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# Tax Problems Incident To the Management of Acquired Real Estate

## IV

### SPECIAL PROBLEMS INCIDENT TO THE OPERATION OF A BUSINESS

Alan R. Vogeler

#### OWNERSHIP OR LEASING

There are many considerations in determining whether real estate used for business operations should be owned or should be leased. The non-tax advantages of ownership include the freedom to use the property as the owner desires, subject to zoning laws, and the possibility of realizing an increase in the value of the property from an inflationary or expanding economy.

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The non-tax disadvantages include the dedication of a substantial amount of capital, the inability of the owner to move freely to another location, and possible depreciation in the property value. The advantages and disadvantages of

leasing are generally the converse of those of ownership.

A lease with an option to purchase offers most of the advantages of both types of holding. However, owners are generally not anxious to grant privileges of purchase on the basis of prices current at the beginning of the lease. Such a privilege, which binds only the owner, operates solely to the advantage of the lessee, fixing a maximum price on the property should the lessee decide that purchase is advantageous.

The respective tax advantages of owning or leasing may best be shown by an example. Assume that a 10-acre tract of land for a factory site will cost \$100,000 and that erecting a factory will cost \$400,000. The outright purchase of such a plant would cost \$500,000 cash. Assume that a corporate taxpayer buys the land and builds the factory. It borrows \$250,000 in the form of a short-term, renewable bank loan based on its own credit rating, for which it pays  $5\frac{1}{2}\%$  interest, and borrows \$250,000 from an insurance company on a mortgage loan at interest of 6%, with annual principal payments of \$20,000. Assume further that the estimated useful life of the building is 40 years and that the declining balance method of depre-

ciation is adopted.<sup>1</sup> The ownership cash picture at the end of the first year would be as follows:

Cash outlay — interest .....	\$28,750	
principal .....	20,000	
	<u>          </u>	
Total cash paid .....		\$48,750
Deductions from income:		
Interest on short-term loan .....	\$13,750	
Interest on mortgage .....	15,000	
Depreciation on building .....	20,000	
	<u>          </u>	
Total deductions .....		\$48,750
Tax reduction in a 52% tax bracket:		
52% of \$48,750 .....		\$25,350
		<u>          </u>
Net cash outlay for first year .....		<u>\$23,400</u>

If the same property were leased for an amount equal to 10% of its cost, the annual rent would be \$50,000, all of which would be deductible. In a 52% tax bracket, that would mean a tax reduction of \$26,000 and a net cash outlay of \$24,000 per year. This presents a cash savings in favor of owning in the first year of \$600.

After a period of five years the comparison is as follows:

#### OWNERSHIP

Cash outlay — interest .....	\$131,750	
principal .....	100,000	
	<u>          </u>	
Total cash paid .....		\$231,750
Deductions from income:		
Interest on short-term loan renewed .....	\$ 68,750	
Interest on mortgage loan .....	63,000	
Depreciation on building <sup>2</sup> .....	90,487	
	<u>          </u>	
Total deductions .....		\$222,237
Tax reduction in a 52% tax bracket:		
52% of \$222,237 .....		\$115,563
		<u>          </u>
Net cash outlay for 5 years' ownership .....		<u>\$116,187</u>

#### LEASING

Five years' rent .....	\$250,000	
Tax saving at 52% .....	\$130,000	
	<u>          </u>	
Net cash outlay for 5 years' leasing .....		\$120,000

1. See pp. 197-98.

2. First year — \$20,000; second year — \$19,000; third year — \$18,050; fourth year — \$17,147; fifth year — \$16,290.

It appears that over a five-year period it would cost less to own than to rent. Not only is there a cash savings of nearly \$4,000, but also an equity of \$9,513 (mortgage amortization of \$100,000 less depreciation of \$90,487) has been acquired. However, the taxpayer has had \$500,000 tied up in land, brick, and mortar. If this same amount of money had been used to purchase inventory and converted into \$1,000,000 of sales annually with a 4% net return, the taxpayer would be substantially better off with a lease.

Of course rental payments, interest rates, and tax rates may fluctuate. Furthermore, the ability to borrow, rather than the tax considerations, may finally be the controlling consideration. Each case must be examined and calculations made to attempt to determine the best course of action.

A popular method of financing for those companies which own their plants but need additional funds is the sale and leaseback. The tax effects of such transactions have been considered in several cases. In *Century Electric Company v. Commissioner*,<sup>3</sup> the taxpayer owned a foundry which had an adjusted basis of \$532,000. To increase working capital, the taxpayer sold the property to a college for \$150,000, an amount equal to the highest bid received from prospective buyers; the college, in turn, granted a twenty-five year lease to the taxpayer, renewable for seven additional ten year terms.

Affirming the Tax Court,<sup>4</sup> the Court of Appeals for the Eighth Circuit held that the transaction constituted an exchange of business property (the fee) for like business property (the long-term leasehold) and, therefore, under the provisions of the Internal Revenue Code of 1939, section 112 (b) (1),<sup>5</sup> the loss could not be recognized. The unrecovered cost of the land and building was converted into cost of the leasehold, and was to be recovered ratably over the ninety-five year term of the lease. The rental payments, however, would be deductible.

The *Century Electric* doctrine has recently been challenged by the Court of Appeals for the Second Circuit in *Jordan Marsh Company v. Commissioner*.<sup>6</sup> In the *Jordan Marsh* case the taxpayer, in 1944, sold its department store and the underlying land, which had an adjusted basis of \$4,769,000, for their conceded fair market value of \$2,300,000. Simultaneously, the taxpayer took back a thirty-year lease of the property at concededly normal and full rentals, which lease was renewable for an additional thirty years. The Commissioner disallowed a deduction of the loss on the sale, which action was upheld by the Tax Court on the basis of the *Century Electric* case.

3. 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952).

4. 15 T.C. 581 (1950).

5. Now INT. REV. CODE OF 1954, § 1031(a).

6. 269 F.2d 433 (2d Cir. 1959), reversing 26 P-H Tax Ct. Mem. 927 (1957). The Internal Revenue Service, however, has announced that it will not follow the *Jordan Marsh* case. T.I.R. 194, 4 P-H 1959 FED. TAX SERV. ¶ 55,160. See discussion p. 249.

However, the court of appeals found that the transaction constituted a sale, not an exchange, and that the doctrine of nonrecognition of gain or loss on exchange of business property for like business property was therefore inapplicable. In essence, the court held that the taxpayer's money was no longer tied up in the same kind of property. The court of appeals distinguished the *Century Electric* case from the situation facing it in the *Jordan Marsh* case on the ground that in the former case there was no finding that the purchase price was the equivalent of the property's value, or that the rent was equal to the rental value of the premises.

This, however, can hardly serve as a valid distinction. A close examination of the *Century Electric* case reveals that the sale price of the building was equal to the highest bona fide offer received from several bidders. The rentals for the first 10 years averaged a net return of 13%, after which they dropped to 7.6%. Certainly this appears to have been a full and normal rental.

Thus, there appears to be a clear conflict between the *Century Electric* and *Jordan Marsh* cases. The more logical rule is propounded in the latter case. If the sale is at fair market value and the leaseback is at fair and reasonable figures, any loss sustained on the sale should be recognized. The money thereby saved in taxes, when added to the sales price receipts, would substantially increase capital funds.

In Ohio, buildings are sometimes owned by persons other than the fee holders of the underlying land. This is another convenient method of financing the construction of buildings. For example, if a builder desires to construct an office building on a site occupied by low-income-producing property, he could acquire the land with its existing structure at present value, tear the building down, encumber the land with a long-term lease to his own construction corporation, and sell the land at the capitalized value of the ground rent. With this money and funds borrowed on his resulting equity he could now construct the building, which then produces sufficient income both to pay the ground rent and to amortize the construction costs.

Many times, in the operation of a business, plant expansion is required. The same considerations involved in determining whether the original acquisition should be of the fee or of a leasehold again come into play. If the existing plant is owned by a taxpayer, he may have little choice but to build the additional facilities himself. But if he is leasing the premises, perhaps the lessor will consent to construct the addition.<sup>7</sup> The length of the remaining term of the lease, the probability of renewal, the cost of borrowing money, and the rate of return from funds invested in the business are pertinent factors. The lessor, if he is asked to build, may ask for rent on the basis of present values, and may ask for an increase in the rental for the existing

7. See p. 187.

plant. If the lessee builds, the costs are amortizable over the remaining term of the lease.<sup>8</sup>

### PERSONAL HOLDING COMPANIES

A personal holding company is defined in the Internal Revenue Code of 1954, section 542, as a corporation with five or less persons owning a majority of its stock, at least 80% of the income of which is personal holding company income. Rent is personal holding company income, unless it constitutes more than 50% of the gross income of the corporation.<sup>9</sup> Amounts paid for the use of corporate property by an individual who directly or indirectly owns 25% or more of the corporate stock, are treated as personal holding company income, and not as rents, if 10% or more of the corporation's gross income is from other personal holding company sources.<sup>10</sup> Since a personal holding company is subject to prohibitive surtaxes unless it distributes all its personal holding company income to its shareholders, and since the shareholders may be put into high income tax brackets if such income is distributed, it behooves every corporation to avoid the personal holding company classification.

Thus, if a corporation is formed, the majority of the stock of which is owned by five or less persons, one should carefully consider the tax consequences before real property owned by the corporation is leased to a 25% shareholder. If more than 90% of the income of the corporation comes from property rental, whether from shareholders or strangers, the personal holding company classification is avoided.<sup>11</sup>

If rental income of a corporation amounts to less than 50% of its gross income, then such rental income constitutes personal holding company income.<sup>12</sup> This automatically classifies rental income from 25% shareholders as additional personal holding company income. Unless the corporation has ordinary business income equal to more than 20% of the corporation's gross income, the penalty surtax will apply to undistributed personal holding company income.

### SURTAX ON ACCUMULATED EARNINGS

A surtax is imposed when a corporation accumulates surplus for the purpose of avoiding the imposition of additional income taxes on its shareholders.<sup>13</sup> However, amounts up to \$100,000 may be accumulated without penalty. The question is whether surplus over this

8. But see INT. REV. CODE OF 1954, § 178, discussed pp. 190-92.

9. INT. REV. CODE OF 1954, § 543(a)(7).

10. INT. REV. CODE OF 1954, §§ 543(a)(6), (7).

11. Treas. Reg. § 1.543-1(b)(9) (1958).

12. INT. REV. CODE OF 1954, § 543(a)(7).

13. INT. REV. CODE OF 1954, §§ 531-37.

amount has been accumulated beyond the reasonable needs of the business. If so, the corporation must prove by a preponderance of the evidence that such accumulation was not to avoid the imposition of income taxes upon its shareholders.<sup>14</sup>

The fact that a corporation is a mere holding company or investment company is prima facie proof of the proscribed purpose to avoid taxes upon the shareholders.<sup>15</sup> A corporation which merely holds property and collects the income therefrom is a holding company.<sup>16</sup> If the corporation trades in real estate, securities, and other investment property, it is considered an investment company.

The question has been raised whether payments on mortgages by real estate development companies constitute an unreasonable accumulation. In *Frank H. Ayres & Son*,<sup>17</sup> a father and son had been engaged for many years in acting as agent for owners of real estate in arranging financing, subdividing, and selling lots. In 1946, with only one agency contract for 400 acres remaining, the father and son realized that in order to perpetuate their business they would have to purchase their own real estate for subdivision. They thereupon formed the taxpayer corporation, purchasing its stock for cash. The corporation took over the job of selling the remaining subdivided lots on the 400-acre tract and began an active search for other real property satisfactory for subdivision. From 1946 to 1950 the corporation purchased only a 47% interest in a 75-acre tract. Meanwhile, its commission earnings from the 400-acre tract were substantial, but no dividends were paid.

The Tax Court held that the corporation was not formed or availed of for the purpose of preventing the imposition of tax on its shareholders. The court said that, in addition to its general working capital needs, the corporation had to acquire real property to provide a source of future income and that a substantial investment is required for subdivision.

The *Ayres* case appears to be authority for the view that where a real estate development company purchases land on a small margin, the balance of indebtedness perhaps being secured by a mortgage, the accumulation of earnings to pay such indebtedness would be valid, even though this adds to the surplus of the corporation. In any event, there appears to be no reason why a contract could not be entered into with the seller under which the purchasing corporation binds itself not to pay any dividends until the remaining balance of the purchase price either is paid in full, or is at least substantially reduced.

14. INT. REV. CODE OF 1954, § 533(a).

15. INT. REV. CODE OF 1954, § 533(b).

16. Treas. Reg. § 1.533-1(c) (1959).

17. 23 P-H Tax Ct. Mem. 886 (1954).

Once the courts have decided that the earnings of a corporation have been accumulated for the "fatal" purpose, future accumulations will nearly always come within the same category. In such situations, thought should be given to a liquidation of the corporation. A liquidation will result in capital gain to the shareholders, with a maximum tax of 25% on such gain. The Board of Tax Appeals has held that a corporation in the process of immediate liquidation could not be said to be avoiding the imposition of tax on its shareholders through the medium of withholding surplus distributions.<sup>18</sup>

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18. Florida Metal & Iron Co., 11 P-H B.T.A. Mem., 1015 (1942).