BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 97-180
. . .	)	Real Estate Excise Tax Document No. . . .

[1] RULE 480; RCW Ch. 82.45: REAL ESTATE EXCISE TAX -- EXEMPTIONS -- IRC § 1031 EXCHANGES. The real estate excise tax exemption allowed for certain IRC § 1031 tax deferred exchange transactions does not apply to transactions where the facilitator uses its own funds to purchase exchange property for its own benefit.

[2] RULE 670; RCW 82.45.105: REAL ESTATE EXCISE TAX -- TRADE-IN CREDIT -- SINGLE FAMILY RESIDENCES. The real estate excise tax credit allowed on the trade-in of a single family residence for another single family residence applies only to single family residential units and not to residential units containing 2 - 4 units.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

Real estate broker who took title to property as part of a series of related transactions protests the assessment of real estate excise tax (REET) on his sale of the property and contends that the transaction is entitled to either a REET exemption for an Internal Revenue Code (IRC) § 1031 tax-deferred exchange or a REET credit for the trade-in of a single family residence.[1]

FACTS:

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

Mahan, A.L.J. -- A husband and wife, are trustees and beneficiaries of the a trust. They use the trust for investment purposes. The husband (taxpayer) is a licensed real estate broker.

As a real estate broker, the taxpayer helped put together a multiparty transaction that involved an IRC § 1031 tax deferred exchange. As the transaction finally came together, in accordance with an addendum dated December 12, 1995, the owners of two single family rental units wanted to acquire a triplex and a four-plex owned by another individual by trading the equity in their property along with a promissory note for the difference. By trading their single family property, the owners sought to defer recognizing any gain they had in their property. The owner of the triplex and four-plex did not want to acquire the single family property and wanted to be cashed out. Operating as a buyer/facilitator, the taxpayer acquired the single family property and paid REET on the sale. He then advanced his own funds for the equity in the single family property to the owner of the triplex and four-plex and passed along the sellers' promissory note. In exchange, the owner of the triplex and four-plex direct deeded that property to the sellers of the single family property.

Within a short period of time after the closing of this initial set of transactions, the taxpayer sold the single family property to two third-party purchasers in separate transactions. What amount of REET should be paid on the transfer of one of these properties to a third-party purchaser is at issue in this case. The taxpayer paid REET on the full transfer price on the second sale to a third-party and may seek a refund of that amount, pending the outcome of this case.

The taxpayer originally purchased the property at issue for $70,000 and, after repair work was completed, sold it for $75,000. On March 1, 1996, the taxpayer filed a Real Estate Excise Tax Affidavit, claiming a credit under WAC 458-61-670 (Rule 670) for the trade-in of single family residences, and paid REET only on the $5,000 difference. Alternatively, the taxpayer claims that the transaction is entitled to the exemption provided for under WAC 458-61-480 (Rule 480) for IRC § 1031 tax deferred exchanges.

The Department of Revenue (Department) denied the Rule 670 exemption, because the property traded in was a triplex. The Department reasoned:

> In The Complete Guide to Washington Real Estate Practices, By Alan Tomon, page 524, he states:
>
> > **Single Family Residence** - A structure maintained and used as a single dwelling unit, designed for occupancy by one family, as in a private home.
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> Based on this information, [the Department] must conclude that the definition of single family residential dwelling does not include a three-plex.

In response, the taxpayer contends that, in the real estate closing and lending industry, it is accepted that property with 1 - 4 residential units constitutes a single family residence. By way of example, the taxpayer refers to the preamble to the Real Estate Settlement Procedures Act, 12

U.S.C. § 2601, et. seq., which refers to "single-family (one to four family) residential acquisition, financing, and refinancing." Accordingly, the taxpayer contends that Rule 670's reference to single family residences includes residences with 1 - 4 units.

The Department also denied the IRC § 1031 exchange REET exemption, because the "facilitator needs to be acting on behalf of the Buyers for the exemption to qualify" by using funds provided by the buyers. In response, the taxpayer contends that it was acting as a dual agent and, therefore, it was acting as an agent for the buyers as well as the sellers. Accordingly, the transaction qualifies for the exemption..

At the hearing on this matter, the taxpayer agreed that, upon its purchase of the single family residences from the exchangors/sellers, it bore any risk of gain or loss on the final disposition of the property. If he was able to sell the property for more that he paid for it (as happened in this case) he benefited by the increase in value.

ISSUES:

1. Whether an IRC § 1031 deferred exchange transaction where the facilitator uses his own funds to purchase exchange property is subject to a REET exemption.

2. Whether a transaction involving the trade-in of a single family residential unit for a triplex or a four-plex is entitled to a REET trade-in credit.

DISCUSSION:

1. 1031 Exchange Exemption.

[1] Internal Revenue Code Section 1031 (26 U.S.C. § 1031) provides for the tax deferral of gains on qualifying exchanges of investment and income producing property. Under the authority of that section, tax planners may avoid tax normally incurred when someone sells property by finding property that the seller would take instead of cash, thus deferring income that would otherwise be taxable. Frequently, 1031 exchanges involve multiple parties. For example, a third-party facilitator can be used to take title to the seller's property, sell it, purchase exchange (replacement) property, and then transfer the replacement property to the original seller. Because that seller does not realize cash from the sale of the property, the transaction is considered a like-kind exchange, and if the seller realizes any gain it is deferred under the federal tax provisions. See, generally, Washington Real Property Deskbook, § 73.19 (2nd ed. 1986).

A four-party exchange has become the most common form of exchange. S. Fainsbet, J. Mase, L. Snyder, Real Property Exchanges, § 1.30 (1994). It usually involves "three principals who are receiving or transferring real property and an independent intermediary." Id. The exchange of property can occur simultaneously or be deferred so long as the time limitations of IRC § 1031(a)(3) are satisfied.

As a general rule, each leg of the transfer to and from a facilitator or intermediary is subject to REET in Washington. WAC 458-61-480(1). However, a limited exception is granted with respect to certain transfers by facilitators, as follows:

> Acquisition of property by an exchange facilitator in connection with a section 1031 tax deferred exchange is subject to the real estate excise tax. The later transfer of the property by the facilitator in completion of the exchange will also be subject to the real estate excise tax unless the following requirements are met:
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> (a) The proper tax was paid on the initial transaction;
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> (b) A supplemental statement signed by the exchange facilitator, as provided by WAC 458-61-150, is attached to the real estate excise tax affidavit indicating that the facilitator originally took title to the property for the sole purpose of effecting a section 1031 federal tax deferred exchange; and
>
> (c) The funds used by the exchange facilitator to acquire the property were provided by the grantee and/or received from the proceeds of the sale of real property owned by the grantee. If the deeds for both transactions to and from the facilitator are being recorded at the same time, the proper tax can be paid on either the first or the second transaction at the discretion of the facilitator;...

WAC 458-61-480(2) (emphasis added).

This exemption requires REET to be paid on only one leg of the transfers to and from a facilitator. It generally applies to the type of exchange transactions discussed above. Here, the transfer from the taxpayer/facilitator does not qualify for the exemption in two respects. First, the taxpayer did not take title to the property for the "sole purpose" of facilitating the exchange. Rather, the taxpayer also took title to the property as an investor in the property and, thereby became a principal. Secondly, the funds used to purchase the replacement property came from the taxpayer, not from the grantee or from the sale of the grantee's property. Accordingly, the Department's denial of the 1031 exchange exemption is sustained.

2. Trade-in Credit.

[2] RCW 82.45.090 imposes an excise tax on "each sale" of real property. The term "sale" is broadly defined to include any conveyance, grant, or assignment of real property. RCW 82.45.010.

RCW 82.45.105 provides a credit whereby REET is not paid on certain transactions involving the trade-in of single family residences, as follows:

> Where single family residential property is being transferred as the entire or part consideration for the purchase of other single family residential property and a licensed real estate broker or one of the parties to the transaction accepts transfer of said property, a credit for the amount of the tax paid at the time of the transfer to the broker or party shall be allowed toward the amount of the tax due upon a subsequent transfer of the

> property by the broker or party if said transfer is made within nine months of the transfer to the broker or party: PROVIDED, That if the tax which would be due on the subsequent transfer from the broker or party is greater than the tax paid for the prior transfer to said broker or party the difference shall be paid, but if the tax initially paid is greater than the amount of the tax which would be due on the subsequent transfer no refund shall be allowed.

By administrative Rule 670 the Department limits the credit to improved real property by modifying the term "single family residential" with the word "dwelling." In relevant part, Rule 670 provides:

> (1) When a single family residential dwelling is being transferred as the entire or part consideration for the purchase of another single family residential dwelling and a licensed real estate broker or one of the parties to the transaction accepts transfer of said property, a credit for the amount of the tax paid at the time of the transfer to the broker or party shall be allowed toward the amount of the tax due upon a subsequent transfer of the same property by the broker or party.
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> (2) The subsequent transfer must be made within nine months of the original transfer for the credit to be allowed. If the tax which would be due on the subsequent transfer from the broker or party is greater than the tax paid for the prior transfer to said broker or party, the difference shall be paid, but if the tax initially paid is greater, no refund shall be allowed.

The rule and statute provide a benefit to a taxpayer by allowing a sale without the payment of REET when a single family residence is traded in. Provisions that grant a benefit or an exemption from a taxable category must be narrowly construed. As stated in Budget Rent-A-Car, Inc. v. Department of Rev., 81 Wn.2d 171, 174- 75, 500 P.2d 764 (1972):

> Exemptions to the tax law must be narrowly construed. Taxation is the rule and exemption is the exception. Anyone claiming a benefit or deduction from a taxable category has the burden of showing that he qualifies for it. Exemptions to the tax laws must be narrowly construed.

At issue here is whether transactions involving the trade-in of single family residences for a triplex or a four-plex qualifies for the credit. Depending on the context, there is authority for the proposition that the term "single family residence" includes 1 - 4 units and for the proposition that it is limited to only single units.

For example, Excise Tax Bulletin 460.04.146, with respect to the deductibility of interest on first mortgages, provides:

> The Department has concluded that "nontransient residential property" includes but is not limited to:

> Single family residences (one to four units)
> Apartments. . .

In contrast, the property tax laws draw a distinction between single family residential units and residential units containing 2 - 4 units. WAC 458-53-030(5). In relevant part, it provides:

> The following two digit land use code shall be used as the standard to identify the actual use of the land. Counties may elect to use a more detailed land use code system using additional digits, however, no county land use code system may use fewer than the standard two digits.
>
> RESIDENTIAL
>
> 11 Household, single family units
> 12 Household, 2-4 units
> 13 Household, multi-units (5 or more). . .

Assessment rolls and reports provided to the Department follow this same classification system.

WAC 458-53-050. A similar distinction is used for property valuation methods. WAC 458-12-327, which provides in relevant part:

> Properties shall be valued or adjusted based upon the following uses.
> (i) Single family residential
> (ii) Residential 2 - 4 units
> (iii) Residential multiple units (5 or more). . .

For several reasons, we conclude that we should follow the property tax laws in drawing a distinction between single family residences and residences with 2 - 4 units. As with the property tax laws, the REET provisions are concerned with a fair allocation of the tax burdens based on the use or value of the property. In contrast, we do not find any compelling reason to apply the less precise classifications of property for lending or related purposes. Further, a use of the more limited definition of what constitutes a single family residence is consistent with a narrow construction of this exemption provision.

Accordingly, the Department's denial of the trade-in credit is sustained.

DECISION AND DISPOSITION:

The taxpayer's petition is denied. This matter is remanded to the Miscellaneous Tax Division for collection in accordance with this decision.

Dated this 8th day of September, 1997.