

Cite as Det. No. 17-0041, 36 WTD 572 (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. 17-0041
)	
)	Registration No. . . .
)	

WAC 458-61A-102; RCW 82.45.030: REAL ESTATE EXCISE TAX – SELLING PRICE – TRUE AND FAIR VALUE. When the true and fair value of a partial interest cannot reasonably be determined from the available evidence, the Department may rely on the market value assessment maintained on the county property tax rolls at the time of the transfer to assess 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.

Yonker, T.R.O. – A limited liability company (Taxpayer) that owns a 38.14 percent interest in an apartment complex protests the assessment of real estate excise tax (REET) on 38.14 percent of the assessed value of that apartment complex as a result of Taxpayer’s two members selling their combined one hundred percent interest in Taxpayer to a third party. Taxpayer argues that the amount of consideration that the third party paid for the one hundred percent interest in Taxpayer should be treated as the true and fair value of the 38.14 percent interest that Taxpayer owns in the apartment complex. We deny the petition.¹

ISSUE

Under RCW 82.45.030(2) and WAC 458-61A-101(4), may the true and fair value of the partial interest Taxpayer owns in real property be reasonably determined [from the evidence Taxpayer provided], such that the Department is precluded from relying on the market value assessment maintained on the county property tax rolls at the time of the transfer pursuant to RCW 82.45.030(4) and WAC 458-61A-101(4)(b)?

FINDINGS OF FACT

. . . (Taxpayer) is [an out-of-state] limited liability company created on March 10, 2005, with . . . (Member A) and . . .² (Member B), who were married at the time, named as the only two members, both holding a fifty percent interest in Taxpayer.

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

² [Member B] was known as . . . until she and Member A subsequently divorced.

On July 11, 2007, Taxpayer entered into a Tenants In Common Agreement (TIC Agreement) with [LLC], whose sole member throughout the relevant time period was . . . (Member C).³ Under the terms of the TIC Agreement, Taxpayer and [LLC] agreed to jointly acquire the . . . (Apartment Complex), which is a 192-unit residential apartment building located in . . . , Washington. The TIC Agreement also stated that Taxpayer would hold a 38.14 percent interest in the Apartment Complex, while [LLC] would hold a 61.86 percent interest in the Apartment Complex. The Apartment Complex had been previously acquired in 2006, prior to the execution of the TIC Agreement, for a purchase price of \$⁴

In 2011, Member A and Member B divorced. On September 20, 2011, as part of the divorce proceedings, [Appraiser], an appraiser, issued a letter (2011 Letter) which stated “[t]his analysis is not an appraisal as defined in chapter 18.140 RCW.” The 2011 Letter also stated the following: (1) the estimated value of the Apartment Complex was \$. . . ; (2) the estimated equity in the Apartment Complex was \$. . . ; and (3) the value of Taxpayer’s 38.14 percent interest in the Apartment Complex was \$. . . , which equates to 38.14 percent of the estimated equity.

On September 22, 2015, Member A and Member B entered into a Purchase and Sale Agreement (Purchase Agreement) with Member C, in which Member A and Member B agreed to sell Member C their respective fifty percent interests in Taxpayer for \$ From that date, Member C owned one hundred percent of both Taxpayer and [LLC], which retained their respective interests of 38.14 percent and 61.86 percent in the Apartment Complex. As of that date, Taxpayer represented that the Apartment Complex was subject to a nonrecourse liability of \$

On September 23, 2015, Taxpayer filed a Real Estate Excise Tax Affidavit and Controlling interest Transfer Return with the Department, which stated that the true and fair value of the property owned by Taxpayer was \$ On October 21, 2015, the Department’s Special Programs Division sent letters to Taxpayer, Member A, and Member C, stating that “[t]he true and fair value for the property reported on a controlling interest real estate excise tax affidavit was \$. . . , which is substantially lower than the county assessed value for this property, which was \$” The letter requested additional documentation “to prove that the true and fair value was equal to what the property was worth at the time of the sale of interest in the entity.” The letter instructed the recipients to respond by November 5, 2015. Special Programs received no response to the request for additional documentation by the November 5, 2015, deadline. On November 18, 2015, Special Programs sent a “final request” for additional documentation. On December 9, 2015, following that second letter, Member C made initial contact with Special Programs on behalf of Taxpayer.

Taxpayer subsequently provided a letter dated March 9, 2016 (2016 Letter)⁵, from [Appraiser], which stated the following:

³ While there appears to be no dispute that the TIC Agreement was executed on July 11, 2007, we note that the version in the record is not signed by any of the parties.

⁴ It appears that the Apartment Complex was purchased by one of the parties on December 19, 2006; however, the record is unclear which party initially purchased it before it became subject to the tenancy in common pursuant to the 2007 TIC Agreement.

⁵ While the 2016 Letter is technically dated “March 9, 2015,” we conclude that the references in the body of the document make clear that the year “2015” was erroneous, and actually should have been “2016.”

As you are aware, the 38% owner decided to sell their interest in 2015 to the majority owner which is likely the only party who would buy a fractional interest, unless it was offered at a large discount. There are several reasons for this; including the inability to make any decisions about the operation of the project, the lack of control about when to sell, and the lack of ability to control the financing. I have extensive experience in owning partial shares of real estate holdings and am very familiar with these partial interests.

...

There is no doubt in real estate interests when you hold a minority interest; it is not equal in value to its proportional percentage of the total value of the property. In some ways it is like owning a parcel of landlocked real estate. In that case the only purchaser is an adjoining owner as any other purchaser would not want a property they cannot access.

In this case, the minority ownership wanted to sell their 38% interest in the apartment complex at a negotiated price of \$. . . [, which] was what they determined to be a reasonable estimate of its value. The Buyer did not assume any debt from the minority interest as the Buyer was already liable for 100% of the outstanding debt on the property. The price was determined as follows:

Net Operating Income	\$. . .
Cap Rate	7%
Property Value	\$. . .
Less Outstanding Debt	\$. . .
Total Equity	\$. . .
38% Interest	\$. . .

I do not know the incentives between the parties, but the fact that the income had been going up may have been the reason for the majority owner to pay a slightly higher price. In any event it represented what the parties felt was an accurate measure of the worth of the interest at the time they consummated their sale. In my opinion the value calculated in this manner accurately reflects the current range of values in the market. While the cap rate is at the high end of the current market cap rates, it is justified as the parties were valuing a minority interest.

Special Programs disagreed with Taxpayer’s position that \$. . . was the proper measure for assessing Real Estate Excise Tax (REET). Instead, Special Programs found that the county assessed value at the time of the transfer – \$. . . – multiplied by the percentage of Taxpayer’s interest in the Apartment Complex – 38.14 percent – was the proper measure for assessing REET. On April 7, 2016, as a result of its findings, Special Programs issued a REET assessment for a total of \$. . . , which included \$. . . in REET, a \$. . . five-percent assessment penalty, and \$. . . in interest. Taxpayer subsequently sought review of the full amount of the assessment.

ANALYSIS

Pursuant to RCW 82.45.060, REET is imposed on each sale of real property located within Washington at a rate of 1.28 percent of the “selling price.” RCW 82.45.010(2)(a) defines “sale” to include “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.” In the case of a partnership, association, trust, or other entity, such as an LLC, a “controlling interest” means “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); WAC 458-61A-101(2)(a)(ii). The Department may assess REET “against the entity in which a controlling interest is transferred.” RCW 82.45.033(2)(b).

Here, Taxpayer does not dispute that the transfer of one hundred percent interest in Taxpayer to Member C constitutes a sale under RCW 82.45.010(2). Instead, Taxpayer challenges the amount Special Programs used as the “selling price” to calculate Taxpayer’s assessed REET liability.

RCW 82.45.030 defines “selling price” as follows:

(1) As used in this chapter, 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 to the transferor, or to another for the transferor’s benefit.

(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.

...

(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.

(Emphasis added). Taxpayer argues that RCW 82.45.030(1), as opposed to (2), “controls” here. If Taxpayer were correct, then there would be a rebuttable presumption that the consideration paid for the transfer – \$. . . – was the selling price on which REET should be assessed. In *McFreeze Corp. v. Dep’t of Revenue*, 102 Wn. App. 196, 200-01 (2000), the Court of Appeals disagreed with the argument Taxpayer advances here, reasoning as follows:

The statute defines “selling price” in two ways. Under RCW 82.45.030(1), the selling price is the true and fair value of the property conveyed, presumptively the consideration paid. But RCW 82.45.030(2), the more specific subsection dealing with the transfer of a

controlling interest in an entity owning real estate, defines “selling price” as the “true and fair value of the real property owned by the entity. . . .” Thus, in the sale of an entity, **the value taxed is not the consideration paid, but the value of the real estate owned by the entity.** There is simply no ambiguity in this.

(Emphasis added). Consistent with the Court’s conclusion in *McFreeze*, we have previously held the following:

[T]he tax at issue . . . bears no relation to the funds received by the taxpayers for [their] interest in the LLC. Rather, the incident giving rise to the tax is the transfer of the beneficial ownership in real property located in this state. Accordingly, **the amount of the tax is based on the value of the real property, not the interest in the LLC that was transferred.**

Det. No. 98-083, 17 WTD 271 (1998) (emphasis added); *see also* Det. No. 10-0175, 30 WTD 54 (2011). Likewise, WAC 458-61A-101 (Rule 101), the Department’s administrative rule regarding the transfer of controlling interests, states that the selling price in a transfer of a controlling interest is “the true and fair value of the real property owned by the entity at the time the controlling interest is transferred.” Rule 101(4). Pursuant to all of these authorities, the selling price applicable here is the “true and fair value” of the 38.14 percent interest in the Apartment Complex owned by Taxpayer, and not the \$. . . price Member C paid for the one hundred percent interest in Taxpayer.

Rule 101(2)(c) defines “true and fair value” as “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 property.” We have no evidence in the record of the actual “market value” of Taxpayer’s partial interest in the Apartment Complex as of September 22, 2015.⁶ As a result, we cannot reasonably determine the “true and fair value” of Taxpayer’s partial interest in the Apartment Complex at the time of the transfer.

We, then, must consider the rest of Rule 101(4), which provides as follows:

(a) If the true and fair value of the property cannot reasonably be determined, one of the following methods may be used to determine the true and fair value:

(i) A fair market value appraisal of the property; or

⁶ Taxpayer argues that the consideration of \$. . . that Member C paid for the one hundred percent interest in Taxpayer also represents the true and fair value of Taxpayer’s partial interest in the Apartment Complex pursuant to Rule 101(2)(c) because that amount was “reasonably determined by the parties” in an arms’ length transaction based “upon the value that was done in 2011 for the divorce and considered more current factors to determine the true and fair value.” We interpret this argument as being that the 2011 Letter is an appraisal that supports Taxpayer’s assertion that its partial interest in the Apartment Complex was valued at \$. . . at the time of the transfer. We address Taxpayer’s argument under our discussion of Rule 101(4)(a)(i), below.

- (ii) An allocation of assets by the seller and the buyer made pursuant to section 1060 of the Internal Revenue Code of 1986, as amended or renumbered as of January 1, 2005.⁷
- (b) If the true and fair value of the property to be valued at the time of the sale cannot reasonably be determined by either of the methods in (a) of this subsection, 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.

Thus, if the true and fair value cannot reasonably be determined based on the circumstances of the transfer, a fair market value appraisal of the property may be used to determine the true and fair value. The record here contains no fair market value appraisal of Taxpayer's partial interest in the Apartment Complex from when the transfer of the controlling interest occurred on September 22, 2015. While the record does contain the 2011 Letter and the 2016 Letter, we conclude that neither of these documents may serve as a proper basis for determining the true and fair value of Taxpayer's partial interest in the Apartment Complex.

First, the 2011 Letter was already four years old by the time of the transfer and, therefore, unreliable for determining the true and fair value of Taxpayer's partial interest in the Apartment Complex on September 22, 2015. Additionally, the 2011 Letter's valuation of Taxpayer's partial interest in the Apartment Complex was only based on the estimated equity in the Apartment Complex, as opposed to the full market value, as required under Rule 101(2)(c). We further note that the 2011 Letter expressly states that it is not an appraisal.

Second, while the 2016 Letter purports to be "an appraisal report" for Taxpayer's partial interest in the Apartment Complex, and it is closer in time to the actual date of transfer, it is, nevertheless, incomplete. The 2016 Letter, at most, is a summary and contains no methodology or data supportive of its conclusions. Further, like the 2011 Letter, the 2016 Letter merely attempts to value the equity of the Apartment Complex. Yet, again, it is the full market value of the partial interest in the Apartment Complex that must be valued here to determine the "true and fair value" of that partial interest.⁸ Therefore, we decline to accept the 2016 Letter as an appraisal upon which to base the assessment of REET.⁹

Because the true and fair value of Taxpayer's partial interest in the Apartment Complex cannot be determined under Rule 101(4)(a), such determination must be made based on the "market value assessment for the property maintained on the county property tax rolls at the time of the sale will

⁷ Section 1060 of the Internal Revenue Code of 1986 deals with certain "applicable asset acquisitions." There is no assertion that this section is applicable to the transfer at issue here and, therefore, we conclude that Rule 101(4)(a)(ii) is not applicable in this case.

⁸ Taxpayer appears to also argue that since Taxpayer's partial interest in the Apartment Complex was not subject to any debt on the Apartment Complex, only the equity is under consideration here. We disagree. First, there is no actual evidence in the record that Taxpayer's partial interest is not subject to any debt on the Apartment Complex. Further, even if there was such evidence, as we discussed above, the definition of "true and fair value" clearly contemplates that the full value of the property at issue is the relevant figure to consider.

⁹ We note that were we to accept the \$. . . amount as the property value of the Apartment Complex, such acceptance would result in a higher REET assessment than that imposed by Special Programs, which based the REET assessment on the 2015 assessed value of \$

be used as the selling price” under Rule 101(4)(b). The parties do not dispute that at the time of the transfer on September 22, 2015, the Apartment Complex had a total assessed value of \$. . . according to the . . . County Assessor’s Office. It follows that the value of Taxpayer’s 38.14 percent interest in that property was \$. . . , which is the same value used by Special Programs.^[10]

Taxpayer also argues that because it owns only a “minority interest” in the Apartment Complex, the value of that partial interest should be subject to a “lack of marketability discount.” This is because, as Taxpayer put it, “virtually all third-party real estate buyers would not desire to acquire such a ‘minority interest’ in a relatively illiquid asset.” In Determination No. 10-0175, 30 WTD 54 (2011), we accepted an appraisal that applied a 15 percent lack of marketability discount to determine the true and fair valuation of a one-third tenancy in common interest in real property. In that decision, we stated the following:

Thus not only the real estate appraisal profession, but the Washington Court of Appeals has recognized that the use of lack of marketability discounts can be appropriate in developing appraisals where the seller lacks controlling interest in the asset (including real property) being sold. . . . In short, we have no factual or legal basis to exclude the supplemental appraisal that applied a lack of marketability discount in valuing the tenancy in common interest in the real property at a true and fair (market) value. . . .

Id. (referring to *The Appraisal of Real Estate* 124 (10th ed. 1992) and *Matthew G. Norton Co. v. Smythe*, 112 Wn. App. 865, 880-81, 51 P.3d 159 (2002)). Additionally, in 30 WTD 54, we were provided with the specific method used in the appraisal in that case to determine the 15 percent discount.

While a lack of marketability discount may be appropriate in cases involving tenancies in common, Taxpayer here has not provided an appraisal that contains specific methodology leading to a specific percentage discount due to lack of marketability. Because Taxpayer has failed to provide an appraisal from the time of the transfer that provides for a specific percentage discount for lack of marketability based on specific methodology, we affirm the value used by Special Programs.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 15th day of February 2017.

¹⁰ [This is consistent with *McFreeze Corp. v. Dep’t of Revenue*, 102 Wn. App. 196 (2000), which requires REET to be assessed on the full value of the real estate owned, since Taxpayer only owned a 38.14 percent interest in the Apartment Complex as opposed to a one hundred percent interest.]