

Reproduced with permission from Tax Management Weekly State Tax Report, Volume: 21 Issue: 5, 01/31/2014. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Assessment/Collection

The following is the first of a series of quarterly articles by the State and Local Real Estate Tax Practice of PricewaterhouseCoopers LLP. In these articles, PwC will explore significant state real property tax issues that may be triggered in certain states when businesses own real property, transfer, improve or lease real property, or engage in other activities affecting real property. The same transaction or activity may have different implications across the states. In this first regional report, Sean Kanousis, Sam Melehani, Reed Schreiter, and Adam Robbins address California's change of ownership rules and how the intersection of real property taxes and transfer taxes cause considerable confusion for California taxpayers.

Regional Property Tax Report: California Real Property Taxation; The Tips and Traps Under the State's Property and Transfer Taxes

BY SEAN KANOUSIS, SAM MELEHANI,
REED SCHREITER AND ADAM F. ROBBINS

Introduction

California's real property tax regime is as unique as it is complex. Similar to other states, California imposes two separate taxes that potentially impact real property ownership—the annual real property tax

and the documentary transfer tax. Two areas that provide challenges for taxpayers are California's unique "change in ownership" rules and the complexities that arise when the real property taxes and transfer taxes interact. Although limits imposed by the change in ownership rules on real property tax assessment valuations can be beneficial to real property owners, these rules, potentially affecting both tax levies, can trap the unwary and result in a reappraisal for property tax purposes and imposition of the transfer tax.

In this article we address many of the questions faced by taxpayers owning California real property or interests in entities that own California real property. What transactions qualify as a change in ownership of real property? When will a transfer of ownership of an entity interest result in the taxation of the entity's real property? What exemptions exist for transfers of property or ownership interests between legal entities? Can certain future actions trigger property reassessment for previously exempt transactions? Can changes of control and changes of ownership trigger real property transfer taxes?

Sean Kanousis (sean.richman.kanousis@us.pwc.com) is a New York-based principal in the State and Local Tax (SALT) practice of PwC, focused on the Real Estate Industry, as is Sam Melehani (sam.melehani@us.pwc.com), a Los Angeles-based SALT partner. Reed Schreiter (reed.schreiter@us.pwc.com) is a Sacramento-based SALT director, and Adam Robbins (adam.f.robbs@us.pwc.com) is a senior associate in the SALT practice, based in New York.

Real Property Tax

Background

The passage of Proposition 13 in 1978 dramatically changed the landscape for real property tax assessments in California. Real property values for tax purposes were rolled back to their March 1, 1975, values and strict limits were placed on annual increases in assessed value.

Real property in California is assessed annually on January 1.¹ The taxable value of real property is the lesser of the real property's (1) base year value compounded annually by a specified inflation factor (not to exceed two percent of the prior year's value), or (2) full cash value taking into account any reductions in value.²

The base year value of real property is the full cash value or fair market value as of the later of: (1) March 1, 1975, or (2) the date of the most recent change in ownership or new construction after March 1, 1975.³

The full cash value or fair market value of real property is the amount of cash or its equivalent that the seller of the real property would receive on the open market if neither party were under an exigency to enter into the transaction and both parties were fully informed about any advantages or disadvantage associated with the property.⁴

As a result of the base year and full cash value measurements, the value of real property for California tax purposes does not necessarily increase to keep pace with its fair market value, unless a change in ownership or new construction occurs.

Proposition 13 did not define "change in ownership," leaving it to the California Legislature to define the contours of the term. By statute, California law defines a "change in ownership" as a transfer of a present interest in real property (including the beneficial use thereof) the value of which is substantially equal to the value of the fee interest.⁵ The law also lists numerous specific examples of transactions that qualify as, or are excluded from, a change in ownership.⁶

Although determining when a particular piece of real property changes ownership is relatively straightforward when that property is directly sold from one party to another, there are many situations where transfers between legal entities may be exempt. Additionally, a more difficult issue involves the transfer of ownership interests in a legal entity that has the effect of a "change in ownership" of the entity's underlying real property.

Change in Real Property Ownership When Legal Entities Are Involved

There are two types of transfers involving legal entities that may trigger a change in ownership of real property. The first occurs when real property is transferred either between an individual and a legal entity or between legal entities.⁷ The second occurs when the ownership interests in a legal entity that owns real

property are transferred.⁸ In both instances, if there is a change in real property ownership, the property transferred is reassessed immediately following its change in ownership, unless an exclusion applies.⁹

Change in Ownership Exclusions for Legal Entities. Generally, transfers of California real property or the transfer of majority interests in legal entities holding California real property will raise the specter of reassessment for property tax purposes. There are three exclusions from reassessment that are relevant to legal entities: (1) the proportional ownership interest exclusion, (2) the transfer of ownership interest exclusion, and (3) the statutory conversion and merger exclusion.

Exclusion 1

Proportional Ownership Interest. The most common exclusion is the proportional ownership interest exclusion, which provides that any transfer of real property between an individual (or individuals) and a legal entity, or between legal entities is excluded from reassessment as long as it meets both of the following requirements: (1) the transfer results solely in a change in the method of holding title to the real property (e.g., direct ownership interest in property converted to indirect ownership interest in property through stock ownership or ownership of a partnership interest); and (2) the proportional ownership interests of the transferors and transferees in each and every piece of real property transferred remain the same after the transfer.¹⁰ When a legal entity is involved in a transfer of real property and the ownership interests are not proportional before and after the transfer, then the entire real property interest transferred is subject to reassessment, not merely the disproportionately transferred interest.¹¹

Transfers of real property to and by legal entities are generally treated as a change in ownership of the real property interest transferred.

A simple example of the exclusion may be helpful. A and B own real property, each holding a 50 percent interest. A and B form LLC, contribute the real property to LLC, and each take a 50 percent interest in LLC. Because A and B each own a 50 percent interest in the real property before and after the transfer (i.e., their proportional ownerships have not changed), there is no change in ownership of the real property. If, however, A had a 60 percent interest in the LLC and B had a 40 percent interest, then A and B's proportional ownership interests in the real property have changed and the exclusion would not apply.

A more sophisticated example is also helpful. Real property is owned by LLC-1 and is its only asset. LLC-1 has two individual members, A and B, and an entity member, LLC-2. A owns a 0.95 percent interest in

¹ Cal. Rev. & Tax. Code §401.3.

² *Id.* §51; Cal. Const. Art. XIII A §2(b).

³ Cal. Rev. & Tax. Code §50.

⁴ *Id.* §110(a).

⁵ *Id.* §60.

⁶ *Id.* §§61 & 62.

⁷ Cal. Rev. & Tax. Code §62.

⁸ *Id.* §64.

⁹ *Id.* §75.10(a).

¹⁰ *Id.* §62(a)(2).

¹¹ *Id.* §75.10(a); *Id.* §62(a)(2).

LLC-1; B owns a 0.05 percent interest in LLC-1; and, LLC-2 owns a 99 percent interest in LLC-1. In turn, A owns a 95 percent interest in LLC-2, and B owns a 5 percent interest in LLC-2. LLC-2 proposes to transfer or distribute its 99 percent interest in LLC-1 to A and B in the same percentages as the percentages of A and B's pre-transfer interests in both entities—95 percent to 5 percent. After the transfer or distribution, A will directly own 95 percent of LLC-1 and B will directly own 5 percent of LLC-1.

Because the State Board of Equalization interprets the proportional ownership exclusion to apply to transfers of interests in entities, as well as to transfers of real property,¹² the transfer here does not result in a change in ownership of the real property. Although a change in control of LLC-1 occurs, the proportional ownership interests of A and B in the real property before and after the transfer remain the same, so no change in ownership occurs.

Exclusion 2

Transfer of Ownership Interest With Exceptions. The second exclusion involves the transfer of ownership interests in a legal entity that owns real property. Generally, transfers of interests in a legal entity do not constitute a change in ownership of the real property owned by the legal entity.¹³ Thus, purchases or transfers of corporate voting stock, partnership ownership interests, LLC membership interests, or ownership interests in other legal entities are not changes in ownership of the underlying real property owned by the legal entity. However, there are two exceptions to this general exclusion: 1) a change in control of the entity; and, 2) the transfer of original co-owner interests. To fully appreciate when a transfer of ownership interests may subject the entity's real property to reassessment, it is necessary to identify the types of ownership interests that are relevant to the entity's ownership of real property.

Defining 'Ownership Interest.' Ownership interests in legal entities may be represented differently, such as common or preferred stock, general or limited partnership interests, and managing or non-managing LLC membership interests. However, not all of these ownership interests are used to determine ownership interests in an entity for California real property tax purposes. Voting stock in a corporation is the only relevant corporate stock ownership.¹⁴ A stockholder that owns directly and indirectly more than 50 percent of the voting stock of a corporation controls the corporation for California real property tax purposes.¹⁵ The distinction between general and limited partnership interests is not relevant.¹⁶

Generally, the purchase or transfer of ownership interests in legal entities does not constitute a transfer of the real property of the entity.

State Board of Equalization (SBE) written advice (annotations) provides that ownership interests in partnerships and LLCs may be determined and measured by the partners' or members' capital and profits interests at the end of the entity's tax year.¹⁷ The timing of the measurement of the capital and profits interest may be important, for example, to partners with preferred equity that throughout the tax year may rise in value above the 50 percent level, but then settles down to 50 percent or less by the end of the year. This also allows for variations in the value of partnership assets throughout the year without creating changes in ownership at several points during the tax year. This calculation may be critical for owners of flow-through entities to determine whether the transfer of their ownership interests or the transfer of underlying real property triggers California property tax liabilities—but caution must be used since SBE annotations are not binding on assessors or the courts.

Reassessment When There Is a Change in Control. There are two situations where real property owned by an entity will be reassessed upon the transfer of ownership interests in the entity. Under the first situation, when a change in control of a legal entity occurs, a change in ownership of all real property owned by the entity occurs, and the real property will be reassessed. Here, when any single individual or legal entity obtains control of a legal entity through direct or indirect ownership or control of more than 50 percent of the voting stock in the case of a corporation, or more than a 50 percent of the ownership interests in a partnership or LLC, a reassessment of all real property owned by the acquired entity (and any entity under its control) will occur as of the date of the change in control.¹⁸

This includes when an existing owner that previously did not own or control more than 50 percent of the voting stock, or ownership interests, acquires additional ownership interests to bring its holdings up over the 50 percent threshold.¹⁹ An individual or legal entity may obtain indirect control of an entity by acquiring direct control (greater than 50 percent ownership) of another entity that, in turn, directly or indirectly (by greater than 50 percent ownership) controls the entity at issue.²⁰

Real property owned directly by a legal entity may be attributed to an individual or other entity only when that individual or other entity owns more than 50 percent of the voting stock, capital and profits interest, or other relevant ownership interest of the legal entity that

¹² Cal.Code Regs., tit. 18, §462.180, subd. (d)(4).

¹³ Cal. Rev. & Tax. Code §64(a).

¹⁴ *Id.* §64, subd. (c)(1).

¹⁵ *Id.*; SBE Annot. 220.0375.030.

¹⁶ SBE Annot. 220.0391.

¹⁷ Cal. Code Regs., tit. 18, §462.180, subd. (d)(1)(B); SBE Annot. 220.0375.030.

¹⁸ *Id.* §64(c)(1).

¹⁹ *Id.*

²⁰ *Id.*

owns the real property. An example will help illustrate this point.

P1, a partnership, owns real property in California. P1 is owned 40 percent by A, an individual, 50 percent by P2, a partnership, and 10 percent by C, a corporation. None of the partners of P1 is considered to indirectly own the real property owned by P1 because none owns more than 50 percent of the P1 partnership interests. If A acquires 50 percent of the capital and profits interest of P2, no change in control of P1 occurs because A does not acquire control of P2. P2's 50 percent ownership interest in P1 is not attributed to A. However, if A acquired a 51 percent capital and profits interest of P2, A would acquire control of P2, and P2's 50 percent interest in P1 would be attributed to A. A would then own directly and indirectly 90 percent of P1, resulting in a change in ownership of the real property owned by P1.²¹

Reassessment When Co-owner Subsequently Transfers. The second situation arises when cumulatively more than 50 percent of the "original co-owners'" interests in the legal entity is transferred. As stated above, when a transfer of real property to a legal entity is exempt from reassessment because the transfer results solely in a change in the method of holding title to the property and proportional ownership interests in all property transferred remains the same after the transfer, the persons holding ownership interests in the legal entity immediately after the transfer become the "original co-owners" of the interests in the legal entity.²² However, in the reverse situation when real property is transferred from a legal entity to an individual, the individual does not become an original co-owner because no entity interests represent ownership in the property.²³ When voting stock or other ownership interests representing cumulatively more than 50 percent of the total interests in a legal entity are transferred by any of the original co-owners in one or more transactions, the real property that was previously excluded from reassessment under the proportional ownership interest transfer exclusion will be reassessed.²⁴

However, if the transfer by original co-owners also results in an individual or entity acquiring control, then all the real property owned by the entity will be reassessed as a "change in control," not just the real property previously excluded under the proportional ownership interest transfer exclusion.²⁵ Further, original co-owner status is not attributed to other individuals or entities other than those holding the relevant original ownership interests.

For example, A, B and C own California real property, each holding a one-third interest in the property. A, B and C form D, a corporation, transfer the real property to D, and each take back one-third of the voting

stock of D. The proportional ownership interest exclusion applies to exclude the transfer from resulting in a change in ownership of the real property. However, the exclusion causes A, B and C to become original co-owners of D stock. D subsequently purchases two other parcels of real property in California.

At a later date, A, B and C (either all at once or over a period of time) each transfer 20 percent of D voting stock to unrelated individuals E, F and G, such that no one individual receives more than 50 percent of the stock. As a result, E, F and G each holds 20 percent of D voting stock, and A, B and C cumulatively hold 40 percent. The transfers by A, B and C trigger the original co-owner rule, resulting in a change in ownership of the real property transferred by A, B and C to D corporation. The two parcels subsequently acquired by D do not undergo a change in ownership. If A were a corporation, A's original co-owner status would remain with A and would not be attributed to A's shareholders.²⁶

Caution should be taken to monitor exempt transactions to ensure that subsequent actions do not trigger a retroactive assessment of property. As noted above, transactions that may have qualified in the past under a transfer of ownership exclusion may lose that exclusion based on the actions of the "original co-owners."

Exclusion 3

Statutory Merger and Conversion. The final exception involves statutory conversions and statutory mergers. Reassessment does not apply to statutory conversions or statutory mergers of a partnership into a limited liability company or other partnership, or a limited liability company into a partnership as long as both of the following requirements are met: (1) the jurisdiction governing the merger or conversion provides that the surviving entity is treated as the same entity as the disappearing or converting entity or the surviving entity succeeds to the assets of the disappearing or converting entity without other act or transfer; and (2) the partners or members of the converting or disappearing entity maintain the same ownership interests in the profits and capital of the new entity as they owned in the disappearing or converting entity prior to the conversion or merger.²⁷

Taxpayers dealing with corporate mergers should be aware that California provides no guidance regarding whether the statutory conversion or merger exemption applies to corporations or other types of entities.

Reporting Requirements

There are separate reporting requirements when reporting a change in control or change in ownership of a legal entity as opposed to reporting a transfer of real property to or from a legal entity or between legal entities.

When there is a change in control or a change in ownership of a legal entity that owns California real property, the individual or legal entity acquiring control or the legal entity that has undergone a change in ownership must file a Statement of Change in Control and Ownership of Legal Entities (Form BOE-100-B) with the

²¹ SBE Annot. 220.0501. The SBE proposed to change the long-standing interpretation in Annot. 220.0501 by issuing a follow-up annotation. The SBE's proposal was met with significant negative response and the annotation was withdrawn. To date, the SBE has not taken formal rulemaking action to change the interpretation though this matter is likely still under review.

²² Cal. Rev. & Tax. Code §64(d).

²³ *Id.*

²⁴ *Id.* §64(d).

²⁵ *Id.*, §§64(c)(1) & (d).

²⁶ SBE Annot. 220.0003.

²⁷ Cal. Code Regs. tit. 18, §462.180(d)(4).

State Board of Equalization within 90 days of the date of the change in control or change in ownership. Otherwise, a 10 percent penalty may be imposed.²⁸

Transfers of real property are reported to the county assessor via a Preliminary Change of Ownership Report or Change in Ownership Statement when a document or deed affecting a change in ownership is recorded.²⁹ These forms are available from the county assessor or county recorder.

Documentary Transfer Tax

Background

Prior to Jan. 1, 1968, the United States federal government imposed a documentary stamp tax on sales of real property.³⁰ Congress repealed the federal documentary stamp tax in 1965, but made the repeal effective on Jan. 1, 1968, to give states a chance to enact a replacement tax.³¹ California enacted legislation (Cal. Rev. & Tax. Code §11901 *et seq.*) in 1967 that authorizes counties and cities to impose a transfer tax on sales of realty and also sets forth various exemptions from the tax (the “Documentary Transfer Tax Act” or “Act”).

The Documentary Transfer Tax Act authorizes a county, a city, or a city and county to impose a tax on any document by which “realty sold” in the jurisdiction is transferred or conveyed.³² The Act authorizes counties to impose a tax of \$0.55 per \$500 (often calculated as \$1.10 per \$1,000) of consideration or value of the real property transferred (exclusive of the amount of any lien or encumbrance remaining on the property at the time of the transfer).³³ Cities are also authorized to impose a transfer tax at a rate equal to one-half the rate imposed by the county in which the city is located.³⁴ In such cases, a credit for the city transfer tax is allowed by the county, so that the total transfer tax remains \$0.55 per \$500 of consideration or value.³⁵ All counties, and most cities have enacted their own transfer tax ordinances.

Most cities in California are general law cities governed by the Documentary Transfer Tax Act. California charter cities, however, have supreme authority over “municipal affairs” and are not limited to the \$0.55 per \$500 authorized in the state statute; many charter cities impose transfer taxes at a significantly higher rate. When a charter city imposes a higher rate, the county in which the city is located no longer provides the credit for the city transfer tax, and the total transfer tax due is calculated by adding the full county rate (\$0.55 per \$500) to the charter city rate. For example, the City of Oakland currently imposes its transfer tax at the rate of \$15 per \$1,000 in consideration or value,³⁶ and the County of Alameda imposes its transfer tax at the standard rate of \$1.10 per \$1,000 in consideration or

value.³⁷ If real property is transferred in the City of Oakland for consideration of \$1,000,000, the total transfer tax imposed for both jurisdictions is \$16,100 (\$15,000 by the city and \$1,100 by the county).

Considerations for California Real Property Taxpayers

There are several issues that the real property tax and transfer tax raise for taxpayers.

The California Court of Appeal concluded in *Thrifty Corp. v. County of Los Angeles*, 210 Cal. App.3d 881, 886 (1989), that the phrase “realty sold” used in the Documentary Transfer Tax Act is sufficiently similar to the phrase “change in ownership” contained in the real property tax provisions, such that each phrase should have the same meaning. The court’s decision created some uncertainty in the application of the documentary transfer tax. As previously described, the transfer tax descended from the federal documentary stamp tax imposed on real property, which required payment of the tax only when a document was recorded. Thus, traditionally, the transfer tax was imposed only when a document was recorded to transfer or convey title to real property. *Thrifty*, however, resulted in some jurisdictions, notably, Los Angeles County, seeking to impose the transfer tax on any real property change in ownership, whether or not a document was recorded to transfer or convey title to the real property.

For example, ABC Realty LLC owns real property in California. ABC LLC owns 100 percent of the capital and profits interests of ABC Realty LLC. XYZ Corp. purchases 90 percent of ABC LLC capital and profits interests. A change in ownership of the real property owned by ABC Realty LLC would result. Under a traditional interpretation of the documentary transfer tax rules employed by most jurisdictions, no documentary transfer tax would be imposed because no document was recorded to transfer or convey the real property. A number of jurisdictions, including Los Angeles County, however, assert that the transfer tax is due pursuant to Cal. Rev. & Tax. Code §§11911, 11925, and 64(c)(1), and *Thrifty*.

In a variation on the example, ABC Realty LLC is acquired in equal shares by three separate and unrelated entities. Although more than 50 percent of the capital and profits of ABC Realty LLC are transferred, no one entity acquires more than 50 percent and no change in ownership for real property tax purposes would occur (assuming there are no original co-owners transferring more than a 50 percent of ABC Realty LLC).³⁸ Again, no document conveying the real property is recorded and no change in ownership occurs for real property tax purposes, so traditionally no documentary transfer tax is imposed.

In the wake of *Thrifty*, a number of jurisdictions are amending or interpreting ordinances to provide for the imposition of transfer tax when a change in real property ownership results from a change in control or ownership of a legal entity. Such a tax may be imposed regardless of whether a document is recorded to transfer real property. It is important for taxpayers to check both the county and city codes for the current transfer

²⁸ Cal. Rev. and Tax. Code §480.1 & 480.2.

²⁹ *Id.* §480.

³⁰ Former Internal Revenue Code (I.R.C.) §4361.

³¹ See Pub. Law No. 89-44, 79 Stat. 136 (1965).

³² Cal. Rev. & Tax. Code §11911, subd. (a).

³³ *Id.*

³⁴ *Id.* §11911, subd. (b).

³⁵ *Id.* §11911, subd. (c).

³⁶ Oak. Muni. Code, tit. 4, §4.20.020.

³⁷ Alameda Co., CA, Code of Ordinances, tit. 2, §2.04.020.

³⁸ Cal. Rev. & Tax. Code §64, subd. (c)(1).

tax rules and rates. Under the “change in control” concept, however, some jurisdictions now seek to impose the documentary transfer tax on both transactions described above, regardless of the fact that no change in ownership occurred in the second example.

Conclusion

California’s real property tax and documentary transfer tax are extremely complex as applied to today’s intricate real estate transactions. For purposes of real property tax assessments, state law and judicial interpretations have provided some clarity to California property owners. However, challenges remain for purposes of the transfer tax.

Individuals and businesses engaged in transactions involving California real property—including those involving entities that own California real property—should carefully evaluate real property tax law, regulations, and SBE annotations to ensure the proper application of the taxes and avoid any unwelcome surprises. At the local level, the transfer tax is proving to be a significant challenge to businesses regarding when the tax applies—does a document have to be recorded? Will tax apply if a “change in ownership” occurs? Must both occur before the transfer tax is imposed? Careful and frequent evaluations of county and city local imposition laws to determine their impact are a must before a transaction is completed.