STATE OF DELAWARE
DEPARTMENT OF FINANCE
DIVISION OF REVENUE
CARVEL STATE OFFICE BUILDING
820 NORTH FRENCH STREET
WILMINGTON, DELAWARE 19801

DIVISION OF REVENUE
TECHNICAL INFORMATION MEMORANDUM 86-9 December 18, 1986

SUBJECT: <u>REALTY TRANSFER TAX REGULATIONS</u>

I. <u>PURPOSE.</u>

This Technical Information Memorandum sets forth the Regulations for implementation of House Bill No. 462 (65 <u>Del.</u> <u>Laws</u> Ch. 426).

II. <u>GENERAL RULE</u>.

Except as provided in Section III of these Regulations, the transfer of beneficial (i.e., economic) interest or ownership in real estate through the vehicle of a partnership, corporation or trust (hereinafter "entity" unless the context requires otherwise) will result in the entity being disregarded and the transaction deemed a conveyance of real estate between the beneficial owners to which the tax imposed by 30 <u>Del. C</u> Ch. 54 will apply. The application of this section may be demonstrated by way of example, without limitation, as follows:

<u>Example 1.</u> <u>A</u> conveys property to a wholly owned corporation and then sells the stock of the corporation to <u>B</u>.

<u>Example 2.</u> <u>A</u> conveys a 1% interest in the property to a "dummy corporation" <u>X</u> and pays the tax on this 1% conveyance. <u>A</u> and <u>X</u> form a partnership and convey the property to the partnership. <u>A</u> and <u>X</u> then sell their partnership interests to <u>B</u>.

<u>Example 3.</u> <u>A</u> creates a trust with <u>A</u> as the beneficiary and conveys the property to the trust. <u>A</u> then sells his beneficial interest in the trust to <u>B</u>.

III. EXCEPTIONS.

A) Statutory Safe Harbor. Where the beneficial owners of real estate prior to the conveyance or series of conveyances referred to in the general rule under Section I of these Regulations own 80% or more of the beneficial interest in the real estate following said conveyance or conveyances, such transfer shall not be subject to tax under Section I. Where, however, the beneficial owners of real estate prior to the conveyance or series of conveyances referred to in Section II own less than 80% of the beneficial interest in the real estate following said conveyances or conveyances, such transfers shall be subject to the tax if such transfer or transfers are properly characterized as a sale of real property. Factors which are relevant to this characterization are as follows:

1) Timing of the transaction. If the entity is newly created, a strong presumption arises that such transfer is a sale. The presumption may be rebutted by a showing that the timing of all events surrounding the conveyance through an entity came about for non-tax business purposes and was not motivated by tax avoidance. If the entity is pre-existing, the Division will examine its activities prior to the real estate conveyance in order to determine its principal activities. The Division will carefully scrutinize transactions involving a partnership, corporation, or trust that has been "inventoried" or the utilization of an existing entity as a vehicle to convey an asset not used in, not associated with, or unrelated to the previous business activities of the entity.

2) Percentage Change In Interest. If in any continuous 12 month period there is more than a 50% change in interest in an entity, it will be presumed for purposes of this test that a sale of an interest in real estate has occurred.

3) Transitory Ownership Status. Transitory status as a partner, shareholder, or beneficiary of an entity suggests that transfer of an interest is subject to the tax. The fact that the status is continuing, however, is of no particular importance if facts and circumstances suggest that the transaction in question is in substance a conveyance of real estate.

4) Business Purpose. The fourth and most important factor is whether, under all the facts and circumstances, the transfer by means of an entity was made for a business purpose more significant than conveyance of beneficial ownership in Delaware real estate. Notwithstanding the foregoing, where the transfer takes place by means of an entity chosen for tax avoidance purposes, the transaction is subject to the tax.

The intent of these Regulations is to tax transactions where the substance of the transaction is the sale of real estate or where an intangible is used for tax avoidance purposes. It is not the intent of these Regulations to tax transactions where there is a business motive more important than the transfer of real estate.

Some examples which illustrate these factors are as follows:

Example 1. A owns a retail business which B wishes to purchase. The assets of the business consist of real property and personal property. The personal property constitutes 60% of the value of the business. A's business has been in existence for 10 years as a corporation. A sells his stock to B. The transaction is not subject to the tax. This conclusion is based on the following:

a) Timing. The entity is not newly created.

b) Percentage Change. There is a presumption of a sale since a 100% interest has been transferred within a 12 month period.

c) Transitory Ownership Status. No transitory status.

d) Business Purpose. The purpose of the transaction is to convey an ongoing business which has substantial personal property. In addition, there is no tax avoidance motive.

Example 2. Same as example 1 except that A owns the retail business as a sole proprietor and that he transfers the business into a corporation in order to avoid the tax. Shortly thereafter A sells the stock of the corporation to B. The transaction is subject to the tax based on the following:

a) Timing. This test is failed since the entity is newly created for purpose of tax avoidance.

b) Percentage Change. This test is failed since a 100% interest has been transferred within a 12 month period.

c) Transitory Ownership Status. Transitory status exists since A owns the stock for a short period of time.

d) Business Purpose. Even though there is a business purpose, this purpose is overriden by the purpose of tax avoidance.

Example 3. D Associates is a partnership whose sole asset is real estate. The partners in D Associates sell all their partnership interest in D Associates to A and B who continue to operate the partnership. The transaction is subject to the tax based on the following:

a) Timing. The entity is not newly created.

b) Percentage Change. Presumption of a sale since a 100% interest has been transferred within a 12 month period.

c) Transitory Ownership Status. No transitory status.

d) Business Purpose. This test is not met since the only purpose of the transaction is to convey beneficial interest in real estate.

Example 4. A. Inc., is a manufacturing company whose sole shareholder owns the building and land in which the company is located. The building and land are leased to A. Inc., by the the shareholder. B wants to buy the business and the building and land. The sole shareholder conveys the land and building into the corporation for purposes of avoiding the tax. The transaction is subject to the tax based on the following:

a) Timing. Although the entity is newly created, this test is failed since the land was conveyed into the corporation in order to avoid the tax and immediately before the sale of stock.

b) Percentage Change. There is a presumption of a sale since a 100% interest has been transferred within a 12 month period.

c) Transitory Status. No transitory status.

d) Business Purpose. This test is failed since the only reason for the conveyance of the real property into the corporation is tax avoidance.

B) Regulatory Safe Harbor Provisions. In light of the factors described in Section III(A) of these Regulations, the following transactions are deemed not properly characterized as sales of real estate.

1) Exemption contained in §5401(1)(i). A conveyance from a nominee or straw party will be exempt if the grantees have owned more than fifty percent (50%) of the beneficial interests in the real estate being conveyed continuously throughout the three (3) year period immediately prior to the date of conveyance. A conveyance to a nominee or straw party will be exempt if the grantors have owned more than fifty percent (50%) of both (i) the real estate being conveyed and (ii) the beneficial interests in the nominee or straw party continuously throughout the three (3) year period immediately prior to the date of the conveyance. Notwithstanding the foregoing, if a transaction fails to qualify for the exemption provided under this paragraph solely because of the three (3) year requirement, then either party or both parties to such transaction may submit an application for exemption hereunder in the form of an affidavit, under penalties of perjury:

a) Describing the transaction and the parties thereof;

b) Describing why the transaction would not qualify for the exemption; and

c) Stating that the transaction involves a nominee or straw party in a transaction which, on application, is determined by the Director of Revenue in the exercise of sound discretion to have a primary business or legal purpose other than tax avoidance and not to be motivated by tax avoidance, and is not in substance the conveyance of real property from one real party in interest to another.

2) Exemptions Contained in §5401(j) and (n). A conveyance from a corporation, partnership or trust will be exempt if the grantees have owned more than fifty percent (50%) of the stock of the corporation or the interests in the partnership or trust continuously throughout the three (3) year period immediately prior to the date of conveyance; and provided further a conveyance to a corporation, partnership, or trust will be exempt if the grantors have owned more than fifty percent (50%) of both (i) the real estate being conveyed and (ii) the stock of the corporation or the interests in the partnership or trust continuously throughout the three (3) year period immediately prior to the date of the conveyance.

IV. AUTHORITY.

These Regulations are issued pursuant to 30 Del. C. §5407.

V. TRANSITION RULE.

These regulations will not apply to any contract for sale entered into prior to January 1, 1987.

VI. PROCEDURE.

Parties to conveyances potentially affected by these regulations may seek rulings from the Division to establish the existence or non-existence of liability under the Realty Transfer Tax and these Regulations. Requests for such rulings should be addressed to the Deputy Director and should, at a minimum, address the factors set forth in Section III of these regulations.