

Cite as Det. No. 20-0074, 41 WTD 55 (2022)

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. 20-0074
)	
...)	Registration No. . . .
)	

WAC 458-61A-101; RCW 82.45.030: REAL ESTATE EXCISE TAX - TRANSFER OF CONTROLLING INTEREST - LIMITED LIABILITY CORPORATIONS - MEASURE OF THE TAX - TRUE AND FAIR VALUE. In a sale of a controlling interest in an entity that holds title to real property, the measure of the real estate excise tax due is determined by the true and fair value of the real property owned by the entity. The true and fair value of such real property is determined irrespective of any limitations upon the marketability of the entity owning the real property set forth in the entity’s governing documents or agreements.

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.

Ryan A. Johnson, T.R.O. – A limited liability company seeks cancellation of an assessment of real estate excise tax levied as the result of its owner’s acquisition of a controlling interest in the company. The company objects to the Department’s use of the county market value property tax assessment as the selling price of the real property it held at the time of sale. We deny the petition.¹

ISSUE

Whether the negotiated price for the sale of a controlling interest in an entity that holds real property in this state constitutes the selling price of that real property under RCW 82.45.030, WAC 458-61A-101 and WAC 458-61A-102 when that negotiated price includes a discount based upon the marketability of the entity.

FINDINGS OF FACT

. . . (“Taxpayer”) is a holding company formed to own and maintain properties and equipment for use in the agriculture business. At issue in this matter is the sale by . . . (“Seller”) to . . . (“Buyer”) of Seller’s interest in Taxpayer. Buyer and Seller formed Taxpayer to hold equipment and several

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

pieces of real property (the “Properties”) used in their mutual agricultural business.² Buyer and Seller were equal members in Taxpayer prior to the sale at issue in this matter, each holding a 50% ownership stake.

Activities of Taxpayer are governed by a Limited Liability Company Agreement (“Operating Agreement”). Relevant here, the Operating Agreement provides for limitations on the transferability on Buyer and Seller’s respective ownership in Taxpayer. The Operating Agreement’s definitions for certain terms, such as “Manager,” “Member,” and “Economic Interest,” are helpful in understanding how it limits transferability. Therein, “Manager” refers to Buyer, Seller and any other person who might “become a substitute or additional Manager” subject to the terms of the agreement. Operating Agreement Article 1.

The Operating Agreement defines “Member” as each person “who executes a counterpart of [the Operating Agreement] as a Member and . . . who may hereafter become a Member.” *Id.* It also defines “Membership Interest” as a Member’s share in the profits, losses, and distributions of Taxpayer, as well the Member’s right to participate in the management of its affairs. *Id.* The Operating Agreement distinguishes between Members and “Economic Interest Holders,” the latter defined as a person who holds an Economic Interest, but not a Membership interest, in Taxpayer. *Id.* An “Economic Interest” is identical to a Membership Interest, but for that it does not include any right to participate in the management of Taxpayer’s affairs. *Id.* Members and Economic Interest Holders are collectively referred to as “Unit Holders.” Operating Agreement.

The Operating Agreement provides:

To the extent a Manager has purchased a Membership Interest in the [LLC], it will have all the rights of a Member with respect to such Membership Interest, and the term “Member” as used herein shall include a Manager to the extent it has purchased a Membership Interest in the [LLC]. If a [person] is a Member immediately prior to the acquisition by such [person] of an Economic Interest, such [person] shall have the rights of a Member with respect to such Economic Interest.

Id.

Article 11 of the Operating Agreement pertains to transferability of interests in Taxpayer. It states first that a Unit Holder may not transfer its Membership or Economic Interest, in whole or in part, except as expressly provided in the Operating Agreement. *Id.* at Article 11.1. Article 11.2 provides a right of first refusal for existing Unit Holders to purchase the interest of another Unit Holder who wishes to transfer such interest. It provides in relevant part:

(a) A Unit Holder desiring to sell all or any portion of its Membership Interest or Economic Interest to a third-party purchaser shall obtain from such third-party purchaser a bona fide written offer to purchase such interest, stating the terms and conditions upon which the purchase is to be made and the consideration offered therefor. Such Unit Holder shall give written notice to the other Unit Holders and the Manager of its intention to so transfer such interest. Such notice shall set forth

² Taxpayer was originally formed under the name . . . Taxpayer legally changed its name on . . .

the complete terms of the written offer to purchase and the name and address of the proposed third-party purchaser.

(b) The other Unit Holders, shall, on a basis pro rata to their [respective interest in Taxpayer], have the first right to purchase all (but not less than all) of the interests proposed to be sold by the selling Unit Holder upon the same terms and conditions stated in the notice given pursuant to [Article 11.2(a)] by giving written notice to the other Unit Holders and the Manager within ten (10) days after such notice from the selling Unit Holder

Id. at Article 11.2.

Under Article 11.3(a) of the Operating Agreement, a person to whom a Unit Holder transferred any part of its interest will become merely an Economic Interest Holder by way of that transfer, unless all Members approve in writing for that person to become a Member. Where such approval is not given, the transferring Member is required to sell to Taxpayer, at the price of \$. . . , all remaining rights and interests³ that had been attached to the transferred Economic Interest. *Id.* at Article 11.3(b). Buyer and Seller signed the Operating Agreement as the sole and equal Members of Taxpayer on . . . 2004.

In May 2018, Seller informed Buyer that he would like to get out of the agriculture business and sell his 50% Membership Interest in Taxpayer to Buyer. Buyer and Seller thereafter negotiated the terms of the purchase and eventually agreed on the price of \$ Buyer and Seller executed a purchase and sale agreement [in] 2019, to affect the sale of Seller's Membership Interest in Taxpayer to Buyer (the "Transfer").

On May 16, 2019, Buyer's representative mailed to the Department of Revenue ("Department") a Real Estate Excise Tax ("REET") affidavit signed by Buyer and Seller. The REET affidavit indicates that at the time of the Transfer, Taxpayer held 15 parcels of real property (collectively the "Property"). An exhibit thereto identifies each such parcel and its claimed value, as well as states the total of such values at \$⁴ Buyer paid REET to the Department based upon the claimed total value of \$

On July 10, 2019, the Department's Audit Division ("Audit") mailed Seller a letter to inquire about the details of the Transfer. Seller responded on July 26, 2019, with a brief written narrative of the circumstances surrounding the transfer. Audit reviewed Seller's response, but ultimately determined that the reported value in the REET affidavit did not accurately reflect the true and fair value of the Property. Conversely, Audit determined the assessed values listed in the county property tax rolls reflected the true and fair value of the Property. Such assessed values totaled \$

³ Those rights and interest include, but are not limited to, the right to participate in the management of Taxpayer's affairs. *Id.* at Article 11.3(b).

⁴ This figure corresponds to [twice] the price upon which Buyer and Seller agreed for the Transfer

Based upon the difference between the values reported on the REET affidavit and those in the county property tax rolls, on August 24, 2017, Audit issued a REET assessment against Taxpayer in the amount of \$ The value of the assessment comprised \$. . . of REET, a substantial underpayment penalty of \$. . . interest of \$. . . , and a credit for payment of \$ Without paying, Taxpayer timely filed a petition for review of the assessment.

Taxpayer protests Audit's use of the county tax roll values of the Property to calculate the REET due on the Transfer. Taxpayer asserts that limitations imposed by Article 11 of the Operating Agreement affected the marketability of Seller's Membership Interest in Taxpayer and, by extension, the Property. Taxpayer asserts that those limitations decrease the true and fair value of the Property and that such "marketability discounts" are so prevalent in the valuation of fractional interests of closely held agricultural businesses as to be expected by prospective buyers. Petition at 3. Taxpayer asserts that such marketability discounts are typically in the range of 20-35% of the total value of the real property held by the business.

Taxpayer further asserts that the marketability discount in the Transfer was carefully negotiated at arm's length, with both Buyer and Seller employing the assistance of legal counsel. Taxpayer asserts that the purchase price paid in the Transfer is the most that Seller could ever hope to receive for the sale of his Membership Interest in Taxpayer. Taxpayer asserts that the assessment is disproportionate because Audit has ignored the reality of the limits on marketability set forth in Article 11 of the Operating Agreement. Taxpayer acknowledges that limits on the marketability of Seller's Membership Interest are one step removed from the marketability of the Property, but asserts that such removal weighs in favor of applying the marketability discount to determine the true and fair value of the Property.

Taxpayer asserts that the definition of "true and fair value" of property set forth in WAC 458-61A-101(2)(c) does not apply to the facts in this matter because neither Buyer nor Seller could be said to be unobliged in regard to the Transfer because of the language of Article 11 of the Operating Agreement. Taxpayer also asserts that use of county property tax rolls to determine the value of real property for REET calculation is permissive, rather than mandatory. Finally, Taxpayer asserts that the negotiated price for the Transfer is not a "nominal selling price" within the meaning of WAC 458-61A-303(6)(b).

ANALYSIS

REET is imposed upon the sale of real property in Washington. RCW 82.45.060. "Real property" means any interest, estate, or beneficial interest in land or anything affixed to land, including the ownership interest or beneficial interest in any entity which itself owns land or anything affixed to land. RCW 82.45.032(1). REET is measured by the "selling price." RCW 82.45.030; WAC 458-61A-101(4); WAC 458-61A-102(19). Sales, for purposes of REET, include the transfer of a controlling interest in an entity that has an interest in real property in this state. RCW 82.45.030(2); WAC 458-61A-101(1). "Controlling interest" of an LLC means 50% or more of the beneficial interest in the entity. WAC 458-61A-101(2)(a)(ii).

At issue here is the determination of the selling price under RCW 82.45.030. Taxpayer owned real property located in Washington at the time of the Transfer, and the Transfer involved a controlling

interest of Taxpayer because Seller sold his entire 50% Membership Interest. Accordingly, the Transfer constitutes a “sale” that is subject to REET. RCW 82.45.030(2); WAC 458-61A-101(1). Taxpayer challenges the amount Audit used as the “selling price” to calculate Taxpayer’s assessed REET liability. RCW 82.45.030 defines “selling price” as follows:

(1) As used [for REET purposes], the term “selling price” means the true and fair value of the property conveyed. If property has been conveyed in an arm's length transaction between unrelated persons for a valuable consideration, a rebuttable presumption exists that the selling price is equal to the total consideration paid or contracted to be paid

(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.

(3) 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 encumbrance, either given to secure the purchase price, or any part thereof

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 **will be used** as the selling price.

(Emphasis added); *see also* WAC 458-61A-101(4). “True and fair value” is the “market value, which is 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).

In the purchase of the controlling interest in an entity that holds an interest in real property, the measure of REET is not the consideration paid for that controlling interest, but the true and fair value of the real property owned by the entity. RCW 82.45.030(2); *see also* *McFreeze Corp. v. Dep’t of Revenue*, 102 Wn. App. 196, 201, 6 P.3d 1187 (2000); Det. No. 98-083, 17 WTD 271 (1998) (tax on real estate transferred in sale of an LLC is based on the value of the real estate, not the business); Det. No. 10-0175, 30 WTD 54 (2011) (REET is due on total value of real property conveyed, not funds received for business interest conveyed).

Here, the proper basis for REET is the true and fair value of the Property at the time of the Transfer While we agree with Taxpayer’s position that the limitations in Article 11 of the Operating Agreement limit the marketability of Seller’s Membership Interest in Taxpayer, we disagree that such limitations affect the true and fair value of the Property itself. Because the values of the Property alleged in the REET affidavit are deflated according to the marketability discount

that Buyer and Seller negotiated for the sale of Seller's Membership Interest, those values do not reflect the true and fair value of the Property at the time of the Transfer. In the absence of a separate fair market appraisal or of some other contemporaneous evidence to support Taxpayer's valuation of the Property, we find that Audit properly measured REET using the market value assessment for the Property maintained on the county property tax rolls at the time of the Transfer under RCW 82.45.030(4).

Further, we find unconvincing Taxpayer's assertion that the definition of "true and fair value" in WAC 458-61A-101(2)(c) does not apply because neither Buyer nor Seller could be said to be unobliged due to the limitations in Article 11 of the Operating Agreement. That fact does not preclude application of WAC 458-61A-101(2)(c). Rather, under WAC 458-61A-101(2)(c), the negotiated purchase price for Seller's Membership Interest in Taxpayer cannot be the true and fair value of the Property precisely because neither party was unobliged. WAC 458-61A-101(2)(c), as applied to the present facts, supports our conclusion that Audit properly measured REET based on the county property tax rolls.

...

Finally, Taxpayer's assertion that the negotiated price for the Transfer is not a "nominal selling price" within the meaning of WAC 458-61A-303(6)(b) is not relevant to our analysis here. [Under that rule, a REET affidavit is incomplete "if any required information is omitted or obviously incorrect, such as the use of a nominal selling price." A "nominal selling price" is an amount stated, "that is so low in comparison with the fair market value assessment stated on the property tax rolls that it would cause disbelief by a reasonable person." WAC 458-61A-303(6)(b).] We need not address whether the negotiated price for the Transfer is a nominal selling price because the negotiated price was for the sale of Seller's Membership Interest in Taxpayer, not for the Property itself. As we explained above, we find that the negotiated price for the Transfer does not represent the true and fair value of the Property irrespective of whether it was a nominal selling price.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 28th day of February 2020.