

SUMMARY OF PROPOSED COMMENTS
TO
BILL 7-455

District of Columbia Recordation
and Transfer of Economic Interests
in Real Property Tax
Emergency Amendment Act of 1988

The proposed legislation would impose the real property transfer and recordation tax upon the transfer of partnership interests or stock of entities that own D.C. real property. The Section takes no position on the merits of the statutory purpose, rather our comments relate to the administration of the tax to meet the stated purpose.

1. We recommend that the tax be imposed only upon transfers in interests in entities that have D.C. real property as their primary asset.

2. We oppose any requirement that documents evidencing such transfers be recorded in the land records.

3. We recommend certain exemptions, including exemptions for transfers upon liquidation or dissolution of an entity, for transfers to related entities, and for transfers occurring by operation of law (e.g., descent or devise).

4. We recommend certain definitional sections be clarified and that new definitions be incorporated.

5. We oppose introduction of the legislation as emergency legislation, and recommend an effective date at least 180 days after enactment of the legislation.

REAL ESTATE, HOUSING AND LAND USE SECTION

Steering Committee

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The District of Columbia Bar

Committees:

Commercial Real Estate
Rental Housing
Residential Real Estate
Zoning and Land Use

DRAFT

May 17, 1988

Committee on Finance and Revenue
The District Building
Room 205B
1350 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
ATTN: Jacqueline V. Helm, Esq.

RE: District of Columbia Recordation and Transfer of
Economic Interests in Real Property Tax Emergency
Amendment Act of 1988, Bill 7-455

Ladies and Gentlemen:

The amendments to the District of Columbia Recordation Tax Act and the District of Columbia Transfer Tax Act proposed in Bill 7-455 would have the effect of imposing the 1% Deed Recordation Tax and the 1% Real Estate Transfer Tax upon the conveyance of fifty percent or more of the interests of a corporation, partnership, association, trust or other incorporated entity that owns real property in the District of Columbia. It is our understanding that the intent of the Bill is to eliminate the practice in certain real estate transactions of transferring beneficial interests in entities that own D.C. real property in order to avoid the necessity of the recordation of a deed which, under current law, is the event which triggers the obligation to pay the taxes. The elimination of this method of tax avoidance would have the effect of imposing the transfer and recordation taxes on substantially all transactions which directly or indirectly effect a transfer of real estate in the District of Columbia, and would thereby increase the revenues earned by the taxes.

This legislation would have a significant impact upon real estate transactions in the District of Columbia, and although the Real Estate, Housing and Land Use Section of the D.C. Bar takes

no position as to the merits of the Bill, we would like to present to the Committee of Finance and Revenue and the City Council for their consideration certain issues that are raised by the Bill, and to recommend certain changes that we believe will clarify the Bill and assist in its administration.¹

As our comments indicate, there are many issues involved in this legislation, which go to the core of one of the most basic elements of all commerce: the transfer of land. It must be carefully drafted so as to affect only the targeted transactions without unnecessarily impeding the flow of commerce or discouraging the conduct of business in the District of Columbia, and without inadvertently or retroactively imposing the taxes upon homeowners or businessmen in the District of Columbia. The proposed Bill, for instance, apparently would impose the recordation and transfer tax upon certain (but not all) transfers of stock in publicly traded corporations which have D.C. real property as a part of their assets, in certain (but not all) pledges or collateral assignments of stock or partnership interests in entities that own D.C. real estate, and upon certain (but not all) transfers of stock in cooperative associations.

All of these issues must carefully be considered, and fleshed out through the scrutiny of public comment from as many parties as possible interested in real estate in the District of Columbia (a group that includes, directly or indirectly, all of the residents of the city). These issues are difficult to identify, and even more difficult to resolve.

In reviewing the legislation, members of this Section have identified several issues that we believe will present significant administrative difficulties and inequities in the application of the proposed legislation. The following is a discussion of those points. In addition, attached is a markup of the Bill, showing changes recommended by the Section, which we believe provide a more workable and practical means of accomplishing what we perceive as the legislative end -- the taxing of all actual transfers of D.C. real estate, whether by asset transfers, stock transfers, or otherwise.

I. Section 2 of the Bill (amending D.C. Code §45-921).

1. Definition of "deed". Because the word "instrument" (used for a conveyance of economic interests) is defined in the Bill separately from the word "deed" (used for the conveyance of legal title to real property), several ambiguities are created in the Act as to whether certain provisions apply to transfers of

¹ The views expressed herein represent only those of the Real Estate, Housing and Land Use Section of the District of Columbia Bar and not those of the D.C. Bar or of its Board of Governors.

economic interests as well as to transfers of legal title to real property. Because we felt that the intent was to apply all of the terms of the Act to transfers of economic interests, we recommend that the word "instrument" should not be defined separately and distinguished from the definition of "deed." In particular, this change would avoid ambiguity regarding whether the tax would apply to leases (currently exempt under §45-921(c)), regarding the applicability of the exemption provisions (D.C. Code §45-922) to transfers of economic interests, and regarding the applicability of the provisions for joint and several liability for payment of the tax of buyers and sellers (D.C. Code §45-923) to transfers of economic interests in entities owning real estate as well as to transfers of legal title.

2. Definition of "economic interest in real property". The Bill would have the effect of imposing the tax on transactions regardless of whether D.C. real property constitutes all or only a small part of the assets of the entity involved. This provision has the effect of broadening the tax beyond transactions structured as interest transfers in order to avoid D.C. transfer and recordation taxes, and would impact on transactions where the transfer of an economic interest in real property is an incidental, or even inconsequential aspect of the deal. Thus, for instance, in the case of a merger or acquisition of a national or international company through a tender offer or other purchase of all or a controlling interest in the stock of the corporation, if the corporation owned any D.C. real estate, regardless of how small that interest is in proportion to the acquired company's total holdings, the transfer and recordation taxes would be due. Although payment of the taxes would not have a significant economic impact on a deal of that magnitude, the Act would become a trap for the unwary by imposing a tax (and, potentially, a penalty and interest upon failure to pay) on an sale of interests no matter how small a percentage of the assets involve D.C. real property. This will be particularly problematic because few, if any, other jurisdictions have similar statutes. Moreover, it would be difficult to determine what portion of the consideration is actually attributable to D.C. real property, where the D.C. property is an insignificant part of the total assets.

For these reasons, we suggest using the concept of "real estate company," which is an entity which has D.C. real estate as its primary assets and primary source of income. This concept, borrowed from the Pennsylvania Realty Transfer Tax Statute, focuses the imposition on the tax upon transactions which are essentially a transfer of District of Columbia real estate by another means, but would not burden transactions where the transfer of real estate is incidental and where the nexus to the District of Columbia is slight.

Under the Pennsylvania statute, if real property in the state constitutes at least 90% of the entity's assets, and such entity derives 60% or more of its gross revenues from that real estate, it is a "real estate company." We understand that the Department of Finance and Revenue is considering a 50% ownership test. We recommend a closer identity between the asset and the entity so as to more clearly focus the two on the targeted transactions; i.e., transfers of District of Columbia real property. The Pennsylvania approach seems to be fairly well-received among practitioners there.

3. Definition of "transfer". We suggest that it is important that the Bill provide a reasonable time limit within which the transfer of a "controlling interest" must occur. Otherwise, the imposition of the tax will become unpredictable, unmanageable and inequitable. Under Bill 7-455, if, for example, twenty percent of the total stock in a publicly traded corporation (which owns some D.C. real property) were traded on the average each year, some unlucky and unsuspecting stockholder in the fifth year could, by the transfer of some small amount of stock, cause the tax to become due and, presumably, would be jointly and severally liable for the payment of the tax with all other buyers and sellers of stock in the corporation over the five-year period. We are confident that such a result is not intended, and in order to avoid it (and possible constitutional challenges based upon commerce clause, preemption and supremacy grounds where the nexus to the District of Columbia is insufficient), a reasonably short time frame, as well as a significant D.C. nexus in terms of ownership of D.C. real property, should be provided for in the statute. We have suggested a one year period, and do not recommend selecting any longer time period; however, a shorter time period might also be long enough to discourage multi-step transactions.²

In addition we recommend that transfers of security interests in stock, partnership interests or the like given as collateral for a debt be expressly excluded from the definition of the term "transfer." The transfer and recordation tax is currently imposed upon construction and permanent loans, which always are secured by a lien upon the real property. We are not aware of any instance where such financing is secured solely by a pledge of economic interests in entities that own real property and the sorts of debt that might be secured by such pledges (such as lines of credit or gap financing) are not the sorts of financing that are presently (or appropriately) subject to the tax.

² We understand that the Department of Finance and Revenue is considering recommending a one-year time frame.

4. Definition of "controlling interest". We strongly recommend that the definition of "controlling interest" in proposed Section 301(n) of the Act be revised to clarify that both the management and control of the entity, and a majority of the economic interests in the entity, must be transferred in order to trigger the taxes. It is our understanding of the intent of the Bill, and it is our recommendation, that the real estate transfer and recordation taxes be imposed only upon transactions that are primarily real estate transfers. In our opinion, where stock or stock dividends are pledged, where limited partnership interests are pledged or collaterally assigned, where rights to proceeds from partnership interests are assigned or traded, where a corporation acquires its own stock or interests are transferred among partners or stockholders, or in similar transfers where the management or control of the entity do not change, there has not, in effect, been a transfer of real property, and no tax should be due. Similarly, there should be no incidence of tax until there also has been a transfer of at least 90% of the economic interests in the asset, so as to avoid triggering the tax by a transfer of, for example, a general partnership interest in a limited partnership where the general partner manages the entity (and thereby the asset) but does not constitute the significant economic interest therein.

In connection with this provision, it should be noted that only a few months ago the Council passed the District of Columbia Revised Uniform Limited Partnership Act ("RULPA"), which has been heralded as one of the most advanced statutes of its kind. One of the significant provisions of RULPA is that no filing among the partnership records is required for the transfer of limited partnership interests. This permits the transfer of limited partnership interests freely and anonymously, like the transfer of stock, and facilitates the formation of syndicated limited partnerships and master limited partnerships in the District of Columbia. In our opinion, if the transfer of limited partnership interests, without the transfer of any control in the partnership, could cause tax liability and an obligation to file a return (or record a transfer instrument), then the advances of RULPA will have been substantially negated by this Bill.

Moreover, it is unclear to us how the District of Columbia would propose to enforce the payment of the tax, and upon whom the liability would fall, unless the tax were imposed only on transactions that are in essence simply real property transfers by other means. If, for example, several stockholders transferred stock, in several different transactions, which, in the aggregate, constitute a sixty percent interest in a corporation which owns D.C. real property as a portion of its assets, upon whom would the tax be imposed? Upon all transferors and all transferees, jointly and severally, regardless of the extent of each such person's interest (sold versus acquired) in

the entity? And how would the tax be enforced? Enforcement of the tax through imposition of a lien on the real property, as provided in the case of the current transfer and recordation tax provisions, would penalize the 40% of stockholders who had not transferred their interests. It might also violate the federal due process rights of the corporation and its nontransferring shareholders. We believe that our recommendations reduce these difficulties by imposing the tax only on those transactions where there has been, in effect, a total change in the ownership of the real property, and where that transfer of ownership is, in effect, the essence and purpose of the transaction. We believe that a transfer, within a year or less, of at least 90% of the interests in an entity, which has D.C. real property as its primary asset, is more closely analogous to a transfer of the real estate itself, such that there is, in effect, an identity between the entity and the asset that justifies imposition of the tax upon all of the owners of the entity through a lien upon its primary asset. However, we recognize that there may be challenges to the imposition of the tax upon transfers of stock or partnership interests between out-of-state parties based upon alleged violations of the Home Rule Act and upon Constitutional due process grounds.

5. Exemptions. We also recommend that the Council consider amending Section 302 of the Act (D.C. Code § 45-922) to provide for certain exemptions to the tax for transfers relating to certain types of transfers of interests. One such exemption would be for transfers from a corporation to its stockholders upon complete or partial liquidation of the corporation which qualifies for federal income tax treatment pursuant to §§ 331, 332, 333 or 337 of the Internal Revenue Code of 1986, as amended, and as it exists at the time of liquidation, or upon a contribution of real property to a corporation by its stockholders. In addition, an exemption is necessary for transfers by operation of law as a result of the death or demise of a stockholder or partner, or upon the dissolution of a partnership. We also recommend that there be an exemption for transfers among or between entities under common control, such as a parent corporation to a subsidiary.³ In instances where a transfer is by operation of law rather than due to a sale or similar voluntary assignment or transfer, often no document is executed and indeed the parties may be unaware of when and how the transfer occurred and the tax became due.⁴

³ We note, however, that in order to protect the intent of the statute, transfers occurring as a result of mergers of corporations (or other entities) with unrelated entities would not be exempted.

⁴ Exemptions similar to those recommended here are provided in
(footnote continued)

II. Sections 3 and 5 of Bill 7-455 amending Section 303 of the Act (D.C. Code §45-923) and amending Section 301 of Title III of the Residential Real Property Transfer Excise Tax Act of 1978 (D.C. Code §47-1431).

1. Recordation Requirements. We urge that the proposed requirement of recordation of "deeds" evidencing transfers of economic interests in real property (or notices thereof) be eliminated. Such a requirement would cause a flood of unnecessary documents in the land records and would greatly complicate searching title to real property. The integrity of the land records is critical to the orderly transfer of real property. In our opinion, the obligation to file a tax return form is sufficient to provide the taxing authority with notice of the transfer.

Although we acknowledge that enforcement of the proposed amendments to the transfer and recordation tax acts will be difficult, we do not believe that enforcement is made any more simple or more certain through a recordation requirement. Any person or entity attempting to avoid payment of the tax by failing to file a return would not be likely to comply with a recordation requirement, especially since there is no particular incentive to record instruments evidencing transfers of economic interests. This is due to the fact that without a transfer of legal title, the recordation of the document is legally meaningless, and would not create insurable title or give rise to the protections of D.C.'s race-notice land recordation statute.

In fact, we hope that the real effect of this Bill will be to encourage the transfer of legal title through the recordation of a deed, and a move away from the use of transfers of economic interests in transactions whose intent is to effect a complete change in the management and economic ownership of real property in the District of Columbia. It is always preferable to use a recorded deed, especially if there is no tax savings associated with avoiding recordation.

2. Section 4 of Bill 7-453 (amending the District of Columbia Revenue Act of 1980, D.C. Code §47-901 et. seq.)

As the changes to the Transfer Tax Act parallel the changes to the Recordation Tax Act discussed above, we will not repeat our comments, but simply reaffirm them.

(footnote continued from previous page)
the Virginia Recordation Tax Act. In addition, we recommend broadening the intra-family transfers to include transfers to in-laws in order to eliminate the use of two-step transfers to avoid the tax (e.g., mother to daughter, daughter to husband instead of mother-in-law to son-in-law).

3. Section 7 of Bill 7-453.

The early effective date of this Bill requires that the tax be imposed on transactions already negotiated, financed and ready to close. The effect will be to delay or prevent closing, because no provision has been made in these transactions for the availability of funds to pay the tax and, as a result, no arrangement has been made to determine who must pay it. If it is to be paid by the Purchaser, his financing will be inadequate. If the Seller must bear the burden, the proceeds may be insufficient to pay off his lender or to deliver the required return to his investors. If the parties are not able to allocate the burden of paying the tax, very substantial litigation over equally substantial earnest money deposits may ensue, wasting valuable business and court time and assets.

The orderly conduct of business requires an environment of stability and certainty; we are concerned that the effective date contemplated in the Bill will adversely affect this environment in the District of Columbia.

We understand that the Department of Finance and Revenue intends to propose that the Bill be amended to "grandfather" binding purchase agreements executed before the date of enactment of the legislation. Although we agree with the reasoning behind such a grandfathering provision we would suggest that using a combined deed trigger and effective date 180 days after the date of enactment would accomplish the same goals while avoiding the evidentiary difficulties of determining when a contract is binding or when it was executed. Most real estate contracts close within 180 days of the date of the contract; for the few that have a longer feasibility period or extended closing date, 180 days provides for sufficient time to restructure the deal to accommodate the need to pay the tax.

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We appreciate the opportunity of presenting these comments. We are hopeful that these comments will assist you in meeting the goals of this legislation. Please feel free to call upon any of the undersigned if further explanation or discussion would be helpful.

Respectfully yours,

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