

TITLE ISSUES

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A NEW TRANSFER TAX LAW: STATE OF ILLINOIS TRANSFER TAX IMPOSED ON OFF-RECORD TRANSFERS

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Tax avoidance is a common theme running throughout our legal history. From the time of King Henry VIII onward, lawyers have devised schemes for reducing the tax consequences of their clients' transactions. Every tax law has generated strategies for reducing tax liability, and modern practice is no different. The Illinois Real Estate Transfer Tax Law serves as an example. The Illinois General Assembly recently closed a "loophole" by expanding the state transfer tax to a defined set of off-record transfers. This legislative move may have a significant impact on the structure of real estate transactions. It may also increase state revenue. Finally, it may stimulate attorneys to invent new methods for minimizing the burden of the state transfer tax.

An Act that will become effective June 1, 2004, amends the Illinois Real Estate Transfer Tax Law, 35 ILCS 200/31-1 et seq., to define as taxable events certain off-record transactions. In addition, the Act permits home rule counties and home rule municipalities to similarly expand their existing transfer tax ordinances, and it ratifies home rule ordinances that already tax such transactions. See Public Act 93-657, the full text of which may be viewed at the Illinois General Assembly's website at www.legis.state.il.us/. This article will outline the provisions of the Act and describe their impact on title insurance procedures and real estate transactions.

EXPANDED STATE TRANSFER TAX

In its crucial definition sections, the amended Illinois Real Estate Transfer Tax Law now closely resembles the current municipal transfer tax ordinance of the City of Chicago. See Chicago Real Property Transfer Tax Ordinance, adopted March 1, 1993. We anticipate, therefore, that practice under the expanded state transfer tax will closely resemble practice under the City of Chicago ordinance. Practice under the amended state law will also closely resemble practice under the Cook County ordinance, which also closely resembles the City of Chicago ordinance. See Cook County Real Property Transfer Tax Ordinance, adopted July 7, 1993.

The state transfer tax continues to apply to traditional transfers of real property by deeds of conveyance and by assignments of beneficial interests in Illinois land trusts. The amendments expand the reach of the tax. As amended, the state transfer tax may also be imposed on indirect transfers of real property accomplished by the transfer of partnership interests, by the transfer of limited liability company memberships, by the sale of corporate stock, or by the assignment of a long-term lease. The definitions contained in the amendments determine whether any such off-record transfer constitutes a taxable event.

The amended statute imposes the state transfer tax “on the privilege of transferring title to real estate located in Illinois, on the privilege of transferring a beneficial interest in real property located in Illinois, and on the privilege of transferring a controlling interest in a real estate entity owning property located in Illinois...” See amended 35 ILCS 200/31-10 (underlined language added by P.A. 93-657).

“Controlling interest” is defined as “more than 50% of the fair market value of all ownership interests or beneficial interests in a real estate entity.” See amended 35 ILCS 200/31-5.

“Real estate entity” is defined as “any person, including but not limited to, any partnership, corporation, limited liability company, trust, other entity, or multi-tiered entity, that exists or acts substantially for the purpose of holding directly or indirectly title to or beneficial interest in real property.” Id. In an effort to limit the reach of the tax to transfers of interests in title holding entities (and not to stock market transfers of shares in large corporations that happen to own some real estate in Illinois), the definition includes a rebuttable presumption “that an entity is a real estate entity if it owns, directly or indirectly, real property having a fair market value greater than 75% of the total fair market value of all of the entity’s assets...” Id.

Finally, “beneficial interest” is defined as including, but not limited to, (1) the beneficial interest in an Illinois land trust; (2) the lessee’s interest in a ground lease (and its related improvements) with a term of 30 or more years, considering all options to renew or extend but not considering whether any portion of the term has already expired; and (3) “the indirect interest in real property reflected by a controlling interest in a real estate entity.” Id. (Note: Item (3) would appear to be superfluous as it brings us back, full circle, to other definitions.)

The expanded transfer tax will reach an off-record transfer falling within the above definitions. It will also reach multi-step transactions that might be employed in an effort to avoid the transfer tax. The amended Law states that the tax “is due if the transfer is made by one or more related transactions or involves one or more persons or entities and whether or not a document is recorded.” See amended 35 ILCS 200/31-10.

The state transfer tax rate remains unchanged at \$0.50 for each \$500 of value stated on the transfer tax declaration form. For all taxable transfers, however, the outstanding balance due on a mortgage “shall not be included in the basis of computing the tax.” 35 ILCS 200/31-10.

Public Act 93-657 creates a new exemption to the state transfer tax. Under new 35 ILCS 200/31-46, any taxable transfer of a controlling interest in an entity that is also liable for corporate franchise taxes under the Business Corporation Act, 805 ILCS 5/1 et seq., as a result of the transfer shall be exempt from the real estate transfer tax to the extent of corporate franchise taxes paid as a result of the transfer. (Note: this should probably be characterized as a credit rather than an exemption. Nonetheless, this provision eliminates double taxation of certain transfers.)

COMPLIANCE PROCEDURES

Compliance procedures for transfers accomplished by recorded instruments remain unchanged. Transfer tax stamps must be purchased from the Recorder of Deeds when the transfer instrument, together with a fully executed transfer tax declaration form or forms, is presented to the Recorder for recordation. 35 ILCS 200/31-20. With respect to the newly taxable off-record transfers, however, P.A. 93-657 is somewhat ambiguous. Under amended 35 ILCS 200/31-20, transfer tax stamps are to be purchased when the transfer document is presented for recording. Yet, for off-record transfers, no instrument will be recorded. Amended 35 ILCS 200/31-25, however, states that a transfer tax declaration form must also be presented when the transfer instrument is submitted for recording, “or within 3 business days after the transfer is effected, whichever is earlier,…” From this, it is safe to assume that parties to taxable off-record transfers may both purchase transfer tax stamps and submit transfer tax declaration forms within 3 business days after closing on the transfer.

Unless directed otherwise, the party to the transfer who is responsible for purchasing transfer tax stamps should cancel the stamps and affix them to the transfer instrument or to some other document evidencing the transfer. The Recorder or the Illinois Department of Revenue (DOR) may eventually offer suggestions as to what to do with the canceled stamps and the transfer tax declaration forms.

DOR may also amend its state transfer tax declaration forms. Practitioners should watch for developments in this area as we approach the effective date of the amended Law.

TITLE COMPANY PRACTICE

The amended Real Estate Transfer Tax Law should not require any new title exceptions. Examining practice should remain unchanged.

For traditional transfers by deeds or by assignments of beneficial interests in Illinois land trusts, title companies must still require payment of all applicable transfer taxes (state, county, and municipal, as appropriate). Unless the parties to the transfer submit a sufficient claim to an exemption, the deed cannot be recorded, or the assignment lodged, without payment of transfer taxes.

For off-record transfers, however, title companies may not require payment of the state transfer tax—not even as a pre-requisite to the issuance of special endorsements (such as non-imputation, mezzanine financing, or Fairway endorsements) and special coverages (such as creditors’ rights coverage). Non-payment of the state transfer tax will not impact title to real estate. The Law has no lien provision for the failure to pay the state transfer tax. DOR enforcement procedures are aimed at individuals who file false declaration forms rather than at the subject real estate. 35 ILCS 200/31-50. Thus, any loss or damage suffered by an insured arising from non-payment of the state transfer tax will be excluded from coverage on any title policy. See, for example, ALTA 1992 policy forms, Exclusions 3(a) and 3(d). Before completing any off-record transfer, however, practitioners should verify whether their title insurer has adopted a position that differs from the position suggested in this paragraph.

In the final analysis, the parties to the transaction must determine whether a particular off-record transfer is or may be a taxable event. Title company staff cannot make that decision. The parties, and not title company staff, must decide whether a tax will be paid. Title company staff may assist customers who choose to pay the tax by purchasing transfer tax stamps. Responsibility for the decision to buy stamps, as well as the execution of the transfer tax declaration forms, rests entirely with the parties to the off-record transfer.

HOME RULE COUNTY AND MUNICIPAL TRANSFER TAX ORDINANCES

Public Act 93-657 also amends the Counties Code, 55 ILCS 5/5-1031.1, to permit a home rule county that already has a transfer tax ordinance to expand the reach of the tax. The home rule county may amend its existing transfer tax ordinance to impose the tax “on the privilege of transferring a controlling interest in a real estate entity.” The amended ordinance must, however, use the same definitions of “controlling interest” and “real estate entity” that are now part of the state transfer tax law under 35 ILCS 200/31-5, as amended by P.A. 93-657, and as described above. Further, the existing tax may be expanded in this fashion without resort to a referendum vote, provided there is no increase in the tax rate. Finally, P.A. 93-657 validates any home rule county ordinance that already taxes off-record transfers (Cook County).

Public Act 93-657 also amends the Illinois Municipal Code, 65 ILCS 5/8-3-19, to permit a home rule municipality that already has a transfer tax ordinance to expand the reach of the tax. The home rule municipality may amend its existing transfer tax ordinance to impose the tax “on the privilege of transferring a controlling interest in a real estate entity.” The amended ordinance must, however, use the same definitions of “controlling interest” and “real estate entity” that are now part of the state transfer tax Law under 35 ILCS 200/31-5, as amended by P.A. 93-657, and as described above. Further, the existing tax may be expanded in this fashion without resort to a referendum vote, provided there is no increase in the tax rate. Finally, P.A. 93-657 validates any home rule municipal ordinance that already taxes off-record transfers (City of Chicago and others).

It is hoped that any home rule county or municipality that expands its ordinance to cover off-record transfers will give notice of the expanded tax by means of a recorded instrument or by some other means of notifying title companies of changes in local laws and requirements.

TITLE COMPANY PRACTICE

Existing title exceptions for local transfer tax ordinances give sufficient notice of local requirements, even in those cases in which a municipal ordinance provides for a lien in the event of non-payment of local transfer taxes. No new title exceptions are anticipated. Once again, title company staff will not determine whether a particular off-record transfer is or may be a taxable event under local ordinances (county or municipal). Title company staff will refer customers to the local ordinances (county or municipal, as the case may be) and to local officials, if necessary.

CONCLUSION

By expanding the state transfer tax to off-record transfers, the State has filled a gap (or perhaps, closed a loophole) in its tax collection system. Beginning June 1, 2004, sales of real estate accomplished by transfers of partnership shares, limited liability company memberships, and corporate stock, or by the assignment of long-term leases, will be taxable to the same extent as traditional conveyances made by deeds or by assignments of beneficial interests in Illinois land trusts. While corporate, personal, or other reasons may remain for structuring sales of real estate by off-record transfers, transfer tax incentives for off-record transfers will disappear. By taxing off-record transfers, the State will match the tax collection practices of the City of Chicago and Cook County—practices that have been in place for more than ten years. Revenue collectors might ask the State, “What took you so long?” Attorneys, on the other hand, might ask each other, “What can we do, now?”