NSBN LLP REAL ESTATE ADVANTAGE

Buyer Beware:

Acquiring the Stock of C Corporations Can Be Hazardous

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There are many ways to buy real estate**.** Some buyers acquire properties outright, while others choose a less-advantageous acquisition method by acquiring C corporation stock that holds the property as its primary asset. If you select the latter route, understand that you could encounter some tax pitfalls and legal complications.

Look Beyond Price

To minimize their tax burden, owners of a C corporation that holds real estate would prefer to sell the corporation's stock rather than incur the double taxation that would be imposed if the real estate were sold and the proceeds were distributed to the stockholders. To facilitate a quick transaction, the owners might, therefore, offer a reduced price if you assume their corporate structure.

Potential purchasers, however, need to look beyond the price. You should consider certain tax issues that wouldn't ordinarily arise in a traditional real estate acquisition.

For example, one of the primary disadvantages of a C corporation is the double taxation associated with corporate structures. That is, the corporation's profits are first taxed at the corporate level. Then, if the corporation pays out some of its profits as dividends, the dividend recipients are also taxed. On the flip side, ongoing tax losses — common with real estate activities — can't be used to offset a shareholder's other income because the losses are inside the corporation.

Moreover, it usually isn't advantageous to convert a C corporation to S corporation status, because of the taxes owners would face on built-in gains. Converting to a limited liability company could also have substantial negative tax consequences because it would likely be treated as a liquidation of the corporate entity — which would result in multiple levels of tax.

Beware Other Pitfalls

When you buy a C corporation, the income tax basis in its real estate holdings isn't stepped up to reflect the purchase price, as it would be in a direct purchase. While you, as the new owner, would hold a tax basis in your stock equal to your purchase price, the depreciable assets inside the corporation would continue to be depreciated as they were depreciated before.

Another issue you'll need to tackle is the transfer tax. The cost of the deal could be affected by transfer taxes that commonly range from 0.1% to 5.0% of the real estate's value, depending on the location of the property. Many states and municipalities impose a transfer tax on *indirect* transfers of ownership in real estate. They don't require the recording of a deed, change of name or bill of sale.

In such jurisdictions, the mere transfer of a "controlling interest" in a legal entity is considered a taxable transfer of real property. A controlling interest is usually defined as 50% or more of the ownership interests in the entity.

Two general approaches are taken for determining whether a transaction triggers the transfer tax. Under the broad approach, the jurisdiction taxes any transfer of a controlling interest in an entity that owns real estate in the jurisdiction.

Under the narrower approach, the jurisdiction taxes transfers of controlling interests *only* if the entity being transferred was primarily in the business of owning real estate (often determined by comparing its real estate activity with its total activity). It's the law of the jurisdiction where the real estate is located that applies — not the law of the jurisdiction of the C corporation's incorporation or of the purchaser. Therefore if you have a Nevada corporation that owns property in California, you will be subject to California regulations.

Another issue is property tax reassessments in California. As with transfer tax rules, property taxes are reassessed when there is a change in control of 50% or more.

Watch Out for Legal Exposure

Beyond taxes, you need to understand that, with a C corporation acquisition, the apparent value of the real estate can be undermined by pre-existing legal liabilities, such as slip-and-fall claims and tax delinquencies. These liabilities stay with the corporation — they don't go with the sellers. This is just another reason why buying corporate stock can be a negative.

Acquiring C corporation stock can be a huge boon, but it can also be a big bust. So, make sure you involve your real estate and tax advisors in these types of transactions. Please contact us with any questions about your individual situation.

Dennis D. Ayers, CPA, Partner at NSBN, serves clients in the real estate industry, including: limited and general partnerships, limited liability companies, management and development companies, investors and owners. Dennis assists clients with acquisitions, sales, IRS Section 1031 and 1033 exchanges, cost segregation studies, Tenants in Common properties, accounting and tax compliance and reporting. He can be reached at 310.288.4298 or dda@nsbn.com.