"Defining a 'Change in Ownership': Is It Time to Reassess?"

AN OVERSIGHT HEARING OF THE ASSEMBLY COMMITTEE ON REVENUE AND TAXATION MARCH 12, 2012

I. BACKGROUND

The property tax is one of the major general revenue sources for local governments in California. It applies to all classes of property, is imposed on property owners and is based on the value of the property. Much of the law pertaining to property taxation is prescribed by Articles XIII and XIII A (commonly known as Proposition 13) of the California Constitution. Proposition 13 was added to the California Constitution in June 1978 and was most recently amended by Proposition 26 in 2010. It was designed to provide real property tax relief by imposing a set of interlocking limitations upon the assessment and taxing powers of state and local governments.[1]

Section 1 of Article XIII A states that, as a general rule, the maximum amount of any *ad valorem* tax on real property may not exceed one percent of the property's full cash value, as adjusted for the lesser of inflation or 2% per year. The term "full cash value" means the "county assessor's valuation of real property as shown on the 1975-1976 tax bill" or, thereafter, "the appraised value of real property when purchased, newly constructed, or a *change in ownership* has occurred after the 1975 assessment" (*emphasis added*) [California Constitution, Article XIII A, Sections 1 and 2]. In other words, the California Constitution requires that real property be reassessed to its current fair market value whenever a "change in ownership" (CIO) occurs.

The definition of a "change in ownership" was not included in Proposition 13, but rather, was

[1] Since any tax savings resulting from the real property tax limitations provided in Sections 1 and 2 of Article XIII A could be effectively eliminated through the imposition of additional state and local taxes, Sections 3 and 4 place additional restrictions upon the imposition of any such taxes. *See* Amador Valley Joint Union High Sch. Dist. v. State Bd. of Equalization, (1978) 22 Cal.3d 208.

left to implementing legislation. Shortly after the passage of Proposition 13, the Assembly Committee on Revenue and Taxation appointed a special Task Force - a broad-based 35-member panel that included legislative and State Board of Equalization (BOE) staff, county assessors, attorneys in the public and private sectors, and trade associations - to recommend a statutory scheme for implementing Proposition 13, including applicable "CIO" provisions. The Task Force focused specifically on how to define a CIO in cases where property is owned by a legal entity (e.g., a corporation) as opposed to a person.

With respect to a transfer of ownership interests in a legal entity that owns real property, the Task Force considered two alternative approaches: a "separate entity" theory and an "ultimate control" theory. The question was whether the transfer of ownership interests in a legal entity should be treated as an indirect change in the ownership of real property owned by that legal entity. Under a "separate entity" theory, the separate identity of a legal entity is respected. In other words, as long as the property is owned by the same legal entity, that property would not be reassessed, even if most or all of the ownership interests in the entity (i.e., stock or partnership interests) were transferred. In contrast, under the "ultimate control" approach, a COI of real property "belonging to a corporation would occur when a single shareholder gains majority control of the corporation through the purchase of shares." (*Id*., p. 45).

The Task Force initially recommended adopting a "separate entity" approach because of the perceived administrative and enforcements problems with disregarding the separate identity of a legal entity and the unpredictable ripple effects of ignoring the general separate entity laws. (*Report of the Task Force on Property Tax Administration*, January 22, 1979). However, in its second report issued on October 29, 1979, the Task Force suggested that the "separate entity" approach be modified to include a "majority-takeover-of-corporate stock" provision. The Task Force made this recommendation "out of a concern that, given the lower turnover rate of corporate property, mergers or other transfer of majority controlling ownership should result in a reappraisal of the corporation's property – an effort to maintain some parity with the increasing relative tax burden of residential property statewide, due to more rapid turnover of homes. It was also a trade-off for exempting transfers among 100% wholly-owned corporations." (*Implementation of Proposition 13, Volume 1, Property Tax Assessment*, a second report prepared by the Assembly Committee on Revenue and Taxation, California State Assembly Publication 748, October 29, 1979, p. 27).

II. DEFINING A 'CHANGE IN OWNERSHIP'.

Existing law defines a CIO 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. [Revenue and Taxation Code (R&TC) Section 60]. It includes a transfer of any interest in real property between a corporation, partnership, or other legal entity and a shareholder, partner or any other person. [R&TC Section 61(j)]. However, the purchase or transfer of *ownership interests* in a legal entity does not generally constitute a CIO. For example, a purchase of real property by Corporation A directly from Corporation B would most likely result in a CIO. In contrast, an acquisition by Corporation A of Corporation B's shares will not lead to a CIO, unless more than 50% of Corporation B's ownership is acquired

by the same entity (i.e., Corporation A). The general rule states that, when real property is owned by a legal entity, the purchase or transfer of ownership interests in that entity does not trigger a CIO of the property, unless a) there is a "change in control" of the legal entity or b) one person or entity acquires more than 50% of the ownership interest of the entity. [R&TC Section 64]. In other words, it is only when any person or entity obtains control, through direct or indirect ownership, of more than 50% of the voting stock of a corporation, or a majority ownership interest in any other type of legal entity, that a reassessment of real property owned by the acquired legal entity (or any of its subsidiaries) is triggered. [R&TC Section 64(c)(1)(A)]. Furthermore, when voting stock or other ownership interests representing cumulatively more than 50% of the total interest in a legal entity is transferred by any of the "original co-owners" in one or more transactions, the real property that was previously excluded from reappraisal will be reassessed. [R&TC Section 64(d)].

Determining a CIO is a relatively straightforward matter for properties that are owned by individuals - it occurs when legal title to the property passes from one person to another. However, it becomes more complex when the property is owned by a legal entity - such as a corporation, partnership, an LLC, or a trust - which itself is sold to another legal entity. The current system provides property owners with several ways to structure transactions to avoid paying higher property taxes and allows purchasers to avoid reassessment even if 100% of a company changes hands. A business may avoid a major reappraisal of the property of an acquired entity by simply structuring the acquisition in a way that prevents any of the separate purchasers from receiving more than 50% ownership in the acquired entity. Thus, if multiple individuals or entities acquire another entity, in a single transaction, but none of the purchasers acquires more than a 50% interest in the entity, then a reappraisal of the property held by the acquired entity is not required.

III. THE LEGAL ENTITY OWNERSHIP PROGRAM (LEOP).

Generally, county assessors discover a CIO via grant deeds or other documents that are recorded with the county recorder. In addition, the county recorder must provide the assessor with a copy of the transfer of ownership document as soon as possible. However, ordinarily, the transfer of ownership interests in a legal entity does not involve a recorded deed or other notice that would inform county assessors, even if a property reassessment is called for under existing law.

The Legislature has attempted to reduce the volume of unreported business property ownership transfer transactions. The most significant accomplishment was the creation of the Legal Entity Ownership Program (LEOP). Under this program, the BOE gathers, and subsequently disseminates to county assessors, information regarding changes in control and ownership of legal entities that own or lease an interest in real property located in California. The purpose of the program is to assist county assessors in discovering changes in control or changes in ownership that have not been captured by a county's own discovery systems.

Existing law requires a legal entity to file a CIO statement with the BOE within 45 days following a "change in control" or a CIO of a legal entity where the entity or any subsidiary owned or held California real property at the time of the change. A legal entity must also file

a CIO statement within 45 days of the BOE's written request. Effective January 1, 2012, the applicable period of 45 days was extended to 90 days.

If a legal entity fails to report and the failure is discovered later on, then an escape assessment will be made for every tax year that the entity failed to file the CIO statement. There is no statute of limitations applicable to these escape assessments. The penalty is 10 percent of the taxes applicable to the new base year value of the real property (e.g., land, improvements, and fixtures) if a change in control or CIO *has* occurred or 10 percent of the current year's taxes on the real property if a change in control or CIO *has not* occurred.