Lewis, A.L.J. – Taxpayer petitions for the correction of a Real Estate Excise Tax ("REET") assessment, claiming that the change in ownership in a limited liability company [(LLC)], which resulted from the distribution of an inheritance, did not constitute a REET-taxable transaction. Taxpayer’s petition is granted.¹

ISSUE:

Did receipt of an ownership interest in an LLC resulting from an inheritance constitute a “transfer” or “acquisition” of a controlling interest in the LLCs subject to REET under RCW 82.45.010(2) and WAC 458-61A-101?

FINDINGS OF FACT:

The [Department of Revenue’s (Department)] interest began following the review of Taxpayer’s June 24, 2015, renewal of Taxpayer’s LLC with the Washington Secretary of State’s office. The annual report included the following questions and answers:

Does your company own real property (including leasehold interests) in Washington? Yes

Has there been a transfer of stock, other financial interest change, or an option agreement? Yes

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.
Has an option agreement been executed in the last 12 months allowing for the future purchase or acquisition of the entity, that, if exercised would result in a transfer of controlling interest? Yes.

On July 24, 2015, the Department’s Special Programs Division [(Special Programs)] sent Taxpayer a letter of inquiry regarding Taxpayer’s statement that a transfer of controlling interest had occurred. Taxpayer failed to answer the letter of inquiry. On September 30, 2015, Special Programs sent a letter making a final request for documents.

On November 4, 2015, after Taxpayer failed to respond to Special Programs request for records, the Department issued a $ . . . REET assessment.² Receipt of the assessment prompted [Taxpayer], on November 16, 2015, to telephone the Department to explain that he and his father were 50% owners of the LLC and that his father had passed away. Special Programs returned [Taxpayer’s] telephone message and left a voice mail message that with [Taxpayer’s father’s (Father)] death a 50% change occurred, which required filing of a return and payment of tax.

Taxpayer disagreed with the assessment. On December 3, 2015, Taxpayer filed an appeal with the Department’s Administrative Review and Hearings Division. Taxpayer argued that no REET was due because it was a REET exempt transfer by inheritance [under] RCW 82.45.010(3)(a).

Taxpayer provided a copy of the Operating Agreement of the [LLC] (“Agreement”). Particularly pertinent to the appeal was Article 7 – Restrictions on Transfer.

Section 7.1 Transfers Prohibited. Each Member agrees that Ownership and Economic Interests in the company are not transferable except as provided in Article 7.

Section 7.3 Transfers of Economic Interests Without Members’ Approval. Ownership interests in the Company may be transferred without the consent of the members and are not subject to the member’s right of first refusal, only in the following events:

(a) The transfer is the result of the death of a member;

. . .

(c) The transfer is a gift to a spouse, a child, a parent, or the spouse of a child or parent of the member and for no consideration;

Section 7.6 Death of a Member. The death of a member shall not terminate the company. The heirs or estate of the deceased member shall retain his interest, which shall become an economic interest. The interest shall be subject to the transfer provisions of this Agreement.

Section 7.6.1 The remaining Member shall have the option of purchasing the interest of the deceased Member by giving written notice to the successors of the deceased Member that they desire to purchase the economic interest. The purchase price shall be negotiated between the parties. If they cannot reach an agreement, the surviving Member shall have

² The $ . . . assessment consists of $ . . . tax, $ . . . interest, $ . . . delinquent penalty, and $ . . . assessment penalty.
the right to have the company dissolved, and distribution shall be accomplished in accordance with Article 8.³

During the March 17, 2016, teleconference, Taxpayer argued that the Department had erred in issuing a REET assessment because: 1) no transfer of real property had occurred by action of [Father’s] death, and 2) even if a transfer had occurred it would enjoy the REET exemption afforded transfers by inheritance per RCW 82.45.010(3)(a). Following the teleconference, Taxpayer provided a copy of [Father’s] probated will. The will did not speak directly to the disposition of the membership in the LLC. However, Article VII – Bequest of Residue: Creation of Trust Estate For Grandchildren did address disposition of residuary shares.

A. Residuary Shares.

All the rest and residue of my estate I give, devise and bequeath in percentage shares, as follows:

1. To my son . . . , Fifteen Percent (15%);
2. To my daughter . . . , Fifteen Percent (15%);
3. To my daughter . . . , Fifteen Percent (15%);
4. To my son . . . , Fifteen Percent (15%);
5. To my then surviving grandchildren, share and share alike, Forty Percent (40%), in trust as hereinafter set forth.

ANALYSIS:

RCW 82.45.060 imposes REET on each sale of real property. RCW 82.45.010 defines “sale” to include: “[A]ny conveyance, grant, assignment, quitclaim, or transfer of the ownership of or title to real property, … for a valuable consideration, . . .” 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). RCW 82.45.033(1)(b) defines the term “controlling interest” in relevant part to mean: “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(1)(b); See also WAC 458-61A-101(3)(a).

Here, there is no dispute that, on the death of [Father], there was a “transfer or acquisition within any twelve-month period of a controlling interest of an entity with [an] interest in real property located in this state,” which is a taxable “sale” as long as it is “for a valuable consideration” RCW 82.45.010(2).

However, RCW 82.45.010(3)(a) specifically excludes a “transfer by gift, devise, or inheritance” from the definition of “sale.” On [Father’s] death, his interest in the LLC was distributed by direction of the LLC Operating Agreement and his will.

³ Article 8 addresses liquidation.
The Operating Agreement provided that on the death of a member “the heirs or estate of the deceased member shall retain his interest, which shall become an economic interest.” Thus, [Father’s] interest in the LLC and the real property it owned was neither extinguished on his death nor passed to [Taxpayer] by right of survivorship. Rather, [Father’s] 50% interest in the LLC became part of his estate, which passed by testamentary disposition (devise) to his heirs.

By the terms of the LLC Agreement, [Father’s] 50% interest in the LLC transferred on his death. [Father’s] will did not make specific provision for disposition of the 50% interest in the LLC. Thus, that asset was distributed in accordance with Article VII, which addressed disposition of the residue of [Father’s] estate. [Taxpayer] received 15% of the residue of [Father’s] estate. Thus, by the terms of [Father’s] will [Taxpayer] received an additional 7.5% of the LLC, which brings [Taxpayer’s] ownership of the LLC to 57.5%. Here, while there was a transfer of an interest in a realty-holding entity there was no consideration paid in exchange for the transfer. [Taxpayer] received his father’s interest in the LLC as a distribution of his inheritance. Thus, we conclude that the receipt by [Taxpayer] of his inheritance from his father’s estate did not trigger REET. Accordingly, Taxpayer’s petition for correction of the assessment is granted.

DECISION AND DISPOSITION:

Taxpayer’s petition is granted. The matter will be remanded to the Special Programs Division for an adjustment consistent with this decision.

Dated this 20th day of May, 2016.

---

4 15% share of 50% of the LLC yields 7.5%.