



Indirect Real Property Transfer Taxes in Non-Real-Estate Transactions

In one of his most popular songs from the 2000s, internationally renowned rapper Lil' Wayne attempted to remind us, in his typical musical fashion, by singing, "You got it down, and you [are] well on your way to the top (keep doin' your thing), but there is something you forgot." Lee Ann Womack, an equally talented American country music singer, shared Wayne's desperate call when she sang, "I feel like I'm forgetting something" in her homonymous 2000 hit song. While countless opinions certainly exist about the hidden meaning behind such lyrics, many tax practitioners seem to have reached a consensus about the source of the artists' anxiety: indirect real property transfer taxes.

Expectedly, this subspecies of real estate transfer taxes, also known as economic interest transfer tax, does not usually take center stage when structuring or negotiating non-real-estate corporate transactions. Consequently, while dutifully focusing on federal and state income tax implications, business and legal professionals alike often fail to realize that the intended activity may also trigger unforeseen (and, sometimes, unheard-of) indirect real property transfer tax obligations. Indeed, to the surprise of many, such "hidden" taxes are imposed by state and local jurisdictions even where no real property is ever transferred as part of the business transaction.

Many states and localities impose a tax on the transfer of an interest in real property located within their respective jurisdiction. The tax, generally known as real property transfer tax, is largely based on the federal documentary stamp tax, which Congress repealed in 1976.¹ As a practical matter, the real property transfer tax is typically triggered at the time a deed or other instrument conveying an interest in realty is recorded with the local clerk or assessor-recorder. However, in stark contrast to the more commonly known real property transfer tax, the economic interest transfer tax is generally imposed upon the transfer of a direct or indirect ownership interest in an entity that holds title to real property, independently of any additional conveyance of a real property interest, and regardless of whether a deed is recorded in connection thereof. Thus, a merger, reorganization, or other non-real-estate corporate transaction, including any transaction that would be "tax-free" for purposes of federal or state income tax, is not necessarily

free from the indirect real property transfer tax where any of the entities involved in the transaction own real estate in an economic interest transfer tax jurisdiction.

Indeed, states and localities that impose an indirect real property transfer tax deem the conveyance of an economic interest to be an indirect transfer of ownership in real property, and normally impose the tax upon the transfer of a "controlling interest" in the legal entity that owns, directly or indirectly, the underlying real property. Generally, a controlling interest is deemed transferred for indirect real property transfer tax purposes when 50 percent or more of the total interest in the entity is conveyed.² Typically, a person or a group of people acting in concert will meet the controlling interest threshold if they transfer or acquire: (1) in the case of a corporation, either 50 percent or more of the total voting stock of all classes of stock of the corporation or 50 percent or more of the capital, profits, or beneficial interest in the voting stock of the corporation; or (2) in the case of a partnership, limited liability company, association, trust, or other entity, 50 percent or more of the capital, profits, or beneficial interest in that entity.³ However, analyzing a single transaction may not be sufficient to determine whether indirect real property transfer tax exposure exists, as taxable transfers of entity interests may occur over time. For instance, in New York, transfers or acquisitions of interests in the same corporation, partnership, or other entity occurring within three years are aggregated to determine whether a transfer of a controlling interest has occurred for economic interest transfer tax purposes.⁴ Similarly, where the conveyance involves an interest in a partnership or limited liability company that is disregarded for federal income tax purposes, certain states impose an indirect real property transfer tax where the transaction causes a partnership termination for federal income tax purposes under IRC section 708 (i.e., when, within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits).⁵

As the economic interest transfer tax is imposed regardless of whether the underlying transaction is intended to transfer an interest in real property, non-real-estate transactions—such as conversions of

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entity form or corporate reorganizations involving entities that directly or indirectly own real property—may trigger unexpected indirect real property transfer taxes.⁶ Certain states, however, expressly exempt transfers of entity interests from the economic interest transfer tax where the conveyance occurs pursuant to a plan of reorganization or consists of an adjustment effecting a mere change in identity, form, or place of organization.⁷ Moreover, state and local jurisdictions generally impose an indirect real property transfer tax on a transfer or acquisition of an interest in an “upper-tier” entity that indirectly owns real property, even where one or more “middle-tier” legal entities separate the underlying real property from the upper-tier entity whose interest is being conveyed. States such as Maryland, however, exempt the transfer of an interest in an upper-tier entity from the indirect real property transfer tax where the value of the real property located in the indirect real property transfer tax jurisdiction constitutes less than 80 percent of the aggregate value of the total assets owned by the upper-tier entity.⁸

Similar to the more commonly known real property transfer tax, the basis upon which the economic interest transfer tax is calculated typically varies by state and often even by locality within the same state. Generally, however, the tax is based on: (1) the fair market value of the underlying real property directly or indirectly owned by the entity whose interest is conveyed⁹ (which may be reduced by any outstanding mortgage balance secured by the real property at issue¹⁰); or (2) the consideration paid for the entity interest.¹¹ In addition to the tax basis, the method to determine that fair market value of the underlying real property varies from state to state. For instance, the real property’s fair market value may be determined by reference to the local property tax assessment,¹² based on the property’s capitalized net operating income, or by appraisal.¹³ Once the tax basis has been determined, the economic interest transfer tax is imposed at a rate that varies significantly from jurisdiction to jurisdiction and generally ranges from 0.1 to 4 percent of the tax basis (or even higher where state and local taxes are combined¹⁴).

Generally, however, states that impose an indirect real property transfer tax also provide for various general tax exemptions where, for instance, the transaction involves the transfer of an entity interest by or to an agency or instrumentality of the United States or a state or political subdivision of either,¹⁵ or where the transfer of an interest in an entity that directly or indirectly owns real property consists of a gift without exchange of valuable consideration.¹⁶

In conclusion, practitioners and business professionals alike should be aware that a non-real-estate corporate transaction may trigger significant indirect real property transfer tax obligations even where the parties do not intend to transfer any real property. Consequently, a prudent due diligence approach to any corporate reorganization, merger, or other business transaction involving a change of form or the transfer or acquisition of an entity interest should include a thorough review of that entity’s direct and indirect real property assets and a determination as to whether any economic interest transfer tax exposure exists. ☉

Endnotes

¹Former Internal Revenue Code § 4361.

²See, e.g., Wash. Rev. Code § 82.45.010(2)(a); Wash. Admin. Code section 458-61A-101(2); Wash. Admin. Code section 458-61A-101(3).

³See, e.g., N.Y. Comp. Codes R and Regs. tit. 20, § 575.6(a).

⁴See N.Y. Comp. Codes R and Regs. tit 20, § 575.6(d).

⁵See, e.g., Cal. Rev. and Tax. Code § 11925; San Francisco Bus. and Tax Reg. Code section 1108.

⁶See, e.g., Ill. Admin. Code § 120.20(e)(8); N.H. Rev. Stat. section 78-B:2 and N.H. Admin. Rules, Rev. section 802.05; N.J. Admin. Code 18:16A-1.5(c), Example 8.

⁷See, e.g., Cal. Rev. and Tax Code section 11923(a)(4); Conn. Gen. Stat. section 12-638b(b)(2); Md. Code Ann. Tax-Prop. section 12-117(c)(4); Md. Code Ann. Tax-Prop section 13-103(c)(2); Me. Rev. Stat. section 4641-C(18) and (19); N.Y. Tax Law section 1405(b)(6); N.Y.C. Admin. Code section 11-2106(8); Wash. Rev. Code section 82.45.010(3)(o).

⁸See Md. Code Ann. Tax-Prop. § 12-117.

⁹See, e.g., Me. Rev. Stat. Ann. § 4641-A.2.A.

¹⁰See, e.g., Cal. Rev. and Tax Code § 11925(b).

¹¹See, e.g., N.H. Rev. Stat. Ann. § 78-B:1; N.Y.C. Rules and Regs. sections 11-2101.9 and 11-2102.b.


¹²See, e.g., N.J. Stat. Ann. § 54:15C-1; Wash. Rev. Code § 82.45.030(2) and (4).

¹³See, e.g., Del. Code § 5401(3).

¹⁴For instance, the city of Philadelphia imposes a 3 percent indirect real property transfer tax in addition to the 1 percent state economic interest transfer tax. See 72 P.S. § 8102-C and Philadelphia Code of Ord. Ch. 19-1403(1)(g).

¹⁵See, e.g., Cal. Rev. and Tax Code § 11922; Wash. Rev. Code § 82.45.010(3)(n); Wash. Admin. Code § 458-61A-205.

¹⁶See, e.g., Md. Code Ann. Tax-Prop. § 12-108(p).



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