

Cite as Det. No. 18-0043, 38 WTD 165 (2019)

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. 18-0043
)	
...)	Registration No. . . .
)	

RCW 82.45.010(3)(q): REAL ESTATE EXCISE TAX – SALE –EXCLUSIONS – LIQUIDATING DISTRIBUTION TO MEMBER UNDER 26 U.S.C. § 731. A transfer of real property from a limited liability company to a current member, in complete liquidation of the member’s interest, where the transfer qualifies as a liquidating distribution under 26 U.S.C. §731 and there is no gain or loss recognized from the transfer, is exempt from real estate excise tax.

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.

Anderson, T.R.O. – A limited liability company disputes an assessment of real estate excise tax (“REET”) on a transfer of real property to one of its members. The company asserts that the transfer of such real property was a liquidating distribution under 26 U.S.C. § 731, where neither the member nor company recognized gain or loss, and such a transfer is exempt from REET under RCW 82.45.010(3)(q)(i). Petition granted.¹

ISSUE

Whether a liquidating distribution of real property, under 26 U.S.C. § 731, from a limited liability company to its member, where neither the limited liability company nor member recognized gain or loss, is exempt from REET under RCW 82.45.010(3)(q)(i).

FINDINGS OF FACT

. . . (“Taxpayer”) is a Washington limited liability company formed in June of 2008, by three family members to purchase real property that had been in the family for decades and was at risk of foreclosure. The three family members and their initial membership interests in Taxpayer are as follows: (1) [Member A] – 33.3%; (2) [Member B] (brother of [Member A]) – 33.3%; and (3) [Member C] (son of [Member A]) – 33.3%.

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

From 2008 through 2012, Taxpayer acquired real property from its members' families. Taxpayer acquired nearly 75 acres located at . . . WA . . . , from . . . ([Member A's] brother) and his wife in 2008. In 2012, Taxpayer acquired another 5 acres from [Member A's brother] and his wife, located at . . . WA Also in 2012, Taxpayer received contributions of parcels of real property located . . . [in Washington], from all three members.²

Later in 2012, Taxpayer performed lot line adjustments and sold two parcels to third parties – one for cash and one seller-financed. This left Taxpayer with cash from the sale, a promissory note, and approximately 80 acres of real property.

In April of 2014, [Member B] no longer wished to be a member of Taxpayer and the members agreed that [Member B] would receive 40 acres as his distributive share of Taxpayer's assets. On September 4, 2014, Taxpayer executed a quit claim deed to convey the 40 acres to [Member B], and on September 15, 2014, [Member B] resigned his membership interest in Taxpayer. The parties filed a REET Affidavit that reported the transfer of real property and claimed the transfer was exempt from REET under WAC 458-61A-211(2)(b) as a mere change in identity of the owner.

On October 19, 2016, the Department's Special Programs Division ("Special Programs") contacted Taxpayer to audit the exemption claimed on the REET Affidavit. Taxpayer stated that it had erroneously claimed the transfer of real property was exempt from REET under WAC 458-61A-211, when it should have claimed an exemption from REET under WAC 458-61A-212, as a transfer where no gain is recognized under the Internal Revenue Code. In support, Taxpayer provided a copy of the Quit Claim Deed, excerpts from Taxpayer's 2014 federal tax return, Taxpayer's Certificate of Formation, and Taxpayer's Limited Liability Company Agreement.

Special Programs reviewed these documents and concluded that Taxpayer had not shown that no gain was recognized under the Internal Revenue Code with respect to the transfer of real property, because the excerpts from Taxpayer's federal tax return were workpapers and not the actual tax return. On December 7, 2016, Special Programs issued a \$. . . assessment against Taxpayer; this amount is comprised of \$. . . in REET, \$. . . in interest, \$. . . in delinquent penalty, and \$. . . in assessment penalty.

Taxpayer timely requested review of this assessment. Taxpayer asserts that the transfer of real property to [Member B] is exempt from REET under WAC 458-61-212, as a transfer where no gain was recognized under section 731 of the Internal Revenue Code (26 U.S.C. §731). In support, Taxpayer provided [Member B's] resignation letter, a complete copy of Taxpayer's 2014 federal tax return with accompanying schedules, and the Declaration of . . . (a certified public accountant employed by Taxpayer and [Member B] to prepare their 2014 federal income tax returns). Taxpayer's 2014 federal tax returns and accompanying schedules show a distribution to [Member B] of \$. . . in cash and \$. . . in real property; a decrease to the combined balance of the members' capital accounts; and an increase in [Member A's] and [Member C's] ownership percentage in Taxpayer to 50% each.

² . . . (father of [Member A] and [Member B], grandfather of [Member C]) gifted [Member A], [Member B], and [Member C] parcels of real property and each member, in turn, contributed the gifted parcels to Taxpayer.

ANALYSIS

A sale of real property is subject to REET. RCW 82.45.060. “Sale” is broadly defined by statute and “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). However, certain transfers of real property are excluded from the definition of “sale.” *See* RCW 82.45.010(3).

Here, Taxpayer transferred the real property at issue to [Member B] via quitclaim. Under RCW 82.45.010(1), this transfer constitutes a “sale,” unless a specific exclusion applies. Taxpayer asserts that the transfer of real property to [Member B] is not a “sale” (and not subject to REET) because it is a transfer where gain was not recognized under 26 U.S.C. § 731 and excluded from the definition of “sale” (and REET) by RCW 82.45.010(3)(q)(i).

RCW 82.45.010(3) reads as follows:

(3) The term “sale” does not include:

...

(q)(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 26 U.S.C. Sec. 332, 337, 351, 368(a)(1), 721, or 731 of the internal revenue code of 1986, as amended.

RCW 82.45.010(3)(q)(i). Thus, the statute sets forth three requirements to exclude a transfer from the definition of “sale” as an Internal Revenue Code nonrecognition transfer: (1) a transfer of real property; (2) for entity formation, liquidation, dissolution, or reorganization; and (3) that does not result in the recognition of gain or loss, for federal income tax purposes. *Id.* *See also* WAC 458-61A-212. Only the second and third requirement are at issue here.

To start, we must determine whether Taxpayer’s transfer of the real property to [Member B] was for entity formation, liquidation, dissolution, or reorganization. While these terms are not defined in RCW 82.45.010(3)(q)(i) or elsewhere in Chapter 82.45 RCW, these terms are defined by the federal income tax provisions referenced in RCW 82.45.010(3)(q)(i) (“ . . . entity formation, liquidation or dissolution, and reorganization, including but not limited to nonrecognition of gain or loss because of application of 26 U.S.C. Sec. 332, 337, 351, 368(a)(1), 721, or 731 of the internal revenue code of 1986, as amended.”). By mentioning these specific provisions of the Internal Revenue Code, RCW 82.45.010(3)(q)(i) includes, but does not limit, how those terms are defined with respect to the specific code provisions mentioned.

One of the mentioned Internal Revenue Code sections, 26 U.S.C. § 731, governs the taxation of distributions. For purposes of 26 U.S.C. § 731 (and the entire subchapter K), “liquidation of a partner’s interest” means 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 U.S.C. § 761(d).

Here, Taxpayer provided [Member B's] resignation letter and its federal tax return with accompanying schedules that show [Member B] received cash and real property in exchange for his entire membership interest. The liquidating distribution of cash and the real property to [Member B] converted [Member B's] membership interest in Taxpayer to cash and real property; it satisfied [Member B's] claim to his interest in Taxpayer's assets and terminated his interest in Taxpayer. We conclude that, under U.S.C. § 761(d), Taxpayer's transfer of cash and real property to [Member B] was a liquidation of [Member B's] membership interest. Accordingly, we conclude that the transfer of real property to [Member B] was for liquidation. The second requirement is met.

Next, we must determine whether Taxpayer's transfer of real property to [Member B] did not result in the recognition of gain or loss for federal income tax purposes. To do so, we first look to the filed federal income tax return(s). In the case of a limited liability corporation that has elected to report to the Internal Revenue Service as a partnership, we examine the filed, complete federal tax return for the entity (Form 1065 – U.S. Return of Partnership Income with supporting attachments) and the accompanying Schedule K-1s (Partner's Share of Income, Deductions, Credits, etc.) for each member.³ Although a partnership will never recognize gain or loss at the entity level . . . [(see 26 U.S.C. § 731(b) (“no gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money”)], the partnership's federal income tax return with accompanying Schedule K-1s, will report each partner's share of income, deductions, and credits. See Laura E. Cunningham & Noel B. Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships*, 1 (3rd ed. 2006) (“The partnership acts as a conduit, through which its various items of income and loss flow to the individual partners, who must annually report their shares of those items on their own income tax returns.”). This return, with accompanying schedules, may provide information sufficient to determine whether a partner recognized gain or loss on a specific transfer.

Taxpayer asserts that the transfer of real property to [Member B] was a liquidating distribution where gain was not recognized under 26 U.S.C. § 731. As mentioned above, 26 U.S.C. § 731 governs the recognition of gain or loss on a distribution from a partnership to a partner. In pertinent part, it reads: “In the case of a distribution by a partnership to a partner – (a) gain shall not be recognized to such partner, except to the extent that *any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution . . .*” 26 U.S.C. § 731(a)(1) (emphasis added).

In order for a partner to recognize gain with respect to a partnership distribution, the partner would need to receive a distribution of money that exceeds the partner's outside basis in the partnership. 26 U.S.C. § 731(a)(1); see Treas. Reg. § 1.731-1(a)(1).⁴ When a partner receives a distribution of

³ [We note that in interpreting the REET exclusion in RCW 82.45.010(3)(q), we look to whether any gain or loss for federal income tax purposes was recognized on the transfer of real property. In such cases, we would normally look to the transferor or transferee to determine if either recognized any gain or loss. However, as mentioned above, when the transferor or transferee is an entity treated as a pass through for federal income tax purposes, and will never recognize gain or loss on the transfer, we must look to whether the individual partner(s) or member(s) recognized gain or loss to determine whether the transfer of real property qualifies under RCW 82.45.010(3)(q).]

⁴ A reduction in a partner's share of partnership liabilities is treated as a distribution of money. 26 U.S.C. § 752(b). We have no information that indicates Taxpayer had any liabilities at the time of the transfer of real property to [Member B].

money and property in liquidation of the partner's interest, the partner's outside basis in the partnership is, first, reduced by the amount of money received; then, the partner takes a transferred adjusted basis in the distributed property that is equal to the partner's remaining outside basis in the partnership. 26 U.S.C. § 732(b). This preserves any gain or loss with respect to the distributed property because the partner's adjusted basis in the distributed property is exactly equal to the partner's remaining adjusted outside basis in the partnership.

Here, the Schedule K-1 issued to [Member B] shows that his capital account balance at the beginning of the year was \$. . . ; it decreased by \$. . . during the portion of the year that he was a member, to \$. . . ; and ended with a balance of \$ The Schedule K-1 issued to [Member B] reports that he received a liquidating distribution of \$. . . in cash and \$. . . (adjusted basis and fair market value) in real property. Taxpayer's Form 1065 corroborates this information in the Schedule M-2 – Analysis of Partners' Capital Accounts, Schedule B-1 – Information on Partners Owning 50% or More of the Partnership, and Federal Statements. Because the amount of money distributed to [Member B] did not exceed [Member B's] capital account balance, we conclude that [Member B] did not recognize gain or loss under 26 U.S.C. § 731 with respect to the liquidating distribution. Accordingly, Taxpayer's transfer of real property to [Member B] did not result in the recognition of gain or loss for federal income tax purposes. The third requirement is met.

Because Taxpayer has shown that the transfer of the real property to [Member B]: (1) was a transfer of real property; (2) for liquidation; and (3) that did not result in the recognition of gain or loss for federal income tax purposes, we conclude that this transfer is excluded from the definition of "sale" by RCW 82.45.010(3)(q)(i) and exempt from REET.

DECISION AND DISPOSITION

Taxpayer's petition is granted.

Dated this 8th day of February 2018.