

# Property and Transfer Tax Considerations For Business Entities

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By Mark E. Mueller

Business attorneys are often called on to advise in restructuring business entities, forming new companies, transferring interests among individuals and entities, and moving assets around. Quite often the parties to the transactions are related and everyone is in agreement as to what is to happen. In such an environment, details are often neglected and it might be tempting to be less than thorough in analyzing the transaction in all of its aspects. Clients often assume that if no cash is changing hands, there is little concern about taxes. This article is a reminder to check the property tax issues that attend even these friendly deals. With state and local budgets under tremendous pressure, we can expect tax authorities to scrutinize transactions and claimed exemptions.

## State Real Estate Transfer Tax

Is the transfer taxable under the State Real Estate Transfer Tax Act, MCL 207.521-537 (“SRETT”)? The SRETT Act imposes on the seller or grantor a 0.75 percent transfer tax<sup>1</sup> on (1) contracts for the sale of real property, (2) deeds or instruments of conveyance of real property for consideration, and (3) contracts for the transfer or acquisition of a controlling interest in an entity in which real property comprises at least 90 percent of the fair market value of the entity’s assets. MCL 207.523.

There are numerous exemptions to the SRETT, specified in MCL 207.526. For transfers to an entity by one or more of the owners or by a related entity, the key exemptions are:

- (p) A conveyance that meets 1 of the following:
  - (i) A transfer between any corporation and its stockholders or creditors, between any limited liability company and its members or creditors, between any partnership and its partners or creditors, or between a trust and its beneficiaries or creditors when the transfer

is to effectuate a dissolution of the corporation, limited liability company, partnership, or trust and it is necessary to transfer the title of real property from the entity to the stockholders, members, partners, beneficiaries, or creditors.

(ii) A transfer between any limited liability company and its members if the ownership interests in the limited liability company are held by the same persons and in the same proportion as in the limited liability company prior to the transfer.

(iii) A transfer between any partnership and its partners if the ownership interests in the partnership are held by the same persons and in the same proportion as in the partnership prior to the transfer.

(iv) A transfer of a controlling interest in an entity with an interest in real property if the transfer of the real property would qualify for exemption if the transfer had been accomplished by deed to the real property between the persons that were parties to the transfer of the controlling interest.

(v) A transfer in connection with the reorganization of an entity and the beneficial ownership is not changed.

and

- (t) A written instrument evidencing a contract or transfer of property to a person sufficiently related to the transferor to be considered a single employer with the transferor under section 414(b) or (c) of the internal revenue code of 1986, 26 USC 414.

The exemption under Section 6(p) will apply to a transfer from a dissolving entity to its owners in dissolution. If property is contributed to an LLC or partnership (but not a corporation), and the interests in the entity are unchanged as a result of the transfer,

then the transfer of the property is exempt under Section 6(p)(ii) and (iii). For example, if Able and Baker each contribute \$50 to form a new LLC with 50 percent membership interests each, and then Able contributes real estate worth \$50,000 and Baker simultaneously contributes \$50,000 cash, it seems that the interests have remained the same both before and after Able's transfer and would therefore be exempt. It is not at all clear that this is the intended result under the statute. If the new LLC promptly dissolves with Able getting the cash and Baker getting the property (which should be exempt under Section 6(p)(i) as a transfer in dissolution), then the property has effectively been transferred from Able to Baker for a net consideration of \$50,050 in cash without paying the SRETT.

Application of the "single employer" exemption under Section 6(t) is not readily apparent from the language of the statute and requires a bit of further study. The reference to IRC 414(b) or (c) directs us to the concept of a group of entities under common control. This can be a parent-subsidary group (basically, an 80 percent control test), or a brother-sister group. RAB 1989-48 provides that a brother-sister group consists of two or more organizations conducting business if:

- the same five or fewer individuals own a controlling interest (at least 80 percent) in each organization, and
- taking into account the ownership of each of those persons only to the extent that such ownership is identical with respect to each organization, those persons are in effective control (more than 50 percent) of each organization.

The Michigan Department of Treasury uses RAB 1989-48 (originally issued in connection with the Single Business Tax) to define entities under common control for purposes of the SRETT. RAB 1989-48 contains several useful examples and is required reading for interpretation of the Section 6(t) exemption.

Undoubtedly, some taxpayers have been tempted to misuse the exemption set forth in 6(a), which exempts instruments in which the "value of the consideration for the property is less than \$100.00." If Able and Baker form a real estate LLC, with Able contributing the real estate worth \$50,000 and Baker contributing \$50,000 cash, and each receives a 50 percent membership interest, it's tempting to claim the \$100 exemption since there's no cash changing hands between Able and the new LLC. But Able's 50 percent member-

ship interest is valuable consideration for the transfer of his property to the LLC. The value is "the current or fair market worth in terms of legal monetary exchange at the time of the transfer."<sup>2</sup> Able exchanged his property for a membership interest that has value greater than \$100, and such exchanges are taxable.<sup>3</sup> Lawyers who prepare deeds for such conveyances and claim the \$100 exemption put themselves at risk of civil and criminal penalties under MCL 205.27.<sup>4</sup>

### Application of Transfer Tax to Controlling Interest Transfers

The SRETT was imposed on transfers of "controlling interests" by amendments to the Act contained in Public Act 473 of 2008, which was given a retroactive effective date of January 1, 2007. The amendment was an attempt by the legislature to close a perceived loophole. In commercial real estate transactions, it had become somewhat common to drop the subject real estate down into a subsidiary LLC (a transfer that would be exempt from the SRETT), and to then convey the LLC interests to the buyer rather than giving a deed. This tactic avoided the need to record a deed conveying the property to the buyer and thereby evaded the SRETT.

The SRETT amendment added a definition to the Act, setting an 80 percent threshold for a "controlling interest," and modified the definition of "value" for purposes of determining the tax base in a transaction involving the transfer of a controlling interest.

Consider a simple case. Suppose Able, Baker, and Charlie are the three equal members of an LLC, which in turn owns a commercial rental property valued at \$950,000, plus cash and other holdings valued at \$50,000 for a total of \$1,000,000. The members each sell their membership interests in the LLC to Delta, which thereby acquires a controlling interest in the LLC (100 percent). The new SRETT amendments impose the transfer tax on the sellers in this "transfer or acquisition" because the real property owned by the LLC comprises more than 90 percent of the fair market value of the LLC's assets. The tax base is the "value of the real property or interest in the real property, apportioned based on the percentage of the ownership interest transferred or acquired in the entity."<sup>5</sup> This yields a tax base equal to  $\$950,000 \times 100\% = \$950,000$ , and a tax of

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\$7,125, payable by the three sellers in the amount of \$2,375 each.

Now suppose things are a little more complicated. Able owns a 50 percent membership interest, Baker 35 percent, and Charlie 15 percent. Able and Baker each sell their membership interests in the LLC to Delta, which thereby acquires a controlling interest in the LLC (50%+35%=85%). In this case, there should be a transfer tax equal to 0.75 percent of \$807,500 (85 percent of \$950,000), or \$6,056.25, payable by Able and Baker. If the tax is proportionately allocated between them, Able would pay \$3,562.50 and Baker would pay \$2,493.75.

The act does not address what happens if Able sells his 50 percent interest to Delta, and then Baker, in a separate transaction a few months later, sells his 35 percent interest to Delta. On closing with Baker, Delta might be said to have acquired a controlling interest. Is the tax base 35 percent of \$950,000, reflecting only the transaction by which Delta "acquired" a controlling interest? Or is it 85 percent including Able's sale too? If Able's sale is to be included in the tax base, is he then responsible for paying the tax even though his sale in itself was not taxable? Is Baker's sale not a transfer or acquisition of a controlling interest at all, since it is only 35 percent?

These and other questions have caused the SRETT amendments to be roundly criticized, not so much for the closing of a loophole, but for an overall lack of clarity and the impracticality of various provisions.<sup>6</sup>

### County Transfer Tax

Is the transfer subject to the county Real Estate Transfer Tax under MCL 207.501-513?

MCL 207.502 imposes on the grantor a 0.11 percent transfer tax<sup>7</sup> on:

- (a) Contracts for the sale or exchange of real estate or any interest therein or any combination of the foregoing or any assignment or transfer thereof.
- (b) Deeds or instruments of conveyance of real property or any interest therein, for a consideration.

The tax is collected by each county for transfers of property in the county. The county tax pre-dates the SRETT and contains some, but not all, of the same exemptions. Unlike the SRETT and the General Property Tax Act (discussed below), the county tax does not have exemptions for transfers between affiliates or entities under common control.<sup>8</sup> The county tax does not apply to entity interest

transfers, but it will apply to most transfers of real property by or to legal entities.

### Property Tax Valuation Uncapping

Does the transfer cause uncapping of the taxable value of the property under MCL 211.27a? Beginning in 1995, annual increases in the taxable value of real property were limited to the lesser of five percent or the inflation rate.<sup>9</sup> The limitation applies until there is a "transfer of ownership," whereupon the taxable value for the calendar year after the transfer is equal to the property's state equalized value.<sup>10</sup> The transfer of ownership starts the process over, and future annual increases in the taxable value are again limited.<sup>11</sup> This removal of the limitation on taxable value following a transfer of ownership has come to be called "uncapping."

Uncapping is caused by a transfer of ownership, which Section 27a(6) of the Act defines as "the conveyance of title to or a present interest in property, including the beneficial use of property, the value of which is substantially equal to the value of the fee interest."<sup>12</sup> Conveyances by deed, land contract, by will, or in trust are covered, as are changes in the beneficial interests under a trust.<sup>13</sup> A conveyance of more than 50 percent of the ownership interest in a corporation, partnership, LLC or other entity is also deemed to be a transfer of ownership of the entity's real property under Section 27a(6)(h) of the Act.<sup>14</sup>

Since no deed is filed for a conveyance of entity interests, such a transfer might not ever come to the attention of the property assessor, so the statute requires the affected entity to notify the assessor by filing a Property Transfer Affidavit no more than 45 days after the transfer.<sup>15</sup>

There are numerous transfers that are expressly excluded from uncapping, set forth in Section 27a(7), including transfers between spouses, transfers subject to a life estate in the grantor, foreclosures, transfers to a trust for the benefit of the grantor or his or her spouse, etc. The key statutory exemptions for transfers by or to business entities are set forth in Section 27a(7), subsections (j), (k), (l), and (m):

- (j) A transfer of real property or other ownership interests among members of an affiliated group. As used in this subsection, "affiliated group" means 1 or more corporations connected by stock ownership to a common parent

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corporation. Upon request by the state tax commission, a corporation shall furnish proof within 45 days that a transfer meets the requirements of this subdivision. A corporation that fails to comply with a request by the state tax commission under this subdivision is subject to a fine of \$200.00.

- (k) Normal public trading of shares of stock or other ownership interests that, over any period of time, cumulatively represent more than 50% of the total ownership interest in a corporation or other legal entity and are traded in multiple transactions involving unrelated individuals, institutions, or other legal entities.
- (l) A transfer of real property or other ownership interests among corporations, partnerships, limited liability companies, limited liability partnerships, or other legal entities if the entities involved are commonly controlled. Upon request by the state tax commission, a corporation, partnership, limited liability company, limited liability partnership, or other legal entity shall furnish proof within 45 days that a transfer meets the requirements of this subdivision. A corporation, partnership, limited liability company, limited liability partnership, or other legal entity that fails to comply with a request by the state tax commission under this subdivision is subject to a fine of \$200.00.
- (m) A direct or indirect transfer of real property or other ownership interests resulting from a transaction that qualifies as a tax-free reorganization under section 368 of the internal revenue code, 26 USC 368. Upon request by the state tax commission, a property owner shall furnish proof within 45 days that a transfer meets the requirements of this subdivision. A property owner who fails to comply with a request by the state tax commission under this subdivision is subject to a fine of \$200.00.

#### *Affiliated Groups (MCL 211.27a(7)(j))*

The affiliated group exemption under Section 27a(7)(j) presumably refers to a group or chain of commonly owned corporate entities that would qualify as an affiliated group under IRC 1504, so as to be allowed to file a consolidated federal income tax return under IRC 1501. Transfers between corporations in

such a group will avoid uncapping for transfers between parent and subsidiary corporations or between brother-sister subsidiary corporations of the same parent.

#### *Public Trading (MCL 211.27a(7)(k))*

The administrative impossibility of tracking changes of ownership resulting from normal public trading of shares in a publicly traded entity no doubt gave rise to the “public trading” exemption set forth in Section 27a(7)(k). This does not mean that public companies always get a pass, however. The State Tax Commission (“STC”) has identified six types of transfers for public companies that may result in uncapping:

- The merger of two or more companies;
- The acquisition of one company by another or by an individual;
- The initial public offering (IPO) of the stock of a company (an IPO occurs when a company’s stock is first offered for sale to the public);
- A secondary public offering of the stock of a company (a secondary public offering occurs when a company whose stock is already publicly traded issues additional new stock for sale to the public);
- The trading of the stock of a privately held company (a privately held company is a company whose stock is not available for sale to the public); and
- A takeover involving a public offer by someone to buy stock from present stockholders in order to gain control of a company.<sup>16</sup>

#### *Commonly Controlled Entities (MCL 211.27a(7)(l))*

The exemption that should be of keen interest to lawyers working with individual owners of small and medium business entities will be Section 27a(7)(l), which concerns transfers of real property or ownership interests among legal entities if those entities are “commonly controlled.” As we saw with the SRETT, the Michigan Department of Treasury relies mostly on RAB 1989-48 to determine whether entities are commonly controlled. The bulletin describes three categories of common control:

- a parent-subsidiary group of trades or businesses,
- a brother-sister group of trades or businesses, or

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- a combined group of trades or businesses (a specific combination of a parent subsidiary group and a brother-sister group of trades or businesses).

The STC guidelines take some liberties here, departing from the strict application of RAB 1989-48. First, the STC notes that in order for entities to be commonly controlled under RAB 1989-48, they must be engaged in a business activity. The guidelines give an example of a husband and wife who, for estate planning reasons, convey their residence to an LLC owned by the wife.<sup>17</sup> The STC notes that the “entities involved (the husband and wife and the limited liability company)” cannot be entities under common control according to RAB 1989-48 because no business activity exists in the situation.

The STC goes on to state that certain situations will constitute common control even though the strict requirements of RAB 1989-48 are not met, such as:

Property (or an ownership interest) is conveyed from one entity to another entity and both entities are owned by the same individual(s) with the same percentage of ownership.

Let’s call this the Proportionate Ownership Rule. The guidelines give the following example:

Example: Individual A and individual B own a lakefront cottage property together as tenants in common, each with an undivided 50 percent interest. This is the only such property these individuals own and they use the property solely for recreational purposes, residing there from time to time. For liability protection purposes, individual A and individual B convey the property to a limited liability company. Individual A and individual B are the only members of the limited liability company, each having a 50 percent ownership interest. Even though these entities (individual A, individual B, and the limited liability company) are not entities under common control under Michigan Revenue Administrative Bulletin 1989-48, these entities are considered to be under common control by policy of the State Tax Commission and this property transfer would not be a transfer of ownership.

First, let us note that the example does not really exemplify the Proportionate Ownership

Rule. The rule speaks of transfers between two entities owned by the same individuals in the same proportions. The example has two individuals transferring property that they own 50/50 to an entity they own 50/50. “Entities” says the STC, “means corporations, partnerships, limited liability companies, limited liability partnerships, or any other legal entity.”<sup>18</sup> Individuals do not appear on the list.

For contrast, the STC then draws the same example again, but instead of a 50/50 LLC, the individuals convey their 50/50 owned property to an LLC that is owned 49/51. This makes all the difference under the Proportionate Ownership Rule, and, in such a case, the STC says the entities are not under common control.

With these examples, the STC guidelines appear to dispense with two requirements of RAB 1989-48 as to who can be an “entity under common control.” First, RAB 1989-48 nowhere contemplates individuals as “entities under common control.” Second, the STC itself notes that RAB 1989-48 requires such entities to be engaged in a business activity. Neither of these requirements is imposed on our cottage owners in the examples. Instead, the STC creates the Proportionate Ownership Rule seemingly out of whole cloth. Other commentators have also questioned the Proportionate Ownership Rule.<sup>19</sup>

As the STC giveth, so the STC taketh away. In another departure from RAB 1989-48, the STC dispenses with the constructive ownership rules set forth in the Bulletin:

Michigan Revenue Administrative Bulletin 1989-48 refers to Internal Revenue Service regulations concerning constructive ownership (also commonly known as ownership attribution). It is the opinion of the State Tax Commission that, although Michigan Revenue Administrative Bulletin 1989-48 is to be used in determining entities under common control, the Internal Revenue Service regulations concerning constructive ownership are to be disregarded. Application of the regulations regarding constructive ownership (ownership attribution) would result in transfer of ownership exemptions that were clearly not intended by the legislature.<sup>20</sup>

Unfortunately, the STC guidelines do not inform us as to what the supposed intent of

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the legislature was. The legislature presumably knew what “commonly controlled” meant when it included that language in the statute. At the time, RAB 1989-48 was already the Michigan Treasury’s published guidance on commonly controlled entities under Michigan tax law.

***Corporate Tax Free Reorganization (MCL 211.27a(7)(m))***

Finally, Section 27a(7)(m) exempts transfers of real property or ownership resulting from transactions that qualify as a tax-free reorganization under IRC 368. Section 368 applies only to corporate reorganizations.

***Hypotheticals***

Returning to our examples, if Able, Baker, and Charlie are equal owners of ABC One, LLC, and they own ABC Two, LLC as follows: Able (40 percent), Baker (40 percent) and Charlie (20 percent), will a transfer by deed of real property from ABC One to ABC Two result in uncapping?

The transfer of the real estate by deed is a “transfer of ownership” under Section 27a(6)(a). Is there an exemption? Since these are LLCs and not corporations, and the interests are not publicly traded, we can look only to Section 27a(7)(l) for an exemption as entities under common control. The test will be whether ABC One and ABC Two can qualify as a brother-sister group under RAB 1989-48 as discussed above. Assume the entities have business activities. In our case, Able, Baker, and Charlie own 100 percent of both ABC One and ABC Two, so they satisfy the first prong. To satisfy the second, we need to see if as a group, they meet the minimum level of effective control in both entities, considering their individual interests only to the extent those interests are the same in each entity. Able and Baker each own 33.3 percent of ABC One for a total of about 67 percent. Clearly they are in effective control of ABC One. Looking at ABC Two, Able and Baker each own 40 percent, but we can consider this only to the extent that their respective ownership is the same in both companies, i.e. a maximum of 33.3 percent each. The sum of these interests also exceeds 50 percent, so Able and Baker are also in effective control of ABC Two. Therefore, the transfer between the entities should not result in uncapping.

Suppose the same example, except that ABC Two is owned as follows: Able (90 percent), Baker (5 percent), and Charlie (5 per-

cent). Again, together they own 100 percent of both companies. But considering their individual interests only to the extent they are identical in both companies, we see that the same “group” is not in effective control of ABC Two. We can only count 33.3 percent of Able’s interest in ABC Two, plus the 5 percent for each of Baker and Charlie. This comes to only 43.3 percent—not enough for effective control. So in this example, the transfer results in uncapping.

For another example, assume that Able, Baker, and Charlie are siblings and in 1990 they inherited a commercial property as equal tenants in common. The property is leased to their small business, an auto repair shop. Their lawyer advises them to form an LLC and contribute the property for liability protection and ease of management. They form ABC, LLC and contribute the property by deed, taking equal membership interests in exchange. Under the statute, this is clearly a transfer of ownership, and no exemption seems to apply. The property is not being conveyed among entities under common control. Each of the individuals is under his own control. The Proportionate Ownership Rule described in the STC guidelines does not seem to apply either for the same reason: the individuals are not entities. The only basis for claiming the exemption in this transaction appears to be the STC’s example in the guidelines—an example that has been called into question by the Michigan Tax Tribunal.<sup>21</sup> This seemingly innocuous transfer into the LLC may result in a huge increase in property taxes. Did the lawyer advise them of that? How about the state and county transfer taxes that may also be due?

**Conclusion**

Before advising a client on (i) a conveyance of real property to or from a business entity, or (ii) a transfer of entity interests where the entity owns real property, lawyers need to stop, think, and read the statutory provisions and exemptions for transfer taxes and uncapping, combined with the administrative guidance and caselaw, which are far from simple. Seemingly minor changes in your facts can make the difference between whether a transfer is taxable or exempt, and the difference between good advice or bad.

## NOTES

1. Technically, the tax rate is \$3.75 for each \$500 (or any fraction thereof) of the consideration, so if the consideration is not a multiple of \$500, the tax base is rounded up to the next \$500 increment. MCL 207.525(1).
2. MCL 207.522(g).
3. *Hansen Plaza, LLC v Michigan Dept of Treasury*, MTT Docket No. 263743 (2001).
4. See also *State Real Estate Transfer Tax Questions and Answers*, 74 Mich. B J 196 (February 1995).
5. MCL 207.522(g).
6. For an excellent discussion of the SRETT amendments and these criticisms, see J. Scott Timmer, *The Application of State Transfer Tax to Entity Interest Transfers*, 36 Michigan Real Property Review 84 (Summer 2009).
7. The tax rate is \$0.55 for each \$500 (or any fraction thereof) of the consideration, so if the consideration is not a multiple of \$500, the tax base is rounded up to the next \$500 increment. MCL 207.504.
8. Robert F. Rhoades and Nancy G. Itnyre, *Property Tax Cap and Transfer Taxes*, 27 Michigan Real Property Review 63 (Summer 2000). This article is especially useful for its detailed table setting forth the application of the SRETT, the General Property Tax Act, and the County Tax to various transactions.
9. MCL 211.27a(2)(a).
10. MCL 211.27a(3).
11. MCL 211.27a(4).
12. MCL 211.27a(6).
13. *Id.*
14. MCL 211.27a(6)(h).
15. *Id.*
16. Transfer of Ownership and Taxable Value Uncapping Guidelines, Mich. Dept. of Treasury, State Tax Commission/Property Tax Division, March 31, 2001, [http://www.michigan.gov/documents/Transfer\\_of\\_Ownership\\_Q&A\\_128474\\_7.pdf](http://www.michigan.gov/documents/Transfer_of_Ownership_Q&A_128474_7.pdf).
17. Such a transfer will also result in the loss of the Principal Residence Exemption. MCL 211.7cc.
18. Transfer of Ownership and Taxable Value Uncapping Guidelines, p. 20.
19. David E. Nykanen, *The Danger of the Unintended Uncapping: Issues in Estate Planning and Financing Transactions*, Michigan Real Property Review (Fall 2009). This article discusses a small claims case before the Michigan Tax Tribunal, *Lakewood Cottages, LLC v Township of Sanilac*, MTT Docket No 302715 (Jan 6, 2005), which seems to call the Proportionate Ownership Rule, or at least the STC examples, into question.
20. Transfer of Ownership and Taxable Value Uncapping Guidelines, Mich. Dept. of Treasury, State Tax Commission/Property Tax Division, March 31, 2001, [http://www.michigan.gov/documents/Transfer\\_of\\_Ownership\\_Q&A\\_128474\\_7.pdf](http://www.michigan.gov/documents/Transfer_of_Ownership_Q&A_128474_7.pdf).
21. *Lakewood Cottages, LLC v Township of Sanilac*, MTT Docket No 302715 (Jan 6, 2005).



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