Should I Own Real Estate through an S Corporation or a Partnership?

TAX SECTION

By John G. Hodnette

Holding real estate through an S corporation may seem like a good idea at first glance. Almost all professionals, however, recommend a partnership over an S corporation as the preferred vehicle to own real estate. S corporations and partnerships are both pass-through entities, meaning the income or loss generated by these entities flows through to the owners, who are responsible for paying the tax due. However, there are a number of disadvantages of owning real estate via an S corporation compared to a partnership.

First, although S corporations are often excellent for reducing self-employment taxes, income from passive real estate investments do not benefit from that because such income is not subject to self-employment taxes.

Second, when property subject to a mortgage is contributed to an S corporation, gain is triggered if the mortgage balance exceeds the tax basis of the contributed property. In contrast, contributing mortgaged property to a partnership will generally not result in taxable gain. Partners in a partnership receive an increase in their outside basis for their shares of the Partnership's liabilities. Moreover, contributing appreciated property to an S corporation is tax-exempt under Section 351(a) only if the transferring shareholders hold 80% or more of the stock. There is no similar issue for partnerships. Section 721(a) generally provides for no tax recognition for any contributing partners (without regard to 80% ownership) since Section 704(c) provides for the allocation of built-in gain or loss to the contributing partner.

Third, partnerships generally allow for tax-free distributions of appreciated property. Such distributions are actually only deferrals of tax because the distributed property has a carryover basis in the hands of the taxpayer but still provide a beneficial time value of money advantage. In contrast, an S corporation's distribution of appreciated assets is a taxable event.

Finally, partnerships can make Section 754 elections. Such an election permits the basis of the partnership's assets to be stepped-up as to the transferee upon the death of a partner or the purchase of a partnership interest. The election results in the basis of partnership assets increasing or decreasing (as to the transferee) to their fair market values as of the date of the partner's death or other transfers. Upon the death of a shareholder or the sale of stock, the stock will be stepped-up or down to its fair market value or purchase price, but there is no equivalent election that allows this step-up to affect the basis of the S corporation's assets.

These advantages of partnerships, together with their general flexibility, make partnerships an ideal vehicle for owning real estate.

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