Subdividing Your Land? Consider an S Corporation for Lower Taxes

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Did you know that Section 1237 allows individuals selling lots on subdivided land to get out of ordinary income taxes and pay at the lower capital gains rate? Well, if you’re classified as a real estate dealer (as are many who sell real estate on a regular basis), you can forget about it. You have $1 million in appreciation on your land? Yup, you’re paying taxes of up to 35 percent.

Capital gains rates, on the other hand, are capped at 15 percent. We’re talking possible tax savings of hundreds of thousands of dollars. Wouldn’t it be nice if you too could benefit from those reduced tax rates? With the right strategy, you can!

The Developer Entity

All you have to do is set up a developer entity to sell your land to. That entity then develops the land. And, how does this change your tax status? Well, it divides your income into two categories: **1)** profits on subdividing, developing, and advertising the lots are *ordinary income*, and **2)** the land sale is a *capital gain*.

Again assuming that the total appreciation for your land is $1 million, let’s say developing it makes you $500,000 in profit. With a separate developer entity, you pay $325,000 in taxes (15 percent times $1 million **plus** 35 percent times $500,000). But, if you did not set up the separate developer entity to purchase your land, you pay $525,000 in taxes (35 percent on the entire $1.5 million).

Tip: You only get the long-term capital gains tax rates if you were holding the land as an investment ***and*** owned it for more than a year.

Here’s what to do:

1. **Create an S Corporation—**This is the developer. If you own the land, you can simply set up a single-owner S corporation. In the case of a partnership (including some LLCs), you and your partners will also create an S corporation, but you’ll divide the stock according to your ownership interests.
2. **Sell the Land to Your S Corporation—**You’ll make this sale at fair market value. Use the installment payment method in order to pay the capital gains rate on your profits and the ordinary income rate on the interest paid to you by the S corporation. How you set up the loan terms is up to you. You may or may not want a down payment, or the interest may only apply to a certain period of the loan, for instance.

Of course, you will be required to charge some interest.

3. **Develop the Property and Sell—**Finally, your developer entity will prepare the lots for sale. All of the money it makes for subdividing, developing, and advertising is corporate income that passes to you and any other shareholders. Although you still have to pay your ordinary income tax rate on this money, you saved with the capital gains rates on the sale to your S corporation. Basically, the profits have been divided between you and your corporation. Notice the advantage here: you end up paying at the **lower** tax rate for your **biggest** profit and at the **higher** tax rate only for your **smaller** profit.

Why an S Corporation?

Technically, you could set up either an S or a C corporation as the developer entity for these purposes. However, you're likely to face double taxation as a C corporation, and you won't get the lower capital gains tax rates. So, usually that option doesn't make a whole lot of sense.

What you definitely **do not** want to do is set up a *controlled partnership* (including controlled LLCs) as your developer entity. Per tax law, a partnership **must** treat the gains as ordinary income if the property it purchases will not be used as a capital asset.[1] For your purposes (selling the lots at a profit), the property is certainly not a capital asset for the developer entity. With a corporation, on the other hand, you avoid such rules because you are not selling the property for stock.[2]

How Does This Method Stand Up against Audits?

Whenever your business dealings involve transactions between two entities you have an interest in, the IRS will be watching you closely. If you do not take care of all the details, the IRS could ignore your little corporate developer entity structure and just go ahead and tax everything at your ordinary income rates.

What do you need to document?

- The sale of your land to the S corporation
- When using the installment method (promissory notes), evidence that the corporation pays on the principal and interest when its due and follows all loan terms[3]
- That the formation of the corporation was separate from its purchase of the appreciated land (otherwise, the IRS could argue that the land was capital used in exchange for stocks—see Section 351[4])

- A professional appraisal of the land and evidence that this is the price you charged the S corporation

In a nutshell, keep your business and personal finances separate—always. Do not confuse your S corporation with yourself as an individual. It is a separate entity, and as long as you treat it as such, you and the IRS will get along just fine.

1. IRC Section 707(b)(2) ^
2. IRC 351(b) ^
3. See Jolana S. Bradshaw v. U.S., 50 AFTR 2d 82-5238, 82-2 USTC ^
4. IRC Section 351 ^