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New Rhode Island Acquired Real Estate Company Conveyance Tax Leaves Many Unanswered Questions

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Effective July 1, 2015, Rhode Island now imposes a realty conveyance tax on the transfer of controlling interests in a "real estate company," in addition to any other state taxes. Under prior law, if a person or business entity held real estate, a transfer of the real estate would be subject to the conveyance tax. If a person transferred interests in the entity holding the real estate, the person wouldn't be subject to that tax. The new law closes this "loophole." Under the new law, the transfer of a Rhode Island "real estate company" that makes that company an "acquired real estate company" triggers a $2.30 real estate conveyance tax for each $500 (or fractional part thereof) paid for the purchase of real estate through the acquired real estate company. To ensure compliance with the new law, a business entity making the transfer must both give notice to Rhode Island's Division of Taxation at least five days prior to such a disposition and pay the tax due. The State will treat as fraudulent and void any transfer made without such notice and payment. Taxpayers are to use new Form CVYT-2 (Acquired Real Estate Company Conveyance Tax Return) together with the purchase and sale agreement to provide the Division with notice and payment of the tax. If Form CVYT-2 is properly completed and the tax is paid, the Division of Taxation will issue a Certificate of Payment of Tax within eight to ten business days.

First, the basics: two types of companies qualify as "real estate companies." The first category is composed of real estate businesses that directly deal in real estate—corporations, limited liability companies, partnerships, or other entities that are "primarily engaged in the business of holding, selling or leasing real estate." These businesses are considered "real estate companies" if 90% or more of the ownership of the real estate is held by 35 or fewer persons[1] and either (i) the business derives at least 60% of its annual gross receipts from the ownership or disposition of

[1] The language of the statue is puzzling. First, as written, it's unclear whether "90% or more of the ownership" is tested by the percentage of real estate held by the entity, by voting control, or by the value of all of the entity's real estate. Second, normally a real estate company would be the only owner of its real estate. Therefore, the reference to 35 or fewer owners of the real estate is difficult to comprehend. It's possible that the statute contains a drafting error, and the proper text would state the test as whether 90% or more of the ownership of the real estate company is held by 35 or fewer persons. If correct, the statute—while clearer—would still leave open the first question raised in this footnote: how is "ownership" determined? The correct answer might be that ownership would be determined by the fair market value of the entity, as the test for the second category of "real estate company"—the real estate holding company—employs a 90% ownership in the fair market value of the underlying assets test. However, that definition of ownership would raise another set of questions. In any case, perhaps the words of Winston Churchill are most appropriate to describe this and other language of the new statute: "It is a riddle, wrapped in a mystery, inside an enigma."

real estate[2] or (ii) the business owns real estate the value of which comprises 90% or more of the value of all the business's tangible assets, exclusive of tangible assets which are fairly transferrable and actively traded on an established market.

The second type of "real estate company" is a holding company for a real estate business dealing directly in real estate. Specifically and somewhat circularly, "real estate company" includes entities that 90% or more of their ownership interests are held by 35 or fewer persons and hold as 90% or more of their total assets' fair market value a direct or indirect interest in a "real estate company." An indirect ownership interest is an interest in an entity 90% or more of which is held by 35 or fewer persons the purpose of which is ownership of a real estate company.[3]

The tax applies when a transfer of interests occurs in which a "real estate company" becomes an "acquired real estate company." To become an "acquired real estate company," two things must occur. First, the "continuity of the operations" of the "real estate company" cannot be "affected" by the ownership change. Second, the change—whether alone or together with prior changes within a three-year period[4]—must have "the effect of granting, transferring, assigning or conveying or vesting, transferring directly or indirectly, 50% or more of the total ownership in the company."

The new law leaves many questions unanswered. Important definitional elements of "real estate company" and the nature of the now-taxable transfer that makes a "real estate company" an "acquired real estate company" remain uncertain, making application of the general rule difficult. Also, the consequences of not complying with the law are unclear.

First, it's unclear when the "continuity of operations" of a real estate company has been "affected" such that it becomes an "acquired real estate company." No guidance is provided for determining what aspects of operations must continue and to what extent.

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[2] The statute does not appear to limit the state in which the real estate sits. Therefore, so long as 60% of a company's gross receipts are from real estate, a Rhode Island company can be considered a "real estate company"—even where all of its real property is located outside of Rhode Island. However, where there's no Rhode Island real estate, the statute seems to provide that there's no tax to apportion to Rhode Island. While that's a sensible and appropriate result, there still may be unnecessary and burdensome notice obligations incumbent upon the transferring company.

[3] Thus, the statute includes in the definition of "real estate company" at least two levels of holding companies: a holding company that holds the real estate company and a holding company that holds another holding company that holds a real estate company. It's not entirely clear whether the statutory language encompasses additional levels of holding companies in its definition of real estate company.

[4] The statute attempts to detail when transfers of interests in a real estate company are deemed to have occurred within a three-year period of one another. However, the statute explains when transfers of "said realty" are grouped together. "Realty" is a term used earlier in this section of Rhode Island General Laws to refer to the real property itself, not interests in an entity holding real property. Therefore, it appears that the intent of the statute, despite the use of the word "realty," is to refer to such interest: if the transferring party provides a legally binding document transferring interests in the entity or enforceable options to transfer interests in the entity at some future date, these future transfers will be deemed to occur when they become legally binding, not when the future transfers occur or the options vest. Strictly speaking, though, as currently drafted, transfers of interests in a real estate company that occur in the future probably should not be grouped together until those transfers occur.

Second, it's unclear what transfers are considered in applying the 50% ownership change. For instance, Rhode Island generally doesn't impose a realty conveyance tax upon transfers by gift, death, divorce, tax free reorganization, dissolution, or an income tax-free transfer such as to or from a trust, a corporation, an LLC, or a partnership. Nothing in the statute clearly prevents these transfers, if made of interests in a "real estate company," from being subject to the tax.

Additionally, while traditional real estate businesses, such as commercial developers, are obviously "primarily engaged" in holding and selling real estate for purposes of the definition of "real estate company," trusts holding real estate—including trusts established to accomplish common estate planning goals—may also be included. But that depends, amongst other things, on whether the trust will be considered "primarily engaged in the business of holding, selling or leasing real estate." No definition or guidance is offered for making the subjective determination of whether a company is "primarily engaged" in such a real estate business. For example, would an irrevocable trust be considered primarily engaged in holding real estate if it holds 90% of its value in the family residence but whose trustees devote nearly all of their time to managing the trust's marketable securities and investment partnership interests?

Other difficult applications of the "primarily engaged" test will undoubtedly arise. Consider a wholly owned subsidiary of a manufacturing company formed to hold the real estate upon which the business sits. The parent company generally shouldn't be considered "primarily engaged" in a real estate business, regardless of the amount of real estate it holds. And if the real estate weren't held in a separate subsidiary entity, a transfer of a controlling interest in the company shouldn't be taxable. But because the subsidiary is "primarily engaged" in "the business of holding" the real estate, the new controlling interest transfer tax—arguably overbroad in its reach—likely applies. If it does, before such companies not engaged directly in a real estate business sell controlling interests in stock or other equity interests in the company, they should consider dissolving these wholly owned companies, taking into consideration other tax and non-tax factors.

Aside from these definitional problems, it's unclear what the effect of noncompliance is upon the transferor and the transferee of the interest as well as the effect upon the real estate itself. Under existing law, any unpaid conveyance tax, together with penalties and interest, are a debt to the State from the person liable for the payment of the tax. However, if the transfer is "fraudulent and void" against the State, the State could seemingly place a lien upon the transferred interest.[5] The State could also treat the transfer as though it never occurred. That is, the State could consider the transferor as the owner of the interests transferred. While unlikely, that would mean, for instance, that—for Rhode Island state income tax purposes—the State could require tax items of the transferred entity to continue to be reported by the transferor, if the interests were in a

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[5] Such treatment would be consistent with the remedy available under Rhode Island's Uniform Fraudulent Conveyance Act.

pass-through entity, such as a corporation with a subchapter S election in effect, a partnership, an LLC taxed as a partnership, or a single-member LLC taxed as a disregarded entity.[6]

Other concerns relate to maintaining title insurance on, and transferring marketable title to, the real estate and other property held by the acquired real estate company. While the statute does not appear to create a lien on the underlying real estate, the State's ability to void the transfer as to the State's tax interest may affect the grantor's authority to convey and the insurability of the title. It would be better from a title insurance perspective if the statute expressly stated that a conveyance of an acquired real estate company to a bona fide purchaser does not affect title to the underlying real estate.

Guidance issued by the Division of Taxation on September 4 does nothing to address these questions and raises additional questions. Perhaps most importantly, Form CVYT-2 (used to report and pay the tax) doesn't provide a mechanism to allocate the price paid for the interests in an acquired real estate company to real estate it holds outside of Rhode Island. Rather, Form CVTY-2 calculates the tax upon the entire purchase price, without reduction for non-Rhode Island property. However, the new law clearly provides that the tax is based upon the assessed value of real estate located in Rhode Island. While Schedule D of the Form could be adapted to make an allocation of the purchase price to non-Rhode Island property, the current form doesn't appear to be intended to be used in such a manner. The Division of Taxation will know the purchase price of the interests from the purchase and sale agreement that the Form instructions require to be submitted with the Form. So, reporting a purchase price less than the amount listed on the purchase and sale agreement will likely result in a request for more information from the Division.

These and other questions must await guidance in the form of regulations, rulings, and decisions from Rhode Island Division of Taxation. If such guidance isn't forthcoming—and we understand that the Division has no existing plan to issue such guidance—expect cases under the new law to wind up in the courts of Rhode Island. Nevertheless, the law is in effect now, and transfers of real estate companies are presumptively occurring. In the absence of guidance, we understand that real estate title insurance companies are considering the new law and whether to make necessary and appropriate changes to their documents. If you have any questions on how these rules may apply to you, please contact us at (401) 274-7200.

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[6] Both the sales and use tax and the business corporation tax rules currently impose upon transferors of the assets of a business the same requirements that the new acquired real estate company rules now require: notice to the Division of Taxation prior to the transfer and payment of the taxes, with noncompliant transfers treated as "fraudulent and void" as to the State. Again, like with the new conveyance tax, such unpaid taxes together with penalties and interest, are a debt to the State. Therefore, treatment of a transfer of interests in an acquired real estate company as fraudulent and void would seemingly allow the State to treat the transfer as if it never occurred or to place a lien upon the transferred interest.