

Cite as Det No. 09-0240, 29 WTD 58 (2010)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| In the Matter of the Petition For |) | <u>D E T E R M I N A T I O N</u> |
| Correction of Assessment of |) | |
| |) | No. 09-0240 |
| ... |) | |
| |) | Registration No. . . . |
| |) | Document No. . . . |
| |) | Docket No. . . . |
| |) | |

WAC 458-61A-212; RCW 82.45.010(3)(p) – REET – CONTROLLING INTEREST TRANSFER - EXEMPTIONS: Taxpayer’s acquisition of a 50% interest in a limited liability company (LLC) through the sale of 50% of the membership units does not qualify for the exemption provided in WAC 458-61A-212 and RCW 82.45.010(3)(p), which is limited to transfers under the Internal Revenue Code that involve “entity formation, liquidation or dissolution, and reorganization.” When a LLC member receives a payment from the LLC and the payment is treated as a sale under 26 I.R.C. § 741, REET is imposed on the selling price.

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.

Callahan, A.L.J. – A [business] owner protests the real estate excise tax (“REET”) assessment on a controlling interest transfer claiming that, pursuant to RCW 82.45.010(3)(p) and WAC 458-61A-212, the assessment should be reduced [only] to the extent that the gain was recognized in an Internal Revenue Code (“I.R.C.”) § 731 transaction. We deny the petition.¹

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

ISSUE

[Does a limited liability company (LLC)'s payment to the taxpayer, as a result of the transfer of one member's entire interest in the LLC, qualify as a liquidation distribution under I.R.C. section 731 and thus limit the measure of the REET to the extent when the gain is recognized pursuant to RCW 82.45.010(3)(p) and WAC 458-61A-212(4)?]

FINDINGS OF FACT

[Taxpayer] and his spouse owned 50% of [a] corporation and the other 50% was owned by Taxpayer's [relative] and . . . spouse. The corporation leased real property from a related entity [Lessor LLC], which was owned in the same proportion by the same individuals who owned the corporation.

The Department of Revenue's ("Department's") Special Programs Division received a license renewal and annual report dated November 12, 2007, for [Lessor LLC] from the Department of Licensing. According to the Special Programs Division, this report indicated that [Lessor LLC] owned real property and there was a change of more than 50% ownership in the [Lessor LLC] during the last twelve months from the registration. Based on this information, on January 30, 2008, the Special Programs Division sent an inquiry letter to Taxpayer for the controlling interest transfer transaction. The Special Programs Division received no response from Taxpayer, initially. On June 26, 2008, the Special Programs Division issued a REET assessment against Taxpayer. The assessment was in the amount of \$. . . , which consisted of tax \$. . . , interest \$. . . and delinquent penalty \$. . . and tax assessment penalty \$. . . . The assessment was based on the value of the real property recorded in [the] County Assessor's records held by [Lessor LLC]. Taxpayer did not pay the assessment and petitioned the Department's Appeals Division for correction of assessment.

A copy of the Purchase and Sale of Membership Units in [Lessor LLC] provided by Taxpayer indicated that [Taxpayer's relative and spouse] sold their aggregate 50% membership units in [Lessor LLC] to [Lessor LLC] for \$. . . . The sale agreement labeled as "Purchase and Sale of Membership Units in [Lessor LLC]," was signed by [all owners]. It contained the following relevant language:

COME NOW [Lessor LLC] hereinafter referred to as "Purchaser" and [Taxpayer's relative and spouse] hereinafter referred to as "Sellers", and covenant and agree as follows:

Each of the Sellers own 25% of the outstanding membership units of [Lessor LLC]/

[Taxpayer's relative and spouse] are desirous of selling all of their membership units to Purchaser.

1. Purchaser shall purchase and Sellers shall sell all of their membership units in Lessor LLC] for a price of \$. . . to be paid pursuant to the terms of a promissory note executed contemporaneous herewith. . . . Said transaction and transfer shall be effective on the date written herein and upon the execution of the promissory note.

2. This transaction is unsecured and the rights and obligations to the membership units of the limited liability company shall immediately transfer to the limited liability company. Effective immediately herewith, each of the sellers hereby resign any positions held with [Lessor LLC].

3. Purchaser shall assume and hold Sellers harmless from any and all liability arising out of [Lessor LLC].

4. Each of the parties agree to execute, on demand, any and all deeds, receipts, acknowledgements, documents or any other matters necessary to effectuate this transaction.

Immediately after this sale, [Lessor LLC] distributed the acquired 50% membership units in the LLC to Taxpayer and his spouse. Accordingly, Taxpayer and spouse each own 50% of [Lessor LLC].

Taxpayer claims that for federal tax purposes, LLCs with more than one owner are governed by the partnership rules.² Taxpayer argues, thus the LLC's redemption of a partner's interest is treated as a distribution under 26 I.R.C. § 731. Taxpayer argues that under 26 I.R.C. § 731, gain is recognized to the extent the money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. Taxpayer states in this case, for purposes of 26 I.R.C. § 731, [Taxpayer's relative and spouse] recognized an aggregate gain of \$. . . . Taxpayer further asserts when [Lessor LLC] made the payments to [Taxpayer's relative and spouse], those payments were treated as distributions to them, and the taxable amount was limited to the extent that the gain was recognized under 26 I.R.C. § 731. Taxpayer claims,

² Taxpayer did not provide a citation for this statement in its petition. Taxpayer's statement is partially correct because for federal tax purposes, under the "check-the-box" system of entity classification, an LLC is an "eligible entity" that may elect to be classified for tax purposes either as a partnership (if it has more than one member) or as a corporation. Therefore, an LLC may elect to be classified as a corporation for federal tax purposes. Treas. Reg. § 701.7701-3. This federal regulation provides:

A business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

accordingly, that pursuant to RCW 82.45.010(3)(p) and WAC 458-61A-212, the REET should only apply to the amount of the transaction for which gain was recognized. In other words, Taxpayer asserts the taxable portion for REET should be limited to \$. . . . In support of his argument, Taxpayer provided a copy of [Lessor LLC's] federal tax return, Form 1065, Schedule K-1. The Schedule K-1 indicated that the gain recognized by [Taxpayer's relative and spouse] was reported under line 19 of [Lessor LLC] for distributions made to them.

ANALYSIS

Chapter 82.45 RCW imposes the REET on every sale of real estate in Washington. "The term "sale" shall have its ordinary meaning and shall include any conveyance, grant, assignment, quitclaim, or transfer of the ownership of or title to real property" RCW 82.45.010(1). The term "sale" also includes "the transfer or acquisition within any twelve-month period of a controlling interest in any entity with an interest in real property located in this state for a valuable consideration." RCW 82.45.010(2). As used in chapter 82.45 RCW, the term "controlling interest" means "in the case of a partnership, association, trust, or other entity, fifty percent or more of the capital, profits, or beneficial interest in such partnership, association, trust, or other entity." RCW 82.45.033(2) (emphasis added). The Department's administrative rule, WAC 458-61A-101, mirrors the definition of "controlling interest" under RCW 82.45.033(2).

RCW 82.45.032 defines, for REET purposes, the terms "real estate" and "real property" to include the interest that an individual has in an entity that owns real property in this state. It provides that those terms include "the ownership interest or beneficial interest in any entity which itself owns land or anything affixed to land." *Id.* Under these provisions, either the transfer or the acquisition of a controlling interest in a partnership that owns real property in Washington triggers REET liability.

Except where specifically exempted, chapter 82.45 RCW imposes an excise tax on every sale of real estate in this state at the rate of 1.28 per cent of the "selling price." RCW 82.45.060. Additional local excise taxes are also permitted. Under RCW 82.45.030, the term "selling price" is defined to include:

(2) If the sale is a transfer of a controlling interest in an entity with an interest in real property located in this state, the selling price shall be the true and fair value of the real property owned by the entity and located in this state. If the true and fair value of the real property located in this state cannot reasonably be determined, the selling price shall be determined according to subsection (4) of this section.

See also WAC 458-61A-102(8).

Under RCW 82.45.010(3), the term "sale" does not include:

(p)(i) A transfer that for federal income tax purposes does not involve the recognition of gain or loss for entity formation, liquidation or dissolution, and reorganization, including

but not limited to nonrecognition of gain or loss because of application of section 332, 337, 351, 368(a)(1), 721, or 731 of the Internal Revenue Code of 1986, as amended.

(Emphasis added). In accordance with this statutory provision, WAC 458-61A-212 provides an exemption from REET for transfers that do not involve the recognition of gain or loss for entity formation, liquidation or dissolution, and reorganization under 26 I.R.C. § 731. WAC 458-61A-101(11) describes the [reasoning] of this exemption as follows:

Because transfer and acquisition of a controlling interest in an entity that owns real estate in this state is statutorily defined as a "sale" of the real property owned by the entity, the exemptions of chapter 82.45 RCW and this chapter also apply to the sale of a controlling interest.

In the event a transaction qualifies for the exemptions under chapter 82.45 RCW, but a gain is partially recognized under the related I.R.C. provisions, WAC 458-61A-212(4) provides that "the real estate excise tax applies to the amount of the transaction for which gain is recognized."

As quoted in the language above, exemptions under chapter 82.45 RCW such as an I.R.C. § 731 transaction, are applicable to a transfer of controlling interest. It is undisputed that there was a transfer of controlling interest in this case. Thus, if the transaction at issue qualifies as an I.R.C. § 731 transaction, the REET applies to the amount of the transaction to the extent that the gain is recognized. Taxpayer argues that when [Lessor LLC] paid [Taxpayer's relative & spouse] for the membership units sold, the payments were treated as distributions to [Taxpayer's relative & spouse] for federal tax purposes under 26 I.R.C. § 731.

26 I.R.C. § 731 deals with partnership distributions. The Internal Revenue Code, Title 26 I.R.C., defines "liquidation of a partner's interest" as the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. 26 I.R.C. § 761(d). Payments in liquidation of a partner's interest, to the extent they are an exchange for the interest of the withdrawing partner in the partnership property, are considered distributions of partnership assets. 26 I.R.C. § 736(b).

Treatment of the liquidation payments as payments in exchange for partnership interests under I.R.C. § 736(b) would result in the same tax consequences to the partners as I.R.C. § 731. Treas. Reg. § 1.736(b)(1). Under 26 I.R.C. § 731(a)(1), on the receipt by a partner of a distribution in liquidation of a partnership, the partner will not recognize gain, except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.³

In contrast to a liquidation, the sale of an interest in a partnership is a taxable event whereby gain or loss is recognized to the transferor. 26 I.R.C. § 741. For purposes of determining whether a transaction is a liquidation of a partner's interest, so that distributive shares of partnership income

³ A partner's adjusted basis for his/her partnership interest is commonly known as "outside basis." An "inside basis" is the partnership's basis for its assets.

are considered ordinary income to the withdrawing partner, or is a sale of the partner's interest, thereby placing the entire ordinary income tax liability for the partnership income on the remaining partners, the amount received in "liquidation" is contingent on the financial condition of the business at the time of the dissolution, while the amount received in a "sale" is a fixed sum or determined by formula. 26 I.R.C. §§ 736(a), 741.⁴ Thus, a sale is a bilateral act of parties acting at arm's length, which concludes with a property exchange. Inherent in a sale is a fixed or readily ascertainable amount of money, which is traded for something of value. In contrast, a liquidation is the process of reducing assets to cash, discharging liabilities and dividing surplus or loss. If the business continues, surplus or loss is determined by an accounting; and, the remaining partners pay the withdrawing partners for their interests.

The plain language of the contract supports the conclusion that the transaction at issue was in substance a sale and not a liquidation of the retiring partners' . . . interests. It appears that the words "purchase" and "sell" in the contract are . . . evidence that an I.R.C. § 741 sale was contemplated by the parties. See *Foxman v. C.I.R.*, 352 F.2d 466 (3rd Cir. 1965) (affirming the Tax Court's decision below holding that on a consideration of the plain language of the contract and the circumstances surrounding the transaction, the transaction was in substance a sale and not a liquidation of a retiring partner's interest.) . . .

The facts here are similar to *Foxman* in that the contract provided execution of promissory notes upon its consummation of the agreement with a fixed amount of a series of payments. The selling price was a fixed sum rather than contingent on the financial condition of the business at the time of the resignation of the retiring partners. The relevant language in the contract here was couched in terms of "purchase" and "sell" as the Tax Court in *Foxman* recognized that it leaves no room for other interpretation. We conclude that the transaction at issue was a sale rather than a liquidation distribution.

Taxpayer argues I.R.C. § 741 controls the characterization of the gain only, i.e., either capital gain or ordinary income, but does not calculate how much is taxable or exempt, which is governed by I.R.C. § 731. In essence, Taxpayer claims the REET should only apply to the extent of the gain when the basis is subtracted by the amount realized. We disagree. Under 26 I.R.C. § 741, the selling partner's gain or loss is determined by any difference between the amount realized and the outside basis of the partnership interest. The results of the gain recognized are

⁴ 26 I.R.C. § 736(a) provides:

(a) Payments considered as distributive share or guaranteed payment.--Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered--
(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or
(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

26 I.R.C. § 741 states:

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).

the same for an I.R.C. § 731 and an I.R.C. § 741 transaction. However, the tax consequences are different for REET purposes.

The exemptions provided in chapter 82.45 RCW quoted above only apply to non-sale transactions. WAC 458-61A-212 does not apply to sales, but is limited to transfers under the I.R.C. that involve “entity formation, liquidation or dissolution, and reorganization.” The controlling interest that [Taxpayer’s relative and spouse] conveyed to [Lessor LLC] was a sale and thus none of the exemptions provided in chapter 82.45 RCW apply. I.R.C. § 731 deals with the extent of recognition of gain or loss on distributions. Payments made by [Lessor LLC] to the retiring members of the LLC were not made in liquidation of their partnership interests but were made as a part of a capital transaction. Therefore, we conclude that the Special Programs Division correctly imposed REET on the value of the real property held by the LLC at the time of the transaction.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 3rd day of September 2009.