The Transfer Tax Trap — It’s Real

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I. Introduction

Most states (and many localities) have some form of real property transfer tax (RPTT), which is generally imposed when the ownership of a piece of real property changes hands. However, not all RPTTs are created equally, and many taxpayers may find themselves with an unexpected tax bill if they don’t pay close attention to each jurisdiction’s rules.

In our practice, we most often see RPTT issues arise in the context of corporate acquisitions, dispositions, mergers, and reorganizations — including transactions that are generally regarded as “tax-free” because gains are exempt from income tax. This article provides an overview of the applicability of RPTTs to the most common types of transactions, and variations on those transactions, and offers insights into the numerous traps or opportunities that may exist.

II. Real Property Transfer Tax — Practical Application

Most jurisdictions levy some type of RPTT on the transfer of real property in the jurisdiction. These taxes are typically triggered if a deed is recorded or other documents of legal significance are entered into effecting the transfer of real property to a new owner. Also, because taxpayers often transfer real property to a new owner without recording a deed by transferring a controlling interest in a legal entity — such as a corporation or limited liability company — that holds title to real property, a number of jurisdictions revised their taxes to include such transfers of controlling interests, beginning with New York in 1986. Regarding controlling interest transfers, tax is generally imposed when a transfer of interests is deemed to be an indirect transfer of ownership of real property, even if a deed is not recorded.

A. Acquisitions

Consider Corporation A, which owns an office building in State X that Corporation B (unrelated to Corporation A) wants to acquire. Corporation A considers the following alternatives for transferring its office building to Corporation B: a direct sale of the office building, or a sale of a controlling interest in a passthrough entity that owns the office building.

Acquisition Alternative 1 — Direct Sale of Real Property

If Corporation A sells the office building outright to Corporation B and State X has an RPTT, that tax will likely apply. Direct sales are the exact types of transactions that RPTTs were originally designed to capture. However, suppose Corporation A notices that State X doesn’t apply its RPTT to transfers when the consideration paid for the transferred property is less than a specified dollar amount.

1RPTTs should not be confused with various deed or mortgage recording fees, which are outside the scope of this article.

2Alaska, Arizona, Idaho, Indiana, Kansas, Louisiana, Mississippi, Missouri, Montana, New Mexico, North Dakota, Oregon, Texas, Utah, and Wyoming do not have RPTTs. California does not impose a state-level RPTT, but authorizes localities to impose such taxes and provides the statutory language that localities must use. See Calif. Revenue and Taxation Code section 11911(a).
Although not all states have a statutory dollar amount minimum, many do. For example, Connecticut imposes its RPTT only when the consideration for the real property is over $2,000, and New York state imposes its RPTT only when consideration is over $500. Although most significant corporation acquisitions will not fall into these statutory minimums, it is worth considering whether a jurisdiction has a minimum and whether any portion of a transaction would be exempt from the RPTT.

The definition of consideration can also be complicated; some jurisdictions, such as Florida and Hawaii, include in taxable “consideration” the amount of any encumbrances — such as liens or mortgages — on the property, even if not assumed by the purchaser. Other jurisdictions, such as Georgia and Massachusetts, do not include such encumbrances provided that they would not be removed by the sale.

Suppose Corporation A is feeling generous and accepts $1 as nominal consideration from Corporation B for the office building. In this scenario, there is no RPTT due because the consideration paid falls under the statutory minimum, or the RPTT due is nominal, right? Not necessarily. Many jurisdictions measure the amount of tax to be paid based on the fair market value of the real property, not by the consideration actually paid. In Washington, for example, when a transfer for “valuable consideration” occurs, RPTT is due on “the true and fair value of the property conveyed.” Delaware imposes its tax on the actual consideration paid or on the FMV of the real property (assumed to be the highest appraised value of the property unless otherwise proven), whichever is higher. The District of Columbia will even apply its RPTT when no consideration is given for the transfer, basing the tax on the FMV of the real property transferred.

What if, after researching the applicable statutes related to State X’s RPTT, Corporation A and Corporation B agree that the best thing may be for Corporation A to lease the office building to Corporation B under a 99-year lease? Does this transaction have any RPTT consequences? Possibly. The term “transfer” may be broadly defined for RPTT purposes to include leases of real property. Thus, if Corporation B enters into a 99-year lease with Corporation A for the office building, RPTT may apply to the lease. However, the type of lease that will effectuate a taxable transfer varies by state; for example, Wisconsin includes leases with a period of at least 99 years (though New York City includes all leases, regardless of term), but Nevada exempts all leases from its RPTT.

Thus, when a basic sale or other type of direct acquisition of real property of significant value occurs within a state that has an RPTT, serious consideration must be given to whether that tax will apply.

### Acquisition Alternative 2 — Sale of a Controlling Interest in a Passthrough Entity

After learning about the RPTT consequences of Alternative 1, Corporation A considers a different approach. Corporation A notices that State X exempts from its RPTT transfers of real property when the “beneficial ownership” of the property remains the same after the transfer. This exemption is quite common in the RPTT world. Many jurisdictions exempt transfers within a commonly controlled group from the tax, provided that the beneficial ownership interest in the real property remains the same.

As a result, Corporation A plans to transfer the office building to a newly formed, wholly owned LLC for which the office building will be its only asset. After the office building is transferred to the LLC, Corporation A immediately plans to sell its interest in the LLC to Corporation B, thereby indirectly causing the transfer of the office building to Corporation B. Because the transfer of the building to the LLC did not result in a change in the office building’s beneficial ownership — since the LLC is wholly owned by Corporation A — and the sale to Corporation B was a sale of interests in the LLC and not a transfer of real property the RPTT will not apply.

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4New York Tax Law section 1402(a).
5Florida Stat. section 201.02(1); Hawaii Rev. Stat. section 247-2.
6Georgia Code Ann. section 48-6-1(a); Massachusetts Gen. Laws ch. 64D, section 1.
7Washington Rev. Code section 82.45.060; Washington Rev. Code section 82.45.030. If the real property is conveyed in an arm's-length transaction between unrelated persons, a rebuttable presumption exists that "the true and fair value" of the property is equal to the consideration given for the property.
820 Delaware Code Ann. section 5402(a); 20 Delaware Code Ann. section 5401(3).
10Wisconsin Stat. section 77.21(1).
11New York Tax Law section 1401(e). Regarding leases, New York state also requires that the following two conditions exist for the RPTT to apply: substantial capital improvements are or may be made by or for the benefit of the lessee or sublessee, and the lease or sublease is for substantially all of the premises constituting the real property.
12New York City Admin. Code section 11-2101(2).
14There are, of course, property transfers that may be exempt, such as transfers to a state or to the federal government and transfers to certain organizations that are exempt under IRC section 501(c)(3).
right? Not necessarily. The tax consequences of this two-step transaction vary by state. Each step should be separately analyzed.

**Step 1: The Transfer of Real Property to the Wholly Owned LLC**

As an initial matter, will the transfer of the office building from Corporation A to the LLC be taxable? In most jurisdictions, the answer is no, either because such transactions are specifically exempt from the applicable RPTT or because there is a general exemption for transfers that do not result in a change in “beneficial ownership” of the real property.

The best-known beneficial ownership exemption is in New York, where both the state and New York City exempt “conveyances to effectuate a mere change of identity or form of ownership or organization where there is no change in beneficial ownership.” Of course, there are still a handful of jurisdictions that have no such exemption. For example, New Jersey will impose its RPTT on a deed “transferring real property from one legal entity to another legal entity that has common ownership.” In that case, the consideration subject to the RPTT includes the monetary value of stock transferred or contribution to capital by the grantor.

Notwithstanding the New Jersey approach, the transfer of the real property by Corporation A to the LLC generally should not have transfer tax consequences.

**Step 2: The Sale of the Wholly Owned LLC To Corporation B**

As mentioned, beginning with New York in 1986, many jurisdictions have adopted statutory provisions taxing transfers of controlling interests in entities that own real property in the state. Generally, jurisdictions that have adopted such provisions take one of two approaches in determining whether a transfer of a controlling interest represents a taxable conveyance of real property.

The first approach taxes transfers of controlling interests in any entity that owns in-state property. Jurisdictions that adopt this approach may impose tax in connection with business acquisitions, mergers, stock sales, or other changes in any legal entity’s ownership.

In contrast, the second approach taxes transfers of controlling interests only in situations in which the entity being transferred is primarily in the business of owning real property. Generally, whether an entity is primarily in the business of owning real property is determined by measuring the entity’s real estate activity against its total activity (each jurisdiction differs in how it determines whether a particular company is primarily engaged in the business of owning real estate).

Within those two approaches, there are issues to consider. The first is what constitutes a controlling interest. Generally a controlling interest is more than 50 percent — but 50 percent of what? Illinois requires that “more than 50 percent of the fair market value of all ownership interests or beneficial interests” in a “real estate entity” be transferred before its “controlling interest” tax will apply. Maine requires, for corporations, the transfer of more than 50 percent of the total combined voting power of all classes of stock of the corporation entitled to vote or more than 50 percent of the capital, profits, or beneficial interest in the voting stock of the corporation; and for partnerships and other entities, the transfer of more than 50 percent of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity.

There are exceptions to the “more than 50 percent” standard. For example, Maryland requires a transfer of more than 80 percent, while New Hampshire imposes tax on transfers of any interests in certain entities holding real estate. As seen in these examples, it is critical that taxpayers pay attention to the statutory definition of controlling interest in each jurisdiction that extends its RPTT to transfers of controlling interests.

An equally important issue for transfers of controlling interests is determining whether the legal entity is engaged primarily in the business of owning real estate. As noted, many jurisdictions impose taxes only on the transfer of a controlling interest in such an entity. Thus, transfers of controlling interests in any other type of legal entity will not trigger the applicable RPTT, regardless of the amount or value of real property owned by the entity being transferred.

For example, Michigan imposes its RPTT only on transfers of controlling interests in an entity “if the real property owned by that entity comprises 90 percent or more of the fair market value of the assets of the entity.” The District of Columbia requires that the transfer be of interests in an entity that “during the 12-month period immediately preceding the transfer of an economic interest in real property, derives more than 50 percent of its gross receipts from

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15For example, Virginia Code Ann. section 58.1-811(A)(9).
16New York Tax Law section 1405(b)(6); 20 NYCRR 575.10; New York City Admin. Code section 11-2106(b)(8).
18Id.
1935 ILCS section 200/31-5.
21Id. at section 4641(1-A)(B).
23New Hampshire Rev. Stat. section 78-B:1-a(V); New Hampshire Admin. Rules, Rev. 802.05.
24Michigan Comp. Laws section 207.523(1)(c).
from the ownership or disposition of real property in the District; or holds real property in the District that has a value comprising 80 percent or more of the value of its entire tangible asset holdings.” 25

**Staggering the Transfers**

Under the basic example described above, if Corporation A were to sell 100 percent of the LLC — for which the office building is its only asset — to Corporation B, and the transfer were made in a jurisdiction that imposes RPTT on the transfer of controlling interests, the tax would likely apply. Therefore, Corporation A may contemplate some variations on its initial plan. Under one variation, Corporation A would sidestep transferring a controlling interest in the LLC at any one time by transferring a 34 percent interest in the LLC to Corporation B in January, a 33 percent interest in July, and the remaining 33 percent interest the following January.

Unfortunately for Corporation A, this variation is unlikely to change the RPTT consequences. Most, if not all, jurisdictions will aggregate transfers of interests that occur within a specifically defined period of time to determine whether a controlling interest has been transferred. For instance, Washington aggregates all transfers within a 12-month period, 26 Illinois aggregates all transfers within a 24-month period, 27 and Pennsylvania aggregates all transfers within a three-year period. 28 Even if staggering the transfers results in the transaction falling outside the applicable RPTT’s limits, Corporation A should tread lightly because jurisdictions might also aggregate transfers from outside the time period if they are contemplated during the applicable statutory time period or are otherwise made under a tax avoidance plan. 29

**Acting in concert**

Under a second variation, Corporation A would transfer a 34 percent interest in the LLC to Corporation B, and 33 percent interests each to corporations C and D, which may be related or unrelated to Corporation B. This variation is also unlikely to achieve Corporation A’s goals for the reasons just discussed.

If corporations C and D are related to Corporation B or are otherwise “acting in concert” with Corporation B, most — if not all — jurisdictions will aggregate those separate transfers. For example, New Jersey provides that a “sale or transfer of a controlling interest subject to taxation . . . may be accomplished by one purchaser or may be made by a group of purchasers acting in concert. Purchasers who are related parties are presumed, unless shown to the contrary, to be acting in concert.” 30 Even if corporations C and D were not related or otherwise acting in concert with Corporation B, many jurisdictions provide that tax is imposed on the “transfer or acquisition” of a controlling interest. 31 Therefore, even if Corporation B (or any other entity) does not acquire a controlling interest from Corporation A, if Corporation A has transferred a controlling interest in the LLC, the tax may still apply.

One final consideration is whether the drop down of the office building to the LLC followed by a sale of the LLC interest would be subject to application of a step transaction, sham transaction, or economic substance analysis by State X’s revenue department. That analysis could lead to State X treating the transaction as one that amounts simply to a direct sale of the office building, even if State X does not tax the transfer of a controlling interest in an entity that owns real property.

The danger would be particularly acute if Corporation B liquidated the LLC immediately after acquiring it. For example, regarding California’s 1954 Bank and Corporation Tax Law, the Franchise Tax Board applied a step transaction doctrine to the acquisition of corporate stock followed by a liquidation, holding that “where to fulfill its intention of acquiring assets a taxpayer purchases the stock of a corporation and within a short time after the corporation is liquidated, the incidental step of liquidation will be ignored in computing the tax effect of the entire transaction.” 32

Accordingly, as demonstrated in the discussion above, transfers of controlling interests in entities owning real property are more complicated than direct sales of real property. 33 As such, these transfers require a greater level of attention from taxpayers to determine if an RPTT will apply.

**B. Corporate Reorganizations**

Corporate businesses are often sold in transactions that are referred to under the IRC as tax-free reorganizations. If the corporation that is sold (Target) merges into another corporation and the Target

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25District of Columbia Code Ann. section 42-1102.02(a).
26Washington Rev. Code section 82.45.010(2)(a).
27Illinois Admin. Code 120.20(d).
29For example, 72 Pennsylvania Stat. Ann. section 8102-C.5(a)(3); 20 NYCRR 575.6(d).
31For example, Michigan Comp. Laws Ann. section 207.523(1)(c); Washington Rev. Code section 82.45.010(2)(a).
32California FTB Legal Ruling 221 (June 27, 1958).
33Also, the drop down technique may change the corporate and business nature of the transaction. For example, a buyer would likely want detailed representations from the seller of interests in an LLC that the LLC has no undisclosed liabilities, lawsuits, and similar items. The same buyer would likely not need these representations if it were simply buying a parcel of real estate.
shareholders receive only stock of the buyer corporation, their gain on the sale will not be currently taxed. If they receive some cash or consideration other than buyer corporation stock, their gain will be recognized only to the extent of the non-stock consideration. The same treatment applies if the transaction is structured not as a merger but as a sale of stock by the Target shareholders or a sale of assets by Target followed by a liquidation of Target, although the requirements for tax-free treatment are slightly different.34

In a typical income-tax-free reorganization, the Target shareholders’ basis in the buyer corporation stock that they receive in the transaction is the same as their basis in the Target stock that they surrender, so their gain is only deferred and not avoided completely; however, the transaction in which the business is sold results in no immediate income tax for the parties involved. But even though a transaction may not have income tax consequences, it may have RPTT consequences. While many jurisdictions exempt transfers under statutory mergers or reorganizations, some do not. For example, Illinois exempts transfers resulting from plans of reorganization under the IRC,35 but neither New York state nor New York City provide exemptions for “tax-free” reorganizations in which the seller’s gain is not subject to income tax.

Taxpayers who have come to regard plain vanilla reorganizations — in which all the consideration is buyer stock — as being so obviously tax-free and simple to structure may fall into the trap of thinking that they don’t have to worry about taxes.36 But when a state does not exempt transfers under mergers and reorganizations from its RPTT, unwary taxpayers may be surprised by a tax bill for their “plain vanilla” reorganization whereby real property or controlling interests in entities owning real property was transferred.

### III. Conclusion

While RPTTs can seem like inconsequential and straightforward taxes on paper, a brief look into the substance of the taxes raises many questions and reveals many potential traps, and even some opportunities, for the parties involved. Some of the most important questions that we have illustrated above and that should be considered are:

- What constitutes a transfer of real property? Specifically, do transfers of economic interests (typically, “controlling interests”) in entities owning real property qualify?
- If transfers of economic interests in entities owning real property qualify, what constitutes a “controlling interest” in the entity, and what types of entities are relevant (that is, all entities or only those “primarily in the business of owning real property”)?
  — Are there aggregation rules for transfers of economic interests?
- What is the measure of the tax (in other words, consideration or fair market value of the real property transferred)?
  — What is the measure of “consideration”?
- Is there an exemption for transfers when the “beneficial ownership” of the real property remains the same?
- If the transaction is a corporate merger or reorganization, is there an exemption for transfers resulting from such transactions?
- Is there any danger of a state applying a step transaction, sham transaction, or economic substance analysis to a series of transactions?

Taxpayers must pay close attention to the RPTT provisions of each state, as even seemingly uniform provisions can have slight differences in application. Anything less than careful consideration may lead to unexpected and unwanted tax consequences.

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34 IRC section 368.
35 35 ILCS section 200/31-45(i).
36 Although not the principal subject of this article, income-tax-free reorganizations may also be subject to state and local sales taxes.