Philadelphia Revises Realty Transfer Tax Treatment of Acquired Real Estate Companies

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On December 8, 2016, the Philadelphia City Council voted unanimously to amend the ordinance governing realty transfer taxes in an effort to increase tax revenue. The current combined realty transfer tax rate in Philadelphia is 4.0% and will increase to 4.1% after December 31, 2016.[1] The amendment significantly impacts how taxes are imposed upon transfers of ownership in so-called "real estate companies" and effectively eliminates deals commonly referred to as 89-11 transactions. The amendment mainly focuses on transfers of real estate companies, rather than direct transfers of real estate, but it also affects certain direct transfers of real estate in exchange for noncash consideration.

In realty transfer tax parlance, a "real estate company" is, very generally, an entity that is primarily engaged in the business of holding, selling or leasing real estate. Currently, realty transfer tax is imposed when a real estate company becomes an "acquired real estate company"; that is, when at least 90% of the ownership of the real estate company is transferred within a three year period. The amendment makes several changes relevant to real estate companies.

First, City Council effectively eliminated a strategy that has long been used to minimize the taxes imposed upon transfers of ownership in real estate companies: the 89-11 transaction. The high rate of tax applicable to deals in Philadelphia creates a significant benefit for parties willing to consider structuring their deal as a so-called 89-11 transaction. In such transactions, a seller might, for instance, convey 89% of its ownership in a real estate company and retain 11% for at least three years, thus avoiding the 90% threshold and the associated realty transfer tax. The amendment reduces the threshold from 90% to 75% and allows the city to look at a six year period, rather than a three year period, in determining whether that threshold has been exceeded. While this undoubtedly is the death knell for 89-11 transactions, it is too early to know whether this will simply give rise to some form of 74-26 transaction or be a hurdle too high for such transactions.

Second, under the amendment, in determining whether an entity is a real estate company, certain long-term leases will be considered tantamount to ownership of real estate. Generally, these include leases with a term of 30 years, including certain renewal periods. This means a lessee under a long-term lease could be considered a real estate company by virtue of the lease.

Third, for transfers of real estate companies that are subject to the tax, City Council also revised how the tax will be calculated. Currently, the tax base is related to the value of real estate held in an "acquired real estate company" determined based on the value as assessed by the City's Office of Property Assessments (OPA). City Council's amendment creates a rebuttable presumption that the value of the real estate, i.e. the tax base, is the actual consideration paid for interests in the real estate company rather than the "computed value" (the OPA's assessed value multiplied by the common level ratio) of the underlying real estate. Taxpayers may overcome this presumption by providing proof of the actual value of the real estate.

The amendment also adds that the realty transfer tax base "shall never be less than the readily ascertainable market value of any property" for which real estate is exchanged. This forecloses the opportunity to use a potentially lower computed value as the tax base in a transaction involving certain types of noncash consideration.

It is important to note that the amendment is not effective until July 1, 2017. Therefore, if you are considering a transaction involving a real estate company, there are certainly advantages to closing on deals before the amendment becomes effective. For transactions closing after July 1, 2017, it will be important to understand the changes to the city's realty transfer tax law and how best to structure transactions.

If you have questions or would like additional information regarding specifics of the change in the City of Philadelphia's realty transfer tax, please contact Nancy Frantz (frantzn@whiteandwilliams.com; 215.864.7026), Kevin Koscil (koscilk@whiteandwilliams.com; 215.864.6827), or James Vandermark (vandermarkj@whiteandwilliams.com; 215.864.6857).

[1] This combined rate includes the Commonwealth of Pennsylvania's 1% realty transfer tax, though the amendment has no bearing on the Commonwealth's imposition of realty transfer tax.