

Cite as Det. No. 16-0350, 36 WTD 406 (2017)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS 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. 16-0350
)	
...)	Registration No. . . .
)	

RCW 82.45.010(3)(a); RCW 82 .45.030(3); WAC 458-61A-201(1), (3), and (6)(f): REAL ESTATE EXCISE TAX (REET) – DEFINITION OF “SALE” – “TRANSFER” OR “ACQUISITION” – CONTROLLING INTEREST TRANSFER IN LLC THAT OWNS RENTAL PROPERTY – EXEMPTIONS - GIFTS. The extinguishment of members’ fifty percent interest in a LLC that owns rental property constitutes a controlling interest transfer and is not exempt from REET taxation as a gift.

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.

Stojak, T.R.O. – A limited liability company (LLC), that owns real property in the state, petitions for correction of an assessment of Real Estate Excise Tax (“REET”) on the transfer of a controlling interest in the LLC asserting that the transfer of interest was a gift where there had been no change in the parties responsible for the debt on the property or in the source of funds used to make monthly mortgage payments. Taxpayer’s petition is denied.¹

ISSUES

Is the transfer of a controlling interest, in an entity that owns real property, subject to REET when the rental income is used to make mortgage payments and the grantors remain liable for the underlying debt on the property?

FINDINGS OF FACT

[Couple 1] are husband and wife and are the parents of [Daughter].² [Daughter] and [Ex-husband (Couple 2)] were husband and wife until they divorced in August of 2014. In August of 2005, [Couple 1] and [Couple 2] purchased a parcel of real property in . . . Washington (“property”).

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

² [Daughter] is the contact person listed on the Review Petition.

The property was financed through a mortgage from . . . whereby all four individuals were borrowers on the loan.³ The property has at all times been maintained as a rental property.

In December of 2009, [Couple 1] and [Couple 2] formed a member-managed Washington LLC . . .⁴ (“the LLC”) in which each individual held a twenty-five percent interest. Upon formation, ownership in the property was transferred to the LLC pursuant to a statutory warranty deed. Subsequently, in December of 2009, all interests in the LLC were assigned to . . . (“the Partnership”).

In July of 2014,⁵ the Partnership was dissolved and all interests in the LLC held by the Partnership reverted back to the LLC. In August of 2014, [Ex-husband’s] interest in the LLC was assigned to [Daughter] pursuant to divorce proceedings. On January 1, 2015, the [Couple 1] transferred each of their respective interests in the LLC to [Daughter] pursuant to an Assignment of Limited Liability Interests (“Assignment”) rendering her the sole remaining member. The Assignment included the following language:

Whereas . . . a Washington limited Liability company . . . [(Company), has] been the subject of ambiguous ownership;

Whereas, the member(s) and manager(s) of [Company] desire to clarify ownership of [Company], and Assignors (defined herein) desire to gift their interests in . . . Company to [Daughter.]

On December 10, 2015, [Daughter] renewed the LLC’s business license indicating that the LLC owned real property in Washington and that there had been a transfer of a controlling interest. The Department of Licensing notified the Department of Revenue (“Department”), and on January 6, 2016, the Special Programs Division (“Special Programs”) of the Department sent an inquiry letter to the LLC. The letter requested completion of a controlling interest affidavit and informed the LLC that if it failed to submit the affidavit, it would be assessed REET based on the information currently available.

In response to Special Programs’ inquiry, [Daughter] completed a REET Affidavit Controlling Interest Transfer Return and a REET Supplemental Statement (“Supplemental Statement”). [Daughter] indicated on the Supplemental Statement that the transfer of interests reported on the LLC’s renewal report was a gift without consideration, and therefore, not subject to REET. [Daughter] checked line 2.B.3. on the Supplemental Statement attesting that “Grantee (buyer) has made and will continue to make 100% of the payments on total debt of \$. . . and has not paid grantor (seller) any consideration towards equity,” and therefore, no tax is due.

Special Programs held several phone calls and exchanged multiple emails with the LLC’s representative requesting additional documentation, including mortgage statements, bank statements, the divorce decree from the [Couple 2’s] divorce, and any other documents relevant to

³ . . . services the loan.

⁴ The address of the relevant property is . . . WA

⁵ [Daughter] stated, in an August 8, 2016 email, that she did not recall the exact date of dissolution. Secretary of State Website lists the date of dissolution as July 2, 2014.

the transfer of interests in the LLC. Through various exchanges with Special Programs, [Daughter] explained she did not believe the transfer of interests in the LLC was subject to REET based on the fact that [Couple 1] were still liable for the outstanding loan on the property and that there had been no change in who was making the mortgage payments.

On June 2, 2016, the Department assessed the LLC⁶ \$. . . in REET based on the total taxable value determined by the . . . County Assessor for the 2016 tax year.⁷ [Daughter] appealed the assessment on behalf of all parties and maintains the position that REET is not due because the transfer of interests was a gift.

[Daughter] provided additional details during the administrative review process regarding the relevant property to support her assertion that the transfer of interests in the LLC was a gift. [Daughter] explained that each month, the rental income from the property is deposited in a bank account in the LLC's name. Funds from this bank account are then used to pay the mortgage on the property. If there are insufficient funds in any given month to cover the mortgage, or any other expenses related to the property, [Daughter] deposits her own funds into the LLC's bank account to cover the shortfall. [Daughter] asserts that these facts remained the same both before and after [Couple 1] transferred their interests in the LLC to herself. [Daughter] asserts that all of these facts support her position that the transfer of interests in this case was a gift.

ANALYSIS

Chapter 82.45 RCW imposes the REET on every sale of real estate in Washington. “[T]he term ‘sale’ has its ordinary meaning and includes 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 RCW 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).

For controlling interest transfers, REET is measured by the “selling price.” RCW 82.45.030(2) defines the “selling price” applicable to controlling interest transfers. It provides:

(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.

. . .

⁶ Pursuant to RCW 82.45.033 the obligation to pay the REET may be enforced against the LLC in which a controlling interest is transferred, against the persons who acquired the controlling interest in the LLC, or against the person who transferred the controlling interest. In this case, the assessment was sent to the LLC, the transferors, and the transferee.

⁷ This total included tax of \$. . . interest of \$. . . , a delinquency penalty of \$. . . , and an assessment penalty of \$. . .

(4) If the total consideration for the sale cannot be ascertained or the true and fair value of the property to be valued at the time of the sale cannot reasonably be determined, the market value assessment for the property maintained on the county property tax rolls at the time of the sale shall be used as the selling price.

Thus, in the transfer of a controlling interest in an entity, the value taxed is not the consideration paid, but rather, the value of the real estate owned by the entity. *See* 34 WTD 061 (2015) (citing *McFreeze Corp. v. Dep't of Revenue*, 102 Wn. App. 196, 6 P.3d 1187 (2000)).

[Daughter] does not dispute that the acquisition of a controlling interest in the LLC transpired.⁸ However, [Daughter] asserts that [Couple 1's] transfer of their interests in the LLC to herself was a gift.

RCW 82.45.010(3)(a) excludes from the term "sale" a transfer by gift. WAC 458-61A-201 ("Rule 201") is the administrative rule that explains the REET gift exemption. Rule 201(1) explains as follows:

A gift of real property is a transfer for which there is *no consideration* given in return for granting an interest in the property. If consideration is given in return for the interest granted, then the transfer is not a gift, but a sale, and it is subject to the real estate excise tax to the extent of the consideration received.

(Emphasis added). The statutory definition of consideration is quite broad. RCW 82.45.030(3) defines consideration as:

As used in this section, "total consideration paid or contracted to be paid" includes money or anything of value, paid or delivered or contracted to be paid or delivered in return for the sale, and shall include the amount of any lien, mortgage, contract indebtedness, or other incumbrance, either given to secure the purchase price, or any part thereof, or remaining unpaid on such property at the time of sale.

Accordingly, if there is consideration exchanged, then the transfer is not a gift and the exemption is inapplicable. Rule 201(6) explains that consideration includes "monetary payments from the grantee toward underlying debt (such as a mortgage) on the property that was transferred, whether the payments are made toward existing or refinanced debt."

Rule 201(3) addresses assumption of debt. It states:

If the grantee agrees to assume payment of the grantor's debt on the property in return for the transfer, there is consideration, and the transfer is not exempt from tax.

⁸ [Daughter] has not specifically challenged Special Program's use of the . . . County Assessor's taxable value for purposes of calculating the applicable REET. However, Special Programs sent [Daughter's] representative an email on March 28, 2016, stating that the correct measure for calculating the tax "would be 50% of the outstanding debt at the time of transfer." It is worth noting that this statement was incorrect, and that ultimately, the assessment was based on the correct measure.

Here, the transfer of controlling interest at issue involved an interest in an LLC that owns rental property. Rule 201(6)(f) provides the following example regarding a transfer of rental property:

Sue owns a rental property valued at \$200,000, with an underlying mortgage of \$175,000. Sue conveys the property to herself and Zack as tenants in common. Prior to the transfer, the rental income went to a bank account in Sue's name only, and she made the mortgage payments from that account. After the transfer, Zack's name is added to the bank account. The rental income is now deposited in the joint account, and the mortgage payments are made from that account. There is a rebuttable presumption that this is a taxable transaction, because this appears to be a business arrangement. As a business venture, one-half of the rental income now belongs to Zack, and is being contributed toward payment of the mortgage.

In this case, payments towards the outstanding debt on the property were made from an account where rents were deposited. With the transfer of the controlling interest in the LLC, the grantors, [Couple 1], relinquished their rights to any rental income and 100 percent of the rental income now belongs to the grantee, [Daughter]. From the time the property was transferred, [Daughter] has used the rental income to pay the mortgage for which [Couple 1] remains liable. The reduction of debt that [Couple 1] receives each month is consideration.

[Daughter] bases her position that the controlling interest transfer was a gift on the fact that there has been no change in the parties liable for the outstanding debt on the property or in the source of funds used to make mortgage payments. However, as exemplified by Rule 201(6)(f), these facts alone are insufficient to defeat the presumption of taxability in the case of rental properties. Like Zack in the example provided by Rule 201(6)(f), the controlling interest transfer in this case resulted in [Daughter] receiving rental income to which she was not previously entitled. Like Sue in the example in Rule 201(6)(f), [Couple 1] receives relief of debt from [Daughter's] contribution of the additional rental income she realized as a result of the transfer towards the outstanding mortgage.

Unlike the example in Rule 201(6)(f), the controlling interest transfer in this case did not result in a change to the holder of the bank account from which rental income flows in and out. The holder of the bank account in this case remains the LLC. However, before the controlling interest transfer, multiple members maintained control over the direction of rental income deposited in the LLC's bank account. Now, the control over the direction of the rental income is vested in a single member, [Daughter]. Like the rental income belonging to Zack in Rule 201(6)(f), the additional rental income belonging to [Daughter], as a result of the transfer, is directed towards payment of the mortgage. . . .

In summary, [Couple 1] received consideration for their transfer of controlling interests in the property to [Daughter]. With the transfer of interests in the LLC, [Couple 1] has no claim on the rental income received, which is used to make mortgage payments. [Daughter] continues to use the rental income from the property to make the mortgage payments, which remain a legal obligation of [Couple 1]. This relief of the amount due under the mortgage constitutes consideration. Thus, the transfer does not qualify for the gift exemption and REET is due. The

REET was correctly calculated by using the taxable value determined by the . . . County Assessor. Accordingly, the assessment is sustained.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 3rd day of November 2016.