

Tax Reassessments of Transferred Property

PRIOR TO THE DEVELOPMENT OF REAL PROPERTY, owners often want to transfer their interests in the property to a partnership or limited liability company to secure the liability protection the entity provides or to facilitate development. Thereafter, the owners may want to transfer ownership interests in the new entity among themselves or to nonowners for business or personal purposes. For the unwary, such actions may cause unintended property tax reassessment consequences. If the property has appreciated in value since the time of its acquisition, the reassessment will generally generate a property tax increase. Practitioners therefore need to be aware of the California property tax reassessment consequences of transfers of California real property to partnerships and limited liability companies, transfers of real property by these entities to their constituent owners, and transfers of ownership interests within these entities.

Under Proposition 13,¹ real property located in California is generally reassessed when it is purchased, newly constructed, or a “change in ownership” occurs. California Revenue and Taxation Code Section 60 provides, “A ‘change in ownership’ means 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.” Sections 61 through 66 apply this basic definition to various transfer scenarios and describe when these transfers will and will not cause a change in ownership for property tax purposes.

As a general rule, the transfer of California real property to a legal entity constitutes a change in ownership and will cause a reassessment.² In this case, the transferred property will generally be reassessed for property tax purposes to its then-current fair market value. Like most rules, there are exceptions. Section 62(a)(2) provides that there is no change in ownership if the transfer merely changes the method of holding title to the transferred property and the proportional ownership interests in the property remain the same before and after the transfer.³

The application of Section 62(a)(2) can be illustrated by example. First, assume that two individuals own a property as equal cotenants. If the two transfer the property to a newly formed partnership (or limited liability company) and each receives an equal capital and profits interest in the new entity, the transfer would not constitute a change in ownership, since the proportional ownership interest of each remains the same before and after the transfer.⁴ Accordingly, the property would not be reassessed upon transfer. However, if the two cotenants each receive a 49 percent interest in the capital and profits of the newly formed entity and a third party receives a 2 percent capital and profits interest in the entity, there would be a change in ownership, and the entire property would be reassessed.⁵

Next, assume that one individual owns 100 percent of one property and another individual owns 100 percent of a separate property. If each transfers their respective properties to a newly formed partnership (or limited liability company) and each receives an equal capital and profits interest in the new entity, there will be a change in ownership of 100 percent of both properties, and each will be reassessed.⁶

This is due to the fact that the proportional ownership interests of the two owners have changed. Before the transfer each owned 100 percent of their respective properties, while after the transfer each indirectly owns 50 percent of both properties. Accordingly, the transfers are not afforded the protection of Section 62(a)(2).

The general rule governing transfers of real property by a partnership or limited liability company to its constituent owners is that the transfer will cause a reassessment of the transferred property.⁷ However, Section 62(a)(2) applies to these types of transfers as well. Accordingly, if the transfer merely changes the method of holding title to the transferred property and the proportional ownership interests in the property remain the same before and after the transfer, there will not be a change in ownership of that property.⁸

For example, assume that a limited liability company owns two properties of equal value and that two individuals each own a 50 percent capital and profits interest in the LLC. If the LLC transfers one property to one of the individuals and the other to the other individual, there would be a 100 percent change in ownership of both properties, and each would be reassessed.⁹ Before the transfer the two individuals each held a 50 percent indirect ownership interest in each property, while after the transfer, one owns 100 percent of one property and the other owns 100 percent of the second property. However, if the LLC transfers both properties to both individuals as joint tenants or as equal tenants in common, then, pursuant to Section 62(a)(2), there would not be a change in ownership, and the properties would not be reassessed.¹⁰

In *Munkdale v. Giannini*,¹¹ transfers similar to those described in the above example were considered by a court of appeal. Steven and Paul Munkdale dissolved their general partnership, which owned 11 parcels of real property located in San Mateo County. Five parcels were deeded to Steven, and five were deeded to Paul. The remaining parcel, the so-called Magnolia parcel, was deeded to Steven and Paul as tenants in common. Immediately after the transfers, the county assessor reassessed all the parcels except the Magnolia parcel. Steven challenged the reassessment, arguing that the transfer of the other 10 parcels did not give rise to a reassessment event. Steven alternatively argued that if the transfers did cause a reassessment, only 50 percent of each of the other 10 parcels should be reassessed, since the partnership could have transferred each property to Steven and Paul as equal cotenants (a transfer that would be excluded from reassessment pursuant to Section 62(a)(2)), and each brother could then have conveyed his undivided interest in the parcels that the other was to receive to that individual.

In rendering its decision, the court first found that the county assessor's reassessment of the non-Magnolia parcels that were distributed to Steven was proper since the partnership's transfer of these prop-

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erties constituted a change in ownership unless otherwise exempted.¹² The court found that Section 62(a)(2) was inapplicable to the transfers, since Steven's ownership interest in each property had changed. In doing so, the court stated that Steven had, at most, a 50 percent interest in the subject parcels before the transfer and obtained a 100 percent interest in each parcel after the transfer.¹³ With respect to the Magnolia parcel, the court recognized that the transfer did not cause a reassessment, since the brothers' proportional ownership interests in the property had not changed.¹⁴

In determining whether 50 percent or 100 percent of each non-Magnolia parcel should be reassessed, the court found Steven's argument unpersuasive. The court stated that even through a two-step procedure could have been implemented that would have caused a reassessment of only 50 percent of each property based on a technical interpretation of the statute, the step-transaction doctrine (discussed *infra*) would have proscribed this, since the evidence in the record indicated that the brothers intended to sever their business relationship completely and to go their separate ways as independent owners of a fee simple interest in each of the non-Magnolia parcels.¹⁵ Accordingly, the court found that the reassessment of 100 percent of each non-Magnolia parcel was proper.

Transfers among Entity Members

After real property has been transferred to or acquired by a partnership or limited liability company, the entity's constituent owners may want to transfer ownership interests in the entity amongst themselves or to outside investors. The general rule governing such transfers is to honor the legal entity, resulting in no change in ownership of the real property owned by the entity.¹⁶ However, there are several exceptions to this rule. The two main exceptions for partnerships and limited liability companies are the "change in control" exception¹⁷ and the "original co-owner" exception.¹⁸

The change in control exception provides that when an entity or 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.¹⁹

In order to obtain a majority ownership interest in a partnership or limited liability company, the acquirer must obtain direct or indirect ownership of more than 50 percent of the total capital and profits of the entity.²⁰ In other words, when a person or entity obtains more than 50 percent of the total capital and profits of a partnership or limited liability company, a change in control of the entity will generally be deemed to have occurred, and the real property owned by the entity will be reassessed.

For example, assume two individuals each own a 50 percent capital and profits interest in an LLC. The LLC acquires a property from an unaffiliated third party, and that property is reappraised upon acquisition. One individual transfers a 30 percent capital and profits interest in the LLC to a third individual, and the second individual later transfers a 25 percent capital and profits interest in the LLC to the same third individual. Upon that person's acquisition of a 55 percent capital and profits interest in the LLC, a change in control occurs, and the property is reappraised.²¹

The original co-owner exception, found in Section 64(d), applies only if the entity acquired the property after March 1, 1975. The exception provides that if property is transferred to a legal entity on or after that date, and the transfer is excluded from a change in ownership under the "same proportional interest" provisions set forth in Section 62(a)(2), the owners of the entity are deemed to be original co-owners. Section 64(d) further provides that when cumulatively more than 50 percent of the original co-owner interests are transferred, the property previously excluded from reassessment is reassessed. The reassessment date is the date of the transfer of ownership interests representing individually or cumulatively more than 50 percent of the interests in the entity.²²

The original co-owner exception can be illustrated by the following example: Two individuals hold equal interests as tenants in common in a property, which they transfer to an LLC. In exchange the two individuals each receive a 50 percent capital and profits interest in the LLC. There is no change in ownership pursuant to Section 62(a)(2) since the transfer is merely a change in the method of holding title.²³ Pursuant to Section 64(d), the two individuals become original co-owners.²⁴ One co-owner transfers 30 percent of his or her capital and profits interest in the LLC to a third individual, and the second co-owner then transfers a 25 percent capital and profits interest in the LLC to a fourth individual. There will be a change in ownership

of the property upon the second co-owner's transfer, since this transfer will result in a transfer of more than 50 percent of the original co-owner interests.²⁵

More Complex Transactions

The transfer of an ownership interest in any legal entity must pass both the change-in-control and the original-co-owner exceptions to avoid a reassessment. If an entity owns more than one property, there are certain instances in which a transfer of an ownership interest in the entity may cause a reassessment of one property but not the other.

For example, assume an individual is the sole member of an LLC that owns a single property. In 2005, the sole member transfers a second property to the LLC. This transfer is excluded from constituting a change in ownership pursuant to Section 62(a)(2), and the individual is deemed to be the original co-owner only of the second property. If the individual subsequently sells a 20 percent capital and profits interest in the LLC to each of three other individuals, the transfers will constitute a change in ownership for the second property because more than 50 percent of the original co-owner interest was transferred. However, the first property has not changed ownership because no one person has obtained control of the LLC. If, on the other hand, the original member sold a 51 percent capital and profits interest in the LLC to any single individual, there would be a change of control under Section 64(c), and all the real property owned by the LLC would be reappraised.²⁶

Section 64(c)(1), which sets forth the change-in-control rule, provides that there is a control change when a person or entity obtains control through direct or indirect ownership or control of more than half of the stock or ownership interests of an entity. The statute seems to suggest, therefore, that upon the transfer of a direct and/or indirect interest in any legal entity, each ownership interest directly and/or indirectly held or acquired by the transferee should be aggregated to determine whether the transferee has obtained control of the applicable property owning the entity.

For example, assume an individual and a partnership each own 50 percent of the capital and profits of a second partnership. The individual then acquires 10 percent of the capital and profits of the first partnership. A literal reading of the statute seems to suggest that the individual has acquired control of the second partnership because the individual owns 50 percent of the second partnership directly and 5 percent indirectly by virtue of the newly acquired ownership interest in first partnership. Accordingly, it would appear that individual has obtained control of the first

partnership, and any property owned by that partnership would be reassessed. However, a 1999 advisory letter from the State Board of Equalization provides that ownership interests of a partnership in subtler entities will not be attributed to any partner of the partnership until that partner owns more than 50 percent of the capital and profits of the partnership.²⁷

For example, assume P1 is a partnership that owns real property in California. P1 is owned 40 percent by A, an individual; 50 percent by P2, a partnership; and 10 percent by C1, a corporation. Assume A then acquires 50 percent of the capital and profits of P2. A literal reading of Section 64(c) seems to provide that there would be a reassessment of the property owned by P1 since A now holds a 40 percent direct interest in P1 and a 25 percent indirect interest in P1 (i.e., 50 percent x 50 percent). Accordingly, it seems that A would now have control of P1.

However, in analyzing this scenario, the State Board of Equalization determined that the transfer would not cause a reassessment.²⁸ In its analysis, the board stated:

There is a change in ownership of the real property owned by P1 only if A obtains direct or indirect ownership or control of more than 50 percent of the total interests in both the partnership capital and profits in P1. Under the facts posited, A *directly* owns only 40 percent of P1 and acquires a 50 percent capital and profits interest in P2. Upon such acquisition, A would *not* own a controlling interest in P2, and therefore, *indirectly* owns no interest in P1 through his 50 percent capital and profits interest in P2. Accordingly, no change in control of P1 would occur. In order for A to acquire an *indirect* interest in P1 attributed to him through P2, he must own more than a 50 percent *direct* interest in P2.²⁹

While Section 64(d) generally provides that when more than 50 percent cumulatively of the original co-owner interests in an entity are transferred, the property previously excluded from reassessment is reassessed, it does not address how the original co-owner rule is applied when the original co-owners are legal entities. In a 2001 advisory letter, the State Board of Equalization seems to have adopted the approach that unless a transfer of an ownership interest in an original co-owner results in a change in control of the original co-owner, the transfer will not constitute a transfer of the ownership interest of the original co-owner in the property-owning entity for purposes of applying the original co-owner rule.³⁰ However, if the transfer results in a change in control of the

original co-owner, then it will constitute a transfer of the entire ownership interest held by the original co-owner for purposes of applying the rule.³¹

The Step-Transaction Doctrine

Even if a series of transfers, when viewed separately, do not cause a reassessment based on a technical reading of the statutes, the transfers may be subject to the step-transaction doctrine. For example, in *McMillin-BCED/Miramar Ranch North v. County of San Diego*,³² the owner of 1,200 acres of undeveloped land decided to develop the property with the assistance of an experienced residential developer. In order to achieve this goal, the following steps were undertaken, all in a two-week period: 1) The owner conveyed a 70 percent undivided interest in the land to its wholly-owned subsidiary, BCE Development Properties, Inc., 2) The owner and BCE refinanced the land with a \$50 million loan from an affiliate of the original owner, which reduced the amount of equity in the land that a future developer/investor would be required to buy into, 3) The owner and BCE contributed their respective undivided interests in the property to a newly-formed partnership formed by and between the owner and BCE, and 4) McMillin Communities, Inc., a developer, contributed \$5 million in cash to the new partnership, and the original owner withdrew as a partner of the partnership. At the time of the withdrawal, the original owner had a 30 percent interest in the partnership and BCE had a 70 percent interest in the partnership.

With McMillin's admission into the partnership, the partnership's name was changed to McMillin-BCED and the partnership agreement was amended to reflect that McMillin had acquired a 14 percent interest in the capital of the partnership, a 30 percent interest in the profits, and a 50 percent management interest. The San Diego County Assessor reassessed the property, claiming that a 100 percent change in ownership occurred on the date that McMillin bought into the partnership. The partnership challenged the reassessment. Although the trial court recognized that each step, when viewed independently, did not cause a property tax reassessment, it relied on the step-transaction doctrine to find for the county. The partnership appealed.

In reviewing the lower court's decision, the court of appeal stated that the step-transaction doctrine applies when any single one of three basic tests are met:

- 1) The "end result test," in which purportedly separate transactions will be considered as a single transaction when it appears that they were taken from the outset for the purpose of reaching an ultimate result.
- 2) The "interdependence test," requiring an

evaluation of whether, upon reasonable interpretation of the facts, the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.

3) The "binding commitment test," which requires that if one transaction is characterized as a first step, there must be a binding commitment to take later steps.³³

The court noted that although there are significant differences between the tests, each is faithful to the central purpose of the step-transaction doctrine—that is, to assure that the tax consequences turn on the substance of a transaction rather than on its form.³⁴

In ruling for the county, the court held that the interdependence test applied since all of the steps were aimed toward accomplishing the purpose of developing the land by an experienced developer, with the original owner and BCE having dominant capital and profit-sharing roles and an equal management role with the actual developer.³⁵ The court further held that the existence of an independent business purpose for each of the steps, while relevant, did not preclude the application of the step-transaction doctrine, since the steps undertaken would have been fruitless if a developer was not found to join the project.³⁶ Accordingly, *McMillin-BCED* illustrates that even if a series of transfers, when viewed separately, do not cause a reassessment event, a court may use the step-transaction doctrine to consolidate the transfers if they are undertaken to prevent a property tax reassessment.

A property tax reassessment of any property can severely affect the financial return expected from the property. With the appreciation of California property values over the last few years, a reassessment could result in a property tax increase of more than 100 percent. Unfortunately, a reassessment does not represent a one-time cost. Rather, the tax consequences of the reassessment will be felt by the property owner year after year until the property is disposed. Accordingly, prior to transferring any real property to or from a partnership or limited liability company or an ownership interest in any partnership or limited liability company that owns a direct or indirect ownership interest in California real property, the property tax reassessment consequences of the transfers must be analyzed. ■

¹ CAL. CONST. art. XIII A.

² REV. & TAX CODE §§60 and 61(j); Prop. Tax R. 462.180.

³ REV. & TAX CODE §62(a)(2): "A change in ownership shall not include 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.”

⁴ See Prop. Tax R. 462.180(b)(2) (providing for a similar example based on the transfer of real property to a corporation); Advisory Letter from the State Board of Equalization (May 28, 1992), *cited as* Property Tax Annotation 220.0488. Note that advisory letters are only advisory in nature and are not binding on any person or entity. Accordingly, the counties are not bound to follow the rules set forth in the advisory letters.

⁵ See Prop. Tax R. 462.180(b)(2) (providing for a similar example based on the transfer of real property to a corporation); *Penner v. County of Santa Barbara*, 37 Cal. App. 4th 1672 (1995); *Kodaira v. County of Los Angeles*, 2001 WL 1471656 (Cal. App. 2d Dist. 2001), *unpublished* (finding that Taxation and Revenue Code §62(a)(2) was inapplicable to the transfer of real property by a revocable living trust to a family limited partnership composed of the trust, the grantors of the trust, and the children of grantors).

⁶ See Prop. Tax R. 462.180(b)(2) (providing for a similar example based on the transfer of real property to a corporation).

⁷ TAX. & REV. CODE §§60, 61(j).

⁸ See Prop. Tax R. 462.180(b)(2).

⁹ See Prop. Tax R. 462.180(b)(2) (providing for a similar example based on a corporation's transfer of real property to its shareholders); Advisory Letter from the State Board of Equalization (Mar. 12, 1992), *cited as* Property Tax Annotation 220.0385 (analyzing property tax reassessment consequences of distribution of real property owned by a limited partnership to partners thereof); and Advisory Letter from the State Board of Equalization (Feb. 15, 2000) *cited as* Property Tax

Annotation 220.0375.015 (analyzing property tax reassessment consequences of distribution of property from a single-member limited liability company to its sole member).

¹⁰ See Prop. Tax R. 462.180(b)(2).

¹¹ *Munkdale v. Giannini*, 35 Cal. App. 4th 1104 (1995).

¹² *Id.* at 1109-10.

¹³ *Id.* at 1110.

¹⁴ *Id.*

¹⁵ *Id.* at 1112-13.

¹⁶ See EHRMAN & FLAVIN, *TAXING CALIFORNIA PROPERTY* §2:15 (3d Ed. 2004).

¹⁷ REV. & TAX. CODE §64(c).

¹⁸ REV. & TAX. CODE §64(d).

¹⁹ REV. & TAX. CODE §64(c)(1). REV. & TAX. CODE §64(c)(2): “On or after January 1, 1996, when an owner of a majority ownership interest in any partnership obtains all of the remaining ownership interests in that partnership or otherwise becomes the sole partner, the purchase or transfer of the minority interests, subject to the appropriate application of the step-transaction doctrine, shall not be a change in ownership of the real property owned by the partnership.”

²⁰ See EHRMAN & FLAVIN, *supra* note 16, §2:15. See also Prop. Tax R. 462.180(d)(1)(B).

²¹ See Prop. Tax R. 462.180(d)(2) (providing for a similar example based on transfers of stock in a corporation).

²² REV. & TAX. CODE §64(d).

²³ See Prop. Tax R. 462.180(d)(2) (providing for a similar example based on transfers of property to, and stock in, a corporation); Advisory Letter from the State Board of Equalization (May 28, 1992), *cited as* Property Tax Annotation 220.0488.

²⁴ See Prop. Tax R. 462.180(d)(2).

²⁵ *Id.*

²⁶ See EHRMAN & FLAVIN, *supra* note 16, §2:15 (providing for a similar example based on transfers of property to, and ownership interests in, a corporation). See also Advisory Letter from the State Board of Equalization (Feb. 15, 2000), *cited as* Property Tax Annotation 220.0375.015.

²⁷ Advisory Letter from the State Board of Equalization (Jan. 22, 1999) *cited as* Property Tax Annotation 220.0501, at 4-5.

²⁸ *Id.* at 2-3.

²⁹ *Id.*

³⁰ See Advisory Letter from the State Board of Equalization to Hon. Dick Frank, assessor of the County of San Luis Obispo (July 5, 2001).

³¹ However, note that the old rule on transfers of ownership interests in original co-owners is that a transfer of an ownership interest in an original co-owner is a proportional transfer of the original co-owner's interest in the property-owning entity for purposes of applying the “original co-owner” rule. For instance, the old rule provides if 1) Partnership A and Partnership B are original co-owners and each owns a 50% ownership interest in Partnership AB and 2) a partner who owns a 10% ownership interest in Partnership A transfers its interest to an unaffiliated third-party, then such transfer would constitute a transfer of a 5% ownership interest in the Partnership AB for purposes of applying the original co-owner rule. (i.e., 50% x 10%). See *id.* at 3.

³² *McMillin-BCED/Miramar Ranch North v. County of San Diego*, 31 Cal. App. 4th 545 (1995).

³³ *Id.* at 554-55 (citing *Shuwa Invs. Corp. v. County of Los Angeles*, 1 Cal. App. 4th 1635 (1991)).

³⁴ *Id.* at 555 (citing *King Enters., Inc. v. United States*, 418 F. 2d 511 (1969)).

³⁵ *Id.* at 560.

³⁶ *Id.* at 560-61.

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