Cite as Det. No. 06-0289, 26 WTD 244 (2007)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of TI&E Letter Ruling	)	<u>DETERMINATION</u>
	)	
	)	No. 06-0289
	)	
. . .	)	Registration No. . . .
	)	. . .
	)	TI&E Letter Ruling

[1] WAC 458-61A-101, WAC 458-61A-212, WAC 458-61A-101; RCW 82.45.010, RCW 82.45.030, RCW 82.45.032, RCW 82.45.060: REET – EXEMPTION – CONTRIBUTION OF ASSETS AND LIABILITIES IN RETURN FOR PARTNERSHIP INTERESTS. A transaction is exempt from real estate excise tax (REET) when partnerships that merge with another partnership, pursuant to Section 708 of the Internal Revenue Code of 1986 (I.R.C.) as amended, contribute, pursuant to Section 721 of the I.R.C. all of their assets and liabilities, including ownership interests in certain apartment buildings, to the other partnership (OP) in return for partnership interests in OP.

[2] WAC 458-61A-101, WAC 458-61A-212, WAC 458-61A-101; RCW 82.45.010, RCW 82.45.030, RCW 82.45.032, RCW 82.45.060: REET – EXEMPTION – CONTRIBUTION OF ASSETS AND LIABILITIES IN RETURN FOR PARTNERSHIP INTERESTS. Partnerships that contribute all of their assets to another partnership (OP) pursuant to Sections 708 and 721 of the I.R.C., including their ownership of apartment buildings, are not required to obtain a majority interest in OP in order for the transaction to be exempt from REET for the contributing partnerships.

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.

De Luca, A.L.J. – Two partnerships comprised of several business entities planned to contribute their assets and liabilities, including ownership of two apartment buildings located in Washington, to another partnership (OP) in return for partnership interests in the other partnership. The two partnerships and their partners requested a ruling from the Taxpayer Information & Education (TI&E) section of the Department of Revenue (DOR) that their transaction would be exempt from real estate excise tax (REET). We agree with the partnerships that the transaction is exempt from REET and we reverse the TI&E letter ruling, which concluded that the proposed transaction was not tax exempt.[1]

ISSUES

1. Is a transaction exempt from REET when partnerships that merge with another partnership, pursuant to Section 708 of the Internal Revenue Code of 1986 as amended, contribute, pursuant to Section 721 of the Internal Revenue Code of 1986 as amended, all of their assets and liabilities, including ownership interests in certain apartment buildings, to the other partnership (OP) in return for partnership interests in OP?

2. Must the partnerships that contribute all of their assets to OP, including their ownership of apartment buildings, obtain a majority interest in OP in order for the transaction to be exempt from REET for the contributing partnerships?

FINDINGS OF FACT

This matter is an appeal from a . . . letter ruling from TI&E. At the time of the ruling request the parties were partners in two existing partnerships comprised of . . . business entities . . . . We will refer to them collectively as the "partnerships." The partnerships owned . . . buildings in the state of Washington. They intended to contribute all of the assets and corresponding liabilities, including ownership in the . . . buildings, to another partnership (OP) in return for partnership interests in OP. The partners of the two partnerships asked TI&E if their transfer would be exempt from REET pursuant to RCW 82.45.10(3)(p)(i). That statute lists specific sections of the Internal Revenue Code (I.R.C.) that involve the non-recognition of gain or loss for entity formation, liquidation or dissolution, and reorganization, *infra*. TI&E responded by letter . . . ruling that the transaction did not qualify for the REET exemption because the transfer of assets took place under provisions of I.R.C. § 708, which is not generally a non-recognition section of the I.R.C. and is not specifically listed under RCW 82.45.010(3)(p)(i) as a section of the I.R.C. that qualifies for the REET exemption.

The letter ruling added that another reason the transfer of real property from the partnerships to OP did not qualify for the REET exemption was because the continuing partners that contributed their controlling interests in their partnerships to OP would have a minority interest in OP and, thus, would have relinquished and transferred a controlling interest in the real property.

The partnerships disagree with both reasons given in the letter ruling and appealed the ruling to the Appeals Division. We note that after filing the ruling request with TI&E, the partnerships completed their transaction by merging with and transferring their assets to OP, paid REET, and filed with the IRS a completed Form 1065 (U.S. Return of Partnership Income) with schedules and attachments. The return recognized no gain or loss from the transfer of assets and liabilities

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

to OP pursuant to I.R.C. § 721, *infra*. Nonetheless, the partnerships decided to continue with their appeal of the TI&E letter ruling.

ANALYSIS

Transfers of Controlling Interests.

Under RCW 82.45.010, a sale for REET is defined to include:

> [T]he 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. For purposes of this subsection, all acquisitions of persons acting in concert shall be aggregated for purposes of determining whether a transfer or acquisition of a controlling interest has taken place. The department of revenue shall adopt standards by rule to determine when persons are acting in concert.

(Underlining ours.)[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: "[T]he ownership interest or beneficial interest in any entity which itself owns land or anything affixed to land."

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. Det. No. 00-083, 19 WTD 1037 (2000).

Measure of the Tax.

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 percent of the "selling price." RCW 82.45.060. Additional local excise taxes are 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

[2] The legislature amended Ch.82.45 RCW in order to treat the transfers of controlling interest in a uniform manner with other interests of real property. In doing so, it expressly stated as its intent:

> The legislature finds that transfers of ownership of entities may be essentially equivalent to the sale of real property held by the entity. The legislature further finds that all transfers of possessions or use of real property should be subject to the same excise tax burdens.

Laws of 1993, ch. 25 section 501.

> 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.

(Underlining ours.) *See also* WAC 458-61A-101(4) (formerly WAC 458-61-025(4)); Det. No. 00-083.

Exemptions from the Tax.

RCW 82.45.010(3) defines the term "sale" not to 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.

In accordance with this statutory provision, WAC 458-61A-212(1) and (2)(d) (formerly 458-61-376(1) and (2)(e)) provide an exemption from REET for transfers that do not involve the recognition of gain or loss for entity formation, liquidation or dissolution and reorganization of partnerships under I.R.C. § 721. WAC 458-61A-101(11) (formerly WAC 458-61-025(11)) describes the effect 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.

See Det. No. 00-083.

Thus a transfer of a controlling interest in a partnership that owns real estate in this state is exempt from REET providing the transfer for federal income tax purposes does not involve the recognition of gain or loss for entity formation, liquidation or dissolution, and reorganization under I.R.C. § 721.

The TI&E letter ruling denied the exemption, in part, because it found that the partnerships' transfer took place under I.R.C. § 708, which is not one of the non-recognition sections of the I.R.C. listed in RCW 82.45.010(3)(p)(i). We first note that the exemption language in that statute expressly states that the REET exemption is not limited to only those sections of I.R.C. that are specifically listed in the exemption statute. But, more importantly, as we will explain, the partnerships actually made their transfer of their controlling interests in real property to OP pursuant to I.R.C. § 721.

I.R.C. § 708 is not in conflict or mutually exclusive with I.R.C. § 721. For federal tax purposes, I.R.C. § 708 provides the process and consequences of what happens when two or more partnerships merge or consolidate. Whereas, I.R.C. § 721 provides for the non-recognition of gain or loss to a partnership or any of it partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. The general rule is

> [I]f two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can, under the preceding sentence, be considered a continuation of more than one of the merging or consolidating partnerships, it shall . . . be considered the continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership. <u>Any other merging or consolidating partnerships shall be considered terminated.</u>

(Underling ours). Treas. Reg. § 1.708-1(c)(1). Thus, under I.R.C. § 708 when two or more partnerships merge and one partnership continues to own more than 50 percent of the capital and profits of the resulting partnership, the resulting partnership is considered the continuation of the majority partnership. The other partnerships are considered terminated for federal income tax purposes. By itself, I.R.C. § 708 does not determine or control the taxability of the contribution of assets and liabilities from one partnership to another. Instead, it governs what becomes of those partnerships upon merging or consolidating. On the other hand, a consequence of the merger is the contribution of assets and liabilities from one partnership to the other. And I.R.C. § 721 controls whether or not the contribution qualifies for a non-recognition of gain or loss for federal income tax purposes.

In the present matter, when the partnerships that owned the apartment buildings in Washington contributed their controlling interests in those assets and merged with OP, they were considered terminated and OP was considered the continuing partnership for purposes of I.R.C. § 708. Concurrently, the non-recognition of gain or loss on the contribution of the controlling interests in the apartment buildings from the partnerships to OP occurred pursuant to I.R.C. § 721. In fact, that is how the partnerships reported the non-recognition of gain or loss to the IRS when they filed their return earlier this year for the transaction with OP (we have been provided a copy) by stating in the return:

> On July 28, 2005, the Partnership entered into an "assets-over" merger within the meaning of Treasury Regulation Section 1.708-1(c)(3) with [OP]. . . .
>
> <u>. . . The Partnership then (i) contributed its assets and liabilities to [OP] in exchange for a limited partnership interest in [OP] represented by units ("OP Units") in a tax-deferred contribution of property governed by Code Section 721</u> and (ii) distributed the OP Units to the partners other than [OP] in liquidation of the Partnership in a tax deferred distribution of property governed by Code Section 732(b).

(Underlining ours.) *See also* Rev. Rul. 77-458, 1977-2 CB 220 for an example of a ruling that demonstrates I.R.C. §§ 708 and 721 are not mutually exclusive, but can and do work together. That ruling pertained to the merger of ten general partnerships pursuant to I.R.C. § 708 and the non-recognition of gain or loss pursuant to I.R.C. § 721 resulting from the transfer of all the assets and liabilities from the various partnerships into the continuing partnership.

Thus, we find that the partnerships transferred all of their assets and corresponding liabilities, including the apartment buildings, to OP with a non-recognition of gain or loss in accordance with I.R.C. § 721.

The second issue is whether the partnerships that contributed their assets and liabilities to OP had to obtain a majority interest in OP in order for the transfer of their controlling interests in the apartment buildings to be exempt from REET. We find no basis for that position. I.R.C. § 721(a) provides that as a general rule:

> No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

See also Treas. Reg. § 1.721-1(a). There is no requirement in I.R.C. § 721 or the supporting regulation that requires a partnership or any of its partners to obtain a controlling or majority interest in the partnership following its contribution of property to the partnership in order to qualify for the non-recognition of gain or loss. The statute and regulation simply require a contribution of property to the partnership in exchange for an interest in the partnership. The statute and regulation do not state that the contribution must be "for a majority interest in the partnership." This conclusion is supported by an example given in WAC 458-61A-212 ("Transfers where gain is not recognized under the Federal Revenue Code"):

> (5)(c) Brenda and Julie are partners in LIMA Partnership. In a nontaxable Internal Revenue Code section 721 transaction, Mike transfers real property to LIMA Partnership in exchange for a partnership interest in LIMA Partnership. No consideration, other than the partnership interest in LIMA Partnership, is given to Mike in exchange for Mike's transfer of real property. Because the transfer is exempt under Internal Revenue Code section 721, the real estate excise tax does not apply to Mike's conveyance of real property to LIMA partnership

There is no requirement in this rule example regarding Mike's transfer of his real property to the LIMA Partnership that he obtain a majority interest in that partnership to qualify for the REET exemption. Thus, in the present matter there is no requirement that the partnerships obtain a majority interest in OP upon transferring their controlling interests in the real property to OP in order to qualify for the REET exemption.

DECISION AND DISPOSITION

The petition is granted. We reverse the . . . TI&E ruling and hold that the transfer of the properties to OP in return for partnership interests in OP are exempt from REET.

Dated this 29th day of November 2006.

STATE OF WASHINGTON DEPARTMENT OF REVENUE