Controlling Interest Transfer Taxes: A (Mostly Critical) Review

Few state controlling interest transfer tax provisions apply in a straightforward, expected way to all transfers of a "controlling interest" in a real property-owning entity.

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In an effort to prevent tax planning and to maximize transfer tax revenues, a number of states have enacted laws extending the imposition of their real estate transfer taxes to the transfer of a controlling interest in an entity that owns real property within the state. For ease of reference in this article, we will refer to these laws as laws that impose a "controlling interest transfer tax" (and sometimes by the abbreviation CITT).

Few state controlling interest transfer tax provisions apply in a straightforward, expected way to all transfers of a "controlling interest" in a real property-owning entity. Instead, the majority of states have included a variety of sometimes strange, often ambiguous limitations on the scope of such provisions, such that only specific entities or specific transactions will be subject to the tax. Furthermore, the states' administration of such taxes varies widely and suffers from substantial gaps in guidance and interpretation.

We hope this article will serve as a valuable resource for taxpayers and practitioners seeking to comply with the law in one or more of the jurisdictions that we have addressed, and perhaps it will point the way to the drafting and administration of a sensible controlling interest transfer tax provision for one or more states in the future. Unfortunately, time and space constraints prevent us from addressing every state with a CITT, so we will return to address the remainder in a sequel to this article.

Finally, because it's a tall task to make an article about controlling interest transfer taxes compelling, we've sprinkled in a few references to our favorite musicians throughout this piece (tied to the state under discussion, of course).
The Exemplars

States in our "exemplar" category include New Jersey and New York.

New Jersey

Everybody remembers where they were for specific moments in their lives: where you proposed to your wife, for example, or the night you spent with old friends watching your team win Game 7 of the World Series. For one of our authors (the older one), one of my most distinct memories is the first time I heard Bruce Springsteen's "Thunder Road"—a song that was my point of entry into Bruce's world by the boardwalk in Asbury Park, N.J., full of characters different than anybody I'd ever met (there was no Hazy Davy at Greasy Lake in the Atlanta suburb where I grew up, and there definitely was no Magic Rat flashing a switch-blade).

Speaking of New Jersey: the New Jersey government has had a run of bad news in recent years, but the state can point proudly to its straightforward controlling interest transfer tax provision. New Jersey's CITT statute provides, in pertinent part: "There is imposed and shall be paid a tax upon the sale or transfer for consideration in excess of $1,000,000 of a controlling interest in an entity which possesses, directly or indirectly, a controlling interest in classified real property, which shall be paid by the purchaser of the controlling interest and which shall be equal to 1% of the consideration paid on the sale or transfer; provided however that in the case of the sale or transfer of a controlling interest in an entity which possesses, directly or indirectly, an interest in classified real property and an interest in other property, real or personal, there shall be paid a tax upon the sale only if the equalized assessed value of the classified real property exceeds $1,000,000 which shall be paid by the purchaser of the controlling interest and which shall be equal to 1% of that percentage of the equalized assessed value of the classified real property that is equal to the percentage of the ownership interest transferred."\(^1\)

Broadly speaking, New Jersey imposes its CITT on any sale of a "controlling interest" (50% or more) in an entity which possesses, "directly or indirectly," an interest in "classified real estate," which is explicitly defined to include Class 4A commercial properties.\(^2\) By including that "direct or indirect" language, New Jersey imposes its tax both where a controlling interest in the property-owning entity itself is transferred directly, as well as the situation where an upper-tier entity is transferred.\(^3\) Furthermore, the New Jersey law is clear about the computation of the tax base: if the entity owns only classified real property, and the sale price exceeds $1 million, it's the sale price; and if the entity owns other property in addition to the classified
real property, then it's the "equalized assessed value" of such property, if the equalized value of the property exceeds $1 million.

New Jersey's use of assessed value helps to avoid some substantial administrative concerns in a transaction in which the sale price applies to both real property and other property types, because in a stock sale or membership interest transaction, the parties will not typically agree to the allocation of the sale price among the assets of the entity. And the parties will, of course, often have different incentives in whether to apply more or less of the sale price to real property assets and/or other tangible or intangible assets. This allocation becomes even more complicated when the entity owns assets in multiple local jurisdictions or multiple states.

New Jersey's sensible rule avoids these concerns, however, by setting forth two distinct tax base calculations: if the entity owns only New Jersey class 4A commercial property, then the tax is computed based on the sale price, but if the entity owns any other property—be it personal property, intangible property, real property in another state, or non-class 4A real property in New Jersey—then the tax is computed based on the equalized assessed value. By applying clear and easily administrable rules for the tax base in the two scenarios, New Jersey has crafted a straightforward and sensible CITT provision. Note, however, that the New Jersey CITT applies even to a tax from one affiliate to another (i.e., there is no "inter-company exemption" from the CITT). 4

Finally, New Jersey's CITT is further set apart by its well-designed transfer tax form (Form CITT-1), which provides comprehensive line-by-line instructions and a schedule for computing and reporting the tax due on each property—even those in a multi-property transaction, which many state CITT provisions do not take into account. 5

**New York**

Perhaps even more than those of New Jersey, New York's controlling interest transfer tax provisions are broadly applicable, covering any transfer of a controlling interest in an entity that owns, directly or indirectly, real property in New York. 7 While New York—like New Jersey—also has a robust tax form and instructions, 8 New York has not provided different methods of computing the tax base depending on whether the sale involves only real property assets or a mix of real property and other assets.

Instead, the tax base for the New York CITT is entirely based on the amount of "consideration," which is defined as: "the price actually paid or required to be paid for the real property or interest therein . . . . It shall
include the cancellation or discharge of an indebtedness or obligation. It shall also include the amount of any mortgage, purchase money mortgage, lien or other encumbrance, whether or not the underlying indebtedness is assumed or taken subject to.9

The exclusive use of consideration generates material problems in apportioning and computing the tax base in a multi-property transaction where the parties have not explicitly agreed to an allocation of either (i) the value ascribed to each property in the transaction or (ii) the extent to which any debt assumed in the transaction is ascribed to any particular property. For example, assume that a buyer purchases an affiliated group of entities with a portfolio of properties across multiple states in a transaction where the buyer pays $10 million in cash and assumes $10 million in debt owed on the properties by the entities. Assume further that the entities own real property and other assets, including personal property and intangibles, but the parties have not agreed to a specific allocation of the sale price or debt among the entities in the affiliated group (much less the specific assets owned by each entity).

How do the parties prove the amount of "consideration" to which any particular parcel of real property was subject? How do they apportion the debt to any particular parcel of real property? And finally—perhaps most importantly—how do they prove that allocation and apportionment of value to New York, and what happens if they cannot agree to the amount that the grantor should pay?10

Ultimately, while New York's broadly applicable statute places it into the "exemplar" category, its reliance on consideration for providing the tax base is a source of frustration in complying with even that state's CITT. Accordingly, if a mutual agreement regarding the allocation of value to the New York real property cannot be achieved, it is a good practice for the parties to such a transaction to have at least an internal set of records to explain the basis for its reported "consideration" attributable to a particular property subject to the New York CITT.

Finally, however, New York does provide a basis to use assessed values where the buyer provides consideration "other than money," because in that case, the New York CITT provides that "it shall be presumed that the consideration is the fair market value of the real property or interest therein."11 New York has not provided guidance regarding how much "other" consideration would trigger this presumption.

The Outliers

Our "outliers" category includes Florida and Minnesota.
Florida

Florida's controlling interest transfer tax statute appears to be more focused on preventing perceived "tax avoidance" by property owners who transfer title to an entity and then sell their interest in that entity than in maximizing tax revenues. Florida's CITT applies only to the transfer of a "conduit entity," defined as "a legal entity to which real property is conveyed without full consideration by a grantor who owns a direct or indirect interest in the entity, or successor entity." The statute imposes a tax on the consideration paid when "real property is conveyed to a conduit entity and all or a portion of the grantor's direct or indirect ownership interest in the conduit entity is subsequently transferred for consideration within 3 years of such conveyance."

Thus, the Florida CITT does not apply to any sale of a controlling interest in an entity that owns Florida real property. Rather, it only applies when the owner of Florida property first transfers such property to a conduit entity without paying tax on the value of the property determined on an arm's-length basis. Interestingly, if the grantor does not pay tax on the full value of the property when it transfers the property down, then the grantee becomes a "conduit entity," and the tax would be due on the full consideration for the sale of that "conduit entity" within three years, with no credit given for any taxes paid on the drop-down transaction. Conversely, if the grantor pays tax on the full value at the time of the initial transfer, then the grantee is not deemed a "conduit entity," and a transfer of the controlling interests in the grantee entity will not be subject to tax.

Like the New York law, the Florida CITT statute also provides that if the conduit entity owns assets other than real property, "it is presumed that the consideration is equal to the fair market value of the real property or interest therein . . . ." The regulation is somewhat inconsistent with this statutory presumption and may, accordingly, be invalid.

A taxpayer that needs to report and pay tax due under the Florida CITT should file Florida Form DR-228, which is due to the Florida Department of Revenue on the 20th day following the taxable transaction. Oddly, the form does not require the payor to provide any information with respect to the specific property or transaction that is the basis for the tax filing.

Minnesota

Minnesota's CITT, like that of Florida, applies only to the sale of an entity following the non-taxable transfer of property. Minnesota calls the non-taxable transfer of property a "designated transfer." The statute defines a "designated transfer" as follows:
1. A transfer between a sole owner and an entity owned by that sole owner;
2. A transfer between one or both married spouses and an entity owned solely by one or both spouses;
3. A transfer between an entity with multiple co-owners and "all of the co-owners, so long as each of the co-owners maintains the same percentage ownership interest in the transferred real property, whether directly or through ownership of a percentage of the entity";
4. A transfer between a revocable trust and the grantor or grantors of the revocable trust; and
5. A transfer of substantially all of the assets of one or more entities pursuant to a reorganization.

Most typically for our clients, this applies when a parent transfers property to a subsidiary entity. If a controlling interest in the grantee entity is sold within six months of such a "designated transfer," then Minnesota imposes a retroactive deed tax on the initial transaction at a rate of 0.33% on the "net consideration" for such transaction. Consideration given for the transaction excludes any amounts related to personal property, but the statute does not provide how to account for intangibles owned by the entity and for which consideration is given.

Unlike many states, Minnesota provides a deduction for a lien; however, such lien must be attached to the property—meaning that the statute treats debt differently if it is specifically attached to a property, as opposed to merely being debt of the entity. However, since most such debts will normally be recorded against each property owned by the entity, there may be a position that a proportionate part of such debt can be taken as a deduction.

Finally, Minnesota imposes an additional penalty on the transfer following the designated transfer, if "the subsequent transfer of ownership interests was reasonably expected at the time of the designated transfer . . . ." The grantor must file a Form DT2 with the Minnesota Department of Taxation within 30 days of the transaction that triggers the tax.

The Others

Examples drawn from other states include Illinois, Pennsylvania and Rhode Island.

Illinois

Illinois taxes the sale of a controlling interest in a "real estate entity," which the statute defines as any entity "that exists or acts substantially for the purpose of holding directly or indirectly title to or beneficial interest in real property. There is a rebuttable presumption that an entity is a real estate entity if it owns, directly or
indirectly, real property having a fair market value greater than 75% of the total fair market value of all of the entity's assets, determined without deduction for any mortgage, lien, or encumbrance.\textsuperscript{28}

There are two issues raised by this definition. First, Illinois has provided no guidance on when an entity exists "substantially for the purpose of holding" real property. Does an apartment developer qualify? (i.e., how literally must that provision be interpreted, and does an apartment developer exist for the purpose of "holding" real property or for leasing apartment units?) What about an entity that exists for the purpose of holding a subsidiary entity that owns real estate?

Second, it is unclear whether the fair market value of the entity's assets is measured before the sale of the entity or is based on the sale price of the entity. Does the "real estate entity" presumption apply if a selling entity values its own real estate assets at less than 75% of all its assets prior to the sale, but the buyer values those real estate assets at more than 75% of the entity's assets?\textsuperscript{29} In discussions with the Department of Revenue, representatives have suggested that the statutory "presumption" is effectively irrebuttable, which is of course contrary to the Legislature's intent.

The tax base for the Illinois CITT is the "the amount of the full actual consideration for the real property or the beneficial interest in real property located in Illinois, including the amount of any lien on the real property assumed by the transferee."\textsuperscript{30} Illinois's tax base is similar to New York's, and it faces the same problems. For deals stretching across multiple states or involving multiple kinds of assets, how does an entity separate the consideration paid for Illinois real property if this is not separately listed in the deal? And how does an entity allocate debt assumed by a purchaser if the debt was not allocated to specific properties at the time of the sale? Illinois provides no guidance on how to treat multi-state transactions or transactions where the debt assumed is not allocated to specific properties, and the tax forms provide an imperfect method to calculate and report the tax for these transactions.\textsuperscript{31}

Finally, the administration of the Illinois CITT is highly flawed. The statute requires the buyer and seller to present the declaration of transfer to the county recorder and pay the tax within three days after the transfer, but many county recorders are unaware of the tax and do not understand how to accept and file such documents.\textsuperscript{32} In multiple cases, county recorders have even refused to accept the filings. Finally, the timing is virtually impossible to achieve in cases where the property is located within a city that imposes its own transfer tax, as the taxpayer must first approach the city for a local transfer tax stamp, and the cities are often even less experienced with administration of the CITT than the counties.
Pennsylvania

Pennsylvania imposes its CITT based on the value of the real estate held by a "real estate company" when it is sold. Pennsylvania's CITT statute has two ambiguities involving: (1) when the transfer of a real estate company triggers the tax; and (2) the definition of a "real estate company."

First, the statute imposes the tax when there is a change in the "ownership interest" of a real estate company, but that tax is subject to a limitation stating that the tax only applies when the change "does not affect the continuity of the company." However, neither the statute nor its regulations define this phrase, and the department has not issued any guidance as to that strange limitation's meaning.

Does the hiring of a new property manager constitute an interruption in continuity? What about a change in business plan (e.g., from a property held for investment to a property that is actively developed)? Given that the limitation is in the statute, by rules of statutory construction that limitation generally must be construed broadly, in favor of the taxpayer and against the imposition of taxation.

Second, the meaning of the phrase "real estate company" is also ambiguous. The statute defines a "real estate company" as a corporation or association that is "primarily engaged in the business of holding, selling, or leasing real estate, ninety percent or more of the ownership interest in which is held by thirty-five or fewer persons and which: (i) derives sixty per cent or more of its annual gross receipts from the ownership or disposition of real estate; or (ii) holds real estate, the value of which comprises ninety per cent or more of the value of its entire tangible asset holdings exclusive of tangible assets which are freely transferable and actively traded on an established market."

The statute's limitation that the company must be "primarily engaged in the business of holding, selling, or leasing real estate" is ambiguous, but the Pennsylvania Department of Revenue has provided helpful guidance on the scope of this limitation. In a letter ruling, the Department of Revenue ruled that a cemetery company was not a "real estate company" for purposes of the CITT, morbidly analogizing a cemetery to a "hotel with a longer stay." It added that "while the real estate is an integral part of the service [provided by the cemetery company], it is the service that is the primary business of the cemetery company."

While the distinction between real estate being the company's "primary business" as opposed to "an integral part of the service" of the company provides at least some guidance on how broadly the CITT applies, there remains some gray area. The letter ruling does not discuss how the cemetery transfers plots to customers, nor does it draw a clear line between the cemetery providing grave services and the company being in the "primary business" of selling or leasing plots.
While the department's guidance may be better than the guidance from Illinois, there is a similar flaw in Pennsylvania's local administration of the CITT. The statute requires the company to present a "declaration of acquisition" and pay a tax on the assessed value of the real estate to the county recorder in each county in which it holds real estate. The declaration form is straightforward, but individuals at the county recorder's office are often unfamiliar with the tax or how to record the document without a corresponding deed.

Rhode Island

Rhode Island's controlling interest transfer tax is almost identical to Pennsylvania's, but because its provisions were passed in 2015, the state's Division of Taxation has provided little guidance regarding the scope of the tax's application. Rhode Island imposes a tax on the transfer of a controlling interest in a "real estate company," the definition of which is effectively the same as Pennsylvania's definition. The statute has the same ambiguities as Pennsylvania's CITT statute regarding the meaning of "real estate company," but unlike Pennsylvania, Rhode Island has not issued any guidance on when a company is "primarily engaged in the business of holding, selling, or leasing real estate."

The statute also includes the same requirement as Pennsylvania's that the change in ownership of a real estate company "does not affect the continuity of the operations of the company" for the tax to apply. The Division of Taxation likely will issue more guidance as time passes and disputes arise, but, until then, it may be best to consult Pennsylvania's CITT guidance because the Division acknowledges that Rhode Island copied its statute from Pennsylvania.

Finally, don't look for help understanding the tax from the Rhode Island tax form or its instructions, because the entirety of the Division's instructions are five sparse bullet points and (most helpfully) the phone number for the Division of Taxation's Excise Tax Section. The tax form has a major defect by only asking for the consideration paid for the acquired company without other basic identifying information regarding the property at issue.

Generally, Rhode Island imposes the tax on the consideration paid for the interest in the real estate company, but the statute provides that if the company "has assets other than interests in real estate located in Rhode Island, the tax shall be based upon the assessed value of each parcel of property located in each municipality in the state of Rhode Island." This provision solves the apportionment problem for multi-state transactions or transactions that involve assets other than real property, but the tax form is woefully inadequate in allowing the taxpayer to communicate to the Division regarding the basis for its filing and the computation of the tax that it seeks to report and pay.
Conclusion

As we have discussed in this article, states have imposed CITT provisions in a number of ways, but the limitations imposed on such provisions and the limited guidance regarding how to administer them has made compliance extremely difficult. If states are going to continue to seek to impose such taxes, they need to pass significantly more straightforward laws, and the state taxing authorities need to provide substantially more guidance to both taxpayers and local officials regarding how to report, compute, pay, and collect such taxes.

5 See Form CITT-1 at http://www.state.nj.us/treasury/taxation/pdf/current/cbt/citt_1.pdf.
6 Two of our favorite artists both have deep New York connections: Bob Dylan and the Beastie Boys. Amazingly, Bob Dylan is still going strong in 2016, winning a Nobel Prize for Literature and headlining the Desert Trip festival (jokingly referred to as "Oldchella" for hosting a roster of aging rock acts on the site of the annual Coachella Festival near Palm Springs), while the Beastie Boys have called it quits in the wake of one member's death from cancer in 2012.
7 N.Y. Tax Law § 1402(a) ("A tax is hereby imposed on each conveyance of real property or interest therein when the consideration exceeds five hundred dollars, at the rate of two dollars for each five hundred dollars or fractional part thereof . . ."); N.Y. State Dep't of Tax. & Fin., Pub. 576, at 3-5.
8 See NY Form TP-584 and TP-584-I.
9 N.Y. Tax Law § 1401(d).
10 New York is one of a small handful of states that requires both grantor and grantee to sign the CITT form.
11 N.Y. Tax Law § 1404(b).
12 We’re having trouble coming up with an artist for Florida. Oh wait—what’s that from the back of the auditorium? Oh right—“Freebird!” Lynyrd Skynyrd is the pride of Orlando, Florida, with a throw-away name that was a reference to an old high school gym coach.


14 Fla. Stat. § 201.02(1)(b)(2).


16 Fla. Stat. § 201.02(1)(b)(3).

17 See Fla. Admin. Code Ann. § 12B-4.060(b)(6) (“If the conduit entity owns assets other than the real property referred to in subsection (2), tax is calculated by multiplying the consideration for the interest in the conduit entity by the tax rate and then multiplying the result by a fraction, the numerator of which is the value of the real property referred to in subsection (2) and the denominator of which is the value of all assets owned by the conduit entity.”)


19 Minnesota offers an embarrassment of riches for a music fan, most notably the deep and idiosyncratic catalog of Prince (who tragically passed earlier this year). Chuck Klosterman posits that Minnesota has produced a disproportionately large number of great American musicians (in addition to Prince, there’s the Replacements, Husker Du, the Jayhawks, the Hold Steady, and Bob Dylan) because the long winters force young boys and girls inside to their garages and basements and bedrooms for an extra few months out of the year.

20 Minn. Stat. § 287.21(1)(a)-(b). Technically, the state imposes a tax of $1.65 on the "designated transfer."

21 Minn. Stat. § 287.20(3)(a).

22 Minn. Stat. § 287.21, subd. (1)(b).

23 See Minn. Stat. § 287.20, subd. (2).

24 Minn. Stat. § 287.20, subd. (2)(f).
25 Minn. Stat. § 287.21(1)(c) (imposing "a civil penalty of $250, or 100 percent of the tax, for each such failure, whichever is less" under Minn. Stat. § 287.31(1)).

26 At the time of the "designated transfer," the owner would have recorded a deed with the county recorder and paid the $1.65 minimum tax due with that document.

27 Home of the Chicago blues, one of America's great musical traditions (Bo Diddley, Jimmy Reed, Pinetop Perkins, Buddy Guy, and a hundred others, including one of our all-time favorites in any genre: Howlin' Wolf).


29 See id. ("Value means the amount of the full actual consideration for the real property or the beneficial interest in real property located in Illinois, including the amount of any lien on the real property assumed by the transferee.")


31 See Ill. Form PTAX-203-B.


33 Philadelphia doesn't get its due as a source of great American music, but it should, because it's produced many of our favorites from the last 30 years—think of the War on Drugs, John Legend, Hall & Oates, and, of course, Will Smith (as it turns out, "In West Philadelphia born and raised" is biographically true).


36 72 Pa. Stat. § 8101-C.


39 See Pa. Form REV-1728.


42 See Instructions for R.I. Form CVYT-2.

43 See R.I. Form CVYT-2.
