

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

*2006 Joint Fall CLE Meeting*

TITLE: Transfer Tax Issues Affecting Changes in Entity

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PANEL: Changing the Closely Held Business Entity and Addressing Family Disputes

DATE: 10/20/06

COMMITTEE: Business Planning Group (PT), Litigation and Controversy Group (PT),  
Closely Held Business (TX)

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## **Transfer Tax Issues Affecting Changes in Entity**

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### **Joint Meeting, Closely Held Business Committee, Section of Taxation, and Business Planning Group, Section of Real Property, Probate and Trust Law**

**Denver, Colorado**

**October 20, 2006**

#### **I. Real Estate Conveyance Tax (Conveyance Tax)**

- A. Most states impose a tax on the transfer of interests in real property for consideration, generally couched in terms of a transfer by deed or other writing. The tax is most commonly imposed on the grantor. Rates of tax range from 0.10% in Alabama, Georgia and Kentucky<sup>1</sup> to 1.50% in Connecticut and Maryland,<sup>2</sup> and even to 3% in certain counties of Delaware and New York.<sup>3</sup>
- B. Many states first adopted conveyance taxes in the 1970s when the federal Documentary Stamp Tax on deeds was repealed. That tax had existed since the Civil War. The regulations, withdrawn by T.D. 8314, 1990-2 C.B. 220, 55 Fed. Reg. 41519, 41522 (1990), are reproduced at Appendix A.
- C. Interests in real property
  - 1. Defined in the federal regulations as “those interests in real property which endure for a period of time, the termination of which is not fixed or ascertained by a specific number of years, such as an estate in fee simple, life estate, perpetual easement, etc.” Treas. Regs. § 47.4361-1(a)(4)(i)(a).
    - a. Thus, leases are generally excluded.
      - (i) However, the federal regulations included long-term leases as: “Those interests enduring for a fixed period of years but which, either by reason of the length of the term or the grant of a right to extend the term by renewal or otherwise, consist of a bundle of rights approximating those of the class of interests mentioned in subdivision (a) of this regulation.” Treas. Regs. § 47.4361-(a)(4)(i)(b).

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<sup>1</sup> Ala. Code § 40-22-1 (on excess over mortgage, which is taxed at 0.15% of debt incurred, Ala Code § 48-6-2; Ga. Code Ann. § 48-6-1; Ky. Rev. Stat. Ann. § 142.050.

<sup>2</sup> Conn. Gen. Stat. § 12-494 (1.25% or 1.5%, depending on municipal tax rate); Baltimore City Code §§17-2, 17-5 (in other Maryland localities, the combined state and local rates generally equal 1%).

<sup>3</sup> 30 Del. Code Ann. § 1601, 9 Del. Code Ann. § 8102; N.Y. Tax Law §§ 1402, 1402-a ; N.Y.C. Admin. Code § 11-2102.

(ii) State regulations are ordinarily more specific, including as taxable leases with terms as short as five years or more or as long as more than ninety-nine years.<sup>4</sup>

(iii) And regulations may specifically include transfer of the lessor's reversionary interest. *See, e.g.*, Conn. Agencies Regs. § 12-494-2(a)(4).

b. Also excluded as not being conveyances are contracts of sale, options that do not convey legal title, assignments of such contracts and options, and deeds deposited in escrow, *see* Treas. Reg. § 47.4361-2(b)(6), and Conn. Agencies. Regs. § 12-494-2(c)(1)-(4), but New York includes contracts of sale and options as conveyances subject to tax, N.Y. Tax Law § 1401(f), exempting such instruments where the consideration is less than \$200,000 and the real property is the residence of the transferor. N.Y. Tax Law § 1405(b)(10).

c. Included may be other transactions, such as sales of mobile homes *in situ*. Conn. Agencies Regs. § 12-494-2(a)(5).

D. Transfer by deed or writing

1. The federal regulations defined deed to include any instrument whereby realty "is assigned, transferred, or otherwise conveyed to, or vested in, the purchaser, or at his direction, any other person." Treas. Regs. § 47.4361-1(a)(4)(iii).

2. The statutes ordinarily provide for payment to a clerk at the time of filing. However, the tax is ordinarily imposed on the transfer, not the act of filing.

a. A delayed filing may incur an interest charge.

E. Transfer for consideration

1. In most states consideration is both an element of the tax and its measure. In some, the tax is imposed without regard to consideration and is measured by the value of the property interest transferred. *See, e.g.*, 72 Pa. Stat. § 1102-C.

2. Among the examples of taxable transfers for consideration listed in Treas. Regs. § 47.4361-2(a):

a. An exchange of real property for other property, real or personal.

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<sup>4</sup> Del. Realty Transfer Tax Regs. § 3; Conn. Agencies Regs. § 12-494-1(b)(2).

- b. A transfer by a defaulting mortgagor in cancellation of the mortgage debt.
  - c. A deed of foreclosure.
  - d. A conveyance in condemnation or under threat of condemnation.
  - e. A conveyance to a corporation in exchange for shares of its stock.
    - (i) In Connecticut, where this is settled law, *Bjurback v. Commissioner*, 44 Conn. Sup. 354, 690 A.2d 902 (1996), it is also settled law that a transfer to a wholly-owned LLC is not subject to tax. See, e.g., *Mandell v. Commissioner*, Super. Ct. No. CV 00 0504213 S, 2001 Conn. Super. Lexis 3042, affirmed 262 Conn. 659, 816 A. 2d 619, 2003 Conn. Lexis 94 (2003). (J.D.N.B. Oct. 15, 2001).
  - f. A conveyance by a partner in contribution to partnership assets.
  - g. A conveyance in liquidation by a corporation to its shareholders, subject to corporate debt. Compare, *Greyhound Corp. v. United States*, 208 F.2d 858 (7<sup>th</sup> Cir. 1954) and *R.H. Macy & Co. v. United States*, 107 F.Supp. 883 (S.D.N.Y. 1952) (assumption of debt in a liquidation is consideration), with *Tide Water Assoc. Oil Co. v. Jones*, 57 F.Supp. 482 (W.D. Okla. 1944), and *Socony-Vacuum Oil Co v. Sheehan*, 50 F.Supp. 1010 (E.D. Mo. 1943) (corporate liquidation is entirely without consideration).
  - h. Separately addressed are partnership terminations. Treas. Reg. § 47.4383-1(b)
3. Among those listed as in Treas. Regs § 47.4361-2(b) excluded as either not being a transfer or not being for consideration:
- a. A gift: “Conveyances of realty without consideration and otherwise than in connection with a sale . . .”
  - b. A deed to a trustee not pursuant to a sale.
  - c. A deed of realty held to secure a debt upon repayment of the debt.
  - d. A deed confirming title, such as one to correct a flaw in title.
  - e. A deed by an executor under a will (unless the heirs take shares different from those specified in the will).
  - f. A deed from agent to principal conveying property purchased with funds of the principal.
  - g. A deed of partition (unless the parties take shares different from their undivided interests).
  - h. A deed by a debtor to a trustee for benefit of creditors (but the trustee’s later deed to creditors is not excluded).
  - i. A conveyance to a receiver and reconveyance at termination of the receivership.

- j. A transfer in a merger or consolidation from a constituent corporation to the continuing or new corporation.
  - k. Note that a conveyance in corporate liquidation, not subject to corporate debt, but solely for cancellation of stock, was said not to be subject to tax. Treas. Reg. § 47.4361-2(a)(8).
4. Measure of tax – amount of consideration
- a. In the federal tax, consideration included a purchase money mortgage, but not a preexisting mortgage that was assumed. Treas. Regs. § 47.4361-1(b).
  - b. States may include or exclude an assumed mortgage and some states impose a separate tax on the recording of mortgages. Compare Conn. Agencies Regs. § 12-491(a)(1) and (2) and Kans. Stat. Ann. § 79-3102.
    - (i) A mortgage obligation of which the seller is relieved in the transaction would appear to be consideration.
  - c. When the consideration is not money or denominated in money, as in the case of an exchange or of a contribution to capital, the tax is ordinarily measured by the fair market value of the property.
5. Exemptions
- a. The federal tax exempted deeds given as security for debt. Treas. Reg. § 47.4362-1(a).
  - b. Also exempted were deeds to which the United States, a state or certain kinds of organizations were a party; and the Bankruptcy Act exempted deeds relating to certain reorganizations. See *id.* and § 47.4382-1.
  - c. Connecticut and New York exemptions include:<sup>5</sup>
    - (i) Deeds given by the U.S., a state or a municipality of the state.
    - (ii) Deeds given by an exempt person, *e.g.*, a charitable organization, to another exempt person.
    - (iii) Deeds given to secure a debt (Note that in a number of states mortgage deeds are taxable).
    - (iv) Deeds given in corporate mergers.
      - (1) Statutes may not have been updated to include mergers of noncorporate entities.<sup>6</sup>

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<sup>5</sup> See, *e.g.*, N.Y. Tax Law § 1405, Conn. Gen Stat. § 12-498. Note that many of the listed exemptions are actually nontaxable transactions for no consideration.

- (v) Deeds given in tax sales.
  - (vi) Deeds in bankruptcy (perhaps limited to deeds in federal bankruptcy proceedings).
  - (vii) Bona fide gifts.
  - (viii) Contracts of sale.
  - (ix) Deeds from agent to principal.
  - (x) Options that do not vest title,
  - (xi) Deeds of partition (at least to the extent each party takes an unchanged share).
  - (xii) Leases of a term of less than [x] years.<sup>7</sup>
  - (xiii) Deeds given by a subsidiary to a parent solely in liquidation of its stock.
- d. There may be an exemption for transfers between parties when there is merely a change in identity and no change in beneficial ownership, but this is not common and is likely a signal that a controlling interest transfer tax applies.<sup>8</sup>

## II. Controlling Interest Transfer Tax (CIT Tax)

- A. A change in beneficial ownership of real property occurs whenever a corporation or other entity owning real property changes hands, but such a transaction is not subject to Conveyance Tax.
- B. Connecticut, New York, Maine, Washington and to a limited extent, the District of Columbia and New Jersey have responded to perceived avoidance by enacting taxes imposed on the transfer of a controlling interest in an entity that owns an interest in real property located in the state.<sup>9</sup>
- C. There are two basic statutory models:
  - 1. New York includes in the definition of a conveyance the transfer of a controlling interest in an entity holding New York real property.<sup>10</sup>
  - 2. Connecticut enacted a separate tax.<sup>11</sup>
- D. The taxable event is the transfer of a controlling interest in an entity owning an interest in real property located in the state.

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<sup>6</sup> See, *Acadia Brandywine Town Center, LLC v. New Castle County*, 879 A.2d 923 (Del. Sup. Ct. 2005).

<sup>7</sup> 99 years in Connecticut, Conn. Agencies Regs. § 12-494-1(b)(2); 49 years in New York, N.Y. Code Rules & Regs. § 575.7(a).

<sup>8</sup> See, e.g., N.Y. Tax Law § 1405, Conn. Gen. Stat. § 12-498.

<sup>9</sup> Conn. Gen. Stat. § 12-638b. D.C. Code Ann. § 42-1102.02(a); Me. Rev. Stat. Ann. § 4641-A; N.J. Rev. Stat. § 46:15-7.2; N.Y. Tax Law § 1401(e); Wash. Rev. Code § 82.45.010. Vermont requires reporting of controlling interest transfers, but imposes no tax. Vt. Stat. Ann. § 9618.

<sup>10</sup> N.Y. Tax Law § 1401(e). New York authorities relating to controlling interest transfer tax include those arising under the now repealed transfer gains tax.

<sup>11</sup> Conn. Gen. Stat. chapter 228b, §§ 12-638a *et seq.*

1. An interest in real property is generally the same for both CIT Tax and Conveyance Tax
  - a. However, to be effective, the tax looks through tiers of beneficial ownership to a lower level entity that owns such property.
    - (i) For many years the Connecticut Tax Department did not take this approach, effectively permitting nontaxable transfer of property held by second-tier subsidiary entities.
  
2. Control may be defined either as “50% or more” or as “more than 50%”, but generally it means the requisite percentage of ownership of voting stock in a corporation, and, the capital or profits or beneficial interest in the entity in other entities.<sup>12</sup>
  
3. Transfers are aggregated.
  - (a) To determine whether a transfer of control has occurred, the tax ordinarily provides for the aggregation over time of multiple transfers.<sup>13</sup>
  - (b) Further, a control transfer is ordinarily measured among groups of transferors and/or transferees acting in concert, not simply between an individual transferor and or transferees.<sup>14</sup>
    - (i) Attribution rules provide some guidance, but do not cover all the possibilities.
    - (ii) The Connecticut DRS has ruled that an IPO is not subject to the tax because the transferees are not acting in concert. Connecticut Ruling 90-40.
  
- 4.. When considering mergers and consolidation within corporate groups, the Connecticut DRS has consistently looked to whether there has been a change in ultimate beneficial interest. *See, e.g.*, Ruling 99-6 and other rulings cited therein.
  - (a) Where the Conveyance Tax and CIT Tax are separate, mergers present the issue which tax they are subject to. The Connecticut DRS held they are not subject to the Conveyance Tax, from which deeds of merger are exempt,<sup>15</sup> but to the CIT Tax, which has no such exemption.

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<sup>12</sup> Conn. Gen. Stat. § 12-638a

<sup>13</sup> *See, e.g.*, D.C. Code Ann. § 42-1102-02(a); Me. Rev. Stat. Ann. § 4641 (1-A); Wash. Rev. Code § 82.45.010; N.Y.C.R.R. §575.6; Conn. LSN 89.

<sup>14</sup> *Id.*

<sup>15</sup> Query: Why an exemption if the transaction is not subject to tax?

- E. The tax is ordinarily measured by the full fair market value of the property, but it may be the FMV times the percentage of the entity transferred.
- F. The rate of tax is ordinarily the same as the conveyance tax rate, but it may differ.<sup>16</sup>
- G. Exemptions may or may not track the exemptions for Conveyance Tax.
  - 1. In New York, where the CIT Tax is part of the conveyance tax, the exemptions are identical.
  - 2. In Connecticut, where the two taxes are separate, there are no CIT Tax exemptions at all, simply exceptions for property located in an “enterprise zone” and for transfers that effect a mere change of identity or form of ownership where there is no change in beneficial ownership.<sup>17</sup>
- H. Returns are required of the transferors who are liable for the tax, but information returns from the entity may also be required.

### **III. Sales and Use Taxes**

- A. Sales taxes are generally imposed on transfers for consideration of tangible personal property.
  - 1. As is the case with conveyance tax, contributions to capital, mergers and other forms of reorganization are facially taxable because they are transfers for consideration.
- B. However, the sales tax is ordinarily a privilege tax or a gross receipts tax imposed only on those engaged in retailing and the use tax a complementary tax imposed only on purchases from a retailer.
  - 1. The definition of “retailer” may explicitly state a threshold level of activity required to qualify as a retailer or it may be implied.<sup>18</sup>
- C. A sale by a person who is not a retailer, or a sale by a person who is a retailer but is not a retailer of the kind of goods sold may qualify as an exception to the sales and use taxes referred to variously as a “casual”, “isolated” or “occasional” sale.
  - 1. Most states recognize some form of casual sale exception when an entity disposes of all or substantially all of its assets.
    - a. “[A] sale of tangible personal property not held or used by a seller in the course of an activity for which he is required to hold a

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<sup>16</sup> In CT, the rate of tax on conveyances is 1.25% or 1.5%, depending on the location of the property, but the CIT Tax rate is 1.11%.

<sup>17</sup> Conn. Gen. Stat. § 12-638b(b).

<sup>18</sup> See, Cal. Rev. & Tax Code § 6019 (Three sales in twelve months).

certificate of registration, including a sale or exchange of all or substantially all the assets of any business.” Va. Code § 58.1-609.

- (i) “All or substantially all” may present an issue where there are significant unwanted assets.
  - (ii) Additionally, does the “all or substantially all” requirement apply to the seller’s worldwide assets or just to those located in the taxing state.
- b. Inventory held for sale cannot be part of a casual sale.
- (i) It may be sold in a nontaxable sale for resale if the purchaser will carry on the seller’s retailing line of business.
  - (ii) If that is the case, the buyer should give the seller a resale certificate.
- c. In most states, motor vehicles, boats and aircraft fall within an exception to the casual sale rule so that transfers of these items are always taxable. N.Y. Tax Law § 1115(a)(18) ; N.Y.C.R.R. 20 § 528.19;
- (i) This is one reason for holding such property of high value in a stand-alone entity.
- D. However, a particular sale may not qualify, and some states, such as California, Maryland and New York, do not recognize the casual sale exception, at least not in a form applicable to sales of property of substantial value.<sup>19</sup>
- 1. If no exemption applies, consideration may be given to conducting the transaction in a jurisdiction where the casual sale rule would apply.
  - 2. Regulations may provide that, under certain circumstances, a contribution of assets to a newly formed corporation or other entity is not taxable, apparently on the theory that such a transaction is not for consideration.

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<sup>19</sup> N.Y. Tax Law § 1115(a)(18); N.Y.C.R.R. 20 § 528.19 (sales at private residence only); Md. Code Ann. Tax-Gen. § 11-209(a); Md. Regs. Code § 03.06.01.12 (sales of \$1,000 or less); Cal. Rev. & Tax Code. § 6006.5; Cal. Rev. & Tax Code § 6006.5(a); Cal. Code Regs. 18 § 1595(a) (exclusion for any sales by a retailer).

- a. For example, exempt from tax in New York is “the transfer of property to a corporation upon its organization in consideration for the issuance of its stock” and “the contribution of property to a partnership in consideration for a partnership interest therein.” N.Y. Code, Rules & Regs. § 526,6(d)(I)(iv) and (v).<sup>20</sup>
  - (i) Strict adherence to the regulatory provision is essential. For example, the transfer must be made upon the organization of the corporation. *Id.* at (d)(5). Where the corporation issues securities other than stock or assumes liabilities, the transaction will be taxable to the extent of the consideration. *Id.* at (d)(5)(iv).
  - (ii) This suggests that a carefully executed “drop kick”, *i.e.*, a contribution to capital followed by a sale of stock, will effectively transfer assets free of tax.

#### IV. Franchise Taxes

- A. Tax considerations in choice of entity include the state income tax treatment of the entity in each jurisdiction where it will operate.
  - 1. Generally, any entity will be taxable where it has physical presence and substantial nexus.<sup>21</sup>
    - a. Physical presence includes having property (leased or owned), employees or agents inside the state.<sup>22</sup>
    - b. Exceptions include a federal prohibition on state taxation of the net income of sellers of tangible personal property who limit their activity in a state to solicitation of orders which are sent outside the state for approval and acceptance and which are filled by delivery from outside the state. Public Law 86-272.<sup>23</sup>
    - c. H.R. 1956, if enacted, would expand P.L. 86-272 to include capital-based taxes and those measured by gross receipts and to bring service providers within its protection, but a number of states oppose this enactment and the Multistate Tax Commission has proposed a nexus standard that lacks a physical-presence component.
- B. In general, corporate net income is taxed at a rate higher than that imposed on the net income of individuals and is taxed again when distributed.

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<sup>20</sup> Similar rules apply in California and Maryland. *See*, Cal Code Regs. 18 § 1595(b)(4); Code of Md. Regs. § 03.06.01.13B(2).

<sup>21</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>22</sup> *Northwestern States Portland Cement Co, v. Minnesota*, 358 U.S. 450 (1959); *Scripto v. Carson*, 362 U.S. 207 (1960).

<sup>23</sup> 15 U.S.C. 381(a).

1. In addition, corporations are in many states subjected to an additional or alternative tax on capital, usually measured by net worth.
  2. Corporations are also generally subject to minimum taxes, which in some cases may be substantial.
- C. In some states, entities that are pass-through entities for purposes of federal taxation may be subject to corporate income and capital-based taxes and/or to the corporate minimum-tax regime.
1. S corporations are vulnerable to treatment as a corporation, either because the state does not recognize S elections<sup>24</sup> or because the entity fails to make a separate state S election.<sup>25</sup>
    - a. Even when the election is recognized, the state may impose franchise or corporate minimum taxes on the S corporation.<sup>26</sup>
  2. LLCs taxable as partnerships for federal tax purposes and other pass-through entities may also incur tax burdens because they are classified as corporations for a particular state's tax purposes or because they are subjected to a minimum or other tax.
    - a. For example, Kentucky and Texas treat LLCs and LLPs as corporations,<sup>27</sup> and Kansas, Louisiana, Pennsylvania, Tennessee, West Virginia and Wyoming subject LLCs to franchise tax.<sup>28</sup>
    - b. Washington, D.C. and New York City impose unincorporated business taxes.<sup>29</sup>
    - c. New Hampshire's Business Profits Tax applies to all business entities.<sup>30</sup>

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<sup>24</sup> See, D.C. Code Ann § 47-1801.04(16); Ky. Rev. Stat. Ann. § 141.010(24)(b); La. Rev. Stat. Ann. § 47:287.732(A) (but see § 47:287.732(B) for exclusions that approximate an S corporation result); Mass. Gen. Laws ch. 63, §§ 38B, 52A and 32D(a)(i) (exceptions to recognition of S election); Mich. Comp. Laws §§ 208.6(1), 208.35(1)(a), 208.37 (Single Business Tax); N.H. Rev. Stat. Ann. § 77-A:1(1); N.Y. City Admin. Code § 11-602(8)(ii); Tenn. Code Ann. §§ 67-4-2006(a)(2), 67-4-2105(a); Tex. Tax Code § 171.001(a)(1).

<sup>25</sup> See, Ark Code Ann. § 26-51-409; Miss. Inc. Tax Rule § 803(c); N.J. Rev. Stat. § 54:10A-5.22(a); N.Y. Tax Law § 208(1-A); Pa. Stat. Ann. 72 § 7307.

<sup>26</sup> See, e.g., N.Y. Tax Law § 210(i)(g); Pa. Stat. Ann. 72 §§ 7601(a), 7602(a), 7602(b); S.D. Cod. Laws § 10-43-10.1; Vt. Stat. Ann 32 § 5915; W.Va. Code §§ 11-23-1, 11-23-3(b)(6).

<sup>27</sup> Tex. Tax Code Ann. §§ 171.001(b)(3), 171.0002(a); Ky. Rev. Stat. §§141.040 (franchise tax for years beginning on or before Dec. 31, 2006), 141.0401 (entity tax for later years).

<sup>28</sup> Kan. Stat. Ann. § 17-5401(a)(2); LA. DOR Rev. Rul. 01-013; 15 Pa. Cons. Stat. § 8925; Tenn Code Ann. §§ 67-4-2105(a), 67-4-2106(a); W.Va. Code §§ 11-23-3(b)(2)(C), 11-23-6; Wyo. Stat. §§ 17-15-132(a)(vi), 17-16-1630(a).

<sup>29</sup> D.C. Code Ann. § 47-1808.03; N.Y.C. Admin. Code § 11-502.

<sup>30</sup> N.H. Rev. Stat. Ann. §§ 77:15, 77-A-1(XXIII-a).