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Cite as Det. No. 21-0190 Annual WTD Page (Year)

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. 21-0190
)	
...)	Registration No. . . .
)	

[1] WAC 458-61A-211; RCW 82.45.010: REAL ESTATE EXCISE TAX – SALE – EXCLUSIONS – MERE CHANGE IN IDENTITY OR FORM. Individuals with an ownership interest in an entity that transfers an interest in real property to another entity owned by the individuals must establish through documentation that the interest in the real property transferred was the entirety of their ownership interest in the transferring entity.

[2] WAC 458-61A-212; RCW 82.42.010: REAL ESTATE EXCISE TAX – SALE – EXCLUSIONS – DISTRIBUTION TO A PARTNER. A transfer by an entity to another entity is not eligible for the exemption as a distribution to a partner if the second entity is not a partner of the transferring entity.

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.

Orwick, T.R.O. – The owner of an apartment building protests the Department of Revenue’s (Department) assessment of Real Estate Excise Tax (REET), arguing that the transfer of the real property was exempt from REET as a mere change in form or identity. Alternatively, Taxpayer argues that the transfer is exempt as a distribution to a partner We deny the petition.¹

ISSUES

1. Whether the transfer is exempt from REET as a mere change in form or identity under RCW 82.45.010(3)(p) and WAC 458-61A-211.

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

2. Whether the transfer is exempt from REET as a distribution to a partner under RCW 82.45.010(3)(q) and WAC 458-61A-212.

...

FINDINGS OF FACT

... (Taxpayer)[, an LLC,] owned ... (Property) in ... [Washington State]. Taxpayer purchased the Property in 2010. The Property was the only property that Taxpayer owned. Taxpayer's membership (Members) was composed of numerous private individuals with varying percentage interests in Taxpayer. Two members of Taxpayer were [Member A] and [Member B]. [Member A and Member B] each owned a 10 percent interest in Taxpayer. [Member A and Member B] formed a separate company in 2013, ... (Holdings). [Member A and Member B] each owned a 50 percent interest in Holdings. [Member A and Member B] also formed [Subsidiary], a wholly owned subsidiary of Holdings, in June 2016.

In 2016, Members decided to sell Property and liquidate their interests in Taxpayer. [Member A and Member B] wanted to retain their ownership interest in the Property to pursue other real estate investment opportunities. [In early] 2016, Taxpayer entered into a Commercial & Investment Real Estate Purchase & Sale Agreement with a third party (Buyer). There is no evidence that any Members or [Member A and Member B] have any interest in Buyer. At the time of the agreement, Taxpayer owed \$. . . on the Property through a commercial bank loan. Taxpayer asserts that [Subsidiary] did not assume any debt as part of the transfer.

On July . . . , 2016, Taxpayer transferred 20 percent undivided interest in the Property to [Subsidiary] and Taxpayer retained the entire remaining 80 percent interest. Taxpayer contends that the 20 percent transferred to [Subsidiary] represents the full distribution of [Member A's and Member B's] membership interest in Taxpayer and ownership interest in Property. Taxpayer executed, and filed, a Quit Claim Deed as evidence of the transfer of the 20 percent interest in the Property to [Subsidiary]. Also on July . . . , 2016, [Member A] completed a REET Affidavit with Taxpayer as the grantor and [Subsidiary] as the grantee. Taxpayer claimed an exemption from REET under WAC 458-61A-212(2)(f) as a nonrecognition of gain on distributions to a partner. Taxpayer also contends that this transfer is exempt from REET under WAC 458-61A-211, arguing that the 20 percent transferred to [Subsidiary] was wholly owned by [Member A and Member B].

[Later in July of] 2016, the sale of the Property from Taxpayer and [Subsidiary] as grantors to Buyer as grantee closed, with [Member A] signing the deed on Taxpayer's behalf. A REET Affidavit was filed on July . . . , 2016, and REET was paid by Taxpayer and [Subsidiary]. A statutory warranty deed was filed with the REET Affidavit on July . . . , 2016.

On June 24, 2020, the Department's Audit Division (Audit) sent Taxpayer an audit inquiry letter requesting documentation to support the exemption claimed on the REET Affidavit. Taxpayer provided Audit with a written narrative, quit claim deed, Taxpayer's Operating Agreement, [Subsidiary's] Operating Agreement, an amended [Subsidiary] Operating Agreement and Taxpayer's 2015 and 2016 Federal Tax Returns.

Taxpayer's written narrative asserted that two transactions occurred. The first transaction was the distribution of a 20 percent undivided interest in the Property to [Member A and Member B] upon liquidation of their 10 percent interests in Taxpayer. Taxpayer asserted that this transaction was exempt under WAC 458-61A-212(2)(f) and IRC Section 731 as the nonrecognition of gain on a distribution to a partner upon dissolution. Taxpayer then stated that the second transfer was the contribution of the 20 percent interest in the Property, now owned by [Member A and Member B], to [Subsidiary]. Taxpayer indicated that the second transaction was exempt under WAC 458-61A-212(2)(e) and IRC Section 721 as a nonrecognition of gain or loss on contribution by a partner because [Member A and Member B] owned [Subsidiary]. Audit agreed that there were likely two transfers reflected on a single REET Affidavit. Audit indicated that a separate REET Affidavit is required for each conveyance of real estate. Audit asked Taxpayer if it would be seeking a Private Letter ruling from the IRS. Taxpayer indicated that it would not seek a Private Letter Ruling.

Audit states that Taxpayer acknowledged that the exemption was not valid without having two transfers. Audit determined that Taxpayer omitted a portion of the conveyance from the REET Affidavit, making the exemption claimed under WAC 458-61A-212(2)(f) invalid. Audit disallowed the exemption. Based on the representations of the transfer on the REET Affidavit, Audit treated the 20 percent transferred from Taxpayer to [Subsidiary] as being owned 100 percent by Taxpayer. Because [Member A and Member B] owned 100 percent of [Subsidiary, and a 20% interest in Taxpayer], Audit allowed an exemption for 20 percent of the Property ownership transferred from Taxpayer to [Subsidiary] under WAC 458-61A-211(2)(b), a mere change in identity, because Audit assessed REET on the remaining 80 percent ownership interest that was transferred to [Subsidiary]. Audit determined the true and fair value based on the sale price of the Property at the time of the conveyance.

On August 17, 2020, the Department issued an assessment (Assessment) against Taxpayer. The Assessment totaled \$. . . , which consisted of \$. . . in REET liability, \$. . . in interest and \$. . . additional assessment penalties for substantial underpayment. The Assessment also informed Taxpayer that it could provide additional documentation to support the disallowed exemption. Taxpayer subsequently provided an additional narrative, and a Statutory Warranty Deed with a REET Affidavit for the transfer from [Subsidiary] and Taxpayer to Buyer.

On October 26, 2020, the Department reissued the Assessment. Taxpayer contacted Audit to explain the different transfers of the Property. Audit explained that a separate REET Affidavit is required for each conveyance and Audit needed additional documentation to support the exemption claimed on a single REET Affidavit. On November 5, 2020, Taxpayer sent Audit a copy of the Assignment of Membership Interest in Taxpayer (Assignment). The Assignment had the same effective date as the two Property transfers, July . . . , 2016. Audit noted that the signatures on the Assignment were not dated. Audit asked Taxpayer why Taxpayer's documents did not reflect the Assignment. Taxpayer told Audit that it was wound up after the sale of the Property and Taxpayer's operating agreement was not amended to demonstrate the liquidation of [Member A's and Member B's] interests. Taxpayer also stated that a clerical error caused Taxpayer's final 2016 Federal Income Tax Return and Schedule K-1s to not reflect that [Member A and Member B] liquidated their interest in Taxpayer. Audit determined that, because the signatures on the Assignment were not dated, Taxpayer's Federal Tax Returns did not reflect ownership change and

Taxpayer's operating agreement was not amended, it did not have sufficient documentation to show that the ownership interest change in Taxpayer occurred prior to the conveyance at issue.

On December 18, 2020, Taxpayer timely petitioned for administrative review. Taxpayer explains that the transfer from Taxpayer to [Subsidiary] represented [Member A's and Member B's] entire interest in Taxpayer. Taxpayer provided copies of its final Short Year Federal Form 1065 and the Schedule K-1s for every member, including [Member A and Member B]. Taxpayer's Short Year form and the K-1s appear to indicate that [Member A and Member B] did not receive a distribution proportional to their membership interest in Taxpayer based on the final distribution upon Taxpayer's dissolution. Taxpayer contends that the reduced distributions to [Member A and Member B] demonstrate that they had previously received their full interest in Taxpayer and no longer possessed their 10 percent interests in Taxpayer prior to Taxpayer's sale of the Property and Taxpayer's dissolution.

Taxpayer's Short Year form and Schedule K-1s do not show that [Member A's and Member B's] shares were liquidated after the transfer to [Subsidiary]. Taxpayer's Short Year form, Capital Account Reconciliation shows that [Member A and Member B] made capital contributions of \$. . . and \$. . . , respectively. Taxpayer's Operating Agreement was not updated to show that [Member A's and Member B's] shares were liquidated. Taxpayer's Operating Agreement, section 5(d)(i), shows that [Member A] provided a personal guaranty for the loan Taxpayer used to acquire the Property.

ANALYSIS

REET is imposed "upon each sale of real property" in Washington. RCW 82.45.060. "Real property" includes "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. The term includes . . . improvements constructed upon leased land." RCW 82.45.032(1).

RCW 82.45.010 defines "sale" for REET purposes as follows:

- (1) As used in this chapter, the term "sale" has its ordinary meaning and includes any conveyance, grant, assignment, quitclaim, or transfer of the ownership of or title to real property, . . . or any estate or interest therein for a valuable consideration, contract for such conveyance, grant, assignment, quitclaim, or transfer, and any lease with an option to purchase real property, . . . or any estate or interest therein or other contract under which possession of the property is given to the purchaser, or any other person at the purchaser's direction, and title to the property is retained by the vendor as security for the payment of the purchase price. The term also includes the grant, assignment, quitclaim, sale, or transfer of improvements constructed upon leased land.

RCW 82.45.010(1). REET is due on all sales of real property unless the transaction qualifies for a specific exemption under chapter 82.45 RCW. WAC 458-61A-100(1).

1. Mere Change in Form or Identity

RCW 82.45.010(3)(p) states the term “sale” does not include “[a] transfer of real property, however effected, if it consists of a mere change in identity or form of ownership of an entity *where there is no change in the beneficial ownership.*” (Emphasis added.) WAC 458-61A-211 explains the mere change in identity or form exemption further and reads:

A transfer of real property is exempt from the real estate excise tax if it consists of a mere change in identity or form of ownership of an entity. This exemption is not limited to transfers involving corporations and partnership, and includes transfers of trusts, estates, associations, limited liability companies and other entities. *If the transfer of real property results in the grantor(s) having a different proportional interest in the property after the transfer, real estate excise tax applies.*

WAC 458-61A-211(1) (emphasis added). WAC 458-61A-211 also explains that a qualified transfer includes:

(b) The transfer by a corporation, partnership, or other entity of its interest in real property to its shareholders or partners, *who will hold the real property either as individuals or as tenants in common in the same pro rata share as they owned the corporation, partnership, or other entity.* To the extent that a distribution of real property is disproportionate to the interest the grantee partner has in the partnership, it will be subject to the real estate excise tax.

WAC 458-61A-211(2)(b) (emphasis added). Therefore, when a transfer results in the grantee owners not owning the property in the same pro rata shares held prior to the transfer, the exemption does not apply. Tax benefits and all other deductions, exemptions, and credits must be strictly construed against the taxpayer. *Group Health Cooperative of Puget Sound, Inc. v. State Tax Comm’n*, 72 Wn.2d 422, 429, 422 P.2d 201 (1967). Thus, taxpayers must prove they are entitled to the benefit. *Id.* Taxation is the rule; exemption is the exception. *Spokane County v. City of Spokane*, 169 Wash. 355, 358, 13 P.2d 1084 (1932).

Here, Taxpayer owned 100 percent of the Property, with [Member A and Member B] each owning 10 percent. Taxpayer transferred 20 percent of the Property to [Subsidiary] which was owned 100 percent by [Member A and Member B]. Taxpayer contends that the 20 percent interest transferred to [Subsidiary] represented the entirety of [Member A’s and Member B’s] interests in the Property. However, this contention is not supported by the documentary evidence.

First, Taxpayer’s Short Year form and Schedule K-1s show that [Member A and Member B] maintained their 10 percent interest in Taxpayer after the transfer of 20 percent of the Property to [Subsidiary]. Taxpayer states this was a clerical error, however, there is no evidence that Taxpayer amended its return to rectify the error. Additionally, Taxpayer’s Operating Agreement was not amended after the transfer to show that [Member A’s and Member B’s] interests were liquidated.² Thus, based on the available documentation, [Member A and Member B] each retained their 10

² [Member A] also remained as a governing person and signed the deed, on Taxpayer’s behalf, transferring the Taxpayer’s remaining interest in the Property to Buyer after the transfer to [Subsidiary] occurred.

percent interest in Taxpayer after the Property transfer to [Subsidiary], which would have given [Member A and Member B] a combined 36 percent interest in the Property.^[3] Because there was a change in their beneficial interest in the Property after the transfer, the transaction does not qualify as a mere change in form or identity.

2. Distribution to a Partner

RCW 82.45.010(3)(q)(i) states the term “sale” does not include:

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.

In this case, the internal revenue code [section] at issue is 26 U.S.C. 731 (Section 731). Section 731 states:

In the case of a distribution by a partnership to a partner—

- (1) 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.

Taxpayer asserts that the transfer is exempt because the partners, [Member A and Member B], did not realize any gain on the transfer and the transfer was a distribution of their entire interest in Taxpayer. Again, we disagree.

According to the deed and the REET affidavit, a partial interest in the Property was transferred to [Subsidiary]. [Subsidiary] did not possess any interest in Taxpayer, and thus the transfer cannot be considered a distribution to a partner. There is no documentation to show that the property was distributed to [Member A and Member B]. Again, the documentary evidence demonstrates that [Member A and Member B] retained their interest in Taxpayer after the transfer of 20 percent of the Property to [Subsidiary].

Therefore, the transfer does not qualify for the exemption provided under RCW 82.45.010(3)(q)(i).

...

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 1st day of December 2021.

^[3] Member A and Member B owned a combined 20% + (20% of 80% after the transfer) = 36%.]