Taking Money Out: Buying, Selling and Leasing Assets

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Corporate owners often enter into a variety of transactions with their closely held corporations. For sound business reasons, they may sell or lease property to their corporations or buy or lease property from their corporations. Because of the close relationships between the parties, the IRS may pay special attention to these transactions.

When an owner's deal with their corporations, a number of tax issues could arise. For example, depending on the facts, the IRS may contend that a particular transaction amounted to a **constructive dividend**.

Below we provide an explanation to give you a heads-up on these issues. Let's take a closer look at what's at stake.

Sales and Leases vs. Dividends

When a corporation buys property from a shareholder or sells property to a shareholder, the IRS may examine the transaction to determine whether there was, in fact, a bona fide sale.

> **Example**: Suppose an owner is a 100% owner of Corporation A and Corporation B. The owner sells all of the stock in Corporation A to Corporation B for cash. Even though the transaction may have the appearance of a sale, the IRS says that in substance it's a dividend distribution. There is no economic reality to the sale; the owner has the same effective control over Corporation A after the sale as he or she did before [Rev. Rul. 55-15].

In a Tax Court case, the owner of a corporation sold a portion of a parcel of land to the corporation. Later, he leased the remaining portion to the corporation but based the payments on the rental value of the entire parcel (including the portion sold). The Tax Court ruled that the "sale" was a dividend distribution [Mangurian, TC Memo 1979-91].

Lease agreements may also be scrutinized by the IRS to determine if they are what they claim to be. For example, the Tax Court held that "rent" payments an owner received from his corporation were, in fact, dividends because the property subject to the lease had already been sold to third parties [Anderson, TC Memo 1976-28].

Excessive Payments

Even when there has been a bona fide sale of property between a shareholders and the corporation, the IRS may take a close look at the amount of the sales price. A sale by a shareholder to a corporation at an excessive price, or by a corporation to a shareholder at a bargain price, may result in a constructive dividend. For example, in one Tax Court case, a corporation needed cash and sold a commercial property to its sole shareholder for $600,000. The Tax Court determined that the property had a fair market value of $936,500, using an income capitalization approach for valuing the building and a comparable sales approach for valuing the underlying land. As a result, the shareholder had to recognize a constructive dividend of $336,500. The court said that, while the need for cash may explain why the corporation sold the property, it does not justify the sale at a price far below the property's fair market value [Lynch, TC Memo 1983-173].

Suppose payments to a shareholder are determined to be dividends instead of additional capital gain from the sale of the property. Under the **Jobs and Growth Tax Relief Reconciliation Act of 2003** (JAGTRRA), most dividends are taxed at the same rate as net capital gain, at least through 2008 [IRC 1(h)(11)]. So the conversion of capital gain to a constructive dividend has less significance that it did prior to JAGTRRA.

Example: Let's say an owner sells property to his or her corporation and it is determined that the selling price is in excess of its fair market value. The owner's gain up to the fair market value will be treated as gain from a sale while the excess will be treated as a constructive dividend. But both elements will qualify as net capital gain under the JAGTRRA provision and be taxed at a maximum rate of 15%.

However, there will be other tax consequences to the constructive dividend determination. The corporation's basis will be limited to the fair market value. So if the property sold is depreciable by the corporation, the corporation's depreciation deductions will be reduced by the amount of the selling price that is treated as a constructive dividend.

The constructive dividend issue can also arise in a lease situation if the corporation is paying an excessive rent to a shareholder or a shareholder is paying a bargain rent to the corporation. If the rent is particularly high or low, the parties must be able to show that there is a sound business reason behind the rent level.
For example, in one Tax Court case, a corporation was formed to operate a franchise restaurant business. The corporation had trouble securing a lease for property because the corporation was new and unproven and because there was a high failure rate for franchise restaurants. So two of the shareholders of the corporation leased property in their own names and sublet the property to the corporation. The original lease called for a flat monthly rental payments, plus an annual payment equal to a percentage of the gross receipts. The terms of the sublease were similar except that the flat rental payment was 10% higher and the percentage of the gross receipts was 20% higher.
The IRS contended that they payments under the sublease were dividends to the extent they exceeded the payments under the original lease. But the Tax Court ruled that the higher payments required under the sublease were legitimate rent payments. If the corporation could have found a lessor to rent to it directly, the corporation would have had to pay a premium because of the lack of a credit rating and the nature of its business [Roman Systems, Ltd., TC Memo 1981-273].

Questions of Ownership

When a owner sells property to his or her corporation, or vice versa, the transaction may be handled informally or certain provisions may be included in the sales agreement that would not appear in an agreement between strangers. The result is that, after the transaction is completed, it still may not be clear who the owner is. This in turn may raise questions about who is entitled to claim depreciation and other deductions related to the property.
For tax purposes, the "owner" of property is generally the equitable owner-the person or persons who assume the benefits and burdens of ownership. Among the factors that courts have cited as indicative of the benefits and burdens of ownership are: A right to possession; an obligation to pay taxes, assessments, and charges against the property; a responsibility for insuring the property; a duty to maintain the property; a right to improve the property without the seller's consent; a bearing of the risk of loss; and a right to obtain legal title at any time by paying the balance of the full purchase price.

Recent IRS View Confirmed in Tax Court

In one recent case, two shareholders "sold" two properties to their corporation. When the corporation claimed depreciation deductions for the properties, the IRS disallowed the deductions on the ground that the shareholders were still the owners of the properties.
The Tax Court upheld the IRS's position. The Tax Court pointed to a number of factors that indicated that the corporation was not the owner of the properties: (1) the corporation was under no obligation to make payments to the selling shareholders until the corporation sold the properties; (2) the corporation could not make improvements to the properties or mortgage them without the selling shareholders approval; and (3) one of the shareholders continued to reside in one of the properties without paying rent [Delaware Corp., T.C. Memo. 2004-280].

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Related Party Sales

A loss on the sale of property between related parties is not deductible [IRC Sec. 267(a)(1)]. An owner and his or her corporation are considered “related” if the owner owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.

For purposes of the 50% test, a shareholder is treated as owning the stock owned by his or her family. Family includes only a spouse, brothers, sisters, half-brothers, half-sisters, ancestors, and lineal descendants [IRC Sec. 267(b)].

A shareholder is also treated as owning the stock owned by another corporation to the extent of his or her interest in the other corporation. For example, suppose an owner owns 40% of the stock of ABC Corp. The owner also owns a 50% interest in XYZ Corp., which, in turn, owns a 40% interest in ABC. The owner will be treated as a related party to ABC. The owner is considered to be a 60% owner of ABC-40% owned directly, plus 50% of the 40% interest owned by XYZ.

If an owner sells property to a related corporation, or vice versa, any gain on a subsequent resale is recognized only to the extent it exceeds the disallowed loss [IRC Sec. 267(d)]. This rule does not change the basis of the property in the hands of the buying party. So if the buyer resells the property at a loss, the loss is not increased by the amount of the prior disallowed loss.

> **Example**: Suppose an owner owns property with a basis of $50,000 that has a fair market value of $40,000. The owner sells the property to a related corporation for $40,000. The related corporation later sells the property for $55,000. The owner cannot claim the $10,000 loss on the sale. The corporation's recognized gain on the resale is only $5,000 ($15,000 less $10,000). If the corporation sells the property for $35,000, its recognized loss is $5,000. In this situation, neither party receives a tax benefit from the $10,000 loss on the original sale.

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