Strategies for Removing Appreciated Assets from Corporate Solution

Removing appreciated assets (e.g., real estate) from corporations and personal holding companies can create three potential levels of tax: corporate (entity level) income tax, individual income tax, and transfer tax (i.e., gift/estate) tax. This column will explore some tools and techniques for removing appreciated assets from corporate solution. The tools are aimed at reducing and/or eliminating one or more of the potential taxes.

Like many tax practitioners, I subscribe to multiple professional Listservs and internet discussion groups. One of the most common questions that I see involves the tax dilemmas that surround the holding of appreciated real estate inside of a subchapter C corporation. As I remind my graduate school students, there is one basic tax rule that they should always follow: Never, ever, ever put real estate inside of any corporation. When real estate is held inside of the corporation, it is exposed to trade creditors, and the operating risks that are inherent within the corporation.

It happens rather innocently, a closely-held manufacturing business, operating as a corporation, seeks a loan in order to finance the acquisition of real estate for the business. The lender has an established lending relationship with the business, so the parties take the easy lending path, the loan is made directly to the business and the corporation purchases the real estate. The transaction seems harmless, but over the years, the fair market value of the real estate increases through expansion and appreciation. At the same time, the tax basis of the property decreases through accumulating depreciation deductions. The result, after several years of ownership, is an appreciated asset with a significant built-in gain held inside of a corporation.

Unlike Code Sec. 351, which permits shareholders to contribute appreciated assets into a corporation without recognizing the gain inherent in the property (i.e., the “built-in gain”), there is no similar provision that allows shareholders to remove an appreciated asset tax-free from a corporation.

Individuals and entities that are taxed like partnerships (i.e., partnerships, joint ventures, and limited liability companies) are preferred holders of real estate.
Code Sec. 721 permits taxpayers to contribute appreciated assets (like real estate) into a partnership tax-free, and Code Sec. 731 permits partnerships to distribute appreciated assets pro rata to its partners without recognizing the built-in gain.

Closely-held business owners will have greater flexibility in their own estate and wealth transfer planning, if they hold the business real estate outside of a corporation. The real estate held outside of the business can provide a stream of income in retirement or an asset that can be transferred to nonbusiness family members and thus keep them out of direct involvement in the business.

Corporate Strategies for Avoiding Multiple Levels of Income Tax

In order to focus our analysis, let us look at a fairly straightforward set of facts that we can follow across multiple strategies. Adam is 65-years old. He is the sole owner of ABC, Inc. (ABC) a small metal stamping operation. ABC is taxed as a corporation under subchapter C of the Code. The most significant business asset is a factory building which is fully depreciated. The building sits on land that was purchased by the corporation 40 years ago. The land and building have an adjusted basis of $50,000. The land and building are located in a major urban area that is experiencing gentrification. Real estate developers have begun approaching Adam about the possibility of selling his real estate for $10 million. Adam faces the possibility of a C corporation income tax at ordinary rates on the gain, and a taxable dividend on his individual income tax return, when the proceeds of the sale are distributed from the corporation to Adam.

No Silver Bullets or Short-Term Fixes

There are rarely any easy answers or quick fixes in the world of tax planning. However, given time, a prudent planner can ease the burden of the multiple income taxes imposed by Subchapter C.

Electing Subchapter S

If Adam elects to have ABC taxed as a subchapter S corporation (Code Secs. 1361 through 1379), he may be able to avoid the double taxation that would occur on the sale of the real estate. The S corporation election provides an out, but the payoff is not immediate. If any of the appreciated assets are sold within the first five years after the S election is made, a corporate level income tax will be assessed on the Built-in Gain (BIG) under Code Sec. 1374.

After the five-year recognition period has expired, ABC will be free to sell the appreciated real estate without triggering the entity level tax on the BIG. A single level of taxation is available to S corporations. ABC will not be taxable on any portion of the BIG, instead the income that is attributable to the gain will be reported by the corporation to the IRS on Form 1120-S (Schedule K-1) and Adam will personally pay any federal income tax that is associated with the gain. The portion of the BIG that is attributable to the recapture of depreciation under Code Sec. 1250 will be taxable to Adam at a 25-percent capital gains rate; the portion of the gain that is attributable to certain accelerated depreciation, if any, that is taxable to Adam at ordinary income tax rates under Code Sec. 1245; and the portion of the gain that is not associated with any depreciation recapture will be taxed to Adam under Code Sec. 1231 at a long-term capital gains rates (e.g., 20 percent given the magnitude of this gain). The gain will not be subject to the Net Investment Income Tax (NIIT), since Adam is a material participant and the real estate involved in the sale is a business asset. The gain attributable to each level of gain will add to ABC’s Accumulated Adjustment Account (AAA), and the gain will add to the tax basis of Adam’s ABC stock, thus entitling him to distribute the proceeds without incurring a second level of individual income tax.

In short, if you have five years, the election to be taxed under subchapter S can eliminate the entity level income tax on the gain. Additionally, rather than paying tax on the gain at ordinary income tax rates attributable to C corporations, the S election will permit a portion of the gain to be taxed to Adam as a capital gain, at tax rates that are significantly lower.

Defer, Defer, Defer

What if you don’t have five years? The $10 million offer from the real estate developers is at Adam’s doorstep now. Adam fears that the economy might change, the golden goose might fly off, and his opportunity for a significant gain could be lost forever. What are your options if ABC must sell now?

Most tax practitioners appreciate the benefit of deferring the payment of income taxes to some point in the future. Contributions to pension and profit sharing plans permit taxpayers to claim a current deduction against taxable income, invest assets in a qualified deferred compensation plan, and recognize taxable income years later on not only
the original contribution but also on the deferred income and growth that are earned on the funds.

**Use Like-Kind Exchange to Buy Additional Time**

The income tax law allows us to defer the tax on the sale of certain appreciated assets under Code Sec. 1031, if the proceeds of the sale are reinvested as part of a like-kind exchange. Under Code Sec. 1031, if business real estate is sold and the proceeds are reinvested within the statutory period, then the entire gain is postponed until the replacement property is subsequently sold. The Seller must follow very specific rules laid out in the Regulations under Reg. §1.1031 regarding the handling of the proceeds, the identification of the replacement property, and the acquisition of the replacement property in order to qualify for the deferral of income tax. The deferral does not itself reduce the tax, unless the tax rates decrease, but the deferral can buy you valuable time and open other options such as making the S election and starting the five-year recognition period for BIGs.

**Death Is an Option—Post Mortem Sale of S Corporation Assets**

Perhaps the sole benefit to dying is that Adam’s estate will receive a stepped-up basis on his stock of ABC when he dies. If ABC had been an entity that was taxed like a partnership at the time of Adam’s death, the entity could have made a tax election under Code Sec. 754 to set-up the basis of the assets inside the entity to reflect the increased basis in the hands of the estate under Code Sec. 1014. This election would completely eliminate the entity level capital gain.

Although many tax and legal commentators refer to the fact that S corporations are taxed in a similar manner to partnerships, significant differences exist in the actual tax administration rules affecting partnerships and S corporations. In addition to the lack of an S corporation provision similar to Code Sec. 731, referred to previously, that would permit assets to be removed tax-free from the corporation, S corporations do not have a provision available to the shareholders of the corporation that would permit the corporation to make an election similar to Code Sec. 754 and step-up the basis of assets held inside of the S corporation, after the death of one of the S corporation’s shareholders.

Nevertheless, death does provide the possibility of relief, if key steps are followed. Let us look at the impact of Adam’s death.

For simplicity, assume that Adam is the sole shareholder of ABC (an S Corporation) and the only asset inside of ABC at the time of his death is the $10 million of real estate. Adam’s stock would be worth $10 million, and the stock of ABC would receive a step-up in basis equal to its fair market value at death ($10 million). Assume further that ABC took no accelerated depreciation after 1981 that would be subject to ordinary income taxation upon recapture.

After Adam’s death, ABC sells the appreciated real estate for $10 million and it recognizes capital gains under Code Sec. 1250 and Code Sec. 1231 that total $9,950,000. ($10 million less the adjusted basis of the land and building of $50,000).

The S corporation capital gains would flow to the estate (the sole shareholder) on IRS Form 1120-S (Schedule K-1) and be reported on estate’s fiduciary income tax return. At the same time, the gains would increase the estate’s basis of the S Corporation stock from $10 million (the fair market value at death) to $19,950,000 (the “adjusted basis” after the sale).

Upon liquidation, the cash proceeds from the sale of the building and land ($10 million) would be distributed to the estate, but the proceeds would be $9,950,000 less the adjusted basis of the S corporation stock ($19,950,000). The result, is that the estate would report a long-term capital loss on IRS Form 1041, Schedule D of $9,950,000. The capital loss on Schedule D would be netted against the capital gains flowing through the S Corporation Schedule K-1. The net result would be a zero gain to
the estate for income tax purposes, if the corporation is liquidated post-mortem in the same fiscal year that the real estate is sold.

Death can be an option if you are the owner of 100 percent of the stock of the S corporation.

Like-Kind Exchange with a Twist

Let us shift gears, what if Adam is not the sole shareholder of ABC. ABC sells the land and building to a third party for $10 million and ABC wants to defer the tax on the gain by using Code Sec. 1031 and engaging in a like-kind exchange. ABC currently holds the land and building for a business purpose, and in order to qualify for the deferral ABC must exchange it for “like-kind” property. Above, when ABC sought to purchase a “like-kind” asset, it purchased land and building that was to be used by ABC in a similar manner in its manufacturing business, the only difference was that it was located in a different place. Is that our only choice? Reg. §1.1031 tell us that if we sell “real property” we must replace it with “real property”. Furthermore, regulations tell us that the term “like-kind” refers to the nature, use and character of the property, the term does not refer to the grade or quality of the property. In other words, if we sell real estate, we must replace it with real estate. If we sell real property that was held for productive use in a trade or business or for investment, whether improved or unimproved, then we must replace it with real property that is to be held for productive use in a trade or business or for investment. We cannot sell ABC’s manufacturing facility and replace it with a personal residence or real property that will be held primarily for resale or as inventory by a dealer in real property.

Most like-kind analysis ends there with the use of the property, which is clearly important, and it neglects the perhaps larger issues. What is “real estate”? What is “like-kind” real estate? There are very few guideposts in the statute. Code Sec. 1031(h)(1) does tell us that you cannot sell real property located in the United States and replace it with real property located outside of the United States, but there is little else in the language of the statute.

If we sell land and building, do we have to purchase land and building in order to have a like kind exchange? Reg. §1.1031(a)-1(c) gives us three clear examples when it states that we could exchange city real estate for a ranch or a farm; we could exchange improved real estate for unimproved real estate; and we could exchange real estate for a leasehold of 30 years or more as replacement property.

As most lawyers know, real property can be owned in its totality (i.e., fee simple) or it can be divided across horizontal timelines, such as: life estates and terms of interests (i.e., leasehold interests), as well as remainder interests. Each portion of the horizontal timeline division represents a kind of real estate. If that is the case, how can we use this to our advantage?

Split Interest Purchase of Real Estate

Let us return to our fact pattern, ABC seeks to sell its real estate for $10 million. Rather than exchange its fee simple interest in real property for another fee simple interest in real estate, ABC purchases a 40-year leasehold interest in a factory warehouse complex that it intends to use in its business. A partnership or a trust consisting of Adam’s children and grandchildren purchases the remainder interest in the complex (i.e., the right to get the property 40 years from today). During the 40-year period, the family partnership/trust will earn no current income or rent on their invested capital, but at the end of 40 years the leasehold will terminate and the partnership/trust will own the entirety of the property (fee simple). Using present interest formulas (i.e., predicated on the Rule of 72), and the April 2017 Applicable Federal Rate (AFR) under Code Sec. 7520 of 2.6 percent, we could calculate the time value of money of not only ABC’s investment in the 40-year leasehold but also the future generation’s required investment in the remainder. In this example, ABC would pay $10 million of the total purchase price of $15,580,000, and the partnership/trust of Adam’s children and grandchildren would pay $5,580,000 of the $15,580,000 purchase price.

ABC would amortize its $10 million investment for book purposes over the 40-year term of the lease. Code Sec. 167(e)(3) would prohibit it from claiming an amortization deduction on its $50,000 of tax basis for income tax purposes because the remainder interest is being purchased by a related party. The partnership holding the remainder interest would be eligible to increase its tax basis under the provisions of Code Sec. 167(e)(3)(B) by the $50,000 of nondeductible amortization realized by ABC.

The bottom line after 40-years, the leasehold interest in the real estate would lapse and otherwise terminate. ABC would no longer have any right to possess or use the real estate without paying rent to the partnership. The partnership would own 100 percent of the real property, and we would have removed the real estate from the corporation tax free.
The Rule of 72 and the Power of Compound Interest

As undergraduate accounting students, we learned about present value, annuities, and the power of compound interest rates in Intermediate Accounting. These concepts are critical when evaluating tools like Split Interest Purchases (SPLITS), Grantor Retained Annuity Trusts (GRATS), Charitable Lead Annuity Trusts (CLATS), and Charitable Remainder Annuity Trusts (CRATS). Each of these tools leverages off of the two variables that come into play in calculating the present value of an income interest or a remainder interest: Rate and Time.

My fifth-grade mathematics teacher, Miss Dierkes, drilled a variation of this formula into my head at an early age: Distance is equal to Rate times Time. My partner of many years, Irving Blackman, translated the formula into financial terms for me when he introduced me to the Rule of 72. “Any time you multiple two number together (Interest Rate and Investment Time) if the product of those two numbers is 72, then magic happens—Money Doubles.”

The Rule of 72 is at the base of SPLITs, GRATs, CLATs, CRATs, and any number of other assorted estate planning tools. When interest rates are high charitable remainder trusts work well. Today is not the day for a remainder trust. When interest rates are low (as they are today), SPLITS, GRATS, and CLATS work well.

Many of us are familiar with these tools when they are used by individuals, but what if we were to have an S corporation act as the grantor/creator of such a trust? CLATs and GRATs work well here.

Charitable Lead Annuity Trust Created by a Corporation

Charitable trusts generally have one basic requirement, your client must be charitable. If they are not, do not waste your time. In the course of my career, I have met a small number of entrepreneurs that tithe. They give 10 percent of their income each and every year to charity. Where this commitment to give to charity exists, an astute tax practitioner should leverage that commitment to a dual benefit for the client. Let us revisit Adam and ABC in order to see how we might apply a CLAT to our fact pattern.

ABC, an S corporation, transfers the $10 million of real estate, subject to a long-term triple net lease, to a Non-Grantor CLAT. The CLAT will pay an amount in the form of an annuity to qualified charities for a term of years, at the end of the term of years ABC will receive the property back from the CLAT.

Income Tax Consequences for ABC and Adam

ABC’s contribution of the real estate to the CLAT will not represent a charitable deduction for income tax purposes because the CLAT is a Non-Grantor type trust, but the rent that ABC pays to the CLAT will be deductible as a rental expense for both federal and State income tax purposes. Prior to the CLAT, Adam lost a portion of his federal charitable deduction each year due to the Adjusted Gross Income (AGI) phaseout limitation on charitable deductions that high-income individuals face, and no portion of his charitable contributions were deductible for state income tax purposes.

Income Tax Consequences for CLAT

The trust will collect the rental income and the trust will pay an annuity equal to the entire amount of the net rent to qualified charities, the split interest trust will have no taxable income. It will not be subject to the Net Investment Income Tax on the rental income.

Transferring the Remainder

Rather than have the remainder return to ABC, Adam's children and grandchildren could purchase the remainder interest in the CLAT from ABC for the present value of the remainder interest. The value of the remainder interest will be determined under Code Sec. 7520. ABC will recognize a sale a capital gain on the sale of the remainder interest. Any appreciation of the property will be free from both the shareholder's and his spouse's estate for estate tax purposes.

Grantor Retained Annuity Trust Created by Corporation

The GRAT is the cousin to the CLAT; both work well when interest rates are low. Similar to the CLAT, ABC could transfer the land and building to a GRAT, subject to a long-term triple net lease. ABC would pay rent to the GRAT and retain an annuity equal to the rent payment, the remainder interest in the trust could be payable to ABC and then sold to a third party, or it could be paid as deferred compensation to a key employee of ABC.

Remember the Rule of Thumb—Never, ever, ever put real estate inside of any corporation. Regardless of
how careful we are, as tax practitioners we will likely inherit someone else’s mistake at some point in the future. Remember that given time and patience, all things are possible, even removing appreciated assets from corporate solution.

ENDNOTE

1 Neither S corporations nor partnerships are designed to pay entity level income taxes. S corporations and partnerships both file information returns that aggregate the business income but separately state each of the other types of income earned by the entity to its shareholders and partners.