

Over the years, the limited liability company (LLC) has become the preferred entity for holding and conveying real estate. In addition to the LLC's advantageous combination of partnership and corporation characteristics—such as federal pass-through taxation and limited liability—the LLC offers significant state tax advantages for those who use an LLC to convey real estate. Under the laws of many states, sellers have been able to avoid state real estate transfer taxes by assigning membership interests in the LLC that holds the real property rather than conveying the property outright. In recent years, however, many states have begun closing this perceived loophole.

This article discusses the use of an LLC as a vehicle for avoiding the real estate transfer tax and considers whether the LLC will lose its appeal as states eliminate this tax advantage. Some states consider it a tax on the transfer of real estate, but others refer to the tax as a tax on recordation of the deed that transfers title to the real estate. Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law* ¶ 1.07[6] (1st ed. 2002). Because this article focuses only on transfer taxes, it does not discuss the seller's liability for other taxes at the federal and county levels.

The Mechanics: Using an LLC as a Conveyance Vehicle

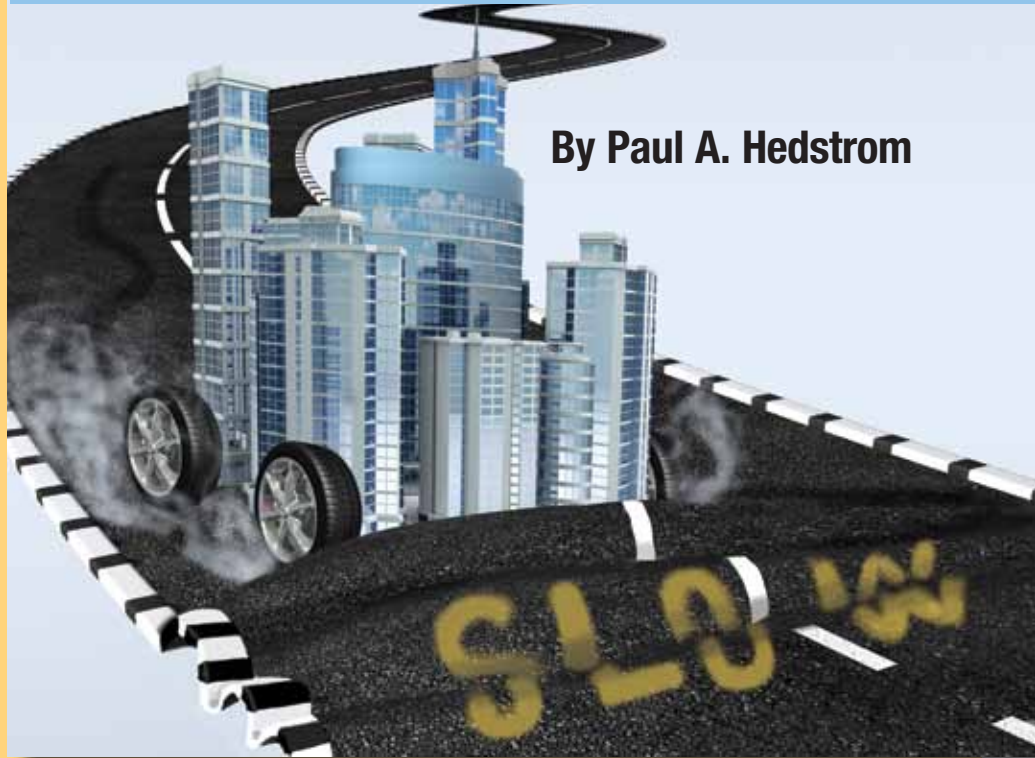
The mechanics of conveying real estate through the assignment of membership interests in an LLC involves several steps. First, the seller (the property owner) sets up an LLC, with the seller as its sole member, exclusively for the purpose of holding the real property. In the purchase and sale agreement, the seller contractually reserves the right to require the buyer to purchase the seller's entire membership interest in the LLC, as opposed to buying the real estate directly. Before closing, the seller "drops down" the real property to the LLC, which becomes the owner of the

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Slow Down

Is the LLC Becoming a Less Appealing Vehicle for Conveying Real Estate?

By Paul A. Hedstrom



property, usually through the use of a quitclaim deed for nominal consideration. The real property becomes the LLC's only substantial asset. The quitclaim deed is generally exempt from state real estate transfer taxes because the conveyance is for less than the minimum consideration required for the collection of a transfer tax. Many states also provide tax exemptions to those transferring real estate to their own business entities. *Id.* ¶ 1.08[4](d). Then, at closing, the seller assigns the membership interest in the LLC, which now owns title to the property, to the buyer. See Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 *Bus. Law.* 1, 14 (1995) ("most [LLC] statutes define an LLC interest to include only financial rights, which are freely transferable in the absence of contrary agreement"). Because this transfer is not recorded, it is not subject to the real estate transfer tax. The property is owned, both before and after the transfer of the membership interest, by the LLC.

Although this practice has increased among real estate sellers, its legitimacy has been questioned for some time. Indeed, even before the turn of the century, one skeptical writer questioned: "Will it now be possible for a taxpayer to avoid such [real estate transfer] taxes by creating a single-member LLC for the sole purpose of holding the real estate, and then effectuating a real estate transfer through the exchange of the LLC interest itself as opposed to the real estate?" Katherine E. Ramsey Roose, *Like-Kind Exchanges and Real Estate Transfer Taxes: Making Hay from the Single-Member Limited Liability Company*, 18 *Va. Tax Rev.* 665, 667 (1999). Depending on the state, the answer to this question has been, and still continues to be, "yes." Some states, however, have begun closing the perceived loophole that allows real estate sellers to avoid real estate transfer taxes through such transactions. This leads to the question of whether the LLC will become less appealing as a real estate conveyance vehicle.

Regardless of a possible trend against using LLCs to hold and convey real estate, the state legislative trend of closing the perceived loophole means that those structuring real estate deals through assigning a membership interest in an LLC must accurately evaluate the law of the state where the property is located and keep apprised of any changes in the state's laws.

Introducing the First Hybrid: The LLC Historically

The LLC has grown significantly in its popularity since its inception. The first LLC statute was adopted by Wyoming in 1977, followed by Florida in 1982. Wyo. Stat. §§ 17-15-101 to -136; Fla. Stat. §§ 608.401 to -471. Thereafter, LLC legislation spread from two states in 1989 to 47 states in less than five years. Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 Syracuse L. Rev. 1193, 1199 (1995). Although S corporations were once the entity of choice for small businesses, LLCs became the preferred choice for the vast majority of private businesses around the mid-1990s. Walter D. Schwidetzky, *Is It Time to Give the S Corporation a Proper Burial?*, 15 Va. Tax Rev. 591, 592 (1996). The main reason for the LLC's increase in popularity can be traced to the entity's flexibility and hybrid partnership/corporate characteristics, particularly federal pass-through taxation and limited liability. Warren H. Johnson, *Limited Liability Companies (LLC): Is the LLC Liability Shield Holding Up Under Judicial Scrutiny?*, 35 New Eng. L. Rev. 177, 177-78 (2000). The LLC has been praised as an innovative form of business organization combining the best features of corporations and partnerships—being described as “the best of both worlds” and “the better alternative.” Goforth, *supra*, at 1198 (citing Marybeth Bosko, *The Best of Both Worlds: The Limited Liability Company*, 54 Ohio St. L. J. 175 (1993); Richard M. Horwood & Jeffrey A. Hechtman, *The Better Alternative: The Limited Liability Company*, 20 J. Real Est. Tax'n 348 (1993)).

A look into what has driven the development of the LLC can offer some further insight into the entity's

popularity. One scholar has noted that “[t]he growth of LLC statutes has been spurred largely by state bar committees rather than by independent legislative initiatives.” Ribstein, *supra*, at 4. One reason given for this phenomenon is that legislators did not have enough time and resources to devote to the project. *Id.* The LLC movement was enhanced by competition among states. Goforth, *supra*, at 1262-63. Those responsible for drafting or enacting LLC legislation in each state have cited motives that include attracting business and revenue to the state and avoiding the loss of business and revenues to other states. *Id.* at 1272. One commentator argues that in enacting LLC legislation, states are not competing to retain existing revenues so much as seeking to attract new business and new sources of revenue. *Id.*

The reason for this competition is simple: “Any state which induces a significant number of businesses to choose that forum in which to incorporate stands to gain significant financial benefits, or at least certain groups within such states stand to benefit.” *Id.* at 1193-94. Therefore, it is not surprising that one scholar has argued that “most trends in corporate law develop as a result of competition between the states. No state wants to be seen as unresponsive to the needs of the business community and so there are pressures to respond in kind whenever legislative initiatives favorable to business occur in another state.” *Id.* at 1262-63.

The Tune Up: States Are Imposing Controlling Interest Transfer Taxes

Although competition among states can lead to changes in corporate law favorable to business, some state legislatures are willing to make doing business in the state less attractive if they believe the benefits of those changes will outweigh the costs. For example, some state legislatures have taken a hard position on the taxation of transfers of controlling interests in entities holding real estate. Taxing these transfers may make the state a less appealing forum for structuring these types of real estate transactions. See Avi M. Lev, *Just How*

Fair Is the Governor's Tax Fairness Bill?, 35 Mass. L. Wkly. 2103 (May 21, 2007) (noting effect of proposed tax in Massachusetts would be to tax sales of businesses in the state, adding large costs and imposing considerable delays on such transactions). Nonetheless, some states have apparently decided that the revenue they will raise from the tax would outweigh any detrimental effects.

New York enacted the first controlling interest real estate tax in 1986 and other states have followed suit, realizing that controlling interest transfer taxes greatly expanded their tax bases. *Id.* The Governor's Office in Massachusetts, for instance, estimated that Governor Patrick's proposed “tax fairness bill” of 2007 would raise more than \$12 million annually. *Id.* Lev observes that the estimated \$12 million revenue increase is likely accurate but suggests that the majority of this new tax revenue will result from sales of businesses that own real estate as part of their overall operations, rather than from the real estate seller that sets up an LLC solely to avoid real estate transfer taxes. *Id.*

To date, states have adopted various approaches to close the perceived loophole of using the transfer of membership interests in an LLC to avoid real estate transfer taxes. The discussion that follows is not a comprehensive survey of state law across the country but instead is meant to provide insight into the major approaches through the use of examples.

First Approach: Redefine the Transfer of Real Estate

One approach has been to modify the definition of “conveyance” or “transfer” in the state's real estate transfer tax laws to include the transfer of a controlling interest in an entity holding real property in the state. For instance, New York has amended the definition of “conveyance” in its real estate transfer tax statute to include the “transfer or acquisition of a controlling interest in any entity with an interest in real property.” See N.Y. Tax Law § 1401(e) (defining conveyance). The statute further provides: “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. . . .” *Id.* § 1402(a). In turn, the statute defines

“controlling interest” as at least 50% of the total combined voting power of all classes of stock or at least 50% of the capital, profits, or beneficial interest in the voting stock of the corporation. *Id.* § 1401(b).

States that tax the transfer of a controlling interest in a corporation vary on how they define “controlling interest,” but generally states define it as either at least 50% of the capital, profits, or beneficial interest in the voting stock of the corporation or at least 80% of the capital, profits, or beneficial interest in the voting stock of the corporation. See Conn. Gen. Stat. § 12-638a (defining “controlling interest” as more than 50% of the total combined voting power of all classes of stock of a corporation); Me. Rev. Stat. Ann. tit. 36, § 4641.1-A (defining “controlling interest” as more than 50% of the total combined voting power of all classes of stock of a corporation); Mich. Comp. Laws § 207.522(a) (defining “controlling interest” as more than 80% of the total value of all classes of stock of a corporation). See also Md. Code Ann., Tax-Prop. § 12-117(a)(6)(i) (defining “real property entity” as an entity that directly or beneficially owns real property that constitutes at least 80% of the value of its assets).

Vermont and Michigan also have addressed the tax loophole by amending the definitions of transactions subject to the transfer tax. Vermont’s real estate transfer tax statute imposes “a tax on the gains from the sale or exchange of land” and defines “a sale or exchange of land” as any sale or exchange of shares in a corporation or property interests that entitles the purchaser to use or occupy the land. Vt. Stat. Ann. tit. 32, §§ 10001, 10004(c). In January 2009, Michigan’s governor signed a law that amended the state’s definition of “transfer” in its real estate transfer tax statute to include the transfer of an interest in real property “acquired through the acquisition of a controlling interest in any entity with an interest in the property.” Mich. Comp. Laws § 207.522(e).

A variation on amending the definition of “transfer” or “conveyance” is New Hampshire’s statutory scheme, which imposes a real estate transfer tax on the “sale, granting and transfer” of

real estate, which includes the transfer of interests in real estate holding companies. N.H. Rev. Stat. Ann. §§ 78-B:1, 78-B:1-a (defining “sale, granting and transfer” as transfers of interests in real estate holding companies and defining real estate holding company as a business organization engaged principally in the business of “owning, holding, selling, or leasing real estate and which owns real estate or an interest in real estate within the state”). Similarly, since July 2009, Florida taxes the transfer of interests in “conduit entities,” which it defines as legal entities “to which real property is conveyed without full consideration by a grantor who owns a direct or indirect interest in the entity, or a successor entity.” Fla. Stat. § 201.02(1)(b)1.a. The statute provides: “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, tax is imposed on each such transfer of an interest in the conduit entity” *Id.* § 201.02(1)(b)2.

Second Approach: Directly Tax the Transfer of Interests

Another approach states have taken to close the loophole has been to enact new statutes that impose controlling interest transfer taxes. Connecticut specifically imposes a tax on the “sale or transfer of a controlling interest in any entity which possesses, directly or indirectly, an interest in real property in this state.” Conn. Gen. Stat. § 12-638b(a)(1). To be subject to the tax, the value of the interest in the real property must be at least \$2,000. *Id.* Maine imposes a tax on “the transfer or acquisition within any 12-month period of a direct or indirect controlling interest in any entity with a fee interest in real property” in the state. Me. Rev. Stat. Ann. tit. 36, § 4641-A(2).

Speed Bump: Will Closing the Loophole Dampen the Popularity of the LLC?

A tax on the transfer of the controlling interest in an entity holding real estate aligns with the original motivation that states had in initially enacting LLC

statutes: bringing revenue to the state and avoiding losing out on revenues that other states are collecting. The question becomes whether this taxation has caused the LLC to become less appealing for use as a real estate conveyance vehicle. Nearly a decade and a half ago, there was uncertainty about whether the LLC would even last or whether it would be superseded by other business forms. Ribstein, *supra*, at 47. Commentators hypothesized that the limited liability partnership (LLP) might end up as the alternative to incorporation because of the entity’s greater flexibility, the substantial existing body of partnership law, and the generally favorable status of general partnership under tax and regulatory statutes. *Id.* at 47–48. Another hypothesis was that both the LLP and the LLC would both be overtaken by new types of business associations. *Id.* at 48.

With the benefit of hindsight, it is clear that the LLC has survived and has been widely used as an entity for holding, and conveying, real estate. Moving forward, although the LLC has certainly become a less appealing entity for conveying real estate in those states that tax the transfer of controlling interests, the entity still enjoys the benefit of avoiding transfer taxes in other states, and it may have additional state tax benefits.

Conclusion

Although LLCs have become a popular vehicle for avoiding state real estate transfer taxes, some states have begun closing this perceived tax loophole. This new taxation will not likely cause the death of the LLC as a vehicle for conveying real estate any time soon, but the taxes will eliminate a significant advantage of LLCs as real estate conveyance vehicles in those states that impose the tax. Most importantly, the changes in state law require those planning on transferring real estate through the use of an LLC to undertake thoughtful planning and preparation. This necessarily must include carefully checking the laws regarding real estate transfer taxes in each prospective state and remaining vigilant for tax code amendments in the future. ■