

ADVANCED ISSUES IN PROPERTY TAX

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Overview

- Property Tax: Background/Introduction
- Target Issues:
 - Legal Entity Issues
 - Drafting: Sprinkle/Spray
 - Non-Pro Rata Distributions
- Documentary Transfer Tax: Watch Out!
- Conclusion

Proposition 13: Value Changes Over Period of Years

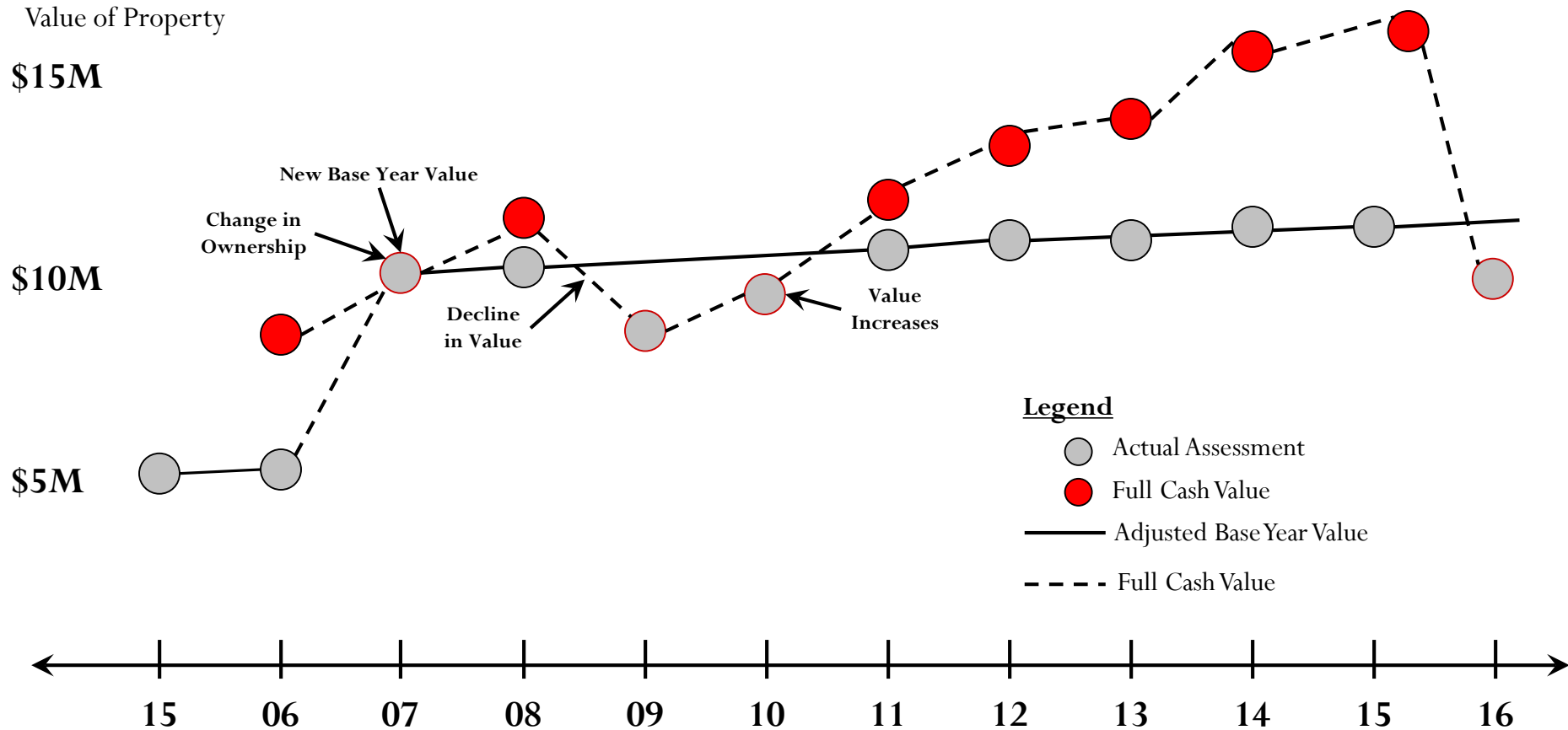


Illustration of Effects of Proposition 13



Compare Two Houses:	A	B
1975 Sales Price	\$100,000	\$100,000
1975 Assessed Value	\$100,000	\$100,000
2017 House B is Sold	Original Owner	New Owner
2017 Sales Price	n/a	\$1,000,000
2017 Assessed Value (Est.)	\$257,000	\$1,000,000
2017 Tax Bill (Est.)	\$2,900	\$11,500

Legal Entities



LEGAL ENTITIES

- Two Primary Scenarios:
 - If Transfer of Real Property interest (e.g., fee, leasehold): RTC § 61(j), RTC § 62(a)(2) and Rule 462.180
 - If transfer of an interest in a legal entity that owns real property (e.g., corporate voting stock, partnership or limited liability company capital and profits interests): RTC § 64 and Rule 462.180

Simplified CIO for Legal Entities

- If a legal entity owns real property, stock/ownership transfers within that legal entity are generally not changes in ownership, unless:
 - Change in Control – someone new has more than 50%
 - Original Co-Owners – more than 50% of original co-owners change

LEGAL ENTITIES: GENERAL RULE

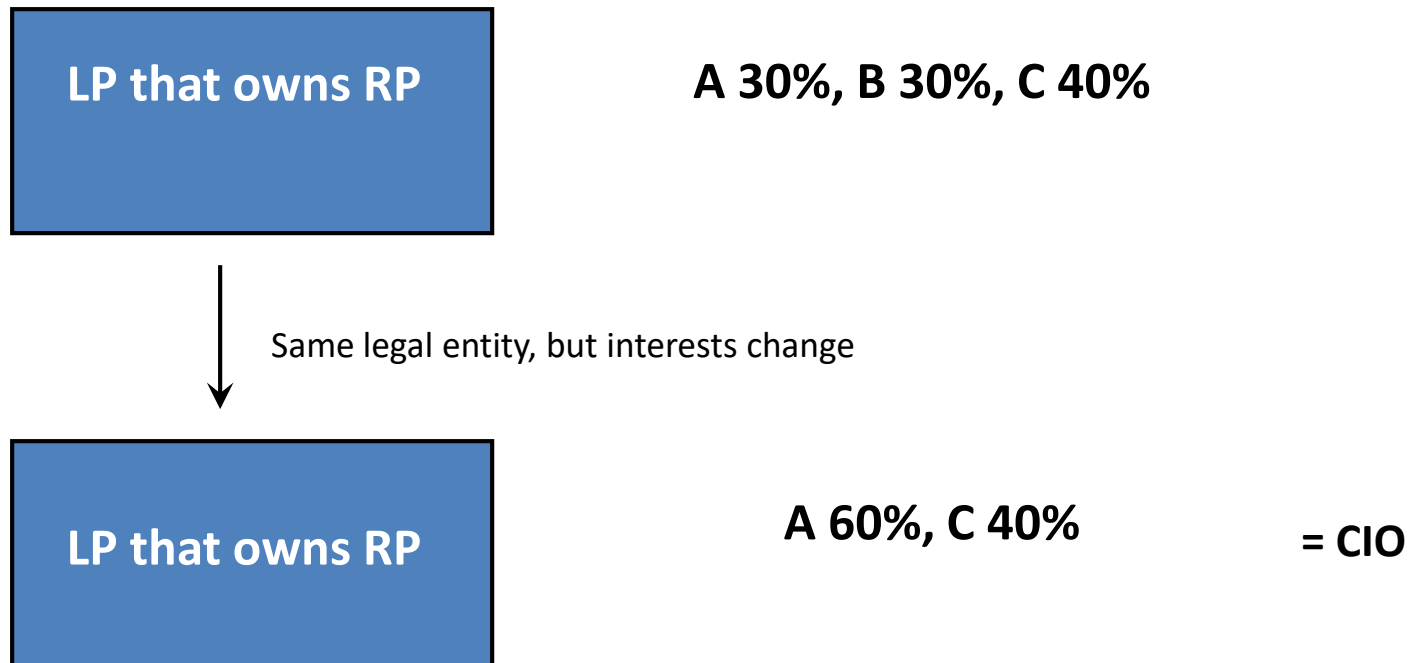
64(a) Except as provided in subdivision (i) of Section 61 [co-op housing] and subdivisions (c) and (d) of this section, the purchase or transfer of ownership interests in legal entities, such as corporate stock or partnership or limited liability company interests, shall not be deemed to constitute a transfer of the real property of the legal entity.

LEGAL ENTITIES

Change in Control

64(c)(1) When a corporation, partnership, limited liability company, other legal entity, or any other person obtains control through direct or indirect ownership or control of more than 50 percent of the voting stock of any corporation, or obtains a majority ownership interest in any partnership, limited liability company, or other legal entity through the purchase or transfer of corporate stock, partnership, or limited liability company interest, or ownership interests in other legal entities, including any purchase or transfer of 50 percent or less of the ownership interest through which control or a majority ownership interest is obtained, the purchase or transfer of that stock or other interest shall be a change of ownership of the real property owned by the corporation, partnership, limited liability company, or other legal entity in which the controlling interest is obtained.

Change in Control

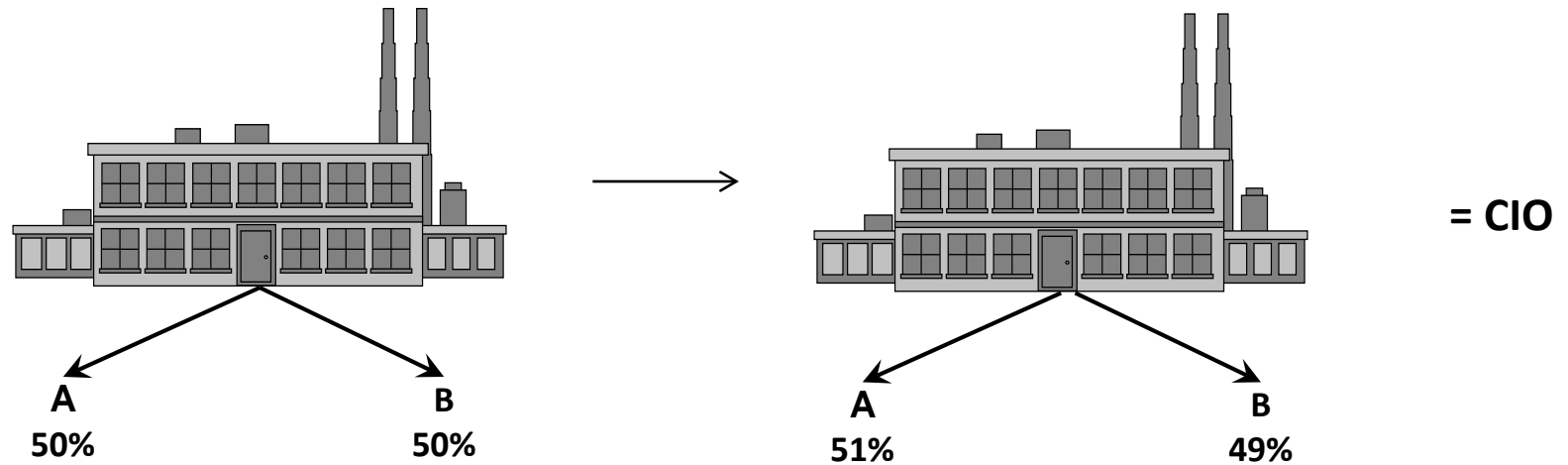


Example

Change in Control

- Mom owns business (LLC) that owns California real property. Getting older so she wants to pass the business on to son.
- She gifts 60% to S, and retains 40%.
- Result: 100% change in ownership. (RTC 64(c)(1).) All of the California real property owned by the LLC is reassessed.

Legal Entities: *Change in Control*



Example

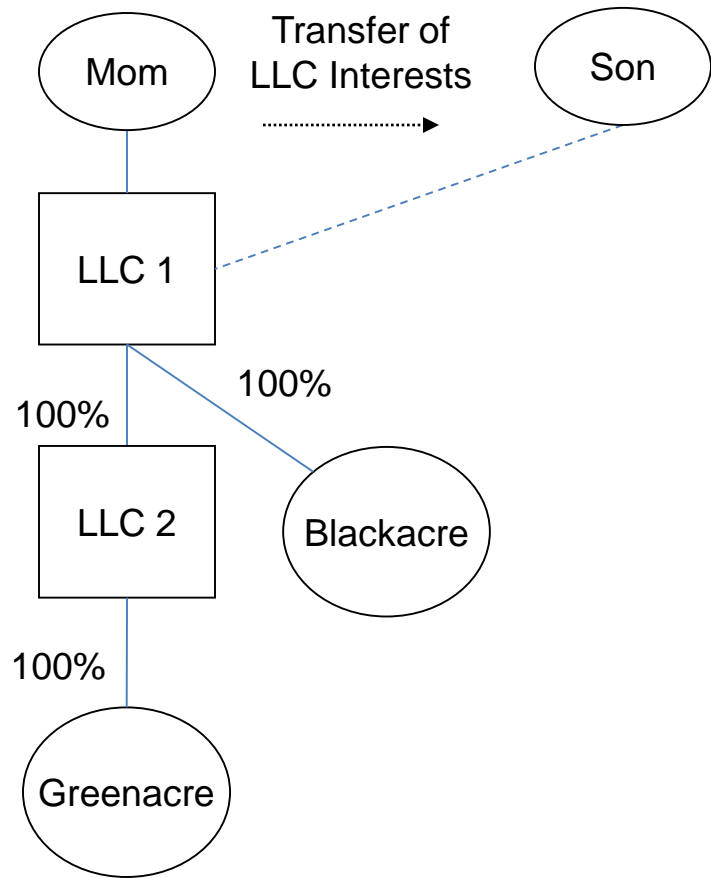
Change in Control

- Husband (H) and Wife (W) create a trust that transfers their LLC, which owns California real property, to their children upon the last of them to die.
- H dies. W dies 2 years later at which time LLC transfers 51% to Son, 24.5% to daughter 1, 24.5% to daughter 2.
- Result: Change in control. 100% change in ownership of all real property owned by LLC.

Q: What about parent-child exclusion? RTC 63.1 only applies to the transfer of real property, not to the transfer of legal entity interests.

Example

Indirect Control



Transfer of >50% of LLC 1
to Son = CIC of LLC 1
= reassessment of
Blackacre & Greenacre

Counting Proportionality & Control



C Corp &
S Corp



GP/LP



LLC

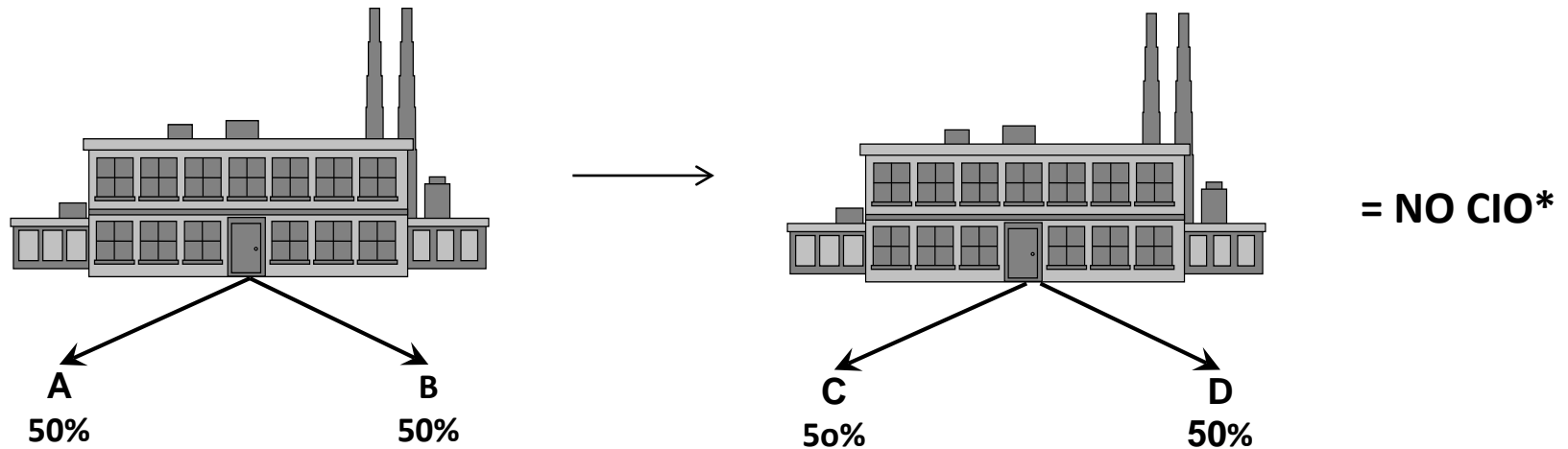
- To determine proportionality and control under RTC 62(a)(2) and 64(c), look at voting stock.
- To determine proportionality and control under RTC 62(a)(2) and 64(c), look at capital and profits interest.
- To determine proportionality and control under RTC 62(a)(2) and 64(c), look at capital and profits interest.

Example

No Change in Control

- Husband (H) and Wife (W) create a trust that transfers their LLC, which owns California real property, to their children upon the last of them to die.
- H dies. W dies 2 years later at which time LLC transfers 49% to Son, 25.5% to daughter 1, 25.5% to daughter 2.
- Result: No change in control.

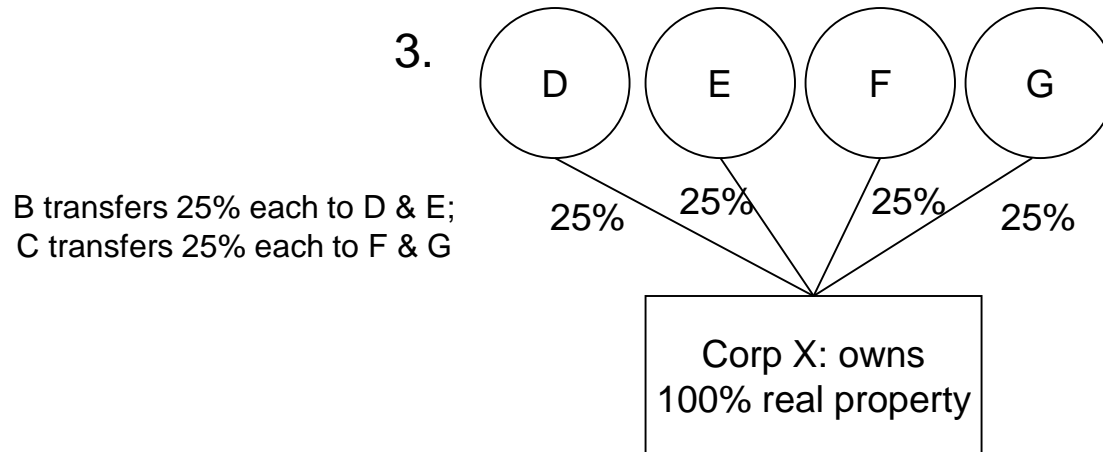
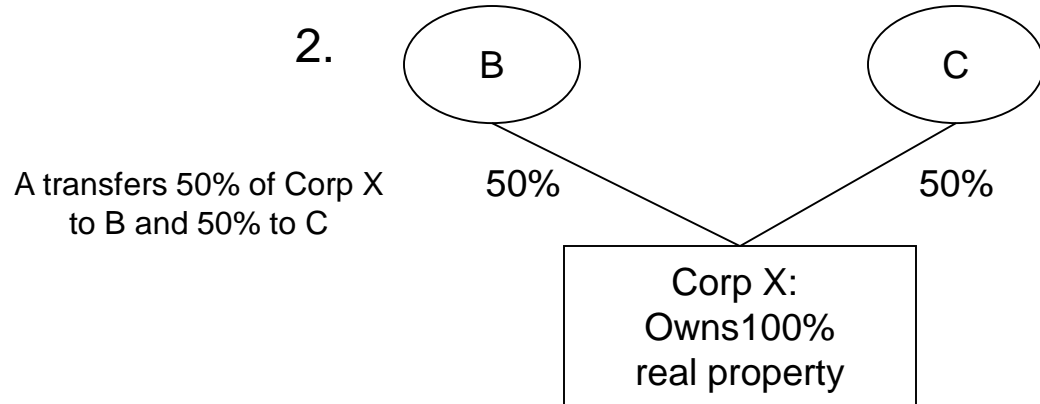
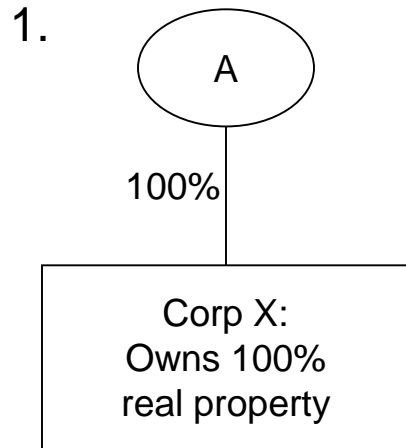
Legal Entities: *Change in Control*



*Assumes no original coowners, discussed later in presentation.

RTC 64(c)(1)

No Change in Control



Rev. & Tax. Code § 62(a)(2)

Proportional Ownership Interest Transfers

62. Change in ownership shall not include:

(a)(2) Any transfer between an individual or individuals and a legal entity or between legal entities, such as a cotenancy to a partnership, a partnership to a corporation, or a trust to a cotenancy, ***that results solely in a change in the method of holding title to the real property and in which proportional ownership interests of the transferors and transferees, whether represented by stock, partnership interest, or otherwise, in each and every piece of real property transferred, remain the same after the transfer.*** The provisions of this paragraph shall not apply to transfers also excluded from a change in ownership under the provisions of subdivision (b) of Section 64.

3 Common Issues:

1. Measurement of proportional ownership NOT of value;
2. Proportionality must be EXACT; and
3. Proportionality must be in EACH and EVERY piece of real property transferred

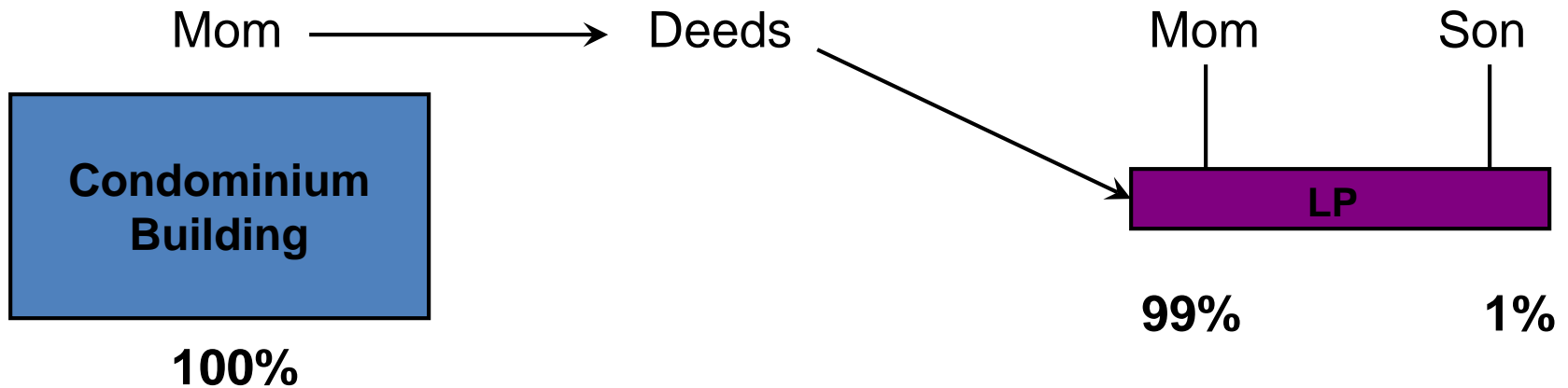
Example

Proportional Ownership Interest Transfers

- Husband (H) and Wife (W) want to start a business. Wife owns the building as her separate property. Husband will run the business.
- For liability protection purposes, W transfers building to LLC owned 50% each.
- Result: 100% change in ownership.
- What about the interspousal exclusion? RTC 63 only applies to transfers to a spouse, not to a spouse's legal entity.

Proportionality Must be Exact

Penner v. Santa Barbara (1996) 37 Cal.App.4th 1672

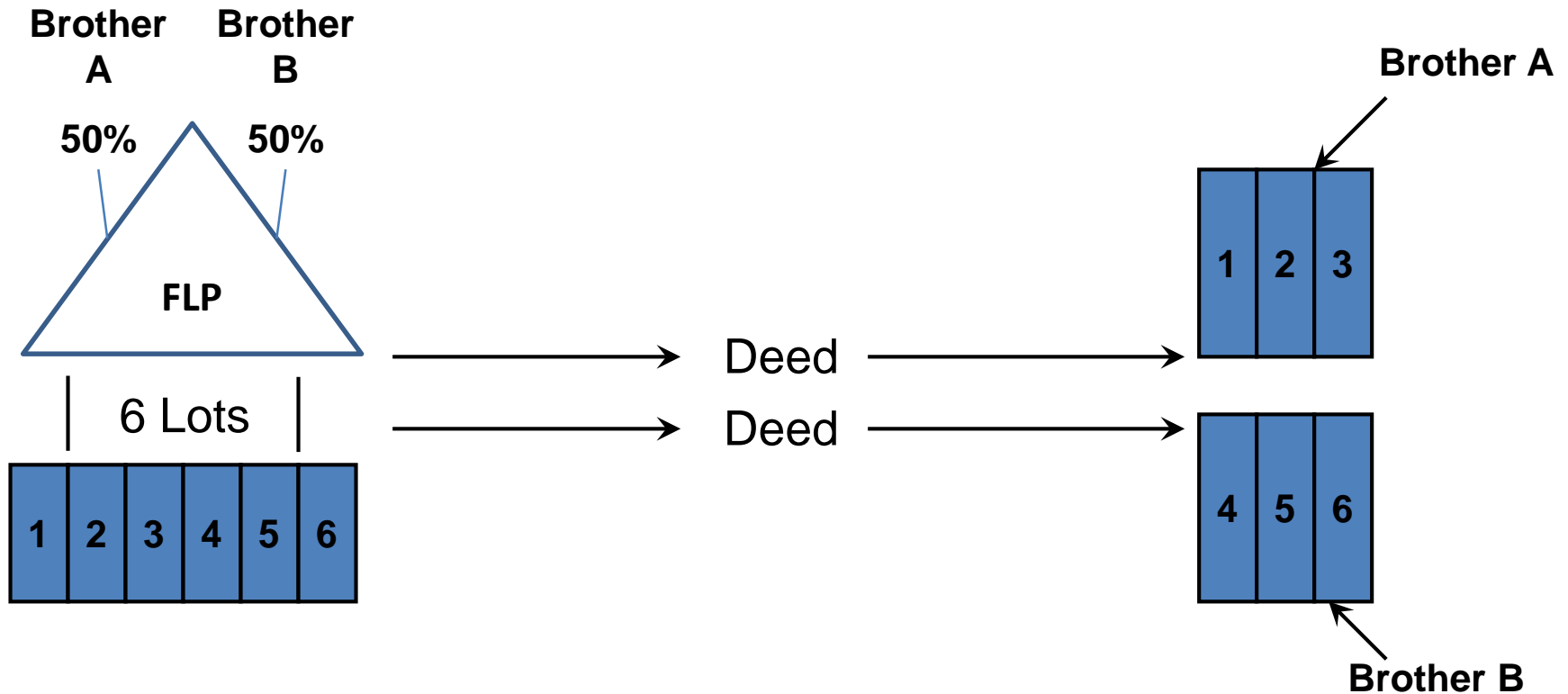


Result

- Disproportionate transfer = 100% reappraisal
- De minimus interest exclusion in § 65.1 does not apply to legal entities
- Parent-Child exclusion does not apply to legal entities

Measure Ownership (Not Value) in Each Property

Munkdale v. Giannini (1995) 35 Cal.App.4th 1104



Result: 100% Change in ownership; reappraisal of all 6 lots.

- Transfer was disproportionate, no exclusion.
- If accomplished in two steps, step transaction doctrine would apply.

Ticking Time Bomb – **Watch Out!**

When more than 50 percent of original coowners interests transfer, this triggers a change in ownership and property is reassessed at market value.



LEGAL ENTITIES

Original Co-Owner Shares

64(d) If property is transferred on or after March 1, 1975, to a legal entity in a transaction excluded from change in ownership by paragraph (2) of subdivision (a) of Section 62, then the persons holding ownership interests in that legal entity immediately after the transfer shall be considered the “original coowners.” Whenever shares or other ownership interests representing cumulatively more than 50 percent of the total interests in the entity are transferred by any of the original coowners in one or more transactions, a change in ownership of that real property owned by the legal entity shall have occurred, and the property that was previously excluded from change in ownership under the provisions of paragraph (2) of subdivision (a) of Section 62 shall be reappraised.

Legal Entity Interest Transfers: *With Original Coowners § 64(d)*

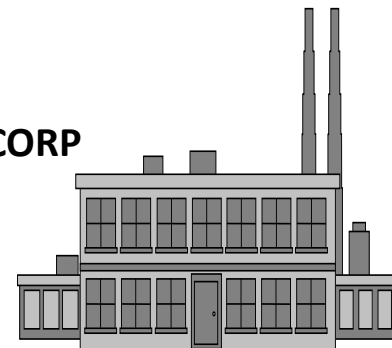
Property

**A & B (50/50)
contribute real
property to Corp**

Excluded § 62(a)(2)

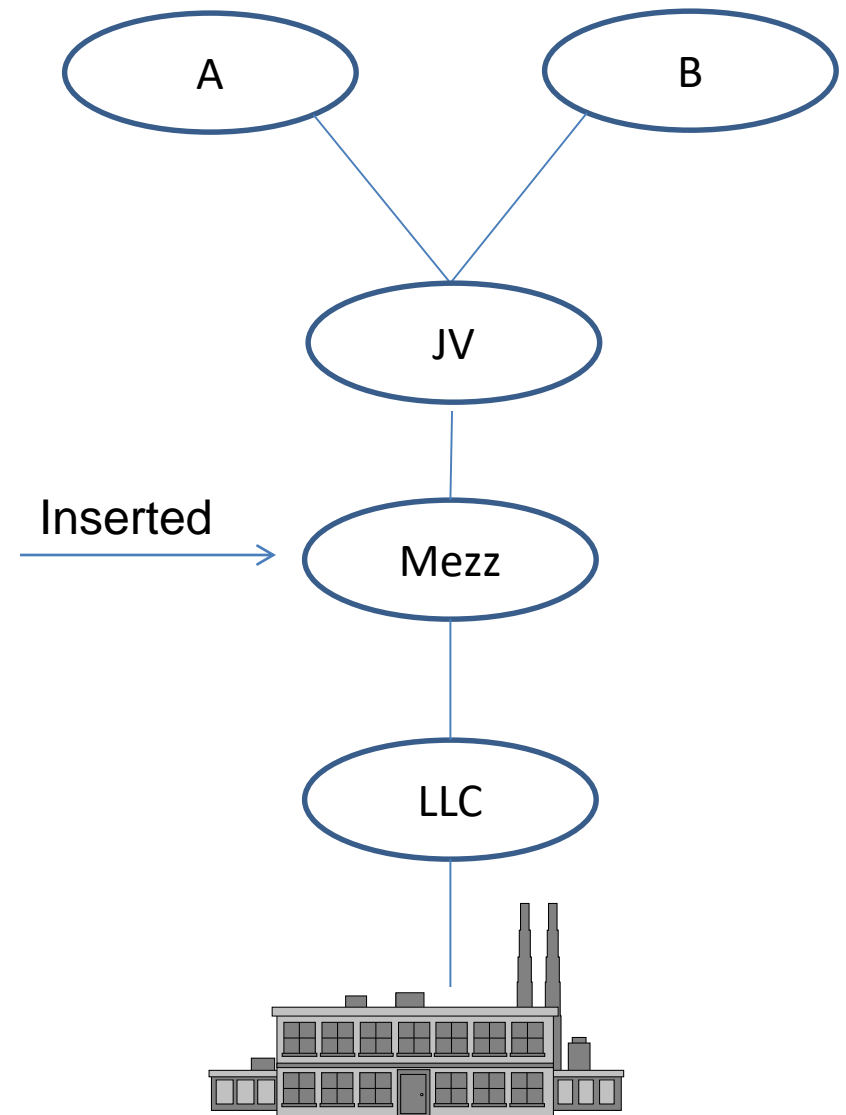
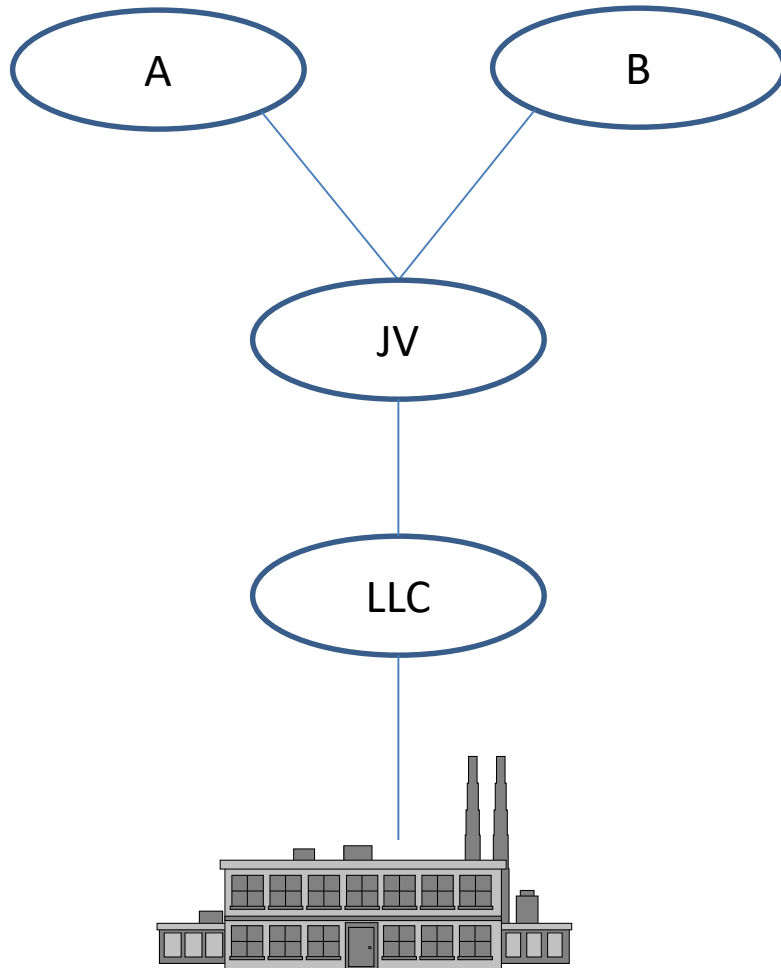


CORP



**A & B = original coowners
(50/50)**

Proportional Transfer Diagram



Example

Proportional Ownership Interest Transfer

- Husband (H) and Wife (W) want to start a business. Wife owns the building as her separate property. Husband will run the business.
- W transmutes building to community property. Then, H & W transfer building to LLC owned 50% each by H & W.
- Result: 62(a)(2) excluded
- However, H & W become “original co-owners” in the LLC.

Example 5

Proportional Ownership Interest Transfer

- Several years later, Husband (H) and Wife (W) (who are OCOs in LLC) want to transfer the business to their two children, retaining 48%
- H transfers 26% to Son, W transfers 26% to daughter
- Result: 100% change in ownership of building.

Cumulation Rules (Rev. & Tax. Code, § 64(d))

Example

- A, B, C and D purchase Blackacre (25% each)
- All transfer Blackacre to LLC, taking back 25% capital/profits interests each.
- All become “original co-owners” with respect to LLC shares.

Cumulation Rules (Rev. & Tax. Code, § 64(d))

Example (cont.)

- A sells 25% to M. 25% actually transferred; 25% counted
- C dies. Her 25% is inherited by her three children; 50% counted.
- D gifts one percent to nephew. 51% transferred.
- Result: CIO of Blackacre on date of D's gift.

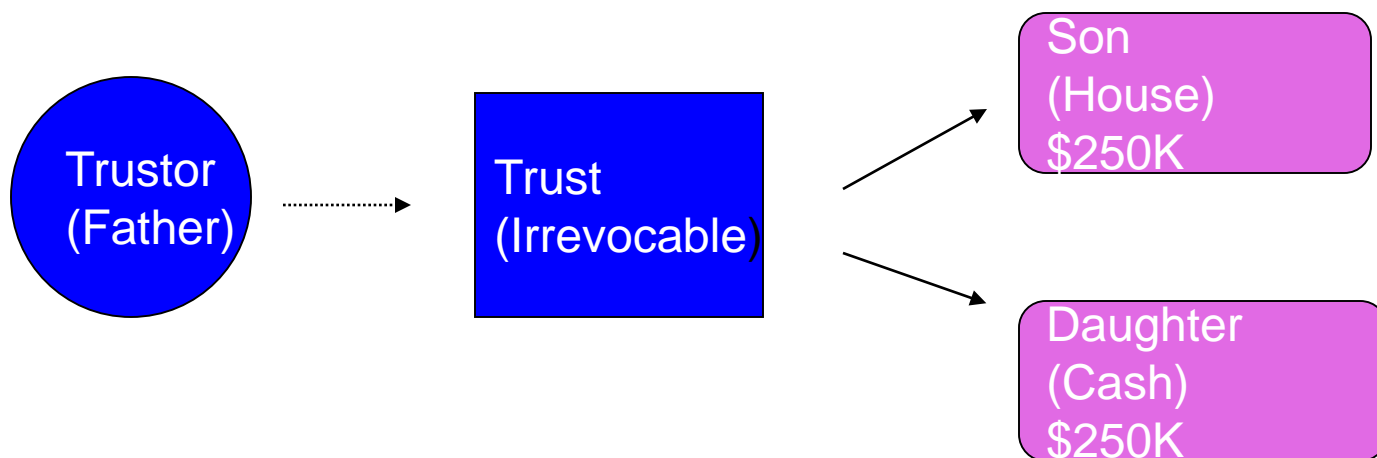
Review/Practice Tip: Ask How Entity Came to Have an Interest in Real Property

- Contribution of Real Estate to Legal Entity in Exchange for Ownership Interest - **Watch out for Original Coowner Rules & Change in Control**
- Purchase of Real Estate by Legal Entity – **Watch out for Change in Control**

Parent to Child Transfer Via Trust

Non-Pro Rata Distribution

- Trust Property: House FMV \$500,000, subject to \$250,000 DOT, and \$250,000 cash.
- Take encumbrance into account.



Rule 462.160

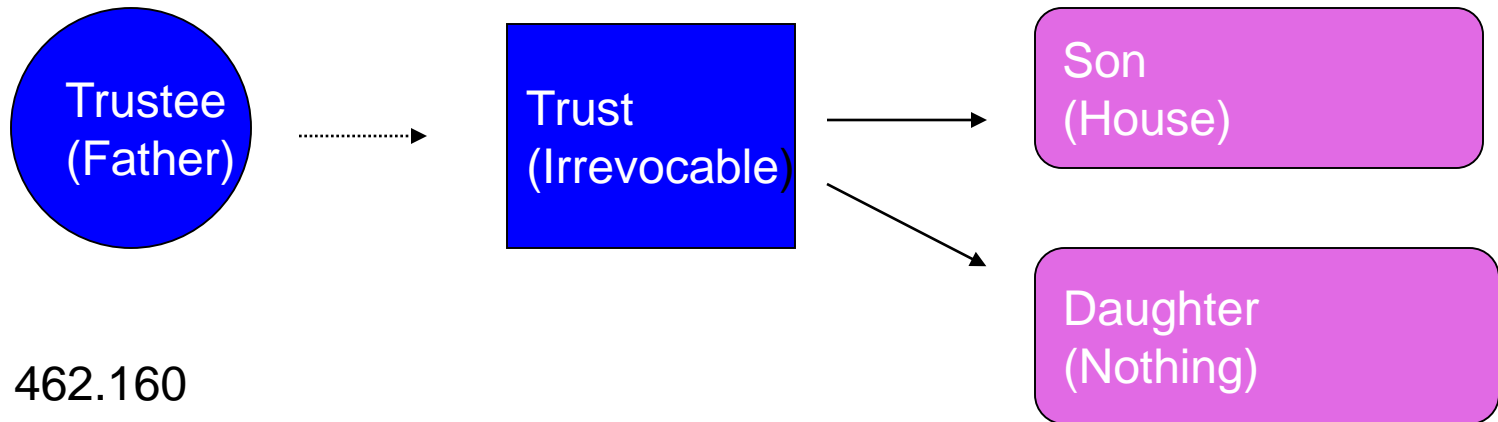
Letter to Assessors 91/08

Parent to Child Transfer Via Trust

Non-Pro Rata Distribution

Taxpayer Problem – Single Property Only Trust Asset

- Trust Property: House \$500,000 FMV with no DOT and no cash.
- Trustee distributes house to Son.
- Son encumbers house with a loan and gives loan proceeds to Daughter.
- Result: Change in ownership of 50% of the house. At distribution, Son received more than his equal share. The Daughter's share is deemed to have transferred to Son.



Rule 462.160

Letters to Assessors 91/08 and 08/18

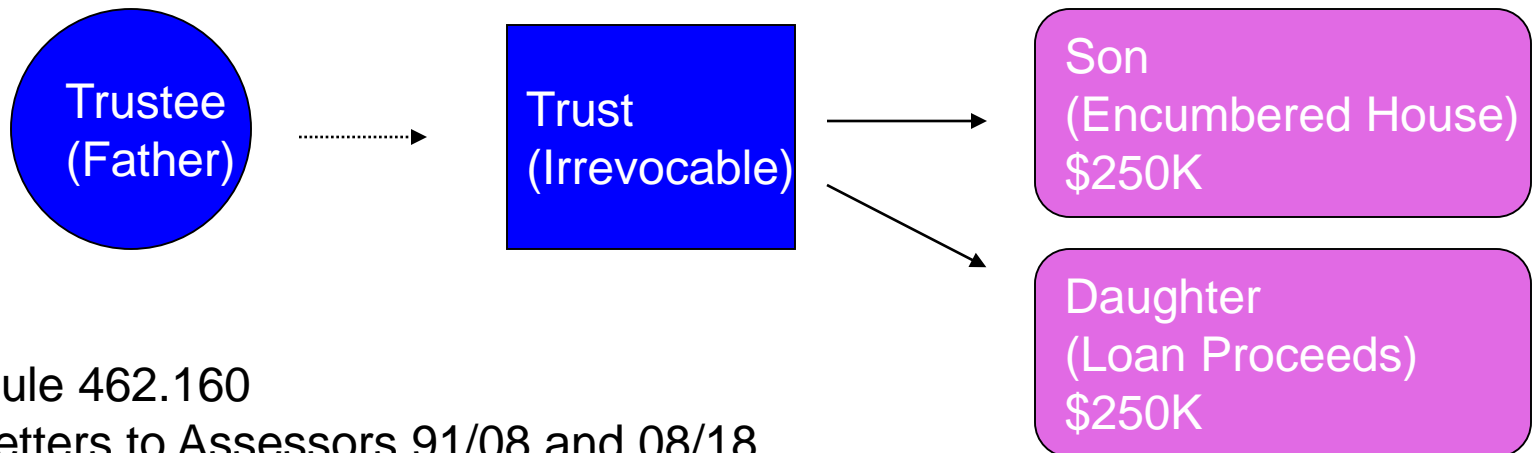
Property Tax Annotation 625.0235.015

Parent to Child Transfer Via Trust

Non-Pro Rata Distribution

Taxpayer Solution – Trustee Encumbers Property Before Distribution

- Trust Property: House \$500,000 FMV with no DOT and no cash.
- Trustee encumbers the property with a loan for \$250,000 (*Loan cannot be made by beneficiary receiving the property*).
- Trustee distributes the property subject to the loan to Son and the loan proceeds to Daughter.
- Result: 100% of House subject to PC exclusion.



Rule 462.160

Letters to Assessors 91/08 and 08/18

Property Tax Annotation 625.0235.005

Requirements for Qualified Borrowing

- Trustee borrows funds in his or her *official capacity* as trustee and grants security interest to lender.
- Trustee does not borrow the funds from the beneficiary who will receive the real property (child 1 in prior slide).
- Both beneficiaries receive non pro rata distributions of property with equivalent values.
- See Annotation 625.0235.015 (5/16/2007).



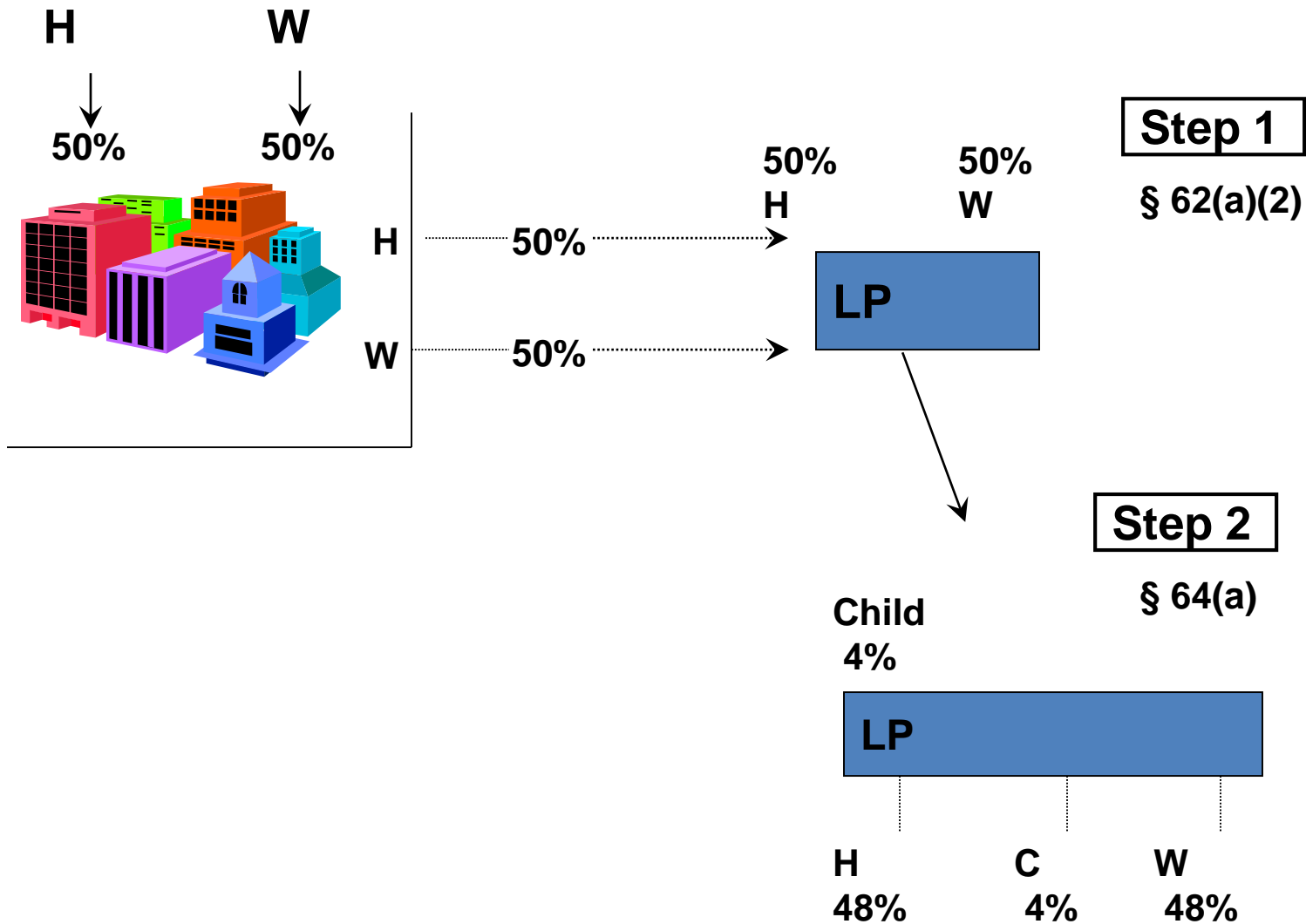


Parent-Child/Grandparent-Grandchild

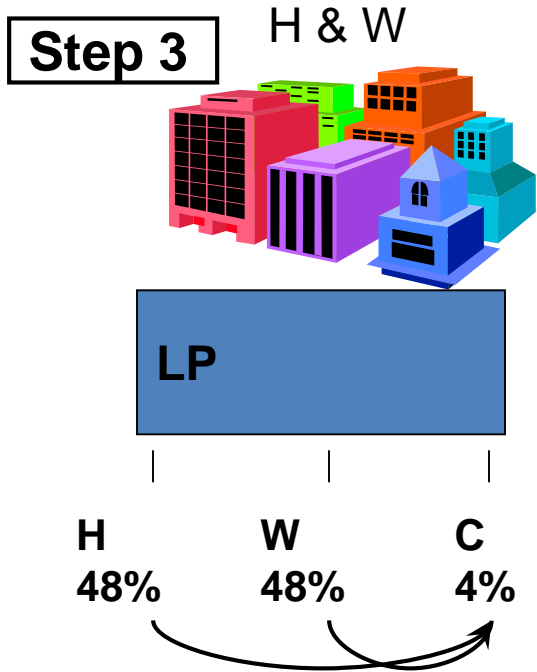
Exclusions: **Step Transactions**

- **Exception: Step transaction doctrine does not apply** to transfers of real property interests in and out of legal entities where the parent-child or grandparent-grandchild exclusions are used.
 - Parent-child – uncodified statement of legislative intent (Stats. 1987, Ch. 48)
 - Grandparent-grandchild – extended by SB 1607 (Stats. 2006, Ch. 224), effective January 1, 2007

§ 63.1 - Uncodified Statement of Legislative Intent: *Steps to Utilize Parent-Child Exclusion for Property Owned By Legal Entity*

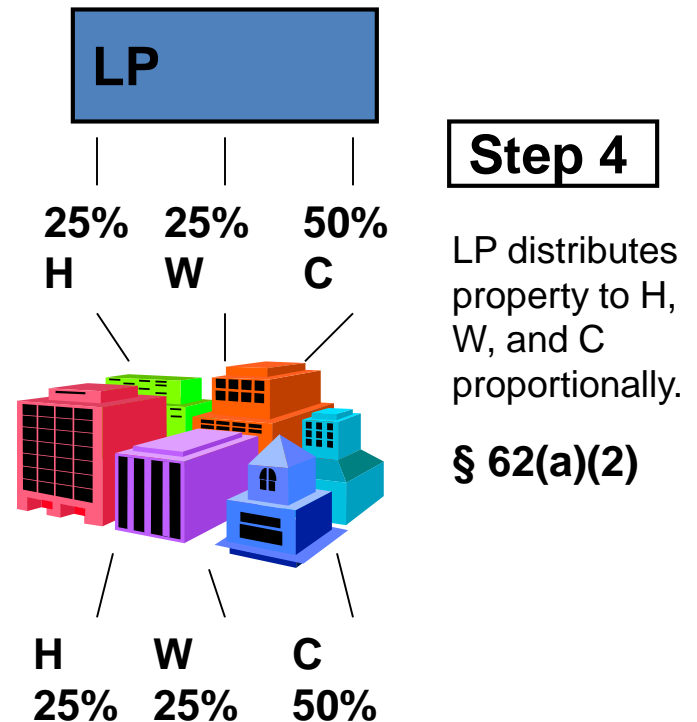


§ 63.1 - Uncodified Statement of Legislative Intent: *Steps to Utilize Parent-Child Exclusion for Property Owned by Legal Entity*



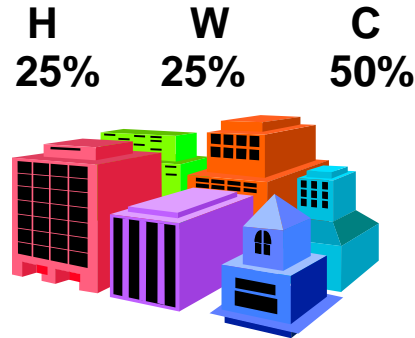
***H & W “original coowners” transfer capital and profits interests to C**

*Stop when H and W cumulatively transferred 50% to avoid § 64(d) CIO.



§ 63.1 - Uncodified Statement of Legislative Intent:

Steps to Utilize Parent-Child Exclusion for Property Owned by Legal Entity



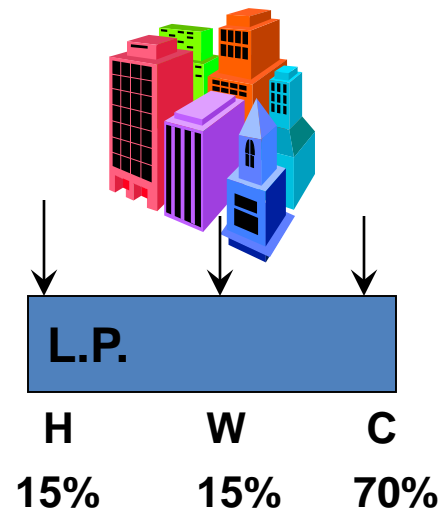
Child

Step 5

Excluded
under § 63.1

[C owns 70% of the property]

(File Parent-Child Claim)

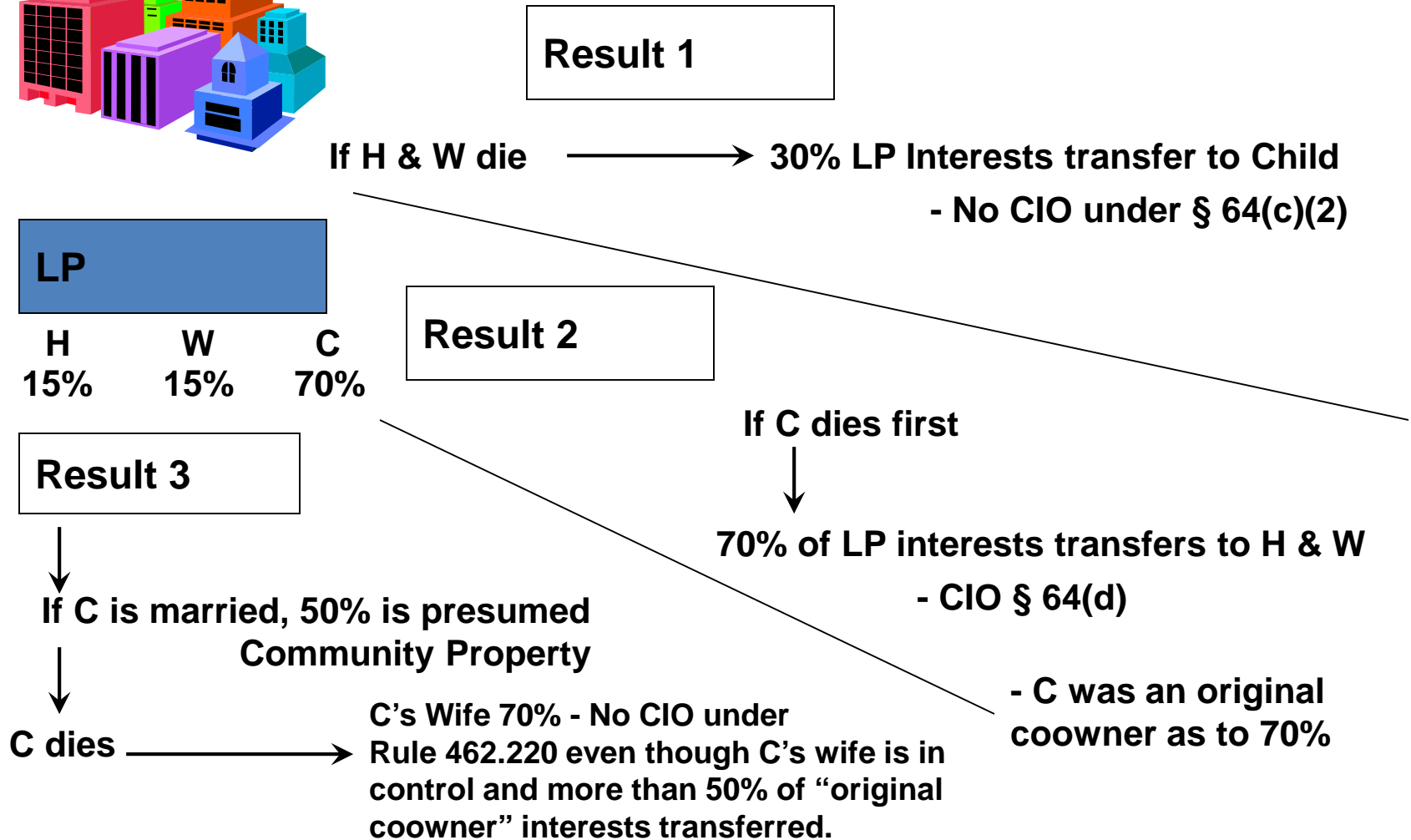


Step 6

§ 62(a)(2)
exclusion

H, W, and Child proportionally transfer property back into LP in exchange for proportional interests in capital and profits

§ 63.1 - Uncodified Statement of Legislative Intent: *Steps to Utilize Parent-Child Exclusion for Property Owned by Legal Entity*



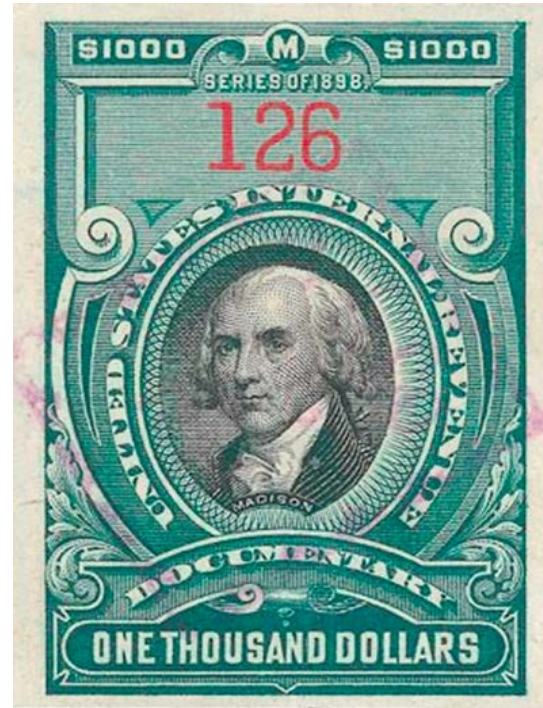
**A Very
Scary
Moment ?**

Multiple Beneficiaries: Sprinkle/Spray (Rule 462.160(b)(1)(A))



- “Sprinkle” power - where the trustee has total discretion to distribute trust income or property to a number of potential beneficiaries.
- Change in ownership of property subject to the sprinkle/spray provision unless all potential beneficiaries have an exclusion.

California Documentary/ Real Estate Transfer Tax



CRUCIAL DEVELOPMENT:

926 N Ardmore LLC v. County of Los Angeles (2017) 3 Cal.5th 319

Holding: Revenue and Taxation Code Section 11911 should be interpreted such that “realty sold” includes the change in ownership of a legal entity owning real property. This permits a documentary transfer tax when a transfer of interest in a legal entity results in a “change of ownership” within the meaning of Revenue and Taxation Code section 64, subdivision (c) or (d).

CA DTT Transfer Tax Triggers (Simplified)

1. Transfer of Realty by Deed [Not discussed here]
2. Change in ownership, either by change in control or original coowner violation, per *Ardmore*.
3. IRC 708 Termination?

THANK YOU



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