Watch Out For Connecticut's Controlling Interest Transfer Tax

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If you buy or sell real property in Connecticut, you're familiar with Connecticut's Real Estate Conveyance Tax. The deed can't be recorded unless conveyance tax is paid, so you can't overlook the tax.

However, a lesser-known Controlling Interest Transfer Tax (CITT) may apply to transfer of a "controlling interest" in an entity that "directly or indirectly" owns Connecticut real property valued at $2,000 or more. Transfer documents don't have to be recorded, and no recording officer demands payment of CITT, which is easily disregarded. Acquisition of an entity with multiple tiers of subsidiaries poses particular peril; lower-tier subsidiaries may be "out of view", but if they own real property, CITT will be payable.

Taxes become interesting when transactional choices can affect the amount of tax, so this brief introduction to CITT will highlight some choices. Taxation of controlling interest transfers, conceptually equivalent to CITT, is integrated into New York's Real Estate Transfer Tax, although there are variations that are beyond the scope of this article.

Transfer of controlling interest in property-owning entity: Corporation F owns Parcel X. Shareholder S transfers 50.1% of F's shares to Buyer B. For CITT purposes, "controlling interest" in a corporation means <u>more than 50%</u> of the "combined voting power of all classes of stock".

The CITT is 1.11% of the "actual true and present value" of Parcel X. If F had owned a half-interest in Parcel X, CITT would have been imposed on the value of the half-interest, but if any controlling interest <u>in the property-owning entity</u> is transferred, CITT is imposed on the total value of the property.

However, if F wants to sell only a fractional interest in Parcel X, F could deed the fractional interest to its wholly-owned subsidiary. That transfer is exempt from conveyance tax, and ordinarily has no income tax consequences. When the subsidiary sells its fractional interest, CITT would be imposed on the value of the fractional interest.

Transfer of controlling interest in entity that indirectly owns property: Company J owns 40% of Company K, and K owns Parcel X. Member M sells a 60% (controlling) interest in J. Because control of the <u>direct owner</u> of the property (K) was not transferred, CITT is imposed on the "applicable ownership percentage" in Parcel X <u>indirectly owned</u> by J. Here, the percentage is 40% (J's stake in K), so CITT is imposed on 40% of the value of

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Parcel X.

For CITT purposes, "controlling interest" in an LLC or other, non-corporate entity means more than 50% of the "capital, profits or beneficial interest". An interest holder's percentages for these interests may not be identical, or may change over time.

The rate differential: Conveyance tax consists of a "State" portion, which is either 0.75% or 1.25% depending on the type of property, and a "local" portion, which ranges from 0.25% to 0.5% depending on location. For example, the aggregate rate applicable to a sale of improved, non-residential property in most larger cities is 1.75%. The difference between this aggregate rate and the 1.11% CITT rate is important.

Example: Company P owns an office park. P could deed the office park to Buyer A, and pay conveyance tax at 1.75%. Or, P could deed the office park to its wholly-owned subsidiary, Company R. When P then sells a 100% interest in Company R to A, P will pay CITT of 1.11% of the office park's value. If that value is $100,000, the "no deed" scenario saves $640 - not enough to justify the complications. If the value is $100 million, the CITT scenario saves $640,000. The CITT scenario will prevent the transaction from qualifying as part of a "tax-deferred exchange".

Related transactions: CITT will apply to a series of related transactions; transactions within a six-month period are presumed to be related. If a transfer of interest in a property-owing entity, followed by acquisition of an interest in the same entity (say, after a reorganization), the taxpayer could "net out" the transfers. This might allow the taxpayer to claim that there had been no "net" transfer of a controlling interest, or that CITT applied to less than 100% of the property's value.

There are many issues beyond the scope of this article, such as which transactions are exempt, and how "value" is determined. Published administrative guidance regarding CITT is scarce. In 2003, the Connecticut Department of Revenue Services published a Special Notice that provides a good summary, but doesn't address the creative possibilities offered by CITT.

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