The Tax Implications of Transferring Property to a Business Entity

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When forming a new business or funding an existing business, you may think it's a good idea to transfer assets to the business entity in exchange for ownership interest (shares in the company).

You may also be thinking about transferring certain liabilities (debt) to the entity. Transactions such as these are common, but the way you structure them can have serious tax implications. Sometimes, they trigger immediate taxation. Sometimes, they don't.



The rules vary dramatically depending on whether you're dealing with a C corporation, S corporation, partnership, or limited liability company (LLC) taxed as a partnership. The wrong choice, or simply structuring the transaction incorrectly, could leave you with an unexpected tax bill.

In this SWC singlette, we explain what you need to know before you transfer assets or liabilities to a business entity.

Transferring Property Tax-Free

If you're wondering whether you can transfer property into a business without immediately recognizing taxable gain, the short answer is yes. But whether a given transaction qualifies for favorable tax treatment depends largely on the type of entity with which you are dealing:

- Corporation (that can be either a C corp. or S corp.)
- Partnership (GP, LP, LLP),
- Limited Liability Company (LLC) taxed as a partnership

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Regardless of the type of business entity, the objective is to complete the transfer without triggering immediate taxation.

Transferring Property to a Corporation

If you're transferring property to a C corp. or S corp., you generally qualify for tax-free treatment only if the people contributing the property collectively own at least 80 percent of the corporation immediately after the transfer. Specifically, the individual or the group contributing the property must collectively own:

- At least 80 percent of the total combined voting power of all classes of stock entitled to vote, and
- At least 80 percent of the total number of shares of all other classes of stock

This ownership requirement, known as the control test, is usually easy to satisfy when you're forming a new corporation. It can be much harder if you're contributing assets to an existing corporation.

> If you want to transfer property to a corporation to which you own less than 80 percent, consider contributing the property as part of a group that collectively meets the 80 percent threshold.

Transferring Property to a Partnership or LLC

If your business is structured as a partnership or as an LLC taxed as a partnership, the rules are generally more flexible. Unlike corporations, partnerships usually don't require you to satisfy the 80 percent control test. That means you can often contribute property tax-free when you form the business, or years later as your business grows without immediately recognizing taxable gain.

That's one reason partnerships and LLCs are popular choices for real estate investors and businesses that expect ongoing capital contributions.

Watch Out for the "Disguised Sale" Rule

Partnerships offer greater flexibility, but they also come with their own pitfalls. For example, if you contribute property to a partnership and then receive cash or other property back shortly afterward, the IRS may conclude that you didn't really make a contribution. Instead, it may treat the transaction as a taxable sale.

As a general rule:

- Transactions occurring within two years receive closer IRS scrutiny; and
- The IRS may presume the transaction was actually a sale unless you demonstrate otherwise

Recent tax law changes have improved the IRS's ability to enforce these rules.

Receiving Shares in Exchange for Services

If you or another owner receives stock in exchange for services instead of property, the IRS treats that stock as taxable compensation. More important, those shares aren't subject to the 80 percent ownership requirement. If excluding those shares causes the owners who contributed property to collectively own less than 80 percent of the corporation immediately after the transfer, the entire transaction could lose its tax-free status, potentially creating an unexpected tax bill for everyone involved.

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Transferring Property with a Mortgage Attached to It

If you're transferring property that has a mortgage or other debt attached to it, the type of entity to which you're transferring it can make a dramatic difference:

- **Corporation:** A corporation can generally assume your debt without creating taxable income for you, but there are important exceptions:

If the main purpose of the transfer is to avoid federal income tax and not a bona fide business purpose, the entire amount of the transferred debt may be treated as a taxable boot (cash received).

If the debt exceeds your tax basis in the property (generally what you paid for the property, plus the cost of certain improvements, minus depreciation), the excess is automatically recognized as taxable gain, even though you didn't receive any cash. This often catches owners of highly depreciated rental property or long-held business assets by surprise.

- **Partnership:** Partnerships generally treat debt much more favorably. Instead of automatically triggering taxable gain, your share of partnership liabilities usually increases your tax basis. That increase offsets the liability relief you receive, allowing you to defer taxes that might otherwise be due immediately.

Understanding Why Your Tax Basis Matters

When you contribute property to a business, your tax basis affects more than today's transaction. It can determine the following:

- How much tax you'll owe when you eventually sell the property or your ownership interest
- The depreciation deduction your business can claim
- Whether you can deduct future losses
- The tax consequences of future transactions involving the business

Although corporations and partnerships both generally receive a carryover basis in contributed property, the way your basis is calculated differs significantly, especially when debt is involved. For example, suppose you contribute a building to a newly formed business:

- Your building is worth $250,000
- It has a tax basis of $80,000
- It has a $120,000 mortgage

If you contribute it to a corporation, you would generally recognize $40,000 of taxable gain, which, in this example, is the amount by which your mortgage exceeds your tax basis. If you contribute the same property to a partnership, you may be able to defer that gain because partnership debt is treated differently.

The property and mortgage are the same, but the tax outcome can be different.

Don't Let Taxes Be Your Only Consideration

Taxes matter, but they shouldn't be the only reason you choose one business entity over another.

For example, if you're forming a qualifying C corporation, you may eventually benefit from Qualified

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Small Business Stock (QSBS) rules, which can allow eligible owners to exclude a substantial amount of gain when they sell their stock after meeting certain requirements.

You should also consider liability protection, financing needs, ownership structure, succession planning, and your long-term business goals.

Complicated? Yes. But we can help.

At SWC, we specialize in handling complex tax scenarios like these. Whether you're struggling to figure out the best way to structure your business or are wanting to transfer property to a business or engage in another complex financial transaction, we can help you analyze the tax implications and make smarter decisions that help you achieve your personal and business goals and objectives, keep more of your money, and build long-term wealth. Contact us to schedule a consultation: (858) 487-4580 or email admin@swc.cpa.

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