AGRICULTURAL TAX PLANNING

Appreciated Ranchland Trapped in a C Corporation

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The scenario below assumes that all inventory and equipment has already been disposed by the owner/retiree. The proceeds have been shifted to the owner and spread over several years to lower the overall tax liability on the items sold. The ranch has operated as a C corporation, and the retiree decides to keep the appreciated ranchland for rental income. These facts create a tax issue. How can the retiree efficiently get the rental income out of the corporation to himself without double tax? Salaries are subject to payroll taxes and could also fall under reasonable compensation rules. After all, how much effort does it take to collect several rent payment checks per year?

Let's look at some options once the appreciated real estate is the only asset remaining in the C corporation. Simple option would seem to be to have the company converted to an S corporation to solve the double tax issue. At first glance that move would allow rental income to flow into the S Corp and out to the individual shareholders without double taxation on dividends and any significant payroll tax costs. Unfortunately, there is another tax trap to confront. The S Corp must deal with the tax on excess passive income (on its rental income). This tax arises if the S Corp previously operated as a C corporation and has retained its accumulated C corporation earnings and profits. IRS Code Sec.1375 imposes a flat 35% corporate-level tax on this excess passive income. In addition, after three years in this position, the S Corp status is mandatorily terminated and the S Corp must convert to C corporation status.

There are several solutions to solve this problem. One option is to distribute the old C corporation earnings and profits via a dividend at today's less costly dividend tax rate of a maximum of 20% (less depending on the amount of taxable income). If this alternative is chosen, it is not necessary to come up with the cash to actually pay out the dividend. An S Corp can make a deemed dividend election. Under this election the former C corporation's accumulated earnings and profits are deemed to be distributed proportionately among the shareholders, and then recontributed as paid in capital that increases shareholder basis. The shareholders would then be taxed at the dividend tax rate on the deemed dividend so, some cash will be required for the tax due.

If the deemed dividend approach does not make sense do to its large size, a second alternative to explore is designing a lease arrangement that meets the status of active rental income. To meet this status, the S Corp must either perform significant services for its tenants or incur substantial costs in its rental business. This type of lease would require the S Corp to incur some costs and supervision such as maintaining irrigation or drainage tile, maintaining fence lines, maintaining weed control in ditches and consulting services.

Note another possible tax trap, once in S Corp status, no land sales can occur for the first five years. Under the built-in gains tax rules, any appreciated asset sales within the first five years of S Corp status causes a flat 35% corporate-level tax. The gain is also taxed again at the shareholder level. After five years the S Corp can sell the land and the capital gain passes through to the shareholders and is taxed once at the shareholder's 1040 level favorable capital gain real estate tax rate currently at a maximum of 20%.

One must recognize that in the real world there are often facts that can alter and complicate the outcome of any transaction. However, this discussion does present a couple of strategies for dealing with generating rental income of ranchland trapped in a C corporation when the owner/operator is nearing retirement.

For more information on this topic and other tax planning for agricultural operations, please contact me at (863) 640-2008 or Tom@beasleybryantcpa.com and/or Ryan Beasley at (863) 646-1373 or Ryan@beasleybryantcpa.com . Please visit our website at www.beasleybryantcpa.com for information on other relevant topics.
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