

Cite as Det No. 10-0175, 30 WTD 54 (2011)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
))	No. 10-0175
))	
))	Registration No. . . .
))	Document No. . . .
))	Docket No. . . .
))	

RULE 458-61A-101; RCW 82.45.010(2); RCW 82.45.030: REAL ESTATE EXCISE TAX (REET) – TRANSFER OF CONTROLLING INTEREST - SELLING PRICE – TRUE AND FAIR VALUE OF PROPERTY CONVEYED – APPRAISAL WITH A LACK OF MARKETABILITY DISCOUNT: For REET purposes, the use of an appraisal with a lack of marketability discount is an acceptable method in determining the true and fair value of real property in which the transfer of a controlling interest in an LLC occurs when the LLC has a one-third tenancy in common interest in real property located in this state.

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. – A trustee of a trust (the taxpayer) protests the amount of the assessment of real estate excise tax (REET) based on the transfer of a controlling interest in an LLC that has a one-third tenancy in common interest in real property located in this state. The measure of the tax is the true and fair value (market value) of the property, which in this matter, is determined by an appraisal of the real property. Decision: Petition granted.¹

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

ISSUE

For REET purposes, pursuant to RCW 82.45.030 and WAC 458-61A-101, is the use of an appraisal with a lack of marketability discount an acceptable method in determining the true and fair value of real property in which the transfer of a controlling interest in an LLC occurs when the LLC has a one-third tenancy in common interest in real property located in this state?

FINDINGS OF FACT

[Taxpayer] is a Washington limited liability company. [Trustee] is the trustee of a trust that owned . . . of the LLC's units, which represented 68% ownership interest in the LLC. The LLC redeemed [those] . . . units from the trustee taxpayer for \$. . . . At the time of the transfer of the units, the LLC's assets included \$. . . in cash and a one-third tenancy in common interest in a shopping center

In order to determine the redemption price, the trustee and the LLC obtained an appraisal of the entire property The appraisal concluded that the fair market value of the entire property, as of [a certain date], was \$. . . . Next, the parties obtained an appraisal of the LLC by [a firm] accredited in business valuation. . . . The appraisal of the LLC determined that the LLC's net asset value was \$. . . (33% of the property's fair market value of \$. . . plus \$. . . in cash.) But the LLC appraiser concluded that the net asset value approach was not an appropriate method for valuing the LLC because it did not reflect the minority nature of LLC's tenancy in common interest, the LLC's only significant asset.

Consequently, the appraiser used the income and market approaches in determining the LLC's value. In applying the income approach, the appraiser used a discounted rate that reflected the minority nature of the LLC's tenancy in common interest. In applying the market approach the appraiser similarly used a price-to-net asset value ratio that reflected the minority nature of the tenancy in common interest. After determining the LLC's value under each approach, the appraiser applied a 30% discount to reflect the lack of market for the LLC's units. He gave a double weight to the income approach value and a single weight to the value reached under the market approach. He then determined that the fair market value of the LLC's . . . units was \$. . . per unit, for a total of \$. . . . Based on this value the parties determined that the fair market value of the taxpayer's . . . units was [the redemption price].

On January 12, 2009, the trustee, as the transferor, filed a Real Estate Excise Tax Affidavit and Controlling Interest Transfer Return with the Department of Revenue (DOR). The trustee paid \$. . . in REET and accrued interest through January 31, 2009. The trustee based this tax amount on the . . . redemption price that the LLC paid her for the controlling interest of [the] units.

On February 25, 2009, DOR's Special Programs Division notified the parties that it intended to assess REET on the property's full assessed value of \$. . . for the 2008 tax year. The trustee then provided DOR with copies of the property and LLC appraisals. DOR agreed that REET was not due on the full assessed value of the property. Instead, it decided that REET was due based on

the one-third tenancy in common interest in the property as measured by the appraised value of . . . the entire property. Consequently, DOR determined that the value of the one-third tenancy in common interest was \$. . . and it assessed the LLC REET on that amount, plus interest and a 20% late payment penalty and a 5% substantial underpayment (assessment) penalty while crediting the parties for the amount of REET previously reported and paid.² The net amount due was \$. . ., which remains unpaid.

The taxpayer next obtained another (supplemental) appraisal from the appraiser who had appraised the LLC as a whole. Unlike the appraisal determining the value of the LLC, the supplemental appraisal valued the LLC's tenancy in common interest in the real property. In the supplemental appraisal, the appraiser applied a lack of marketability discount to the tenancy in common interest, rather than to a minority interest in the LLC, in determining the LLC's value under the income and market approaches. As noted, the appraiser applied a 30% discount for lack of marketability to the LLC's units rather than to its tenancy in common interest. But he determined that the 30% discount that applied to the LLC's value due to lack of marketability did not entirely apply to the value of the tenancy in common interest.

Instead, the appraiser explained that the fair market value of the tenancy in common interest should reflect a 15% discount for lack of marketability, because there was no established market for fractional interests in real property like the one-third tenancy in common interest. The appraiser stated that the 15% discount should apply to both the income and market approaches in valuing the tenancy in common interest. After giving double weight to the income approach and single weight to the market approach, the appraiser determined that the true and fair value of the tenancy in common interest was \$. . ., which was more than the appraised value of the LLC units, but less than the appraised value of the one-third tenancy in common interest in the real property without the discounts for lack of marketability. The Special Programs Division did not accept [that] appraised value . . . with the lack of marketability discounts. Instead it retained the assessment based on . . . one-third of the entire property's appraised value without the discounts. DOR did not obtain an appraisal to counter the taxpayer's appraisals.

ANALYSIS

The taxpayer contends that the REET assessment should be based on the value [of the tenancy in common interest as determined by the supplemental appraisal] rather than the value [based on

² The assessment was issued against the LLC as the transferee because:

- (7) **Tax liability.** When there is a transfer or acquisition of a controlling interest in an entity that has an interest in real property, the seller of the interest is generally liable for the tax.
 - (a) When the seller has not paid the tax by the due date and neither the buyer nor the seller has notified the department of the sale within thirty days of the sale, the buyer is also liable for the tax.
 - (b) When the buyer has notified the department of the sale within thirty days of the sale, the buyer will not be held personally liable for any tax due.

WAC 458-61A-101. The sellers and the buyer failed to notify DOR within thirty days of the January 1, 2008 sale. Accordingly the Special Programs Division issued the assessment against the LLC as buyer.

one-third of the entire property's appraised value without the discounts]. It concedes that the prior payment of REET based on the lower valuation of the LLC units, rather than the tenancy in common interest, was insufficient. But the taxpayer argues that it was [an] error for DOR to reject applying the discount for lack of marketability in appraising the tenancy in common interest.

Chapter 82.45 of the Revised Code of Washington imposes an excise tax on every sale of real property located within this state unless the sale is specifically exempted from the tax. RCW 82.45.060; WAC 458-61A-100.³ The term "sale" for REET purposes "shall have its ordinary meaning and shall include any conveyance, grant, assignment, quitclaim, or transfer of the ownership of or title to real property . . . for a valuable consideration." 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). In the case of a partnership, association, trust, or other entity a "controlling interest" means "fifty percent or more of the capital, profits, or beneficial interest in such partnership, association, trust, or other entity." (Underlining added.) RCW 82.45.033(2); WAC 458-61A-101(2)(a)(ii).

The facts are that a controlling interest transfer occurred on January 1, 2008 when the LLC redeemed 68% of its units from the trustee in exchange for \$. . . REET is due because a sale for REET purposes includes any transfer or acquisition of fifty percent or more of the beneficial interest in the LLC. *Id.* The trustee/transferor does not dispute that REET was and is due, but the question remains how much REET is due and that depends on the measure of the tax.

The measure of the tax is the "selling price." The "selling price" is defined in the rule as "the true and fair value of the real property owned by the entity at the time the controlling interest is transferred." WAC 458-61A-101(4). The rule defines "true and fair value" as "market value." "Market value" means "the amount of money that a willing, but unobliged, buyer would pay a willing, but unobligated, owner for real property, taking into consideration all reasonable, possible uses of the property." WAC 458-61A-101(2)(c). If the true and fair value of the property cannot reasonably be determined, then a fair market value appraisal of the property may be used to determine its true and fair value. WAC 458-61A-101(4)(a)(i). In accordance with this provision the taxpayer provided two certified appraisals of the property, one for the entire property and the other for the tenancy in common interest in the property (plus a third one for the value of the LLC's units.) As noted, DOR accepted only the appraised value for the entire property. But we have no evidence, such as other appraisals, that dispute or contradict the value of the tenancy in common interest in the supplemental appraisal of the property.

In the supplemental appraisal the appraiser described the problems of ownership of a fractional interest in real estate compared to 100% ownership. He explained that any owner of a fractional

³ Interest was assessed as mandated by RCW 82.45.100(1) and (4). A 20% late payment (delinquent filing) penalty was assessed as required by RCW 82.45.100(2). A 5% substantial underpayment of tax (assessment) penalty also was imposed as required by RCW 82.32.090(2) because the taxpayer paid less than eighty percent of the amount of tax that was owed and the tax amount exceeded \$1,000.

interest in real property in Washington has the right to partition the property, a right to a pro rata share of income, a right to a judicial sale if partition is not feasible, and a right of management and possession. Consequently, the owner of a fractional interest does not have complete control over the property. This inability to control the disposition or other use of the property results in the illiquidity of the fractional interest and a decrease in value from the pro rata value of the interest in the property.

The American Institute of Real Estate Appraisers concurs with the statements in the appraisal:

The value of undivided partial interests poses a problem for appraisers. Because no party can exercise complete control, the interest of each party is usually not worth as much as the corresponding fraction of the property's market value.

The Appraisal of Real Estate 124 (10th ed. 1992).

The Washington Court of Appeals has addressed the use of lack of marketability discounts in determining the value of corporate assets. *See Matthew G. Norton Co. v. Smythe*, 112 Wn. App. 865, 51 P.3d 159 (2002). *Norton Co.* concerned a merged company that filed an action pursuant to Chapter 23B.13 RCW, Dissenters' Rights, to determine the fair value of dissenting shareholders' shares. In order to resolve the value of the dissenting shareholders shares, Norton Co. hired Arthur Andersen to determine the market value of certain corporate assets. The Court of Appeals noted that Arthur Andersen used different approaches, such as market and cost approaches, to value the assets. Where the corporation owned less than a controlling share of a particular corporate asset Arthur Andersen applied a minority discount factor to reflect lack of controlling interest and marketability of the corporation's interest in that particular asset. 112 Wn. App. at 866.

The Court of Appeals, later in the opinion, concluded:

A buyer purchasing MGN [Norton Co.] or NWBC in its entirety, or purchasing certain of its assets, would likely require a discount to reflect such company's lack of a controlling interest or lack of marketability of certain of its holdings. Thus, such discounts may very well be appropriate, at the corporate level, with respect to the value of particular corporate assets. As we have noted, Arthur Andersen did apply such discounts with respect to certain of the corporate assets. At the corporate level, the willing buyer-willing seller standard for determining "fair market value" of the various corporate assets is certainly appropriate.

112 Wn. App. at 880.

The Court of Appeals subsequently declared:

The trial court's order may (or may not) have been intended to preclude minority and lack of marketability discounts that Arthur Andersen applied at the corporate level in

adjusting the book value of certain of the assets of the corporation to determine their fair market value. To the extent that the order was so intended, we reverse.

112 Wn. App. at 881.

Thus, not only the real estate appraisal profession, but the Washington Court of Appeals has recognized that the use of lack of marketability discounts can be appropriate in developing appraisals where the seller lacks controlling interest in the asset (including real property) being sold. Moreover, WAC 458-61A-101(4) permits the use of appraisals to determine the “true and fair value” of real property for REET purposes. In short, we have no factual or legal basis to exclude the supplemental appraisal that applied a lack of marketability discount in valuing the tenancy in common interest in the real property at a true and fair (market) value

We note that REET is due on the full value of .[the tenancy in common interest as determined by the supplemental appraisal] and not just on 68% of that amount. We direct the trustee’s attention to this point because when she initially paid REET on the lower appraised value of the LLC units she paid only 68% of the full value of the units because she transferred 68% of the units to the LLC. But it is already well settled that the measure of the tax is the “true and fair value” of the Washington real property owned by the entity. RCW 82.45.030(1) and WAC 458-61A-101(4); *McFreeze Corp. v. State, Dep’t of Revenue*, 102 Wn. App. 196, 201, 6 P.3d 1187, 1190 (2000) (In the sale of a controlling interest of a corporation, partnership, or other entity that owns Washington real property, “the value taxed is not the consideration paid, but the value of the real estate owned by the entity.”). As we explained in Det. No. 98-083, 17 WTD 271, 276 (1998), with respect to the sale of an interest in an LLC that owned Washington real property:

[T]he tax at issue . . . bears no relation to the funds received by the taxpayers for [their] interest in the LLC. Rather, the incident giving rise to the tax is the transfer of the beneficial ownership in real property located in this state. Accordingly, the amount of the tax is based on the value of the real property, not the interest in the LLC that was transferred.

It is also well settled that the tax is not prorated by the percentage of the interest being sold. *McFreeze Corp.* at 201, 6 P.3d at 1190 (“[N]othing in the statutes authorizes the taxpayer to apportion the tax. . . . [I]f the sale is 50 percent or more [of the entity], tax is on the full value of the real estate owned by the entity.”); Det. No. 00-083, 19 WTD 1037, 1040 (2000) (“Under the applicable provisions, the measure of the tax is the value of the real property, not the proportionate amount of the beneficial interest that was transferred.”); Det. No. 98-083, 17 WTD 271, 276 (1998) (“[W]e find no support for construing the statute in such a manner as to require the application of REET . . . on a pro-rata basis.”). Thus, REET is due on the total value of the Washington real property even though only a 68% interest in the LLC was redeemed by the LLC. Therefore, we conclude that the measure of the REET is the true and fair value as determined by the supplemental appraisal, with credit due for the prior partial payment of REET.

DECISION AND DISPOSITION

The taxpayer's petition is granted. The REET assessment with appropriate penalties and interest shall be based on a true and fair value of \$. . . .

Dated this 4th day of June, 2010.