THOMPSON COBURN LLP

insights

California real estate: Change the ownership, increase the tax

In 1978, Proposition 13 was added to the California State Constitution limiting increases in assessed value of real property to help California real property owners, particularly retirees, from suffering drastic increases in their real property taxes due to increases in their home values.

In the event California real property increases in value, Proposition 13 limits the annual increase in assessed values to a maximum 2% annual inflation factor, except in the event of a “change in ownership” or a “new construction.” When a change in ownership occurs, the property can be reassessed up (or down) to current fair market value; likewise, new construction is assessed at the valuation immediately following its completion.

Because of the limitation of annual increases afforded by Proposition 13, a huge disparity can develop between the “base year value,” upon which the real property tax is calculated, and the actual fair market value of the property. If a change of ownership occurs, the “base value” of the property is increased to fair market value and there can be a dramatic increase in the real property tax not only for the current year but for all subsequent years. Thus, an inadvertent triggering of a change of ownership can be very costly.

Tax traps

The most common types of change of ownership occur when property is transferred by deed. However, if one or more properties are transferred to an entity, “changes in ownership” in or “changes of control” of the entity may also trigger a change of ownership of all real property owned by such entity.

1. If you record a deed you must file with the deed a Preliminary Change of Ownership Report that indicates an exclusion from change of ownership. The most common exclusions are a transfer to a revocable trust, the transfer to a spouse (the interspousal exclusion) and the transfer to a child (the parent-child exclusion). If no report is filed or no exclusion is checked on the form, the property will be reassessed.

2. The County Assessor Office must be notified upon the death of an owner of California real property, whether the person is a resident or non-resident, whether owned outright or in trust, within 150 days of the date of death. The penalty can be very significant.

3. If the property is reassessed, a Supplemental Assessment Form will be mailed to the real property owner. An appeal must be filled with the County Appeals Office within 60 days after the mailing date shown on the supplemental bill (or the supplemental refund check) or the assessment will become final and unchallengeable. Thus, a protective appeal should be filed in all events unless the reassessment is reversed by the county assessor prior to the filing due date of the appeal.

4. If a real property is acquired by an entity (including a single member LLC), a change of ownership will only occur if there is a change of control, i.e. a person or entity acquires more than 50% interest in the entity. For example, if the LLC that acquires the property is owned 50/50 by A and B, a transfer by A to B of only 1%, would constitute a change of control, causing reassessment of the property.

5. If the real property is co-owned by persons, it can be transferred to an entity as long as the percentage ownership in the entity is in exactly the same percentages as the property was owned by the co-owners – the so called “proportionality rule.” Because of the complex distribution provisions in some LLC operating agreements, the percentage interests be reflected on an Exhibit to the operating agreement to simplify review by the Assessor. If the “proportionality rule” is used to avoid reassessment on transferring property to an entity, a change of ownership can be triggered not only by a change of control (as discussed above), but also if cumulatively more than a 50% interest in the entity is transferred over time.

For example, property that is owned 25% by A, 25% by B, 25% by C and 25% by D is contributed to an LLC owned by A, B, C and D in the same proportions. Five years later, A transfers his 25% interest to his children. Ten years later, B transfers his 25% interest to his children. If 15 years later C transfers a 1% interest to his children, the cumulative percentage interest transferred would be 51%, which would constitute a change of control, causing reassessment of the property. (Note: This would not have happened if the entity originally acquired the property because none of the transfers caused a change of control).

6. If the real property is held in an entity (including a single member LLC) and the owner of the LLC dies, a change of ownership will occur unless the LLC passes only to the surviving spouse (interspousal exclusion). The parent-child exclusion does not apply to a transfer of an interest in an entity. If, on the other hand, the property were owned by the decedent outright, the transfer would be excluded from a change of ownership if it were to pass to either the surviving spouse (interspousal exclusion) and/or one or more of the children (parent-child exclusion). The death transfer could be accomplished through a trust as long as the only current permissible beneficiaries of the trust are the surviving spouse and/or children (no grandchildren). If the entity is dissolved prior to death, which can usually take place on a tax-free basis, the reassessment may be avoided if the property passes only to the spouse and/or one or more children.

Please feel free to contact Jon Karp of our Los Angeles office if you have questions with respect to California real property change of ownership issues.

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