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Martin Atlas

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and work stoppages. If the union members are allowed to violate this promise and yet enforce the rights which are dependent upon it, management has gained nothing from the contract, but has incurred a substantial liability because of it. Such a violation of the basic requisites of contract cannot be reconciled, economically or socially, with the good of the nation or a sound labor policy.

This is an unfortunate decision and will perhaps be strictly construed by the courts to the exact factual situation. Those who value the advantages of free enterprise operated by private capital, as opposed to rule by the proletariat, must hope that the growing power of organized labor has not yet reached that point where the laws, which have stood the test of time and battering of social interests, are no longer applicable to labor while they continue to govern the other members of our society.

Steve LeSatz, Jr.

BAR BRIEFS

TAX ASPECTS OF REAL ESTATE TRANSACTIONS

MARTIN ATLAS, WASHINGTON, D.C.

(An address given under the auspices of the Taxation Law Section of the Colorado Bar Association under the chairmanship of T. Raber Tayler, Denver, Colorado at its 61st Annual Convention at the Broadmoor Hotel, Colorado Springs, Colorado, October, 1959.)

Real estate, because it has a certain innate flexibility, lends itself to effective tax planning. Unlike the business in which one must go on selling his product and replacing it with inventory, regardless of other circumstances, the real estate transaction can be both tailored as to type of transaction and as to time of transaction. This constitutes the basic ingredient for good tax planning. We shall consider tax planning within the framework of existing law and the present rate structure. While there is a certain inherent thinking that through postponement, good things are going to happen through rate reductions, we should not make that assumption. Rates have a tendency to creep upward rather than downward, and mere postponement in the hope of getting a lower rate structure is not a very fruitful approach to the subject. So we shall consider the problem within the present rate structure, with the assumption, however, that the rate structure of the future will not be higher. Let us assume that things will remain as they are.

Like Gaul, all of tax planning can be divided into three main categories. You either split your income and by this fragmentation method reduce the overall burden because small pieces under a graduated rate structure add up to a lesser tax; you try to convert your income into a capital gains pattern because of the favorable rate granted to capital gains; or you attempt procedures that will defer the tax and time your transactions for the best tax results.

In examining the first category, that is the subject of splitting big ones into little ones, we are all familiar, with the use of multiple corporations. This is probably the most useful and most frequently used device for dividing income. We have also heard that the Treasury is not happy with the use of multiple corporations by individual taxpayers, and it is no secret that they are gunning very actively for an approach which would tend to discourage the use of 25, 50 or even 100 corporations by a single taxpayer. To the best of my knowledge, there is very little that the Treasury can do about multiple corporations at present, so long as the corporations continue doing real business at arm's length under suitable business terms, whether they be with each other or with the outside world.

The big problem that arises for taxpayers who use multiple corporations lies in the fact that taxpayers like to have their cake and eat it, too. They like to consider multiple corporations as separate entities, but through loose thinking, loose accounting, loose advice, they do not always treat these entities as separate corporations. They comingle funds, and turn notes back and forth without adequate interest, without security, without time of payment; the money both is and is not in one company. That is fatal now and will continue to be even more fatal as this type of transaction is increasingly scrutinized. But for those who are willing to endure the additional overhead that is necessary to maintain separate books of account and to make sure that their dealings with their own companies are on the same basis as dealings with a stranger's company, the multiple corporation continues, at least in the foreseeable future, to offer very important means for dividing income.

Trusts and gifts also offer important approaches to the subject, particularly the short term trust, the ten-year trust, or the even shorter charitable trust. The ten-year trust is a very important device because you can separate yourself from the income, and yet not separate yourself from the property forever. There is a small price to pay for the separation during a limited period of time, but during that time you may exercise full managerial authority over property as long as that control does not inure to your own benefit.

A far more frequent problem than either of those just mentioned is the one that arises from the question of what is the status of someone who deals with real estate fairly frequently? The problem is not with the out-and-out real estate dealer nor with the out-and-out investor. The real problem relates to the fellow who gets into the real estate business perhaps backwards, buys and sells something today, and makes some money on it and as a result of that suddenly finds the occupation mushrooming. It is difficult to ascertain when an investor becomes a dealer. Is it after two transactions, six transactions, or fourteen transactions? What is the magic number? It is impossible to tell. It is clear, however, that for one who wishes to maintain an investor status, certain things must not be done. He must not advertise himself as a real estate man; he must not hold a broker's license; he must not have letterheads that say "Real Estate"; he must have none of the outside indications that you would find in a real estate dealer; he must not solicit a deal.

On the other hand, it is recognized that almost everything in this world is for sale, so that it is not necessary that one keep property forever to demonstrate that it is an investment. A dealer may also be an investor and so we may have the same type problem mentioned before with the small multi-corporation taxpayer. If a dealer is not careful, lack of caution may bring about his downfall.

A dealer may in fact get capital gains on investment property. The burden in such case is more heavily on the taxpayer than when he is not otherwise a dealer. In order to get capital gains, property which is not bought for resale should be placed in an investment account and there should be no comingling of accounts so that what is sold is always held out to be investment property whereas what is not sold is held out to be inventory.

Subdivision of land into lots is fatal so far as investment status is concerned. The Code does have one provision allowing subdivision of land, the first five lots, and so on, but this is very limited in both scope and usefulness, and it is not something which is of much help to the man who is involved in real estate transactions.

What is often overlooked, however, is the fact that the sale of acreage which can enjoy capital gains treatment may very often result in a larger net profit after tax than subdivision subject to ordinary income tax rates. There is a great inclination by people to subdivide and enjoy the higher per lot price which can be received from subdivided land. But if you put pencil to paper, unless there is a tremendous difference, much of this difference and even more of the difference on occasion is erased by subjection of the income to ordinary rates rather than to capital gains rates.

The largest avenue for tax planning in real estate, however, is in none of the things mentioned above. The real avenue for tax planning is in proper timing of your transactions.

The reason for this is the peculiarity of the law with respect to the treatment of gains and losses from real estate. There is first of all ordinary investment property which is the capital asset. There is then the magic 1231 asset, which is real estate used in a trade or business but not held primary for sale. With respect to such property held over six months, the gain is treated as a capital gain, whereas the loss, if any, is treated as an ordinary loss.

The important point to remember, however, is that with respect to 1231 assets, losses and gains must be netted out before there is either a net gain or a net loss. Appropriate timing therefore, would show that maximum advantage results if it is possible to get all of your gains into one year and thereby have the gains subject only to the capital gains taxes, and all of your losses into another year so that all of your losses enjoy treatment as ordinary losses. Now, the trick, of course, is how do you do it. And the answer is, very often, it cannot be done. But in a great number of cases it can be done, and it is with respect to those cases that we focus our attention.

First of all, there is always the possibility of postponing the closing date. If your transaction occurred near the end of the year and if it is desirable, you might be able to arrange to close in 1960 as easily as in 1959. Or, if it is the other way around, you might be able to push up the closing date from 1960 to 1959. Whichever way is best for the taxpayer is, of course, the method to select, if business considerations will permit it.

As against postponement of closing, there is also postponement of payment. There is first, the installment method of payment, which spreads out your gains over the period of payment. There is no inherent tax saving by spreading out your payments through the installment basis; however, you do report it over a number of years which gives you the opportunity in future years to have offsetting losses against your profits and thus reduce your total tax. Its main advantage is, therefore, in the opportunity to have a second, third and fourth look as the years proceed in offsetting your taxable income.

An installment sale may occur even though there is no initial payment in the year of sale; hence, none of the income need be picked up in the year of sale and all of the income may be deferred to a later year.

There is also the possibility of using non-negotiable notes, in real estate transactions. The obvious benefit of using the non-negotiable note is that, since it is not negotiable, it has no market value. Because it has no market value, no gain or loss can be determined until after the entire cost has been recouped. This, as distinguished from the installment basis sale, does not require you to pro-rate your profit over the years of payment, but permits you to postpone recognition of any gain until you have recouped your entire loss.

The shortcomings of a non-negotiable note is in the very term "non-negotiable." You have only a piece of paper for the term of the transaction. Here again, one must be balanced against the other, but it does offer the opportunity for deferring completely the recognition of any gain until the entire cost has been recouped.

A similar effect is obtained by the use of escrows and contracts for deeds, where in fact nothing happens until the terms of the escrow are met or the entire payment is obtained and the deed is released.

Still another method is the use of a ground lease. The advantage of such a transaction is that it separates the gain from sale of the ground and the improvements on the ground. Since the ground itself is not sold in the first instance, the amount of gain thus recognized is reduced. At a future date, the ground may be sold to the home owner, and then the gain with respect to the ground is recognized. It separates into two transactions what ordinarily passes as one transaction.

The important thing, however, is that all of these procedures offer the opportunity to balance gains and losses in the appropriate years so that the combination gives the minimum total tax.

An important but not too widely used type of transaction, but one which is increasing in popularity, is the tax-free exchange. Now, here again you have got to cope with the client. The client in a real estate transaction is basically a person of action; he wants to buy or he wants to sell. It is generally not his habit to trade for other property or to inquire whether the type of property to be traded will meet the necessary tests.

The essence of it is, however, that if the opportunity exists, the tax-free exchange is an important means of not only postponing tax, but more important, offers a means of expecting transactions which might otherwise not be possible because of the intervention of the tax bite. If the property is such that it is investment property to your client, he may exchange it for other property, and thus postpone any tax on the transaction until disposition of the new piece of property. In a period of inflation in the real estate market, this offers a person the opportunity to upgrade his property for the longest period of time without the intervention of any tax to interrupt the process. And if he is lucky enough to die before the sale, then the income tax folks will never catch up with him. In many cases that is exactly what has happened. If there is a continually rising market, there is no real need for people to sell outright if they can do as well on an exchange.

Let us now turn to some of the more specific problems. One of these is the importance of real estate in protecting against some of the tax traps that exist for taxpayers.

Particular reference is made to personal holding companies and to the surtax on accumulated surplus. The big problem, especially with respect to personal holding companies, is that very often a client finds himself with a personal holding company without knowing that he was walking into this situation. This can happen very easily where the business of the firm was such that no active sales occurred in a year and the only income that came in during the year was interest and dividends. This is not what was intended, but this is what happened, and the client may very well find himself with a personal holding company.

The best protection against a personal holding company is a piece of income-producing real estate, because the personal holding company provisions do not apply if more than 50 percent of the gross income of a corporation is derived from rents. The idea is to have a piece of property which has very high gross rents included as an asset of the corporation. Whether it has any net rent is irrelevant for the moment; the important thing is for it to have high gross rents. With high gross rents, your client may transfer to his incorporated pocketbook his stocks and bonds and enjoy his capital gain without being subjected to the personal holding company provisions. If, as in many cases, particularly with FHA 608 projects, there is very little net income derived from the real estate. In effect, what happens is that stocks and bonds may be placed into a corporate pocketbook, but the personal holding company provisions which were designed to prevent this from happening are inoperative because of the existence of real estate as an asset of the corporation.

In the case of a surtax on accumulated profits, a similar attraction exists with respect to the existence of real estate, since the accumulation of funds for the payment of a mortgage is an acceptable reason for accumulating reserves, even though they are not necessary for the immediate payment of the obligation. Moreover, these funds need not be kept sterile; they may be invested, but they must, of course, be invested in relatively liquid types of investments. Here again, the opportunity to rebut exists for the enthusiastic Revenue Agent who comes in and always looks for the last line on the balance sheet to see whether a surtax could possibly be asserted, either hoping to collect the tax, or more likely using it as a lever for negotiations on other problems which exist. In such a case, it is always nice to know that the lever can't lift anything.

Undoubtedly, the most important of the deductions for real estate purposes is the depreciation allowance. We are now living in a rather topsy-turvy world, where you find people buying property not because there is anything inherently good about the property, but because it has a large depreciation allowance which offsets income from other sources, and in effect creates a pocket of tax exempt income.

There is a great inclination to take as much depreciation as possible in the earliest years of an asset's life. This has come to such a point that people are now doing it without thinking. And in this field, at least, anything you do without thinking is almost sure to be wrong. The reason for this is that in the earlier years you may not have maximum income from your property, and while the depreciation may not necessarily go to waste, because of loss carryovers, and so on, nevertheless it may serve your purposes better to take a lesser amount, in those early years by not using, say the double declining balance and thus postponing a greater amount of your depreciation to a later period.

The field of repairs versus capital expenditures is a hopeless mess, no tax return relating to real estate ownership has ever been examined without the Revenue Agent coming up with certain invoices which you think fit into the repair category, and which he thinks fits into the capital expenditure category. The chances are that you are both wrong with respect to some of the invoices. The facts of life are that taxpayers try to claim everything they possibly can as repairs while the government tries to claim everything it can as capital expenditures. The argument has lost some of its momentum in the light of more liberal depreciation allowances. Nevertheless, this is an avenue in which there is no real law; it is a matter which is simply negotiation.

The "thin corporation" is another feature which is very peculiar to real estate. Real estate as a whole is a peculiar type of investment because in practically no other field may you deal in such large amounts with so little money that is your own. The effect is multiplied by attempts at very thin corporations. The cases on this continue to mount. The magic number of 4 to 1 is a safe test. Nothing has changed that recently, and it continues to be an adequate test.

Condemnation is on the increase these days, with increased public services and the need for more roads and schools. We are in somewhat a better condition now with respect to the reinvestment of condemnation awards than we were several years ago, because we are no longer up against the very tight rule that the funds must be reinvested in "similar" property. These funds may now be reinvested in property "similar or related in service or use." We do not yet have any clear definition of what the new standard really means, but we know that it is a broader definition than "similar property," and to the best of my knowledge any real estate will now fit the test for reinvestment of proceeds of condemnation of other real estate.

One booby trap which clients should not step into is the necessity for the reinvestment of the proceeds and not merely the gain. This may seem elementary and obvious, but it is surprising how many people have the impression that all that need be reinvested is the profit made on the condemnation. Of course, that is not so. The entire proceeds must be reinvestment. But not all the proceeds must be invested in cash. A piece of property which cost the amount of the proceeds will qualify even though it is subject to a mortgage and the cash investment is much less. This is of significant importance because it permits the taxpayer to have available to him a substantial amount of cash even though he meets the test of reinvesting the condemnation award. Losses on condemnation, if such things occur, are treated as 1231 losses.

Where severance damages are involved, they are not part of the condemnation award. Experience has shown that where severance damages are also clearly indicated condemning authorities will be fairly liberal in dividing the total amount as between severance damages and condemnation award if this will contribute toward an amicable settlement of the problem.

To the extent that part of a condemnation award can be shifted to severance damages, the opportunity exists then to merely reduce the basis for the remaining property to the extent of the damages. This has a twofold happy effect. First, it releases cash in the hands of the taxpayer in the form of severance damages. Secondly, it is necessary to reinvest a much smaller amount because the condemnation award has been reduced to the extent that the severance damage has been increased.

In the last analysis, there is much more that can be done in the field of preventive law than in the field of remedial law, but it is sometimes an impossible task to get the client to come in to ask you beforehand, "What shall we do when we do something?" The more likely situation is for him to come in after he has signed the contract and ask you, "How do we get capital gains on this now?" This is always late in the day. The responsibility remains with the lawyer to try to educate his clients to come in to see him before the transaction is consummated. If he can get across to them that there is far more that he can do for them if they will do this, even though it seems like paying a doctor for keeping you well, he can do a better job for them, and in the long run they will be happier with the outcome.