

Client Alert

Real Estate Department

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Acquiring a C Corp to Obtain Control Over Its Real Estate

Potential purchasers should be aware of unique risks in corporate acquisitions

Where an owner of a property is a C Corp and the property is its primary asset, its principals frequently seek to sell the stock of the C Corp to avoid the double taxation that would occur if the real estate were sold and the corporation were subsequently liquidated. Purchasing the stock of a C Corp significantly complicates the acquisition of the real estate, but at the right discounted price, the purchase may be attractive to an educated purchaser.

Unique Issues

Prospective purchasers should be aware of the unique issues that arise when considering an acquisition of stock, including the following:

1. Liabilities of the C Corp continue. The purchaser would not get the benefit of taking a deed for fair value. Pre-existing slip and fall claims, prior known or unknown disputes with third parties and, perhaps most importantly, possible tax claims could adversely impact the property's ongoing value. Surviving representations and escrow arrangements not generally found in fee simple real estate acquisitions should be considered to minimize the risks.
2. No step up in basis. The C Corp's basis would not be stepped up at closing, so the prospective purchaser would not benefit from the purchase price paid to the seller. This would reduce or eliminate the depreciation available and, of course, the potential tax impact on a future sale of the fee interest in the real estate.
3. Risk of double taxation. C Corps are subject to double taxation unlike LLCs. For example, in 2011, assuming profit (and cash) of \$1 million for a particular year, an LLC would pay no tax and a member of an LLC would pay at most the highest federal individual rate of 35% equaling a total tax payment of \$350,000. A C Corp owning the same asset would pay corporate level tax at 35% (\$350,000) and the shareholder would pay tax at a federal 15% rate on the cash distributed (\$650,000, assuming a dividend of all remaining cash), or \$97,500 resulting in an aggregate tax bill of \$447,500. Reducing profits at the C Corp level by the payment of reasonable management, leasing and other fees would be permitted.
4. Foreclosure risk. A foreclosure is a sale for tax purposes resulting in tax at the corporate level equal to the amount of the mortgage over the old basis. The IRS may seek to recover dividends paid to shareholders over the periods leading up to the foreclosure as a fraudulent conveyance. It would be difficult, therefore, for a purchaser to dividend to itself the C Corp's

cash flow up to the date of a foreclosure and then simply abandon the property in a foreclosure.

5. Limited conversion alternatives. Barring unusual circumstances, under present law, there is no tax effective way to change the status of C Corp to an S Corp or LLC to relieve the double taxation burden.

Transactional Burdens

Nevertheless, a proposed C Corp stock acquisition may make business sense, but prospective purchasers should be mindful of the additional transactional burdens involved, including the following:

1. Increased diligence. The level and scope of a prospective purchaser's due diligence investigation should be much greater than for the purchase of a fee interest. Prior contracts, tax returns, review of operations, etc., must all be reviewed. Expect diligence costs to be a multiple of the typical fee transaction.
2. Additional advisors. In addition to real estate counsel, we recommend that prospective purchasers work with tax counsel to carefully review deal structure and retain a sophisticated accounting firm to review the seller's tax returns and financial statements and to prepare projections.
3. More complex documentation. Prospective purchasers would need to carefully consider the appropriate contract representations, survivals, escrows and post-closing guarantees that might, in a typical deal, be excessive but in a stock acquisition may be crucial.

Long-term Prospects

A prospective purchaser should also have an exit strategy in mind when considering a C Corp acquisition. Long-term prospects for acquirers of C Corps include:

1. Foreign buyer. A foreign buyer with an interest in a long-term hold using a foreign holding corporation in a no or low tax jurisdiction.
2. Corporate buyer. A corporate buyer with an existing net operating loss (NOL) with at least a five-year hold horizon to satisfy rules promulgated under Internal Revenue Code Section 384.
3. Share exchange. A corporate buyer or certain publicly-traded entities with whom a tax-free exchange of shares could be structured.
4. Arbitrager. A financial player who would arbitrage the difference in value between the fair market value of a fee interest and the share purchase price. But beware of default and other risks.
5. 1031 exchange. Possible future 1031 exchange; however a 1031 exchange would only defer the tax issue, not solve it.

Typical Prospective Purchaser Profile

Given these additional considerations, the acquisition of a C Corp that holds real estate as its primary asset may not be attractive for all prospective purchasers. We believe that good candidates to acquire a C Corp's shares include:

1. Operators with affiliated management and leasing companies that provide supplementary income streams.
2. Corporate buyers with NOLs as described above.
3. Strategic buyers for whom such purchase provides an extra incentive for geographical, industry or other reasons.
4. Foreign corporate buyers that ordinarily hold real estate in a C Corp structure.

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