make incorporation imperative. The real estate used in the business (factory, office building, etc.) need not necessarily be transferred to the corporation, however. It may be preferable from a tax standpoint for the shareholders to own the real estate in their names or as a partnership and lease the property to the corporation.[85]

C. *Liquidation of Undesirable Corporation*

It has long been possible under Code section 333 to liquidate certain corporations with little or no tax liability. Liquidation under this provision works particularly well for a corporation that owns only real estate.[86] South Carolina tax law was

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81. See text accompanying note 51 *supra*.

82. See text accompanying notes 2-29 *supra*.

83. S.C. CODE ANN. § 33-43-80 (1976) provides: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."

84. See notes 75 & 76 and accompanying text *supra* for a discussion of the effect of personal liability on loans to limited partnerships.

85. See Subsection III.*B*. *infra*.

86. See text accompanying notes 88-92 *infra*.

amended in May, 1980 to permit the same result.[87]

Under the federal law, such a liquidation is tax-free to electing shareholders, except that their gain is taxed as an ordinary income dividend to the extent of the corporation's accumulated earnings and profits.[88] If the shareholders receive cash or securities acquired by the corporation after 1953, their remaining gain is taxed as capital gain to the extent such cash and securities exceed earnings and profits.[89] When, however, the corporation has no earnings or profits and holds no cash or securities, the liquidation is completely tax-free.[90] The shareholders, having been spared the usual tax on liquidation, are *not* entitled to a stepped-up basis for the assets.[91] Instead, their basis will equal their basis in their stock before liquidation, plus any liabilities that they assume or take subject to, plus any gain recognized to them, minus any cash received by them.[92]

The new South Carolina law provides the same results, with a few important exceptions. First, it applies equally to all shareholders, including corporations.[93] Second, no shareholder vote is

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87. 1980 S.C. Acts 1307 No. ___ (to be codified at S.C. CODE ANN. § 12-7-970(2)).

88. *See* I.R.C. § 333(a), (e). Shareholders are divided into three classes: shareholders other than corporations get § 333 treatment if at least 80% of their voting stock so elects; corporations, other than corporations owning 50% or more of the voting stock of the liquidating corporation, must similarly elect such treatment by 80% or more vote; any corporation owning 50% or more of the voting power is excluded from § 333 treatment. *Id.* § 333(b), (c). The corporations in the second group, if they so elect by 80% or more vote, are not taxed on their share of earnings and profits as a dividend (which would be 85% deductible by them under I.R.C. § 243), but as a capital gain. *Id.* § 333(f).

89. *See id.* § 333(e)(2), (f)(1).

90. Depreciation recapture and certain other problems may prevent this tax-free liquidation, however. *See* note 12 *supra*. These items may create taxable income at the corporate level, thereby increasing corporate earnings and profits which are taxed to the shareholders as ordinary income under § 333. I.R.C. § 333.

Furthermore, if the shareholders sell the assets shortly after the liquidation, their sale may be attributed back to the corporation under the doctrine announced in Commissioner v. Court Holding Co., 324 U.S. 331 (1945). The result would be disastrous. Gain on the sale would be attributed to the corporation. Section 337 would not protect the corporation since that section does not apply when the shareholders elect § 333 treatment. *See* I.R.C. § 337(c)(1)(B). This gain increases the corporation's earnings and profits, on which the shareholders pay ordinary income tax upon liquidation. For a case in which this was the result, see Cohen v. Commissioner, 63 T.C. 527 (1975), *aff'd*, (3d Cir. 1976). One final caveat: Section 333 does not apply to collapsible corporations. I.R.C. § 333(a).

91. *See* I.R.C. § 334(c); Treas. Reg. § 1.334-2 (1955).

92. *See* note 91 *supra*.

93. *See* 1980 S.C. Acts 1307 No. _ (to be codified at S.C. CODE ANN. § 12-7-970(2)(b)).

necessary for one shareholder to elect the statutory treatment.[94] Third, only securities acquired by the corporation after 1979 (the year before the state law was enacted), rather than 1953 (the year before the federal law was enacted), cause recognition of gain to the shareholders.[95] Fourth, though the new state statute does not address the shareholders' holding period for assets distributed by the corporation, the general state rule is that after an exchange a fresh holding period begins,[96] whereas federal law allows a shareholder to "tack" his holding period for his stock onto his holding period for the assets.[97]

The South Carolina law may also provide a different basis rule when post-1979 securities are distributed. Under federal law such securities do not affect the shareholders' basis in the assets they receive from the corporation,[98] except by causing recognition of gain[99] (which increases their basis).[100] The new South Carolina law, however, provides that the shareholders' basis is reduced, not only by cash received, as under federal law, but also by post-1979 securities.[101]

Taken literally, this provision could result in a lower basis for the assets received by the shareholders under South Carolina law than under the federal law after which it was patterned; moreover, upon sale of the assets, double taxation could result.[102] The probable purpose of the South Carolina provision is

94. *Id.*

95. *See id.* (to be codified at S.C. CODE ANN. § 12-7-970(2)(a)).

96. S.C. Tax Comm'n., S.C. CODE ANN. (R. & REG.) 117-87.45(D) (Cum. Supp. 1979).

97. *See* I.R.C. § 1223(1).

98. *See* note 89 and accompanying text *supra.*

99. *See* notes 91 & 92 and accompanying text *supra.*

100. *See* notes 91 & 92 and accompanying text *supra.*

101. *See* 1980 S.C. Acts 1307 No. _ (to be codified at S.C. CODE ANN. § 12-7-970(2)(c)).

102. For example, assume a corporation owns land worth $100 and post-1979 securities worth $50 and has $20 in earnings and profits. Its sole shareholder has a basis of $10 in his stock, so that upon liquidation he realizes a gain of $140 (assets received worth $150, less $10 basis). Under both federal and South Carolina law, he is taxed, if he so elects on the $20 of earnings and profits as ordinary income and $30 of the securities' value as a capital gain ($50 value of securities, less $20 earnings and profits already taxed).

His federal basis for the assets received (land and securities) is $60 ($10 basis in his securities, plus $50 gain recognized). This amount is allocated between the land and the securities according to their relative fair market values—$20 to the securities, $40 to the land. *See* Treas. Reg. § 1.334-2 (1955). If the shareholder ultimately sells the securities and the land for $150 (their value at the time of liquidation), his gain will be $90 ($150

to provide a basis for post-1979 securities equal to their fair market value and to allocate the remaining basis, reduced by the value of the securities, to the other assets.[103] Normally, this would yield a proper result, though the shareholders' basis would be allocated among the assets differently for South Carolina and federal purposes.

The South Carolina statute, like its federal counterpart, does not mention the basis effect of liabilities that the shareholders take subject to or assume. The general principle that such liabilities increase basis was applied to section 333 liquidations by an Internal Revenue Service ruling[104] and was thereafter incorporated into the federal tax regulations.[105] Presumably,

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less new $60 basis). This $90 deferred gain, combined with his $50 gain recognized on liquidation, will equal his $140 overall gain realized on the liquidation ($150 value received, less $10 basis in stock), which is the "correct" tax result.

His South Carolina basis in the assets received should lead to the same "correct" result. The statute provides, however, for a further reduction in his basis in the assets received, by the amount of the value of the post-1979 securities. In the above example, his South Carolina basis might, under the statute, be thought to decrease from $60 to $10. Upon later sale of the assets for $150, his deferred gain would be $140, which is his full economic gain, despite immediate taxation on $50 at the time of liquidation. This "wrong" result could not have been intended. The purpose of the federal basis provisions, and presumably of the South Carolina version thereof, is to defer taxation of that portion of the shareholder's gain which he does not "cash in" at the time of liquidation; the purpose is not to tax him doubly. See B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 11.20-.22. The "correct" result can easily be reached under the South Carolina law. See note 103 and accompanying text *infra*.

103. In the example in note 102 *supra*, the securities should take a basis of $50 (their fair market value), and the entire $10 basis provided by the statutory formula should become the basis of the land. The total basis would be $60, as under federal law. A $50 basis in the securities may even make more sense than the federal rule of allocating $60 of basis between securities and land, because the securities are responsible for recognition of gain on the liquidation and can, therefore, be considered "cashed in" by the shareholder. The purpose of requiring recognition of income by a shareholder on receipt of securities acquired after a certain date is to prevent a corporation that has cash from investing in marketable securities just before liquidation to avoid distribution of cash to the shareholders, which would cause recognition of income. In the absence of that rule, the shareholder could thereafter "cash in" by selling the securities and recognizing a smaller gain. See B. BITTKER & J. EUSTICE, *supra* note 3, ¶ 11.21. Because the law plugs this loophole by having securities cause recognition of income, making securities similar to cash, it would make sense to give the securities a basis equal to fair market value. If they are later sold, the seller should not be taxed again. He would not be "cashing in" any further, since he was taxed on liquidation as though he had already "cashed in."

104. Rev. Rul. 95, 1953-1 C.B. 162.

105. Treas. Reg. § 1.334-2 (1955).

the same principle would apply under the South Carolina statute.

III. Specific Applications

A. *Investment in Rental Property*

An investment in rental real estate, such as an apartment building, shopping center, or office complex, never should be made in corporate form without a sound reason for doing so. Rental property, more than any other type of real property, suffers from corporate tax drawbacks, including the following:

1. Tax losses often occur in the early years of the investment. They will pass through to individual investors in a partnership, but not to shareholders in a corporation.
2. Tax-sheltered cash flow will pass through a partnership, but may be converted to taxable income if a corporation is used.[106]
3. Taxable income may be subjected to two levels of taxation if a corporation is used.[107]
4. Future sale of the property by a partnership, tenancy in common, or proprietorship results in a single taxable gain. Forming a corporation may cause several problems, including two levels of taxation.[108]
5. Proceeds of refinancing may be taxed when distributed to the shareholders.[109]
6. The death of an owner or the sale of a part interest permits an increase in basis if the property is held by a partnership, tenancy in common, or proprietorship, but not a corporation.[110]
7. Under present law, Subchapter S is rarely available for investment in rental property, because rental income normally would exceed twenty percent of the corporation's gross receipts.[111] If the law is changed to remove the twenty percent limit,[112] a Subchapter S corporation would eliminate the third

106. See note 4 and accompanying text *supra*.
107. See text preceding and accompanying note 2 *supra*.
108. See note 4 and accompanying text *supra*.
109. See note 7 and accompanying text *supra*.
110. See notes 25-29 and accompanying text *supra*.
111. See text accompanying notes 58 & 59 *supra*.
112. For proposed changes, see text accompanying note 60 *supra*.

and fourth tax drawbacks above, but probably not the others.[113]

B. Use of Real Property by Operating Business

Operating businesses include manufacturing businesses, mercantile or sales businesses, and personal service businesses such as insurance agencies, law firms, and medical practices. When such a business is incorporated, the owners sometimes transfer to the corporation the factory, store, office building, or other real estate used in the business, or if new real estate is purchased for the business, they may purchase it in the corporation's name. In doing so, the owners miss an opportunity for valuable tax planning. They should consider retaining or purchasing the real estate in their own names and leasing it to the corporation. When there are several owners, they may want to form a partnership to hold title to the real estate, insulate it from creditors of an individual partner, and protect it from title problems at the death of an individual owner[114] by having a buy-sell agreement among the partners.

1. Tax Advantages of Leasing.—Any tax shelter from the property may benefit the shareholders more than the corporation, especially in the early years of the business when the corporation may have little or no income. Leasing also permits earnings to be withdrawn from the corporation through deductible lease payments, rather than nondeductible dividends, thereby minimizing double taxation by reducing the corporate tax. In later years, the owners may want to recover part of their investment in the business by selling the building to a third party and then leasing it back. If the corporation owns the building there will be a tax on the corporation's gain on the sale of the building and a second tax if the sale proceeds are distributed to the shareholders as dividends. By contrast, only one tax would be paid if the shareholders themselves own the building and sell it (subject to the corporation's lease). Finally, if an existing business is incorporated and a building is transferred to the corporation, accelerated depreciation can no longer be used because the corporation would not be the "original user."[115]

113. See notes 55-70 and accompanying text *supra.*

114. *See generally* note 80 *supra.*

115. *See generally* text accompanying notes 44-47 *supra.*

2. *Possible Tax Disadvantages of Leasing.*—When the owner of a closely held business dies, relief provisions may permit payment of estate taxes over a period of years[116] and redemption of some of his stock in the business with favorable income tax treatment.[117] These provisions are available only if the value of the decedent's stock represents a certain percentage of his estate.[118] Contributing the real estate to the corporation may increase the stock's value and allow use of these provisions.

If an existing business is incorporated, any investment credit taken in the preceding seven years may be recaptured if the investment credit property is transferred to the corporation. Recapture can be avoided only by transferring to the corporation substantially all the other assets needed in the business,[119] often including real estate.[120] The solution may be to lease both the real estate and the investment credit property to the corporation.[121]

A proposed change in the federal tax law would allow faster depreciation for certain types of buildings if owned by the person who actually occupies the building.[121.1] This change, if enacted, could sometimes tip the scales against leasing and in favor

116. *See* I.R.C. §§ 6166, 6166A.

117. *See id.* § 303.

118. *See id.* §§ 303(b)(2), 6166(a), 6166A(a).

119. *See* Treas. Reg. § 1.47-3(f)(1)(ii)(c) (1967).

120. Rev. Rul. 76-514, 1976-2 C.B. 11. If, however, only part of a building is used in the business and the rest is leased to third parties, the building itself may be considered a separate business, so that the portion used in the first business does not have to be transferred to the corporation. *See* Private Letter Ruling 8016047 (Jan. 22, 1980).

121. *See* Treas. Reg. § 1.47-2(b)(1) (1967). But investment credit property purchased after incorporation should not be owned by the shareholders and leased to the corporation without attention to I.R.C. § 46(e)(3) (depriving a noncorporate lessor of the investment credit unless certain tests are satisfied).

121.1 H.R. 5829, 96th Cong., 2d Sess. (1980)(the "Tax Reduction Bill of 1980"), as revised and reported by the Senate Finance Committee on September 15, 1980, would allow depreciation of any building, regardless of ownership, over a 20-year period using the straight-line method and composite depreciation (not component depreciation—see text preceding and accompanying note 47 *supra*). Even faster depreciation—over a 15-year life using the 150% declining balance method—could be elected if 80% or more of the building is used *by the owner* as an industrial building, a retail store, or catalog distribution center. Property occupied by a corporation but owned by its shareholders would not qualify. If the 15-year method is elected, all depreciation would be subject to "recapture" upon sale of the property, *i.e.*, any gain on the sale would be treated as ordinary income rather than capital gain, to the extent of past depreciation. H.R. 5829, 96th Cong., 2d Sess. § 245 (1980); I.R.C. § 167(r) (proposed); S. REP. No. 940, 96th Cong., 2d Sess. 62-69 (1980).

of corporate ownership.

3. Possible Advantages Under Subchapter S.—A Subchapter S election may be advisable, particularly for a new business expecting start-up losses. Losses can pass through the corporation to the shareholders to offset their other income. Because South Carolina has no Subchapter S equivalent, however, losses will not pass through for state tax purposes. Even when Subchapter S is used, transfer of real estate to the corporation may be unwise because depreciation may increase the corporation's losses beyond the amount that can pass through to the shareholders, which is limited to their investment in the corporation.[122]

4. Nontax Advantages of Leasing.—Keeping real estate in the shareholder's hands and leasing it to the corporation may yield nontax advantages that are more important than the tax advantages. First, the real estate may be protected from creditors of the business. Of course, the corporation's lenders may require a mortgage on shareholder-owned real estate, but the real estate normally would be protected from other creditors.

Second, holding the real estate outside the corporation keeps the value of the corporate stock low. The business could then be sold more easily to a third party who can afford to buy only the stock and must continue leasing the real estate. Similarly, stock can be sold for a more reasonable price to key employees, such as a new doctor or lawyer entering a professional association, or repurchased from an employee leaving the business. Estate planning also may be facilitated, because stock can be given to children at a lower valuation to remove future appreciation from the donor-parent's estate. Because the value per share will be less, a greater percentage of the stock can be given under the $3000 annual gift tax exclusion[123] or the unified credit against gift taxes.[124] Finally, a buy-sell agreement among the shareholders is less burdensome if large capital items such as real estate are kept outside the corporation. For example, a deceased shareholder's stock can be purchased by the surviving shareholders, but his interest in the real estate (or in a partnership owning the real estate) can pass to his family, subject to the

122. *See generally* text accompanying notes 63-69 *supra*.
123. *See* I.R.C. § 2503(b).
124. *See id.* § 2505.

corporation's lease.

The separation of major capital items, such as real estate, from the corporation that operates the business can help solve the common problem faced by a sole shareholder who would like to leave the business to one child, but who needs to provide financial security to his widow or other children. The corporate stock can be left to the one child to give him control and the benefit of future growth due to his own efforts, while the real estate, still subject to the corporation's lease, can be left to the other family members to provide income. Or, if the parent's will gives one child an option to purchase the stock, the child can better afford the purchase if the real estate is outside the corporation.

5. *Summary.*—Keeping real estate outside a corporation that conducts an operating business can yield tax benefits to the shareholders and flexibility in handling future events, such as the admission of a new shareholder, the death of a shareholder, or the sale of the business.

C. *Real Estate Used as a Motel or Hotel*

A motel is sometimes considered a real estate investment rather than an operating business. When a motel is leased to a third-party operator, the owner is similar to a pure investor, and the principles in subsection III.*A.* (investment rental property) apply, suggesting that the property should be owned by an individual or a partnership rather than a corporation. When the owner also operates the motel, however, the principles in subsection III.*B.* (operating businesses) are more applicable. If the owner wants to incorporate to avoid personal liability, then as in other operating businesses, leasing the real estate to the corporation may be best. Since real estate is a dominant aspect of the motel business, depreciation and tax shelter will be very important. Keeping these tax benefits in the shareholders' individual returns rather than the corporate return usually is preferable.[125]

A Subchapter S election often is advisable if a corporation is used. The twenty-percent limit on rental income does not apply to room rents.[126] Even in a Subchapter S corporation, how-

125. See text accompanying note 5 *supra.*
126. See note 59 *supra.*

ever, the limitation on the pass-through of losses and tax-sheltered cash flow can prevent the effective use of tax shelter if the real estate is transferred to the corporation.[127]

As in other operating businesses, the separation of the major capital item from the operating side of the business provides flexibility if the shareholders want to sell part or all of their interest in the operation, buy out a deceased shareholder, or divide the ownership of the real estate and the operation of the motel among family members at death.

D. *Raw Land Held for Speculation*

From a tax standpoint, raw land usually should not be put in a corporation. The owners will want to deduct the property taxes and interest[128] on any purchase money mortgage, but these deductions will not pass through to shareholders of a corporation. If a corporation is used, the double tax on a later sale of the property may cause a problem, particularly if an installment sale is desired or if only a portion of the property is sold.[129] If any of the land is ever ground leased or developed as rental property, corporate ownership could be a tax disaster.[130] Since the owners can always incorporate later, if needed, it is best to retain flexibility by not incorporating at the outset.

E. *Raw Land to be Subdivided*

Subdivision land is usually put in a corporation for several reasons. First, centralized management may be important if there are investors who do not take part in day-to-day decision-making. Second, limited liability can be essential. Lenders often require the shareholders' personal guarantees, but if the developer builds houses on his lots, avoiding liability to suppliers, subcontractors, and purchasers can be an important benefit of incorporation. A good *tax* reason for incorporating a subdivision is to avoid the individual shareholder's being classified as dealers in real estate.[131]

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127. See text accompanying notes 64-69 *supra*.

128. Interest on raw land investment may be subject to the I.R.C. § 163(d) limitation on deduction of investment interest.

129. See notes 8-11 and accompanying text *supra*.

130. See subsection III.*A. supra*.

131. See text accompanying notes 41-43 *supra*.

A Subchapter S corporation is frequently used for subdivisions to avoid two levels of federal taxation, and may be particularly advantageous if there will be losses in the early years that can pass through to the shareholders. If the shareholders are in high tax brackets, taxes may be saved by terminating the Subchapter S election when the subdivision becomes profitable so that the corporation, rather than the individual shareholders, pays taxes on the income at the relatively low corporate rates.[132] This income frequently must be retained and reinvested for further development of the subdivision. When all subdivision lots have been sold, the corporation can be dissolved and the shareholders will pay only capital gain taxes on the liquidating distributions.[133]

1. At What Point Should the Land Be Put in the Corporation?—Taking title in the corporation immediately can be a mistake because flexibility is lost. For example, if part of the land is sold later for commercial use, it is difficult for the corporation, tainted as a "dealer," to get capital gain treatment.[134] Anticipating this possibility, developers often carve out potential commercial sites before transferring subdivision land to their corporations, but conditions may change and other parts of the land may ripen into commercial sites.[135]

A similar problem arises, with possibly worse consequences, if some of the subdivision land is developed by the owner as rental property, such as an apartment complex, which should not be held in a corporation.[136] In one real-life example, a developer took title to a 300-acre tract of land in his wholly owned corporation, developed most of it as a subdivision over fifteen years, and then found that some of the remaining acreage had become suitable for apartments. The corporate ownership of the land caused serious tax problems.[137]

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132. See text accompanying notes 30 & 31 *supra*.

133. Caveat: If liquidation occurs before all the lots are sold, the corporation may be "collapsible" under I.R.C. § 341, possibly resulting in ordinary income to the shareholders.

134. See note 43 and accompanying text *supra*.

135. See note 29 *supra*.

136. See subsection III.*A*. *supra*.

137. To solve the problem the corporation could have leased the land to the shareholder for development of the apartments and later distributed the land to him as a dividend in a year in which tax losses permitted him to absorb a large dividend—not a possibility in most cases.

Generally, therefore, title to raw land should be kept out of a corporation, and instead should be put in individual or partnership name, until the land is ready for development. The land can later be transferred to the corporation in stages, as needed. In the above example, the 300-acre tract could have been transferred to the corporation in 75- or 100-acre increments, and before the last transfer the developer could more easily have foreseen the possible apartment development and kept that land out of the corporation. This is another example of retaining flexibility by holding land in individual or partnership name.

2. *Should the Land Be Contributed or Sold to the Corporation?*—If land has been held in individual or partnership name until ready for subdivision development, the opportunity to sell, rather than contribute, the land to the corporation should not be overlooked. If the land has been held for more than twelve months before being sold to the corporation, the individual may get long-term capital gain treatment on any appreciation in the land since its acquisition. Obtaining this capital gain treatment is desirable because the corporation's profit from the sale of lots will be taxed as ordinary income.

For example, suppose the individual originally purchased the land for $100,000 and it has appreciated to $150,000. The property can be developed at an additional cost of $100,000 (for roads and utilities) and sold as lots for a total of $325,000. There is a potential profit of $125,000 ($325,000 minus land cost of $100,000 and improvements cost of $100,000). If the land is *contributed* to the corporation, this entire profit will be ordinary income to the corporation,[138] since the individual's $100,000 ba-

138. The federal tax at the corporate level can be avoided by a Subchapter S election, *see* I.R.C. § 1372(a), but the income passing through to the shareholder will be ordinary income. *See id.* § 1373(b). Outside Subchapter S the corporate level tax can be reduced by payment of salaries. Substantial salaries would be reasonable and, therefore, deductible in an active subdivision business requiring considerable personal effort. *See* note 2 *supra*. However, when appreciated property has been contributed rather than sold to the corporation, salaries equal to the entire profit may be difficult to justify, since some of the profit would represent capital appreciation rather than personal effort.

Even reasonable salaries, or the portion thereof allocable to development of subdivision lots, may have to be capitalized and added to the basis of the lots under Commissioner v. Idaho Power Co., 418 U.S. 1 (1974), which held that a utility company constructing its own capital facilities could not deduct depreciation on its construction equipment, but had to capitalize the depreciation as part of the cost of the capital facility. Wages of construction employees were treated the same, and not disputed by the taxpayer. *Id.* at 13.

sis in the land becomes the corporation's basis.[139] On the other hand, if the shareholder *sells* the land to the corporation for $150,000 (its current value), he will have a capital gain of $50,000, and the corporation's profit will be only $75,000 since its tax basis for the land will be its $150,000 cost. Thus, the $50,000 in appreciation will be taxed as capital gain rather than ordinary income. This tax result is not a gimmick but is perfectly legitimate because the $50,000 gain resulted from the appreciation of the individual's capital investment rather than the corporation's "dealer" activity in developing and selling the lots.[140] Even more appreciation can be taxed as capital gain, rather than ordinary income, if the land is sold to the corporation in stages, since the later stages will usually continue to appreciate before they are sold.

Of course, the individual would not want to pay tax on his entire capital gain in the year of sale unless he receives payment in full from the corporation. If the corporation does not have the funds to pay for the land immediately, the sale can be made on the installment basis, with the corporation's payments scheduled to match its anticipated lot sales. The formalities of an arms-length sale should be observed to avoid the installment note's being classified as a "security" for tax purposes and the sale's being recharacterized as a contribution to capital.[141]

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139. *See* I.R.C. § 362(b).

140. Turner v. Commissioner, 540 F.2d 1249 (4th Cir. 1976); Gordy v. Commmissioner, 36 T.C. 855 (1961) (acq. at 1964-1 C.B. (part 1) 4). Sometimes, however, the courts may resist this technique, especially if the individual is active in real estate in his own name. *See, e.g.*, Burgher v. Campbell, 244 F.2d 863 (5th Cir. 1957).

141. *See* Burr Oaks Corp. v. Commissioner, 365 F.2d 24 (7th Cir. 1966), *cert. denied*, 385 U.S. 1007 (1967). For a general discussion of the principles in this area, see B. Bittker & J. Eustice, *supra* note 3, ¶¶ 3.15, 4.04. The purchase money note should be in writing, should bear reasonable interest, and should have a fixed maturity date (as short-term as possible and no more than five or six years). The debt should not be subordinated to lenders or general creditors. Payment should be made scrupulously whether or not the corporation's sale of lots generates sufficient funds. The corporation should have, if possible, substantial financial resources of its own in order to avoid "thin capitalization," *i.e.*, the entire purchase price of the land should not be financed by the selling shareholder. One possibility is purchase by an existing corporation that already is in the development business and has funds remaining from an earlier project. If a newly formed or thinly capitalized corporation is used, the shareholder might consider contributing, rather than selling, the land for the first stage of the subdivision and then selling the land in later stages when the corporation is financially stronger due to sales of lots in the first stage.

The Treasury Department has recently proposed detailed rules on the question

The Internal Revenue Service has been aggressive in attacking sales of subdivision land by individuals to their corporations, especially when the individuals were greedy. It is risky to sell the land at an inflated value in an attempt to take capital gain on all the potential income, rather than just the true appreciation in the land.[142] Obtaining an independent appraisal of the land to substantiate the sale price is advisable.

The Internal Revenue Service may also attack an individual's capital gain on a sale to his corporation if the individual appears to hold the land for the purpose of sale rather than investment.[143] The individual should minimize sales of other real estate held in his own name, particularly any subdivision development of other land in his name. He should hold the land in question as long as possible before selling to the corporation.[144] He should carefully avoid any development activity in connection with any portion of the land before that portion is sold to the corporation. For example, obtaining zoning, platting the subdivision, or cutting roads are activities that would probably taint the land as dealer property in his hands, resulting in ordinary income when the land is sold to his corporation.[145]

The individual should also avoid frequent, repeated sales of

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when corporate debt to shareholders is to be treated as equity for tax purposes. Treas. Reg. §§ 1.385-1 to -12 (1980)(proposed). If adopted, these rules would establish certain "safe harbors" in this previously subjective area and would eliminate the past all-or-nothing dispute between taxpayers and the I.R.S. by classifying borderline instruments as debt with original issue discount which, as the debt is paid off, creates additional ordinary income to the shareholder-creditor under I.R.C. § 1232. See Treas. Reg. § 1.385-3(a) (1980)(proposed).

142. The Internal Revenue Service may try to reallocate the individual's capital gain income to the corporation as ordinary income under I.R.C. § 482. Alternatively, the corporation may be treated as the agent of the individual, and all its income treated as belonging to the individual. Boyer v. Commissioner, 58 T.C. 316 (1972).

143. I.R.C. § 1221(1). For a thorough discussion of this problem for an individual making sales to his development corporation, see Turner v. Commissioner, 540 F.2d 1249 (4th Cir. 1976).

144. The length of time that the property is held by the individual is one indication of his intent to hold it for investment rather than for sale. *See, e.g.*, Burgher v. Campbell, 244 F.2d 863 (5th Cir. 1957).

145. Brown v. Commissioner, 448 F.2d 514 (10th Cir. 1971); Browne v. United States, 356 F.2d 546 (Ct. Cl. 1966); Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966). No development work on the first portion transferred to the corporation should "spill over" to the reserved portions. If possible, the street layout in the first portion should appear to be well-planned even if the reserved portions are never transferred. Also, the division of the land should follow boundaries that would support the purported business reasons for the division.

small parcels to the corporation; otherwise, the corporation may be treated as his agent, resulting in all its ordinary income and its dealer taint being attributed to him individually.[146] This possibility makes somewhat more risky the transfer of the land to the corporation in stages in order to retain flexibility for the later stages and to have further appreciation in the later stages taxed as capital gain. If a 150-acre tract is involved, for example, it should not be sold to the corporation in parcels of a few acres every few months, but a sale of about 50 acres every three or four years should usually reduce the risk to an acceptable level. Having some business reason for separating the entire tract into stages would be helpful, such as uncertainty concerning whether the reserve stages will be subdivided or used for some other purpose.[147]

The proposed changes in the installment sale rules[148] could present a problem for an individual making an installment sale of land to a "related person," including a sale to a corporation in which he owns fifty percent or more of the stock.[149] Under the proposed rules, if the corporation resells the property within two years for a price greater than the amount of the installments actually paid to the individual by the end of the year, the individual would have to accelerate the installment reporting of his capital gain, so as to report at least as much as the corporation receives.[150]

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146. *See, e.g.,* Turner v. Commissioner, 540 F.2d 1249 (4th Cir. 1976); Broughton v. Commissioner, 333 F.2d 492 (6th Cir. 1964); Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966).

147. See note 145 *supra.*

148. See notes 15 & 17 *supra.*

149. I.R.C. §§ 453(e)(1)(A), 453(f)(1) (proposed), *supra* note 15.

150. For example, suppose an individual purchases land for $50,000 and on January 1, 1981, sells it to his wholly owned corporation for $100,000, its fair market value at that time. The terms of the sale are $20,000 down and $20,000 each January 1 for four years. The individual reports his sale on the installment method and, therefore, includes half (the profit half) of each year's $20,000 payment in his income for that year. See *id.* § 453(a)(1); *id.* § 453(a), (c)(proposed), *supra* note 15. Suppose the corporation's only sale during 1981 and 1982 is a bulk sale of part of the land in 1982 for $65,000. The corporation has paid the individual $40,000 (down payment and 1982 installment). Because the $65,000 realized by the corporation is more than the $40,000 it has paid the individual (by the end of his taxable year, see I.R.C. § 453(e)(3)(B)(i) (proposed), *supra* note 15) the individual has to report additional installment receipts of $25,000 (half of which is income) even though he actually receives nothing more from the corporation. Of course, when the corporation makes the next $20,000 payment and $5,000 of the following payment to the individual, he would not have to treat any of it as income, since he was taxed

The purpose of this rule is to prevent installment reporting on a sale to a related person who realizes all the appreciation in value by reselling the property.[151] The legislation has been drafted with a single resale in mind, rather than continuing resales of portions of the property, such as subdivision lots.[152] It is unclear, therefore, whether the sale of a small portion within two years satisfies the resale-within-two-years requirement[153] for all future resales as well as for the resale that occurs within two years. Such a strained interpretation would go beyond the apparent purpose of the proposed statute.[154] If the related person realizes only part of the property's value within two years, there

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earlier as though he had received it. *See id.* § 453(e)(5).

The I.R.S. possibly could take the position that, since the corporation did not dispose of "the property," *see id.* § 453(e)(1)(B), in its entirety, only part of the $40,000 actually received by the individual can be offset against the $65,000 received by the corporation, on the theory that only part of the $40,000 was for the property resold by the corporation. The result of this approach would be acceleration of even more of the individual's income. This position has little or no support in the statute or the House Report, see note 151 *infra*, and ought not to prevail, unless the individual has engaged in the kind of tax avoidance that gave rise to the proposed statute. See note 154 *infra*. Two examples of tax avoidance in the context of the foregoing example are the following: (1) The individual arranged the resale before making his installment sale to the corporation. (2) The individual owned two separate, unrelated tracts which had a combined value of $100,000 and which he planned to sell to the corporation on the installment basis. He knew that a resale of either tract by the corporation would cause acceleration of his gain unless the corporation could offset its prior payments to him on both tracts. He transferred both tracts to the corporation by the same deed in return for a combined installment note, hoping thereby to make them one "property."

151. HOUSE WAYS AND MEANS COMM., 96TH CONG., 2D SESS., REPORT ON INSTALLMENT SALES REVISION ACT OF 1980 part II., F. (Comm. Print 1980) [herein cited as HOUSE REPORT]. See notes 15-17 and accompanying text *supra* for a discussion of these proposed rules in the corporate liquidation area.

152. *See* I.R.C. § 453(e)(1)(B)(proposed), *supra* note 15: "[T]he related person disposes of *the property* . . . ." *Id.* § 453(e)(2)(A) (proposed): *"[T]he second disposition* is not more than 2 years after the date of the first disposition." However, proposed § 453(e)(3) limits acceleration of the individual's (the original seller's) gain during any taxable year to the amount realized on "*any* second disposition . . . before the close of the taxable year" (with other adjustments). *Id.* § 453(e)(3) (proposed). This provision could contemplate acceleration of gain after the individual's taxable year in which falls the second anniversary of his sale to the corporation or simply could state the rule for each taxable year up to and including that second anniversary year.

153. See note 152 *supra*.

154. See note 151 and accompanying text *supra*. HOUSE REPORT, *supra* note 151, part II., F. ("Present Law"), describes the evil to be remedied as deferral of taxation even though cash proceeds from the property are received by the related person "shortly after making the initial purchase." *Id.* Also, "all appreciation has been realized" even though the tax "may be deferred for a long period of time." *Id.* The target of the proposed change seems to be a *quick* resale of *all*, or at least a large part, of the property.

is no reason to extend that period for the remaining property.

Also unclear is whether improvements made to the property by the corporation would increase the amount it could realize on resale without causing acceleration of installment gain to the individual. The corporation should be able to recover, as a minimum, its investment in improvements, such as streets, utilities, and houses, as well as the payments actually made to the individual, without causing acceleration of his installment gain. Theoretically, the corporation also should be able to recover other expenses, such as operating overhead, which have not been capitalized as part of its cost of land and improvements, but which are necessary in developing lots and promoting their sale at as high a price as possible. Perhaps the corporation also should be able to make a reasonable profit on its investment. The uncertainty on these questions stems from the proposed statute's failure to address the situation of a "related person" who develops and improves the property and actively promotes sales. If the Internal Revenue Service is satisfied that tax avoidance is not one of the taxpayer's principal purposes, no acceleration of installment gain is required.[155]

Perhaps regulations under this provision or under the proposed statute's specific grant of regulation authority[156] will address the typical subdivision fact situation. The taxpayer's usual tax goal in selling individually owned land to a development corporation is to obtain capital gain on appreciation occurring before development starts.[157] The additional tax benefit of an installment sale usually is incidental to the corporation's practical business need to pay for the land in installments. The individual's installment sale, therefore, is made for a nontax reason, rather than for "unwarranted tax avoidance" of the sort that inspired the proposed statute.[158] A subdivision development corporation ordinarily is not used to make a fast, "turn-around" re-

155. *See* I.R.C. § 453(e)(7)(proposed), *supra* note 15. Examples of such situations are the following: (1) involuntary dispositions of the property by the "related person," such as a condemnation; (2) dispositions that are tax-free transfers, such as a gift or a transfer to a partnership, and (3) dispositions by the "related person" on the installment basis unless the "related person" receives installments faster than he makes payments to the original owner.

156. I.R.C. § 453(i)(proposed), *supra* note 15.

157. See text accompanying notes 138-40 *supra*.

158. HOUSE REPORT, *supra* note 151, part II ("Reasons for Change").

sale of an asset that is easily marketable or an asset whose resale has been prearranged, which is the tax avoidance that the proposed statute is intended to prohibit.[159] If the proposed statute is enacted, the Regulations and the Internal Revenue Service, in administering the statute, should recognize these facts.

F. Conversion of Apartment Building to Condominiums

The conversion of apartments to condominiums is becoming increasingly popular. For the investor who has owned apartments for some years, the tax considerations are similar to those of the subdivision developer in subsection III.*E.* His objective will be to sell the apartments to a controlled corporation to obtain capital gain on the difference between their value and his tax basis (which may be quite low because of depreciation) and to limit the ordinary income to the corporation's profit on conversion and sale of the units. He should be even more careful than the subdivision developer to transfer the apartments to the corporation in stages, because the sales could go slowly and he would have to retain the apartments for sometime as rental property, which should not be held long in a corporation.[160]

One major difference between selling apartments and selling raw land is found in Code section 1239, which converts capital gain to ordinary income if an individual sells *depreciable* property[161] to a corporation, eighty percent or more of which is

159. See notes 150 & 154 *supra.*

160. The individual who transfers the apartments in stages must not have the corporation as his agent. See note 146 and accompanying text *supra.*

161. For § 1239 to apply, the property has to be "in the hands of the transferee, and of a character which is subject to" depreciation. I.R.C. § 1239(a). Once apartment buildings have been converted to condominiums and offered for sale, their depreciability may be unclear. The taxpayer could take the position that the condominiums are no longer "used in the trade or business" (of renting apartments), as required by I.R.C. § 167(a)(1) for depreciation, but instead constitute inventory or stock in trade, which are not depreciable. Treas. Reg. § 1.167(a)-2 (1956). There are two facts, however, that may allow depreciation in the usual situation and thereby make § 1239 applicable. First, at the time the property is transferred to the corporation, the property usually would not have been converted to condominiums, because that step is normally taken by the developer. (Indeed, if the individual owner takes that step before selling the property to a corporation, he may be taxed on his profit as ordinary income, on the theory that he held the condominiums for sale. See note 145 and accompanying text *supra.*). Second, even after conversion, the corporation frequently will be forced to rent units until they can be sold. Depreciation may be proper during the rental period. *See* Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737 (1954), *acq.* 1954-2 C.B. 3, *aff'd on other grounds,* 230

owned by him or certain related persons.[162] It may be necessary to have an unrelated shareholder own more than twenty percent of the stock—perhaps a professional converter who has experience and expertise and who will be responsible for the work involved in the conversion.[163]

The proposed changes in the installment sale rules[164] would bar installment tax treatment for any individual selling depreciable property[165] to a corporation, eighty percent or more of which is owned by him or certain related persons.[166] If these changes are enacted, a seller seeking to report his gain over a period of years would either have to give up more than twenty percent of the stock or make the sale in stages, but without installment treatment.[167]

IV. Conclusion

The lawyer advising a client who is purchasing or developing real estate should be aware of the varying tax consequences of holding title in different entities. The question of tax planning should be raised at an early stage. Even if title eventually will be transferred to a corporation, it is often wise to retain flexibility by keeping title outside the corporation for as long as possible.

F.2d 555 (5th Cir. 1956), *cert. denied,* 352 U.S. 826 (1956)(company, formed by civic leaders to acquire land and buildings abandoned by the Army after World War II, attracted industry to the area by selling and renting buildings to industry for several years, and then sold its remaining property, including the rented buildings, to the Air Force; held, depreciation allowed on buildings actually rented for several years, but not on those that were sold).

162. The related persons are described in I.R.C. §§ 318, 1239(c).

163. Problems can arise if stock is issued to the professional converter in exchange for his services, rather than a contribution of property by him. The converter may have compensation income equal to the value of his stock, and the incorporation may not be tax-free to the other shareholders (though often they are not concerned about a tax-free incorporation, since they will make a taxable sale of the apartments to the corporation). *See generally* B. Bittker & J. Eustice, *supra* note 3, ¶ 3.03.

164. See note 15 *supra.*

165. The term "depreciable property" is defined as "property of a character which (in the hands of the transferee) is subject to" depreciation. I.R.C. § 453(g)(5)(proposed), *supra* note 15. This definition is almost identical to the description of property that brings into play I.R.C. § 1239. See note 163 *supra.*

166. The related persons are the taxpayer's spouse and estates, trusts, partnerships, and corporations in which they have an interest. I.R.C. § 453(g)(3)(proposed), *supra* note 15.

167. See note 162 *supra.*