

## Updates

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New Washington State Real Estate Excise Tax Legislation

The Washington Legislature completed its 2019 legislative session with the passage of sweeping changes to the real estate excise tax (REET). The REET legislation was the centerpiece of the Legislature's efforts to raise revenue and make Washington's tax system more progressive. If signed by the governor as expected, the changes would be effective January 1, 2020.

## **Rate Changes**

The Legislature changed the state REET rate for most sales of real property from a flat 1.28% of the selling price to a graduated rate structure, as follows:

- 1.1% of the selling price below \$500,000;
- 1.28% of the selling price between \$500,000 and \$1,500,000;
- 2.75% of the selling price between \$1,500,000 and \$3,000,000; and
- 3.0% of the selling price over \$3,000,000.

ESSB 5998, § 1. Local REET rates (most commonly 0.5%) are added to the state rate. The new combined state and local REET rates for Seattle, Tacoma, Spokane, Vancouver, Bellevue, and most of urban and suburban Washington will be 1.6%, 1.78%, 3.25%, and 3.5%.

Unfortunately, the new legislation does not address whether the selling price thresholds are applied on a parcel-by-parcel, transaction-by-transaction, or some other aggregate basis. For example, one might expect the Department of Revenue to aggregate multiple parcels into a single selling price where the transfers are part of a single agreement (e.g., the sale of a shopping mall consisting of multiple parcels) or where parties transfer or acquire a controlling interest in an entity (e.g., an LLC that owns real property parcels throughout Washington). However, should multiple sales by the same seller be aggregated (e.g., a residential developer's sales of multiple homes over multiple months to unrelated buyers)? If so, under what circumstance? The new legislation gives the Department of Revenue broad powers to disregard the form of transactions and little guidance on how to exercise those powers, as discussed in the final section of this update.

The new graduated rates will not apply to sales of timberland or agricultural land, which will remain subject to the current 1.28% flat state REET rate, plus applicable local rates. ESSB 5998 § 1. The preferential rates for timberland and agricultural land appear to be based on the use of the real property at the time of sale. There is no requirement that the purchaser continue the seller's use of the property. Thus, agricultural land sold to a purchaser for residential or commercial development should benefit from the preferential rate for agricultural land.

## **Controlling Interest Changes**

Under current law, REET is imposed on the transfer or acquisition of a controlling interest (50% or more) in an entity that owned real property in Washington within any 12-month period. The new REET legislation expands the period for measuring whether a controlling interest has been transferred or acquired to 36 months. ESSB 5998, § 3.

While these changes are aimed at reducing the ability of parties to plan around the REET, the expanded controlling interest provisions are likely to cause uncertainty, surprise, and frustration for sellers of minority interests in legal entities that own real property in Washington. Sellers of minority interests in entities may find themselves subjected to REET based on transactions by other parties that occurred up to three years before or that may occur three years after their sale. In addition, because the measure of REET in a controlling interest transfer is the full value of the real property owned by the entity (and not the selling price of the interests in the entity), sales of controlling interests can be taxed at effective rates of more than 6.0%.[1]

To help track and enforce the new controlling interest provisions, legal entities that file annual reports with the Washington Secretary of State will be required to disclose transfers of one-sixth or more of the entity (?16.67%). ESSB 5998, § 7. If an entity fails to report such a transfer and REET is ultimately due, the entity is liable for the REET plus a 50% evasion penalty.

## **New Department of Revenue Powers to Recharacterize Transactions**

The Legislature anticipated that its REET changes would encourage taxpayers to structure transactions to reduce or avoid tax. To prevent revenue loss, the Legislature delegated to the Department of Revenue the power to "disregard the form of the transaction or series of transactions and determine the proper tax treatment ... based on the substance of the transaction or transactions." ESSB 5998, § 6. Unfortunately, the Legislature provided no guidance on how the department should exercise this authority. Indeed, the Legislature merely "encourage[s]"—and does not require—the Department of Revenue to provide public guidance on its broad powers to tax the "substance" of transactions. *Id.*

### **ENDNOTES**

[1] For example, in January 2020, Member A sells her 25% interest in an LLC that owns \$10 million of real property in Seattle to Member C for \$2.5 million. No REET applies because Member A has not sold and Member C has not purchased 50% of LLC. Almost three years later, in December 2022, Member B sells his 25% interest in LLC to Member C for \$2.5 million. REET applies because Member C acquired 50% of LLC within a 36-month period (25% from Member A in 2020 and 25% from Member B in 2022). Members A and B would be liable for \$319,050 in REET—6.39% of the consideration received for their membership interests.

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