

Cite as Det No. 09-0089, 29 WTD 19 (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. 09-0089 |
| ... |) | |
| |) | Registration No. . . . |
| |) | Document No. . . . |
| |) | Docket No. . . . |

WAC 458-61A-101; RCW 82.45.033: REET – CONTROLLING INTEREST.
An option to purchase a future interest in an LLC owning real estate does not create a present transfer of a beneficial interest in that entity such that the transaction could result in a transfer of a controlling interest subject to REET.

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 husband and wife (Taxpayer) who held a 100% ownership interest in real property transferred the real property to a limited liability company (LLC) in return for a 100% membership interest in the LLC. Subsequently, Taxpayer sold a 49% interest in the LLC to the buyers with two options to purchase the total remaining 51% interest in the LLC. The Department of Revenue’s (Department) Special Programs Division discovered the transfer of the 49% interest with the options and determined that the transaction was subject to real estate excise tax (REET). Taxpayer argues that the transaction was exempt from REET pursuant to RCW 82.45.010(2) because a transfer of 49% of an entity does not trigger REET and because an option to purchase, until exercised, does not constitute a sale or transfer of a present beneficial interest. We agree with Taxpayer and grant the petition.¹

ISSUE

Under RCW 82.45.010, does the sale of a 49% interest along with an option to purchase the remainder in the future constitute a transfer of a controlling interest subject to REET?

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

FINDINGS OF FACT

On March 3, 2006, Taxpayer transferred their 100% interest in real property to an LLC in exchange for a 100% membership interest in the LLC. Taxpayer reported the transfer but considered the transaction a “mere change in identity or form” and claimed an exemption from real estate excise tax under WAC 458-61A-211(2). On April 24, 2007, the Department’s Special Programs Division sent an inquiry letter asking Taxpayer to validate the exemption claim. Special Programs also contacted Taxpayer to confirm that the buyers were members of the LLC. In response, Taxpayer provided the Special Programs Division a copy of the Unit Purchase and Sales Agreement (Agreement) between Taxpayer and the buyers. The Agreement in relevant part provides:

WHEREAS, Seller [Taxpayer and his spouse] is the record and beneficial owner of Two Thousand (2,000) voting units and Two Hundred Thousand (200,000) non-voting units; and

WHEREAS, Buyer [the buyers] desires to purchase nine hundred eighty (980) of Seller’s Voting Units and ninety-eight thousand (98,000) of Seller’s Non-Voting Units from Seller (collectively “Units”), and Seller desires to sell the Units to Buyer, in each case upon the terms and conditions set forth in this Agreement.

1.3 2007 Option In consideration of this Agreement, Seller grants to Buyer a right to purchase nine hundred eighty (980) of Seller’s voting rights and ninety eight thousand (98,000) of Seller’s non-voting units in . . . following Closing. This option may not be exercised by Buyer prior to November 15, 2007, and may only be exercised by Buyer notifying Closing Agent of the exercise of the option no earlier than November 15, 2007, and no later than November 31, 2007. . . .

1.4 2009 Option In consideration of this Agreement, Seller grants to Buyer a right to purchase Seller’s remaining forty (40) voting units and four thousand (4,000) non-voting units in . . . following Closing. This option may not be exercised by Buyer prior to January 15, 2009, and may only be exercised by Buyer notifying Closing Agent of the exercise of the option no earlier than January 15, 2009, and no later than January 31, 2009. . . .

[Brackets ours]. This Sales Agreement indicated that a 49% interest in the LLC was sold to the buyers on September 7, 2006. The Sales Agreement also granted the buyers an option to purchase a 49% interest in the LLC in November 2007 and an option to purchase the remaining 2% interest in the LLC in January 2009. Based on this information, the Special Programs Division determined that the options granted to the buyers to purchase the remaining interest in the LLC occurred within a twelve-month period from when Taxpayer sold the 49% interest in the LLC to the buyers, and that the transfer of the 49% interest plus the options constituted a transfer of controlling interest in the LLC. As a result of this conclusion, on August 23, 2007, the Special Programs Division issued an assessment against Taxpayer in the amount of \$. . . .

Taxpayer did not pay the assessment but timely petitioned the Department's Appeals Division for a cancellation of the assessment. Taxpayer asserts in his petition that granting an option to purchase does not constitute a sale that triggers REET until such option is exercised where the property is actually transferred pursuant to RCW 82.45.010(2). Taxpayer argues that the options to purchase were not exercised by the buyers. In support of his argument, Taxpayer submitted a letter dated November 15, 2007 from the buyers to Taxpayer. In this letter, the buyers declined to exercise the November 2007 option to purchase the 49% interest in the LLC. The November 15, 2007 letter provided the following language:

This letter is to advise you that we will not be exercising our option to purchase additional units of . . . L.L.C., as outlined in our Unit Purchase and Sale Agreement dated September 7, 2006.

This letter indicated that a copy of it was sent to the escrow company. Taxpayer provided a letter from this escrow company to prove that it indeed received a copy of the November 15, 2007 letter. The letter from the escrow company has the following language:

In regards to the above account, accept this letter as verification that we are in receipt of the letter dated 11/15/2007, wherein the purchasers, . . ., expressed their intent not to exercise the option to purchase **any** additional units of . . . LLC. (Emphasis ours).

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, 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).

It is undisputed that the sale of the 49% interest in the LLC, by itself, was not a transfer of a controlling interest. However, the Agreement between the parties also included two options for the buyers to purchase additional units in the LLC, either of which would result in buyers acquiring a controlling interest in the LLC. Thus, Special Programs deemed the transaction between the seller and the buyers to be a transfer of a beneficial interest. The transfer of a beneficial interest of 50% or more is, according to the definition cited above, a transfer of a controlling interest which subjects the transfer of the real property to REET. While there is no statutory definition of "beneficial interest", this term has been defined as "the profit, benefit, or advantage resulting from a contract, or the ownership of an estate as distinct from the legal ownership or control". *Christiansen v. Dep't of Social Security*, 15 Wash. 2d 465, 131 P.2d 189 (1942). We find this definition helpful in determining whether the Agreement's inclusion of the

options to purchase additional units in the LLC in the future constituted a present transfer of a beneficial interest such that this transfer caused the buyers to acquire a controlling interest in the LLC and therefore subject the transfer to REET. We do not find a transfer of an option constitutes a transfer of a beneficial interest.

In this case, the initial sale of the 49% interest of the LLC was not contingent upon the buyers exercising an option to purchase an additional 49% interest by November 15, 2007 or an additional 2% interest by January 2009. There were no obligations imposed on the buyers to purchase the additional 51% interest of the LLC other than to do so by certain dates. *See Strong v. Moore*, 105 Or. 12, 207 P. 179, 23 A.L.R. 1217 (1922). At issue is whether an option to purchase a future interest in an LLC with an interest in real estate in this state creates a present transfer of a “beneficial interest in that entity” such that the transaction could result in a transfer of a controlling interest and therefore be subject to REET.

Under RCW 82.45.010(2) a transfer of a controlling interest in an entity with an interest in real estate in this state is subject to REET. We conclude, however, that the mere existence of an option does not result in transferring an interest in the entity to the optionee nor does it create any rights of ownership in that entity for the optionee. *Cf. Strong*, 105 Or. 12 at 21 (although the case involved an option to purchase real property rather than an interest in an entity, the court held that “an optionee possesses nothing except the right to elect to buy, and he has no interest in the land until by his acceptance of the option he transforms the option into a contract of sale and changes his character from that of an optionee to that of a vendee”). An “option” is “merely a contract by which an owner agrees that another shall have the privilege of buying his property at a fixed price and within the time expressly or implied prescribed by the writing.” *Id.* In the matter before us, the Agreement similarly provided an option for the buyers to purchase additional interests in the LLC by certain dates. The buyers specifically declined to exercise the first option and it appears from the evidence provided that the parties understood that the buyers had also declined to exercise the second option. Thus, until the buyers exercised their option to purchase the additional 49% or the 2% interest in the LLC, they had not acquired any additional equitable interest in the LLC. We conclude that the cited cases provide analogous authority and that the mere existence of the options at the time of the transfer of the 49% interest in the LLC did not create a beneficial interest in the LLC such that there was a transfer of a controlling interest.

Similarly, under Washington case law, an option itself cannot be construed as conveying or creating a beneficial interest in the entity. *Cf. Gossett v. Farmers Ins. Co. of Washington*, 133 Wn. 2d 954, 948 P.2d 1264 (1997) (although involving an option to purchase real property rather than an interest in an entity, the Supreme Court of Washington held that “a mere option to purchase is insufficient to constitute an insurable interest”); *Robroy Land Co. v. Prather*, 95 Wn. 2d 66, 71, 622 P.2d 367 (1980) (“an optionee acquires no equitable interest or interest in the optioned land”.) We conclude that the cited cases provide analogous authority and that the mere existence of the options at the time of the transfer of the 49% interest in the LLC did not create a beneficial interest in the LLC such that there was a transfer of a controlling interest.

In this matter, Taxpayer did not exercise either option. Without the buyers' acquisition of the additional interests in the LLC within a twelve-month period, there was no transfer of a controlling interest. We conclude the transaction at issue is therefore not subject to REET. We grant Taxpayer's petition.

DECISION AND DISPOSITION

Taxpayer's petition is granted.

Dated this 7th day of April 2009.