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Tax Problems Incident To Family Planning With Real Estate

Alan R. Vogeler

Gifts

The same considerations which govern all family tax planning are applicable also to planning with real estate. In the usual family situation the mother and father together have an income greater than that of their offspring. Because of the progressive income tax rates, the more that income is spread among a number of taxpayers, the larger will be the amount left in the family for personal use.

Three federal taxes, namely, the income tax, the estate tax, and the gift tax, are involved in family tax planning. If a husband gives to his wife income-producing property with a value of $66,000 or less, and if he has made no previous use of his lifetime gift tax exemption,[1] no gift tax will be incurred upon such transfer. But such a gift will result in no savings of income tax because the income from the property will be reported on a joint return with the husband. Whether or not such a gift would save federal estate tax depends upon the interrelation between the husband's estate and the wife's estate.

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Assuming that the husband and wife do not have need for the income from the particular property, a gift of the property by the husband to his children could also avoid gift tax, could eliminate estate tax on the property in the husband's estate, and would probably save a considerable amount of income tax. If there is a third generation, the gift might take the form of a life estate to the children with the remainder to the grandchildren, and thereby avoid a second generation of estate taxes.

If the donor has used up his lifetime exemption and is in a high gift tax bracket so that he hesitates to make large gifts, he can still give valuable real estate whose present value is not reflected in the gift. If the donor owns a building worth $200,000, he could form a family corporation with preferred stock of $175,000 (with a low preferred dividend, if earned) and common stock of $25,000, and transfer the building to the corporation in return for all of the stock. The common stock could then be transferred outright to the children

1. INT. REV. CODE OF 1954, §§ 2521, 2523(a).

and grandchildren. These gifts of common stock totaling $25,000 would result in no gift tax if there were five or more donees and if the donor's wife consented to "split" the gifts.[2] Gifts of the preferred stock could later be made within the annual exclusions, probably without encountering any problem as to the value of such stock. Meanwhile, future increases in the value of the building would redound to the benefit of the common shareholders, rather than to the donor (the preferred shareholder).

The foregoing technique achieves somewhat the same purpose as placing a mortgage on the property. For example, the owner of the $200,000 property might mortgage it for $150,000. He could keep the proceeds of the mortgage in his own pocket and transfer the property to his children and grandchildren, who would assume the mortgage. The net worth of the building in their hands would be $50,000, but their basis for depreciation would be $200,000. The mortgage of $150,000 could be paid off in future years out of the depreciation reserves, which are deductible from the income each year. Through this method the donees would eventually own a $200,000 investment and the donor would have retained $150,000.

A similar saving could be achieved through a sale of the real estate. Assume the basis of the property to the father is $100,000 and its value is $200,000, of which $40,000 is attributable to the land value and $160,000 to the building. The father could sell the property for its fair market value to the children for a small downpayment, with the balance being secured by a mortgage. The depreciation deduction would furnish the children a sufficient amount of money to pay to the father over a period of time most of the balance of the purchase price.

If the father donates the entire property, he will, of course, incur gift taxes, but the basis of the property in the hands of the donee will include not only the donor's basis, but also the amount of gift tax paid by the donor with respect to the gift.[3] If the terms of the gift require the donee to pay the gift tax, then the value of the gift will be reduced by the gift tax payable with respect thereto, which, in turn, will reduce the gift tax.[4]

If the building has a basis of $100,000 and the father sells it for $200,000, the sale by him would result in a maximum capital gains tax of $25,000 and would leave him $175,000 available for gifts. Assuming that there were $36,000 worth of annual exclusions available for the donor's two children and four grandchildren (assuming a "split" gift), the gift to them of $175,000, after deduction of the exclusions, would result in a gift tax of 24 per cent in the $250,000 to $500,000 gift tax bracket, or approximately $35,000. This means

2. INT. REV. CODE OF 1954, §§ 2503(b), 2523(a).
3. INT. REV. CODE OF 1954, § 1015(d).
4. S. H. Harrison, 17 T.C. 1350 (1952).

that the total tax cost of transferring to the children and grandchildren the net proceeds from the sale of the building would be $60,000. Further, the basis of the money in the hands of the children could not be increased because the gift tax paid could not be used to increase the basis to an amount in excess of fair market value.[5]

If, instead of selling such building, the donor gave it to his two children and four grandchildren, his gift tax in the 24 per cent bracket would be $39,360, all of which could be added to the $100,000 basis of the children and grandchildren. Their basis would then be $139,-360, and the subsequent sale of the building by them for $200,000 would result in a profit of $60,640 and a maximum capital gains tax of $15,160 (approximately $2,527 of which would be payable by each child and grandchild). Adding this tax to the $39,360 gift tax paid by the donor, a gift of the building prior to the sale would result in a maximum tax of $54,520. The result of donating the building prior to its sale, rather than selling it and donating the net proceeds, would be a minimum family saving of $5,480.

The saving may be substantially greater if the four grandchildren have no income other than the profit on the sale. One-sixth of the total profit paid to each grandchild would give him $10,100 of income. Of this amount $5,050 would be a capital gain deduction, leaving as his adjusted gross income $5,050, from which the grandchild could deduct the $500 optional standard deduction and the $600 personal exemption. The net taxable income of each grandchild then would be $3,950, the income tax on which is $829. This would be an additional saving of approximately $1,700 per child, compared to the $2,527 maximum capital gain tax previously mentioned, or $6,800 further saving to be added to the $5,480 minimum tax saving available in this family situation. Even greater tax savings might be achieved if the children and grandchildren sell on an installment sale basis.[6]

SALES

Sales at less than fair market value between family members result in gifts.[7] However, it may not be the intention of the seller in selling property to a family member to make a gift and, therefore, it is advisable to know prior to the sale what the fair market value of the property is. When property is sold by one family member to another family member at what an independent real estate appraiser indicates to be its fair market value at the time, this in itself should negate the existence of a donative intent on the part of the seller.

Interesting questions are raised when the consideration paid by

5. INT. REV. CODE OF 1954, § 1015(d).

6. See p. 222.

7. INT. REV. CODE OF 1954, § 2512(b); I.T. 3335, 1939-2 CUM. BULL. 193; and see Reginald Fincke, 39 B.T.A. 510 (1939), *nonacq.*, 1939-1 CUM. BULL. 47.

a son or daughter to a parent for the transfer of the property is either an agreement to support the parent for life or an agreement to pay a fixed dollar amount as an annuity. The case of *Sarah Bergan*[8] provides the ground rules covering this type of situation. Sarah was seventy-four years old when the older of her two sisters died leaving a net estate of $220,000 to each surviving sister. Sarah agreed with her other sister, Margaret, that Sarah would take only $50,000 of the $220,000 left her by the decedent and would transfer the other $170,000 to Margaret, if Margaret would take care of Sarah for the rest of her life. At Sarah's death, the Commissioner claimed that the transfer of the $170,000 balance of decedent's estate to Margaret was a taxable gift by Sarah and, in addition, that the gift was made in contemplation of death, so that the property transferred was includable in Sarah's estate. The Tax Court found that the value of the agreement to support Sarah, who at the time the deal was made had a life expectancy of 6.86 years, was $32,400. The court held that the transfer was not made in contemplation of death, but that the excess of the amount transferred over the fair market value of the consideration constituted a taxable gift.

The value of an annuity can usually be determined. The Commissioner has published tables which specify the value of annuities receivable at various ages.[9] However, there is a problem in determining what amount of yearly support would be required where the annuity contract between parent and child calls for "support," rather than for fixed amounts. Further, the obligation of an individual to pay an annuity is probably not as valuable as a similar obligation of an insurance company. Thus, there might be a gift if the same amount were paid for a private as for an insured annuity.

If property is sold to a controlled corporation for use by the corporation in subdividing, the corporation will realize ordinary income when the property is sold, but the original seller may well have capital gain. In this connection the case of *Aqualane Shores, Incorporated v. Commissioner* is important.[10] In that case a father and his two sons created a real estate development corporation and transferred to it for $250,000 property that they had acquired for $69,000 the year before. The corporation, which had capital of only $9,600, paid $9,000 down to the sellers, and agreed to pay the balance in five annual installments. The corporation proceeded to subdivide the real property but never made any further payments on the purchase price. The Tax Court, which was affirmed by the Court of Appeals for the Fifth Circuit, held that: (1) the transfer to the corporation actually constituted a nontaxable exchange, (2)

8. Estate of Sarah A. Bergan, 1 T.C. 543 (1943).

9. Treas. Reg. § 21.72-9 (1956).

10. 269 F.2d 116 (5th Cir. 1959), *affirming* 30 T.C. 519 (1958); see also James Realty Co. v. Commissioner, 176 F. Supp. 306 (D. Minn. 1959).

the stock had been issued for the property, (3) there was no gain or loss to the sellers, (4) the basis to the corporation was, therefore, the original $69,000 purchase price, and (5) the income received on subdivision by the corporation (to the extent it exceeded $69,000) was all ordinary income.

Where a transferee of property is to derive ordinary income from its subsequent sale, a nontaxable exchange should be avoided; otherwise, the transferee will have to use the transferor's low basis. Such an exchange was avoided in the recent case of *Crosby Company of Beaumont v. United States*.[11] In that case nine children owned real property as residuary beneficiaries of their deceased father's trust estate. All but one of the beneficiaries were married, and when they subscribed for the stock of a corporation formed to acquire the realty, the shares, under Texas law, were community property owned one-half by the spouses of the married beneficiaries. Following incorporation, the real estate was sold to the corporation by the nine individual beneficiaries for $1,000,000, of which only $5,000 was paid in cash and the balance was represented by installment notes payable over 20 years. This sale resulted in a long-term capital gain to the beneficiaries of the trust of $850,000. The court held that since the stock of the corporation was owned by 17 persons (under community property laws), whereas the real estate had been held by nine persons, the persons who transferred the property to the corporation were not in control of the corporation immediately after the transfer and, therefore, the transaction did not constitute a nontaxable exchange.

It has previously been noted that if various phases of a subdivision development are performed by different taxable entities, tax savings may be obtained through the use of multiple surtax exemptions.[12] Yet, this path is not without any danger. For example, in *George K. Heebner, Jr.*,[13] the petitioner was an architect, builder, and contractor who received substantial income from 1949 through 1952 from the contracting and building business. In 1951, learning that Nash-Kelvinator needed a warehouse near Philadelphia, Heebner found land suitable to Nash-Kelvinator, acquired an option on it, arranged for prospective construction loan financing from a bank, and found an insurance company which would purchase the property upon completion if Nash-Kelvinator would take a long-term lease. Heebner bought the land in his own name and then contracted with his construction company to build the warehouse. Nash-Kelvinator agreed to lease the warehouse upon its completion. All of the formal agreements were executed after Heebner had obtained commitments from

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11. 1959-2 U.S. Tax Cas. ¶ 9669 (E.D. Tex. 1959).

12. See note 41, p. 152.

13. 32 T.C. No. 109 (Sept. 10, 1959). See also Rev. Rule. 59-345, 1959 INT. REV. BULL. NO. 42, at 9; and see note 59, p. 184.

all interested parties. The Tax Court held that the profit on the sale by Heebner to the insurance company was ordinary income from the sale of property held by him primarily for sale to customers in the ordinary course of his trade or business.

This was a case where, in effect, all of the steps were taken at one time. The real estate developer did not acquire title to the property until he knew that it could be sold after a warehouse had been built thereon. While Heebner avoided any risk of loss by arranging the package deal before expending any money, by doing so he incurred ordinary income tax on the sale of the property. It appears obvious that if capital gain is desired upon a sale, the property must be acquired before definite commitments for a subsequent sale have been made.

When real property is sold to a corporation controlled by the seller (or to the seller's wife or minor children) and the property is leased back to the seller, care must be taken to provide for fair and reasonable sale price and rentals.[14] There are numerous cases in which courts have held that the payment of rents for property which could have been purchased for less than the rentals was merely a tax minimization device and that the rents were not deductible expenses of the property owner, but were dividend distributions to the extent of earnings.[15]

However, when the rent is reasonable, even if on a percentage basis, and the sale price is at fair market value, the transaction will be allowed.[16] This is true even if the transfer is to a trust for the benefit of the wife or children of the grantor.[17]

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14. See note 3, p. 202.

15. See, for example, Wade Motor Co. v. Commissioner, 241 F.2d 712 (6th Cir. 1957), *affirming* 26 T.C. 237 (1956); Kirschemann v. Westover, 225 F.2d 69 (9th Cir. 1955); W. H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951); Riverpoint Lace Works, 23 P-H Tax Ct. Mem. 465 (1954).

16. Consolidated Apparel Co. v. Commissioner, 207 F.2d 580 (7th Cir. 1953); Estate of Frederick W. Sullivan, Sr., 20 P-H Tax Ct. Mem. 692 (1951); Henry G. Bender, 16 P-H Tax Ct. Mem. 365 (1947).

17. A. A. Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948); J. T. Potter, 27 T.C. 200 (1956); Albert T. Felix, 21 T.C. 794 (1954); see also Stanley Imerman, 7 T.C. 1030 (1946).