Converting Income From Company to YOU

The corporation income isn’t necessarily the same as contractor income and special preparations should be made for proper transferral.

Many owners of real estate or construction companies invest in tax shelters to defer the payment of income taxes or to transform part of their ordinary income into long-term capital gains.

The latter objective is generally considered more rewarding because only one-half of long-term capital gains is taxed.

There are various methods of transforming corporate ordinary income into personal long-term capital gains. One method concerns the purchase of land for use in future construction projects. Although this technique is not new, it is not utilized as often as it should be. Another, and more novel, method is the sale and leaseback of model homes.

**Purchase of Land for Future Development**

A construction company is typically a closely held corporation. When the corporation uses land in a project, regardless of the period of time for which it has held that land, the profit on the entire project, including any appreciation in the value of the land, is taxed as ordinary income. On the other hand, if such land were purchased and held by the individual shareholders, their children, or some other entity, for a substantial period of time and sold to the corporation just prior to its beginning a project, the appreciation which occurred during that period would generally be taxed as a long-term capital gain. The difference in taxes can be dramatic.

Since corporate ordinary income in excess of $50,000 is taxed at 48%, the tax on land appreciation of $100,000, added to other income of $50,000, would be $48,000, leaving “after-tax” cash of $52,000 in the corporation. In contrast, a long-term capital gain of $50,000 realized by each of two individuals who have no other capital gains results in each of the two individuals paying an income tax which cannot exceed $12,5001, leaving total after-tax cash of $75,000 in the hands of the individuals. This difference is the result of three factors:

- The appreciation was taxed as long-term capital gain rather than as ordinary income.
- The gain was divided between

---

1The fact that one-half the long-term capital gain is a tax preference item which could affect both the minimum and the maximum tax computations has been ignored.
more taxable entities—two individuals instead of one corporation.

• The gain was taxed at individual rates (the lesser of the tax computed by adding one-half of the gain to the taxpayer’s other income or the alternative tax of 25% of the first $50,000 of long-term capital gain) instead of at corporate rates (48% of ordinary income in excess of $50,000).

The same result may be achieved by having the individuals buy options to purchase the land rather than the land itself. Later, these options would be sold to the corporation, resulting in long-term capital gains to the individuals. In some cases it is also possible to obtain a tax deferral by structuring the transaction as an installment sale.

Sale and Leaseback of Model Homes

The sale of model homes by a builder is similar to the sale of land held for future development by a construction company. The same tax advantages are obtained by having the individual shareholders or their children build or purchase the models and lease them back to the corporation until they are sold.

In this case, the individual investors would benefit from the appreciation of the homes and, additionally, would realize both a normal rental profit and a conversion of ordinary income into long-term capital gain to the extent of the straight-line depreciation available during the rental period.

Other Advantages

By decreasing the ordinary income earned by the corporation, the land and model home transactions can be used to help avoid an accumulated earnings tax problem: By providing a means of diverting what would otherwise be corporate earnings to shareholder/executives, these transactions can also be used to avoid excessive compensation problems. Further, they can spread income, among a number of “low-bracket” taxpayers, such as children or dependent parents, who would otherwise be supported by after-tax dollars of a “high-bracket” taxpayer.

Potential Problems

While offering considerable advantages, both types of arrangements pose potential problems for the investor. The principal danger in both types of transactions is that the Internal Revenue Service may contend that the gain to the individuals constitutes ordinary income rather than capital gain because the property was purchased or was being held for sale in the ordinary course of their business. If the gain on the sale is classified as ordinary income rather than capital gain, the result of the entire transaction would be to shift ordinary income from the corporation to the individuals. If their tax brackets were substantially higher than 48%, the net result could be disadvantageous. However, if the corporation were in the 48% tax bracket, and the net income shifted was relatively small and distributed among a number of low-bracket taxpayers, the net result of the entire transaction would still be advantageous.

Further, the Internal Revenue Service may contend that the sales price of land sold to the corporation exceeded the property’s fair market value at the time of sale and that the individuals’ capital gain should be reduced. The amount of the reduction would then be taxed to them as a dividend, and the corporation’s ordinary income increased by the same amount. If the entire gain were reallocated to the corporation, the individuals and the corporation would be in the same position as before the transaction, except that the individuals would have received a taxable dividend.

Conclusion

By utilizing these types of transactions, developers can accomplish the same objectives sought by most tax shelters but with considerably less risk from both a tax exposure and an investment standpoint. However, because these transactions are subject to review by the Internal Revenue Service, a qualified tax advisor should be consulted before they are structured.

2The gain on the sale of investment land is long-term capital gain, whereas the gain on the sale of rental property (the models and related land) is Section 1231 gain (assuming the individuals are not dealers in model homes). Since in most cases Section 1231 is taxed as long-term capital gain, this difference usually does not matter.